[Tax Policy and Tax Administration for the Tenth Plan]

Report of

The Advisory

Group on

Tax Policy and Tax Administration for the Tenth Plan

Constituted by

Planning Commission

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Preface

The Advisory Group has attempted to address the terms of reference given to it, comprising an examination of the contribution of various taxes at the level of both the Centre and states, an analysis of the present tax structure and aspects of tax administration, and formulation of appropriate recommendations. The Group coopted two advisers from the Revenue Department to familiarise itself fully with current tax policy and administration concerns from the viewpoint of the Department.

The Group focussed on the expectations that recommendations should be made not only in the context of mobilising resources for the Tenth Plan but also for carrying out fundamental tax reform. The Group had eighteen meetings and visits to states to investigate and discuss its findings, conclusions and recommendations. The Group met Shri S Narayanan, Revenue Secretary, as well as Dr Shankar Acharya, Chief Economic Advisor, Ministry of Finance, and Shri Montek Singh Ahluwalia, Member, Planning commission, several times for discussion. The Interim Report was submitted to Shri K C Pant, Deputy Chairman, Planning Commission, and discussed in a large meeting on January 3, 2001, well in advance of the Finance Minister's 2001-02 budget presentation on February 28.

After the initial meetings, it was decided to submit the Group's report in two stages, an Interim Report at the end of 2000 and a Final Report by mid-2001. While the Interim Report would define the macro-economic perspective and focus mainly on taxes at the central level, the Final Report would include state taxes in greater detail as well as other issues not included in the Interim Report. The Final Report is for presentation on May 22, 2001.

The Group conducted field level dialogue with regard to tax policy and administration issues, both under direct and indirect taxes at the central level. Visits to Bangalore, Chennai, Gangtok, Goa, Hyderabad, Kolkata and Mumbai were organised. In Chennai the Group visited the Income Tax computer unit, and Custom House including the port. The Group also visited the Income Tax office in Calcutta followed by a visit to Hindustan Lever factory to examine excise procedures.

Preface

The Group had extended meetings with the Chief Ministers of Andhra Pradesh, Shri Chandrababu Naidu, of Goa, Shri Manohar Parrikar, of Karnataka, Shri S M Krishna, and of Sikkim, Shri P K Chamling, as well as with the Finance Ministers of Andhra Pradesh, Shri Y Ramakrishnudu, of Maharashtra, Shri Jayant Patil, and of West Bengal, Dr Asim Dasgupta. The Group visited the Commercial Tax departments and had extensive discussions with state government officials—including the Chief Secretary, Finance Secretary, Secretary and Commissioner of Commercial Taxes as well as of other taxes, together with other related secretaries and officers. The Group met representatives of leading chambers of commerce and industry in the states. The Group is grateful to the state authorities for the hospitality provided.

The Group would like to express its appreciation for the encouragement received from Shri Montek Singh Ahluwalia in the progress and completion of its work. The Group would like to recognise the contributions of Shri Arbind Modi, Adviser to the Group, who participated regularly in the Group's discussions and visits and helped draft appropriate sections, as well as of Shri Rajiv Mishra, Convener of the Group, for the same and for ensuring the smooth functioning of the entire process until the production of this Final Report.

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Abstract

The necessary stance of the authorities in the area of tax policy and tax administration for the Tenth Plan comprises many facets. For central taxes, the potential of corporation and personal income taxes—that have demonstrated the highest revenue buoyancy—has to be tapped further. Measures include improvements in the tax structure as well as in tax administration. The former issue has to focus on minimising exemptions and incentives and improving the base of the minimum alternate tax (MAT). The latter issue should include increasing the number of assessees while reducing taxpayer burden to improve compliance, and introducing comprehensive and meaningful computerisation for major functional areas of administration.

Indirect taxes have demonstrated low buoyancy which is likely to continue given anticipated structural changes in indirect tax structure. A composite reduction in customs tariffs to internationally comparable levels for increased competition and global integration should be kept apace. This is reflected in the projected customs revenue being allowed to decline marginally in terms of GDP during the Tenth Plan period even in light of exemptions under the customs being streamlined.

A comprehensive central value added tax (CENVAT) that allows full credit for all inputs including capital goods and minimises the number of rates could also have a short term negative revenue impact. But this has to be accepted to eliminate distortions affecting industry adversely. If multiple and complex exemptions are removed, robust revenue improvement could nevertheless be realised from both Union excises and a state level VAT. Base expansion to include the consumption of services comprehensively should be carried out forthwith at the level of both the Centre and states. It would also support the objective of improved revenue productivity.

States should rationalise their sales taxes first and then introduce a broad based VAT by April 2002 as has been agreed. Equally importantly, they have to address the issue of taxation of interstate trade under a state level VAT. Without that, the VAT—currently focussed only on intra-state trade—would remain distortionary. States should be allowed to tax the consumption of those services that are of an intrastate nature. This would help compensate loss of revenue in some states as they move to

Abstract

a VAT. The ultimate goal should be to have a harmonised VAT comprising both the Centre and states. State excises as well as smaller taxes have to be rationalised further and their revenue potential fully realised.

A goal of 4 percent of GDP in additional resource mobilisation, that would be required for a 15 percent nominal growth rate during the Tenth Plan, would be difficult to achieve from taxes alone. The Group did not find convincing evidence from the Centre or the states of adequate preparedness for it. Their objective seems to be one of maintenance of tax to GDP levels. Though the Group has indicated several measures for additional resource mobilisation to meet the revenue goal, the requirement for additional resources for the Tenth Plan has to be couched also in the correction of public utility charges for which there exist many possibilities. This aspect was, however, outside the scope of analysis of the Advisory Group.

Executive Summary

Executive Summary

Chapter 1

[1] Introduction

The Planning Commission set up the Advisory Group (henceforth referred to as the Group) in July 2000 (Annexure 1) to study tax policy and tax administration issues and make appropriate recommendations at different levels of government with the purpose of generating adequate resources for the Tenth Five Year Plan (2002-03 to 2006-07).

Two challenges faced the Group. First, the parameters for the Tenth Plan have not been set so far. Thus a 15 percent nominal growth target was utilised. Second, while various aspects of the tax structure have improved over time, many deficiencies remain that, when corrected, would have a negative revenue impact in the short to medium term. The Group took the option of analysing such aspects and recommending corrective action despite their potential negative impact. This implies that major complementary revenue yielding measures are needed to improve the overall revenue productivity of the tax system, comprising both tax policy and tax administration, and including all levels of government—central, state and local.

[2] A Macro Perspective and Scope of Tax Revenue

Tax policy and tax administration reform measures have to be placed in an appropriate macroeconomic perspective for feasibility of the effort. The questions to address and the results to follow would be the following:

1 How would the growth rates of sectors—agriculture, industry and services—be distributed? Given agricultural and industrial growth rates, the residual growth would have to come from the services sector.

2 Which states/ regions would contribute to this growth? Successful states have registered growth more than 3 to 4 percentage points above average, while slower states have performed almost that much below average. Should the growth strategy need to have a regional focus to achieve the 15 percent nominal target?

3 What would be the role of government? How much national resources should it draw upon for government expenditure and, of that, how much for capital expenditure, given the persistent decline in capital expenditure over the last 15 years? Which sectors should government investment focus on?

4 How much tax revenue and non-tax revenue should government draw upon? Given the fall in the tax/GDP ratio, the stagnation of non-tax revenue, and their relation to the fiscal deficit and sustainability of public debt, appropriate macroeconomic considerations are essential to receive definitive implications for needed resource mobilisation.

5 Given the tax revenue target as implied, as well as the base year tax/GDP ratio, what is the incremental effort required to be obtained.

6 How should tax revenue effort be divided into centre-state targets and tax-wise targets?

The agricultural sector is characterised by a low and falling share of GDP in the second half of the 1990s (Table 2.1) and a small potential for contributing to the buoyancy of tax revenue. An annual growth rate of 3.5—4 percent may be expected over the next few years, given recent performance of 3.3 percent growth rate (Table 2.2). Industrial growth may be expected at 8 percent given recent performance of just over 7 percent.

Achievement of 15 percent overall nominal rate of growth—an increase of 2-3 percentage points of real growth rate—would, therefore, imply need for very high growth in the services sector at the beginning of the Plan period—as much as 11 percent—declining to 10.5 percent by the end of the Plan period (Table 2.2). Slight variations are of course also possible, as indicated by various simulations carried out (Table 2.3).

A strategy that attempts to increase growth would need to modify the distribution of funds to regions. A services-oriented growth would be focussed on urban centres with strong infrastructure. states with high dependence on agriculture would achieve lower growth. If governance and infrastructure improve, low performing states with unutilised potential could indeed improve performance. Special category states have such small shares in GDP that high growth rates there would make only marginal difference to aggregate GDP growth (Table 2.4). The distribution of development funds (Table 2.5) would need to take these factors into account.

A 15 percent nominal growth rate would also require fundamental changes in the structure of government expenditure. Capital expenditure, which has been crowded out in both central and state government budgets, has to be restored. Further, such expenditure would have to be in growth augmenting sectors such as power, telecommunications and roads. The composition of revenue expenditure has to shift to education and health. Though interest payments in current periods may be considered exogenous, future payments, working through the fiscal deficit and accumulation of public debt, would depend on the success of collection of tax and non-tax revenue. Table 2.11 projects, for 2006-07, the revenue deficit, fiscal deficit, capital expenditure and public debt compatible with a 9 percent real growth rate target.

The tax/GDP ratio reached a peak of almost 16 percent in the late 1980s and has fallen since, to 14 percent of GDP in 1999-2000. Additional tax effort has to focus heavily on the service sector. First, as GDP share of industry decreases while that of the services sector increases, the tax base becomes narrower, aggregate buoyancy of tax revenue[1] declines, and the tax/GDP ratio falls (Table 2.6). Second, states' own tax revenue is also negatively related to the share of services.

Tax revenue targets are shown in Table 2.12 consistent with expenditure restructuring needed for the 15 percent nominal growth rate. Total tax/GDP ratio would need to rise from 14.09 percent in 1999-2000 to 17.78 in 2006-07. Of this, states would need to increase the ratio from 5.29 to 6.90, reflecting rationalisation of the sales tax and smaller taxes, and future replacement of the sales tax by a value added tax (VAT). Much of the Centre's increase comes from direct taxes and from expanding the tax base by including services, and some from central excise duties, while customs duties fall slightly.

[3] Tax/GDP Trends and Future Prospects

Between 1989-90 and 1999-2000, the decline in the tax/GDP ratio has been 1.9 percentage points, mainly reflecting the Centre's revenue loss. As a result, the Centre's share in total tax collection has declined from 66.5 percent to 62.0 percent. Likewise, against the total tax buoyancy of 0.90, the Centre's is 0.85.

As against this, given the macroeconomic growth target, the system's tax buoyancy would have to jump from 0.90 to 1.26. ***The tax/GDP ratio should reach 17.8 percent in 2006-07, which is 3.7 percentage points above 1999-2000*** (Chart 3.1). Of this increase,

1 *Defined as percentage change in tax revenue as a proportion of percentage change in GDP. In practical terms, it may be estimated over a period of time by dividing the average annual growth in tax revenues by the average annual growth in GDP.*

the Centre would have to achieve 2.1 percentage points (Graph 3.2) and the states 1.6 percentage points (Chart 3.3). Nevertheless, the share of states vis-a-vis the Centre in the gross collection of taxes increases in the terminal year 2006-07[2], implying an intensified tax revenue effort by states in the Tenth Plan period.

Of **central taxes**, corporation income tax revenue has grown the most between 1989-90 to 1999-2000, from 1 percent of GDP to 1.6 percent of GDP. The personal income tax grew from 1.0 percent to 1.4 percent. Customs duties and excises recorded declining trends, customs duties from 3.7 percent to 2.5 percent, and excises from 4.6 percent to 3.2 percent[3]. Given anticipated further reductions in customs tariffs and comprehensive extension of the tax credit system under the MODVAT-governed excises, it would not be prudent to assign significant efforts to indirect taxation for the Tenth Plan.

Thus, customs collections have been assigned a slight decrease in terms of GDP from 1999-2000 through the Plan period, excises a slight increase from 3.2 percent to 3.5 percent, corporation income tax a jump from 1.6 percent to 2.4 percent, and personal income tax also a significant increase from 1.4 percent to 1.9 percent. Thus, the shift in tax composition evident in recent years is expected to continue through the Tenth Plan.

State level taxes have been stable in terms of GDP between 1989-90 and 1999-2000. The sales tax remained at 3.1—3.2 percent which accounts for about 60 percent of state's tax revenue, and state excises at 0.8 percent. Together they comprised 74 percent of states' tax revenue. Stamps and registration increased from 0.5 percent to 0.6 percent. Land revenue declined from 0.14 percent of GDP to 0.08 percent. The stagnancy of the professional tax at 0.07 percent of GDP points towards the need for extensive coverage of services under the tax base.

In the projections, inter-se weights of individual state level taxes as obtained in 1999-2000 (historical trends) are maintained for the Plan period[4]. In terms of GDP, state taxes will have to increase by about 1.6 percent. Sales tax is projected to increase from 3.1 percent of GDP to 4.1 percent mainly reflecting the anticipated introduction of the VAT that would go beyond first point taxation. State excises are projected to grow from 0.8 percent of GDP to 1.0 percent. The remaining increase would have to come from other taxes. The shares of both central and state taxes for 1989-90, 1999-2000, and 2006-07 are depicted in Charts 3.4a, 3.4b and 3.4c.

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2 *This is because, notwithstanding a greater effort assigned to the Centre with respect to the base year, the final effort as projected in 2006-07 for the Centre exceeds the 1989-90 levels by a smaller amount as compared to the states.*

3 *Nevertheless, indirect taxes continue to maintain a higher, though declining, share than direct taxes.*

4 *Thus, the sales tax maintains its 60 percent share and so on.*

[4] Reform of Direct Taxes

Even though there has been a sharp increase in the direct tax-GDP ratio in the 1990's, there continues to be large number of incentives and exemptions in the tax structure, which inhibit the realisation of the full revenue potential of direct taxes. Our recommendation on the direct taxes essentially relate to base expansion and rationalisation in the context of the Income Tax Act as it existed prior to its amendment by the Finance Act, 2001.

[A] Personal Income Tax

[i] Rates

Over the years, while progressivity of rate structure has been scaled back, the exemption limit has, however, been revised to exceed inflation thereby leaving more individuals below the tax net. Further, there has also been some "bracket creep" in that inflation has dragged taxpayers into higher tax brackets.

It was therefore recommended in the Interim Report that the maximum marginal rate of personal income tax rate be retained at 30 percent and the surcharge should be removed. Also, correction must be made to remove bracket creep from the structure by broadbasing the various brackets/slabs as indicated in (Table 4.2) even though it may lead to some revenue loss at existing levels of compliance. However, this should be done along with streamlining base erosion as explained below. While the Union Budget 2001-02 has removed the surcharge, the recommended adjustment in the tax slabs and brackets would still need to be followed up in the next budget.

[ii] Savings incentives

The base of the personal income tax remains narrow for various reasons. One aspect is tax relief for savings in specified assets. The main provisions appear in Appendix Table 2.1. Tax credit is governed by Section 88, deductions by Section 80L, and exemptions by Sections 10(11) and 10(15) of the Income Tax Act, 1961. Also available are deductions under Section 80CCC, 80D, 80DD, 80DDB and 80E, exemptions from long term capital gains under Sections 54, 54B, 54D, 54EA and 54EB. Assets in incentive schemes are also exempt from wealth tax.

The scope of Section 88 has been expanded during the 1990s and the amount of tax rebate from Rs.10,000 in assessment year 1991-92 to Rs.16,000 in assessment year 2001-02. The rate at which the rebate is calculated is 20 percent even though the lowest marginal tax rate is 10 percent. The scope of Section 80L has been likewise increased and the maximum available deduction is Rs.15,000 in assessment year 2001-2002.

Taken together, the schemes do not comprise a rational whole and have built up in an ad hoc manner over time. Such schemes do not necessarily result in additional savings; rather, they encourage substitution. They have negative efficiency effects favouring debt financing, crowding out the private sector, discriminating against selected activities such as home construction out of taxed savings, and de-equalising rates of return on savings that have the same risk or holding period. For example, National Savings Certificates and provident funds enjoy deductibility of investment (Section 88) and of interest earnings (Section 80(L) or 10(11) or 10(12)), leading to inordinately high effective rates of return on these assets.

Overall, the incentives are also iniquitous in that the manner in which they are offered tends to favour the richer tax payers. For example, deductions from income under Sections 10 and 80L and the provisions relating to rollover of capital gains tax favour upper bracket tax payers disproportionately. Given the complexity of the savings incentives structure (Table 4.4), inequity also arises simply from asymmetric information available to the lower income earner.

It is recommended that, ideally, tax incentives under Sections 80CCC, 88, 80L and 10 (15) of the Income Tax Act be abolished, at least in phases as has already been initiated by the Union Budget 2001-02.; that tax concessions under Sections 80D, 80DD, 80DDB and 80E be given in the form of tax credit rather than as deduction from income (to improve equity); and the rollover provision relating to capital gains under Sections 54, 54B, 54D, 54EA and 54EB be removed. This reform should eventually enable further reduction in the overall tax rate structure that should enable improved savings behaviour by all tax payers.

[iii] External borrowings

Section 10(15) provides for exemption of interest paid on external borrowings at a concessional rate. However, since the lender is subjected to tax in the country of his residence, it is doubtful whether the rates of interest are truly concessional. In effect, the revenue loss on these borrowings is a gain for the foreign countries' treasury. ***It was therefore recommended in the Interim Report that the exemption for interest on foreign borrowings should be withdrawn. The Union Budget 2001-02 has withdrawn this exemption for interest on ECB in respect of borrowings on or after June 1, 2001.***

[iv] Income of funds

Essentially, funds are in the nature of pass-throughs and therefore income received by them should be exempt, though the beneficiaries of the income should be subjected to tax. Keeping in view the administrative difficulty of collecting tax from millions of small beneficiaries, ***it is recommended that the income of the Funds should be subjected to tax at the lowest marginal rate of personal income tax, i.e., at 10 percent.***

[v] Foreign income and remuneration

There being no economic rationale for exempting remuneration received from international organisations, and reflecting the practice in several western countries, ***it is recommended that the provisions of Sections 10(8), 10(8A), 10(8B) and 10(9) be deleted.***

[vi] Foreign exchange earnings/exports of goods and services

The government's decision to phase out the various incentives for foreign exchange earnings/export of goods and services is a step in the right direction. However, the Group finds no justification in the continuation of the incentives under Section 10A and 10B since the international competitiveness of exports covered under Section 10A is greater than exports from outside the special economic zones. Similarly, the incentive under Section 10B is a premium on licensing. ***It is, therefore, recommended that the provisions of Section 10A and 10B be phased out.***

[vii] Regional/industrial development

The tax incentives under Sections 80 IA and 80 IB of the Income Tax Act are inefficient and iniquitous. Empirical evidence also suggests that these have not significantly contributed to the industrial development of backward areas. ***It is, therefore, recommended that the provisions of Sections 80IA and 80IB be deleted.***

[viii] Income from salaries

The Group notes with some alarm that the Union Budget 2001-02 has, contrary to our recommendations in the Interim Report, raised the maximum level of the standard deduction to Rs30,000. While it is true that the level has oscillated over time, the level of Rs.500 in 1974-75 would be equivalent to approximately Rs.5,000 in current terms. ***However, reflecting the changes in the Union Budget 2001-2002, it is imperative that the ceiling be brought down to Rs.15,000 in the next budget.*** This reflects the fact that, at present, transport allowance is being given as a separate deduction, which was not the case prior to assessment year 1998-99 and most employers provide at their expense the facilities of books and periodicals. Further, it cannot be overemphasised that the goal of resource mobilisation becomes more difficult to achieve with increasing base erosion.

[ix] Income from self-occupied house property

The present provision for allowing of interest deduction on borrowed capital for construction of a self-occupied house property should be discontinued since it is

inconsistent with the matching principle for income determination. However, the Group is rather dismayed to note that contrary to its recommendations, the Union Budget 2001-02 has further enhanced the limit from Rs.1,00,000 to Rs.1,50,000.

[x] Charity and non-profit organisations

Under the Income Tax Act, donations to non-profit organisations (NPOs) are eligible for deduction under Section 80G and 80GGA from the gross total income. Since these are income-based deductions, these are iniquitous. Further, there has been a proliferation of NPOs in recent years. Numerous income tax exemptions in respect of their incomes are provided to them. Many of them are inefficient such as Sections 10 (23) (i) to (iii a) and (iii ab) to (iii ae) since there is no bar imposed on the distribution of net earnings. They are also anomalous and, possibly, iniquitous in that NPOs enjoying exemptions under Sections 10 (23) (iii ab) to (iii ae) coexist with for-profit organisations in their respective areas of operations. Also, the existing provisions produce tax subsidies that increase with income.

Though Sections 11 to 13 do restrict distribution, they overlap with Sections 10 (23) (iv) to (vi a) which do not restrict distribution. In any event, even if distribution of net earnings were restricted, there would be some inequity vis-a-vis for-profit enterprises because of the exemption itself. Further, no differentiation is made between donative and commercial NPOs.

It is recommended that, first, the income-based deduction for donations under Section 80G and 80GGA should be converted to a tax credit at the lowest marginal tax rate of 10 percent—for equity reasons—without any limit as a fraction of gross income as set under Section 80G. Second, the exemptions under Section 10 and 11 to 13 of the Income-tax Act in respect of income of charitable trusts and institutions of various categories should be restricted only to donative NPOs, to be defined as those in which 90 percent of the receipts are through donations. Third, the non-distribution constraint should be made explicit and universal.

[B] Corporate Income Tax

[i] Harmonisation of personal and corporate income taxes

If the corporate income tax rate is higher than the top personal income tax rate, it tends to lead to tax induced non-corporatisation of the business sector and less organised business activity. ***It is, therefore, recommended that the present corporate tax rate should not exceed the maximum marginal personal income tax. Hence, the corporate tax rate should be reduced to 30 percent to bring it in line with the existing level of maximum marginal personal income tax. Further, we also recommend the abolition of the distribution tax on dividends and consequent reduction of the tax rate for foreign companies to the level recommended for domestic companies.***

[ii] Minimum Alternate Tax for companies

Corporate tax legislation all over the world, no matter how streamlined at the outset, becomes subject to a "creeping incrementalism" with respect to special concessions and provisions over time, typically through excessive depreciation allowances. This is because the corporate sector constitutes a focused interest group with financial backing. A group of so-called "zero tax companies" emerges. The result is a higher marginal tax rate for those caught in the tax net.

An indirect attack through presumptive taxation may become more successful than direct attempts to reduce concessions. Such indirect methods also reduce tax evasion. Further, transfer pricing practices by multinationals to optimise on cross-country differences in corporate tax rates become less profitable. A minimum alternate tax (MAT) that targets the average tax liability across taxpayers is a method that allows to keep the marginal tax rate low.

Countries have used various bases for a MAT: Colombia on net worth, Argentina and Mexico on gross assets, Canada and the United States on exclusion of deductions, selected francophone African countries on sales, and so on. It is well known that a minimum tax based on gross assets has proved to be a good revenue earner and equitable across small and big corporations. It is also efficient in terms of reallocation of resources since non-performing companies, that are unable to pay the minimum tax in the medium term, would have to close down and reinvest capital in an area of comparative advantage. In India, however, it might be difficult to introduce given the authorities' restrictive exit policy for businesses.

As the statutory corporate tax rate has declined significantly since 1987, India has developed a history of presumptive taxation—Section 115J through Finance Act, 1987; Section 115JA through Finance Act, 1996; and the present Section 115JB through Finance Act, 2000, which provides for a minimum tax of 7.5 percent on "book profit" (defined as commercial profit). A major shortcoming of the MAT is the fact that it continues to be on reported income, unmindful of the widely prevalent practice of under-reporting. The effective rate of corporate tax has been estimated to be around 21 percent as against the statutory rate of 38.5 percent.

"Book profit"—a flow concept—can be easily manipulated since it is amenable to accounting changes/practices and subject to the existing tax incentives. The base of the MAT could combine a stock and a flow to appropriately reflect a plausible taxable capacity of the company. Thus ***the Interim Report recommended that the 20 percent dividend tax should be abolished. Instead, the MAT should be reconstituted as a tax equal to the aggregate of 0.75 percent of adjusted net worth plus 10 percent of the dividend distributed. The MAT should be allowed to be carried forward for setoff against future tax liability in excess of the MAT as provided in Section 115JAA. The adjusted net worth for tax purposes would be the average of capital employed as on the first day and the last day of the previous year. The definition of capital employed should be the same as was in***

the case of Section 80J of the Income Tax Act, 1961. The choice of adjusted net worth reflects administrative ease. Several judicial pronouncements exist on the definition of capital employed that would serve well to both taxpayers and the administration. While the 2001/02 Union Budget brought down the dividend tax rate to 10 percent, no step was taken to restructure the MAT. This must be attempted in the next budget.

The proposed base would be efficient since, first, it is neutral between retained earnings and dividend distribution. To the extent dividends are distributed, currently they suffer a higher rate of tax in the year of distribution. In the proposed base, if the company chooses to retain its earnings it will be penalised by the capital market and still end up paying tax on it since it would result in an accretion to net worth. Second, the greater is the performance shortfall of a company, the greater is the excess of the implicit tax rate on income actual over the prevailing corporate tax rate.

The proposed base would be equitable since it would remove the bias through depreciation allowances in favour of the manufacturing sector vis-a-vis services. The stock-flow combination also protects base erosion from inflation. When net worth is eroded by inflation, the real tax loss is partly compensated by the capital gains tax paid by shareholders. (Recall the recommendations made to improve capital gains taxation). Further, if assets are revalued periodically, the increase is reflected in an increase in the net worth. If a company chooses otherwise, it will end up paying a substantially larger liability upon liquidation.

[C] Direct Tax Administration

The Department is currently in the process of restructuring to facilitate large scale induction of information technology (IT) and expects to mobilise Rs.10,000 crores from enhanced capability to address tax arrears and stopfilers. Over the last few years, several important steps have been taken to improve administration. They include: (1) expanding the universe of taxpayers from 12 million to 25 million, through a "one by six" scheme that requires any income earner who satisfies any of the six given criteria to register for income tax purposes; (2) extending the scheme of tax deduction at source (TDS) so that an increasing proportion of revenue comes from this source; and (3) a genuine effort towards improvement in the quality of taxpayers' service.

The Group recommends the following immediate reform measures in direct tax administration:

1 extend the pilot voice message system of Calcutta to other centres;

2 make available of forms and returns on floppy diskettes;

3 allow the tax administration to print forms in private presses;

4 develop a long term plan for non-discretionary information gathering;

5 notify the categories of transactions for which the Permanent Account Number (PAN) must be quoted;

6 refuse to accept taxpayer forms by the administration without the PAN;

7 replace the income tax clearance certificate system by the simple requirement of quoting of the PAN;

8 remove the deficiencies from the Taxpayer Master File to enable identification and notification of stopfilers;

9 write off arrears in cases where the identity of the taxpayer is not established beyond doubt;

10 maintain a credible minimum deterrence level by ensuring that a certain minimum percentage of taxpayers are scrutinised annually through a selection pattern that is secret and fair;

11 decentralise selected expenditures to local offices that are currently consolidated at the cost of efficiency at the Ministry of Finance level;

12 identify areas on which resources could be saved with the advent of IT;

13 require banks to furnish information regarding collection of taxes on a magnetic media;

14 provide computers to the staff members;

15 set up an inter-Ministerial Committee to oversee the time bound program for networking of all income tax offices across the country; and

16 specify clearly the rights & obligations of all parties and supporting institutions for greater accountability in the proposed MOU between government and the CBDT.

[5] Reform of Union Excises

The structure of excises levied at the central level has been simplified considerably over the last ten years. The number and level of rates have been reduced with the current central rate at 16 percent. Credit/offset (referred to as CENVAT) is, in general, given for input tax. Nevertheless, many lacunae do remain in the overall structure, rendering it effectively complex and distorted. First, apart from the 16 percent rate,

there are ancillary rates. Second, the immediate credit for tax on capital goods has been staggered over two years from the current year. Third, exemptions continue to be given on a large scale many of which appear to exist on grounds of populism, and resulting in classification disputes and adverse administration. Thus much room remains for structural reform and improved revenue productivity.

[A] Duty Structure

Most goods are taxed at the main rate of 16 percent. Higher rates existed until 2000-01: 40 percent for panmasala, aerated water, chewing tobacco, and motor vehicles for less than six persons; 32 percent for cosmetics and toiletries, tyres, polyester yarn, air conditioners, and motor vehicles for six-twelve persons; 24 percent for cement, carpets and floor coverings, tiles, and two wheelers. These rates have now been combined at 32 percent, a measure in the right direction. Others attract lower rates such as cotton and wool yarn and kerosene. Though the non-16 percent rates pertain only to a selected number of goods, the administration of multiple rates is not amenable to financial control methods (based on a self removal procedure) that have primarily replaced physical controls. The creation of an additional rate of 4 percent for selected items (with an option to pay 16 percent with input credit which were exempted earlier, in the 2001-02 budget has added some complexity into the system. A better method would have been to simply tax them at the 16 percent rate with input credit.

It was recommended in the Interim Report that a two-rate structure of 16 percent together with a higher rate should be introduced. An increasing number of items were to be converged to fall under the 16 percent rate to minimise classification problems. This would be economically desirable and administratively simple. The rates would have to be adjusted for inclusion of services in the CENVAT. The 2001-02 Union Budget has moved clearly towards a two-rate duty structure of 16 percent and 32 percent. However, the lingering lower rates of 4 percent and 8 percent should now be merged with 16 percent in the next budget.

There is also a multiplicity of levies that include, apart from the excise rate structure, additional excise duty (goods of special importance) in lieu of sales tax on sugar, fabrics and tobacco; additional duty on motor spirit (petrol and diesel); additional duty on textiles and textile articles (fibres, yarn and fabric) under a subsidy scheme for "controlled cloth"; and cesses leviable under miscellaneous enactments.

Separate accounts are to be maintained for each of these levies, increasing administrative and compliance costs. It is difficult to work out effective tax rates since CENVAT credit is not given for all of them. ***There should be a single levy under the Central Excise Act.*** For example, conceptually there is no reason why a central excise duty could not be charged on textiles and sugar without jeopardising a state level sales tax on these items. This is what happens with all other goods.

[B] Base of Union Excises

The base of excise is manufacture. While many disputes have occurred over the definition of manufacture, the effective twin test is: (a) a new article should come into existence; and (b) it should be marketable. The current definition—that does not include activities that may be deemed to be manufacture such as labelling or printing a brand name—encourages segregation of manufacturing activities to avoid tax. ***It was recommended in the Interim Report that the definition of manufacture be widened to include the chain of value addition by or on behalf of the manufacturer (undertaken before marketing the product) to be charged to duty. The 2001-02 budget has accepted this principle though only in the case of branded garments. This now needs to be extended to other items like shoes, electrical gadgets etc.***

The credit for CENVAT (earlier MODVAT) is given for tax paid on manufacture. In the case of credit/offset for tax paid on capital goods, the concept is goods "used in the factory of the manufacturer". This gives rise to less litigation than the concept "used in manufacture of final products" that is used for credit of tax paid on raw material. ***It is recommended that both capital goods and other inputs "used in the factory of the manufacturer" should be allowed CENVAT credit. Thus, capital goods and other inputs should not be distinguished for purposes of input tax credit.***

While raw materials and capital goods both received input tax credit in the current year until 1999-2000, the credit for capital goods was staggered over two years from 2000-01 for no other than obvious revenue reasons. Therefore, input tax credit on capital goods ***should be immediately restored by giving the credit in the year of purchase itself.***

The excise base is eroded by exemptions, inter alia, for: (a) small scale industry (SSI); (b) village industry marketed with KVIC assistance; (c) specified goods supplied to various types of public institutions; (d) goods produced without power; (e) cooperative society produced tea; (f) goods produced in the North-East[5]; (g) a number of food items including bread, spices, coffee, khandsari sugar, cereals, edible oils and several unbranded food items; (h) fertilisers; (i) unregistered branded garments, clocks, watches upto Rs.500, electric bulbs upto Rs.20; (j) aircraft, ship and boat; etc.

Further, the formulation of exemptions is extremely complex. Of the standard publication of tariffs of 720 pages, 220 pages are devoted to exemptions. There are 90 exemptions for textiles. For small scale industry, there are 5; for exports, there are 20; for job work, there are 5, and so on. Each exemption has many entries, conditions and lists, in turn, containing hundreds of items in each list.

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5 *Credit is given on inputs manufactured in the North East even though no duty is paid on such inputs. This is said to cause considerable leakage.*

6 *In the main notification which combines all exemptions for the different chapters (3/2001 Central Excise), there are now 262 entries while in the previous year's notifiction (6/2000), there were 259 entries. The list has, thus, expanded, though marginally.*

The Interim Report had recommended that an intensive effort is necessary to rationalise exemptions on the same subject through abolition and merger. Conditions for exemptions must be minimised. When an item is covered under the SSI exemption scheme, there should not be any separate exemption except for some very valid reasons. SSI exemption should be extended to textiles also by replacing the individual exemptions. Overall, there has been no significant change in the area of exemptions.[6]

SSI units receive concessional duty as well as full CENVAT credit. ***SSI units below a turnover of Rs.3 crores should pay a duty of 85-90 percent of the normal rate if they opt for CENVAT credit. The 3 crores turnover calculation should not exclude exports and exempted goods produced by a SSI unit. SSI units must maintain all records and give a declaration. Only really small units with a turnover of Rs.15-20 lakhs should be exempted from declaration/maintenance of records. The unutilised credit should lapse once the Rs.1 crores exemption limit is reached.***

An important issue in expanding the base is the inclusion of services in the tax net through comprehensive taxation of services. ***It is important to integrate services as early as possible with the CENVAT to arrive at a full fledged VAT at the Centre, perhaps as early as in the Budget of 2002-03,*** rather than to continue with a separate structure of service taxation that cascades and causes economic distortions. The Centre should also allow states to tax services so that they can integrate services into their VAT base. A mechanism that would make this feasible is elaborated below (see Section 7e).

[C] Administration

While the VAT mechanism reduces tax induced economic distortions by reducing cascading (of "tax on tax"), the aspect of input tax credit tends to pose particular demands on administration. A substantially faster growth in MODVAT credit vis-á-vis growth in gross revenue has caused concern regarding potential misuse of MODVAT credit invoices. A field survey has indicated that, besides procedural and technical offenses, other violations included: (1) undervaluation of goods; (2) non-reversal of credit in respect of returned rejected inputs; (3) misuse of facility of job work; and (4) availing of credit on exempted final products; twice on the same invoice; without payment of duty; by using fraud/fake documents.

It appears that 10 percent of revenue may be lost from these factors. There is also the perception that the exempted SSI sector exacerbates the misuse of CENVAT credit invoices. As the SSI sector has no interest in CENVAT credit invoices, the invoices relating to their purchases have been misused by the non-exempted sector. Thus ***rationalisation of SSI exemptions from CENVAT should check evasion over and above improving the excise structure.***

While many procedural improvements have been made during the last decade, anomalies continue to bug the system. Some examples should suffice. Union excises are levied on transactions price i.e. the price paid or payable, in reflection of commercial considerations. However, when a good is sent from factory to depot or

other places of removal, duty is paid at the factory gate on a value which is the transaction value at the depot/place of removal at or about the time the goods are cleared from the factory, though the goods in question may be sold from the depot at a different price at a later date. ***Therefore, the depot or other places of removal should be made into duty paying agencies, with accounts-based checks and audits at regular intervals.***

The new procedure that has delinked duty payment from clearance is consistent with improved administration. The fortnightly payment requirement reflects the commitment of the authorities to move towards an accounts based system of administration and audit. ***The fortnightly payment should be replaced by monthly payment to enhance the liquidity of units and to reduce excessively stringent accounting needs.***

Despite the move towards financial control, vestiges of physical restrictions remain. When goods are returned by buyer to seller, in certain circumstances, approval is necessary from the Chief Commissioner for re-entry of goods to the factory. This is time consuming and unnecessarily exacerbates the need for tax official—taxpayer contact. ***Reentry should be allowed on accounts based self declaration or simple intimation to the Department.***

Manufacturers may acquire spare parts for use or they may resell them. For such trading activities, approval of the Department is needed which is generally not given. ***Resale should be allowed on the basis of maintenance of accounts and penalty imposed in case of misuse. On the whole, therefore, excise administration should complete its movement towards financial control from physical control based methods.***

[6] Reform of Customs Duties

[A] Rates and Exemptions

The important challenge in customs tariffs is to reduce them to comparable international levels. The average effective rates (customs revenue as a percent of the value of imports) in East Asia for example, were 5 percent in Indonesia, 4 percent in Malaysia, 14.4 percent in the Philippines, and 7.4 percent in Thailand in 1995. In 1999, the average nominal customs tariff rates were 0 percent in Hong Kong and Singapore, 9.5 percent in Indonesia, 10.2 percent in Malaysia, 10.7 percent in the Philippines, and 17 percent in Thailand.[7]

The median tariff rate in India is much higher. At 35 percent, it is still among the highest in the world. This ***should be brought down to 25 percent in the 2002-03***

budget. Finance Ministers have previously indicated their intention to sequentially bring down the rates further, and of making them comparable to East Asian levels. The objective should now be to bring down the median tariff rate to 20 percent in 2003-04 and 15 percent in 2004-05. This would nevertheless be somewhat above the East Asian average (even ignoring the zero rate structures of Hong Kong and Singapore).

Accompanying reductions in exemptions should accommodate any loss in revenue and help meet the revenue objective assigned to customs duties in the Tenth Plan.[8] In any standard publication of the customs tariff structure containing 1150 pages, 400 are devoted to exemptions, further compounded by exemptions of other customs related duties.[9] ***As many exemptions as possible have to be removed. Relatedly, the countervailing duty (CVD) of 16 percent should be levied uniformly—without exemptions.***

[B] Export Valuation

While in the case of excises and imports transaction value has been introduced, in the case of export, the "deemed value" continues. This lack of uniformity has led to much confusion. ***Transaction value should be adopted since international prices vary from transaction to transaction.*** This is also supported by Article 1 of the WTO agreement. The change can be made by adding an explanation to Section 14(1) of the Customs Act.

[C] Treatment of Exports

There are many schemes for export promotion, remission, exemption and entitlement, including Duty Free Replenishment Certificate (DFRC), DEEC, Export Promotion Capital Goods (EPCG), export under bond, drawback, and special scheme for gem/jewellery/diamonds, Export Processing Zone etc. These tend to create problems for administration since they are linked to export obligations over a period of years. Some of them are superfluous when others exist. There is a need to evaluate if the duty foregone (35-40 percent of export revenue) is compatible with export growth. ***There is no need for so many export promotion schemes. They need to be***

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7 *In Latin American countries also, tariff rates have been slashed in the 1990s. For example, Chile has used a uniform tariff rate that has varied between 10–12 percent reflecting revenue needs in recent years.*

8 *Indeed, in the 2001-02 budget, the number of rates has increased from 14 to 18. Above the median rate of 35 percent, there are nearly ten rates, ranging from 40 percent to 200 percent. The recommended reductions in customs tariffs should target these high rates as well, though agriculture may need temporary special consideration.*

9 *This leads to much complexity in interpretation and to administration problems, leave alone economic distortions.*

rationalised by combining them and removing the overlapping. For this, the authorities should immediately constitute a time-bound Expert Group to examine the schemes and recommend an appropriate scaling back.

[D] Administrative Matters

Many countries are beset with corruption in customs administration. This is worsened by a complex tariff structure since it encourages administrators to summon taxpayers for "explanation" of classification categories sought. Simplification of the tariff structure and computerisation of procedure seeking to reduce the customs official—taxpayer nexus have helped check the problem in many countries. In India, ***computerisation in customs administration is progressing and improvement is an ongoing process. Thus, as in the case of excises, the number of entries has increased.***

Immediate improvements are possible in customs procedures. For example, delay in the clearance of imported cargo in airports and ports was reported by trade and industry. Delay increases cost of production, congestion, under-utilisation of port facility and corruption. Despite computerisation, it was found that, given 300 clearance documents per day, 18 percent were subjected to queries. Thus, of 54 queries in a single day, 42 percent asked for catalogues, 25 percent asked for provisional duty bond without indicating reason, and the rest for chemical tests and other documents.

In sum, the Fast Track Clearance Scheme (STCS) is highly restricted and has not produced the desired result on a sufficient scale. While in excise self removal scheme applies to everybody, the STCS is only for those with "unblemished record". ***To speed up clearance***, based on examination of practices in Canada, Holland, the United Kingdom and the United States, and recalling that not many cases of large scale evasion have been detected by physical examination by the Customs over a period of time, ***only targeted goods should be checked on the basis of intelligence. Thus the intelligence collection machinery should be strengthened, while selective post audit should be based on computerised information***. This will modernise customs administration and minimise the source of delay and abuse.

Provision for advance rulings on classification for Non-resident Indians (NRIs) has been enacted but it is fraught with judicial formalities. This could better be done by the Central Board of Excise and Customs (CBEC) which already has a sufficient stock of technical people to do this job. ***The CBEC should be allowed to give advance rulings.*** What is important is uniformity and certainty. Further, the ***advance rulings should be made available to all and not be restricted to NRIs.***

Section 115B of the Excise Act and Section 12B of the Customs Act deny "***refund in cases of unjust enrichment***". Unjust enrichment is considered to be caused by a refund to a manufacturer (or importer) from the tax administration (based on a subsequent claim by the manufacturer) when a higher tax has already been realised by the manufacturer from his customers. The customers may be too numerous for the manufacturer to give refunds to them. This should not be a justification for the tax

administration to keep the revenue. Hence, ***the provision to deny refunds to the manufacturer by the tax administration should be removed, and the law appropriately amended.***

Finally, excessive litigation has been a major problem for both customs and excises particularly because a lot of revenue is held up because of it. While slow disposal by judiciary is also responsible for this, ***the following actions are recommended to stem the occurance of litigation***: (a) simplification of MODVAT principles and procedures by allowing MODVAT credit on all goods except those in a negative list; (b) more explanations to be added to notitifications to minimise doubts in interpretation; (c) introduce more definitions in the tariff; (d) department should file less appeals to the Tribunal and courts; (e) reduce remanding of cases; (f) exemptions should be reduced in number and conditions simplified; (g) issuing of protective demand should be stopped when assessment has been made under the order of the CBEC; (h) system of advance ruling should be made operative; and (I) the mindset prevailing now to err in favour of revenue should be changed in favour of effective rationalisation.

[7] Reform of the State Taxes and Introduction of VAT

The terms of reference of Group enjoin separate and explicit treatment of central and state level taxes. The Interim Report essentially focused on central taxes with only a brief mention of state taxes in its concluding chapter. We decided that a more detailed treatment of state taxes would be covered in the Final Report after acquiring first hand experience enabled through interaction with various state governments. Based on this and for the detailed reasons indicated in Chapter 6, the Group recommends the following:

[A] On Interim Reform of Sales Tax

1 ***While awaiting the introduction of a state-level VAT, a beginning should be made by streamlining the existing sales taxes further. Though states recently introduced floor rates for the sales tax, more can be achieved by abolishing the turnover tax and entry tax wherever they continue to exist, and reducing concessions and incentives from the prevailing sales tax structures.***

[B] On an Integrated VAT

1 ***The Group's terms of reference require us to assess a comprehensive VAT whereby the central and state VAT stand integrated. To achieve this end, our***

proposal of a state level VAT would be for one that could co-exist with the present arrangement of the central VAT (or CENVAT). Thus central jurisdiction would give setoff only for central duties and state jurisdiction for state duties. Such a national integrated centre-state VAT arrangement can easily exist in parallel or dual format. However, respective tax jurisdictions (and administrations) would have to be careful about excluding the taxes paid to the other jurisdiction from the assessment of value bases.

[C] On Timing of VAT Introduction

1 *The Group does not recommend VAT introduction by individual states in isolation. Rather, they should act in unison on the issue.*

[D] On State VAT Design

1 *The next step on the agenda should be to move over to a state Value Added Tax (state VAT). The Empowered Committee of State Finance Ministers must decide expeditiously on the design of the VAT so that appropriate VAT legislation can be enacted and rules and regulation framed well before April 1, 2002. Similarly, the Committee of Commercial Tax Commissioners that has already been formed must decide on the various administrative issues relating to VAT like manner of registration, establishment of an efficient information system, collection, audit, taxpayer education, a system of penalties and appeal, training and computerisation.*

2 *Since income tax is already fairly well established in India, we recommend that states should adopt a consumption type VAT i.e. there should be no distinction between raw materials and capital goods in allowing VAT credit. Only this VAT variant is equivalent to a retail sales tax. The consumption base must be as wide as possible and must comprehensively include manufacturers and dealers of all goods indicated in sales tax schedules.*

3 *A two floor VAT rate structure in addition to the zero rate: one for essential commodities and another for all other items would be best.*

4 *The states must draw up a common exemption list.*

5 *Unprocessed food articles, life-saving drugs and commodities with negative externalities whose consumption needs to be checked should be exempted from state VAT.*

6 *All concessions with regard to the sales tax should be eliminated under the state VAT and benefits if any should be given only in exceptional circumstances through budget based subsidies.*

7 Small dealers whose annual turnover does not exceed Rs. 15 lakh should be exempt from the liability of VAT but subjected to a sales tax of one percent.

8 All international exports should be zero-rated.

9 Commodities with negative externalities whose consumption needs to be checked should, however, be subject to the Special Additional Tax (SAT) against which no input tax credit should be granted. The states must draw up a common list for the purposes of SAT and the number should not, in any case, exceed ten.

10 Luxuries should not be taxed under the SAT. Instead, it would be better to have a common, high, third VAT rate for luxuries.

11 States should refrain from designing SATs with the primary objective of maintaining revenue equivalence with selected commodities under the prevailing sales tax regime as this would defeat the very purpose of a non-cascading VAT.

12 The local VAT rates should be close to uniform across states, reflecting the existing consensus on uniform floor rates. The two floor rates should be set with smaller states in mind that may need to have lower floor rates reflecting the particular characteristics of their production and distribution patterns, small size of consumption, geographical distance and lack of access to markets. To accommodate these states, the floor rates should be fixed at lower levels than what larger and economically more powerful states may want. That would enable the smaller states to operate at lower floor rates while the others would be obliged to operate at higher than floor rates, given their revenue needs. This would be better than enacting two sets of floor rates, one for smaller, and the other for larger states.

13 The VAT should be structured on the destination principle.

14 The computation of the VAT liability should be based on the credit method.

[E] On Treatment of Interstate Trade

1 A destination based VAT is recommended for the Indian state level VAT, which must remain the ultimate goal. This could be achieved through an application of the "Versano method", named after the Brazilian expert who proposed it. In any VAT return, there would be two columns, one for intrastate transactions and one for interstate transactions, the latter to be taxed at a common rate by all states. The net VAT payable on interstate transactions would be remitted by every taxpayer to an overarching all-state administration, or to the central tax administration. The revenue would be distributed at the end of the period according to the consumption size of states. This is one example of the so-called "clearing house" mechanism that could be operated by the states themselves or

by the Centre. However, the Group did not find any consensus among states regarding such a mechanism though it is not at all impossible to achieve.

2 *The use of "C Forms" should not be a feature of the VAT.*

3 *The initial arrangement for the interstate segment of the VAT when introduced on April 1, 2002 should be a transitory alternative that eschews the difference between destination and origin states would be to require the granting of credit in a state whenever tax is collected. If an interstate sale took place from state B to state A, state B would collect the VAT on sale and also give the appropriate input credit on it. If, however, the good was sent on consignment from B to A, state A would collect the VAT reflecting that no sale took place in B and that any sale subsequent to the interstate transfer would take place only in A. Thus any applicable credit for input tax paid in state B would have to be given in state A. This would meet two elements of the VAT i.e. it would be a tax on consumption and it would remove cascading. But the revenue would accrue to the state where the sale takes place. Such an arrangement would also reflect international practice such as in the transitory arrangement in the European Union and regular practice in Brazil.*

4 *Consequently, the Central Sales Tax Act must also be abolished simultaneously.*

5 *If the Centre were to compensate states, it should not do so according to the origin principle in any event. A lasting solution would be to allow states to tax services and for the Centre to assist in building institutional capacity through modernisation of tax administration in the states.*

[F] On VAT Administration

1 *The administration of VAT on imports should continue to vest in the Customs and Excise Department under central government.*

2 *The central VAT should continue to be administered by the central customs and excise under the central government.*

3 *The state level commercial tax department should administer the VAT, which is proposed to replace the state level Sales tax. The VAT administration should be restructured—from the current sales tax administrative structure- into a functional classification based departmental organisation. The objective should be to enhance administrative efficiency and to minimise the taxpayer—tax administrator nexus. The organisation of the department should be based on return filing, selective audit/assessment, judicial interpretation, collection and investigation, anti-evasion and policy unit/VAT monitoring unit.*

4 *Since the income tax administration has established a system of Permanent Account Number (PAN), is otherwise engaged in collecting information relating to sale and purchase by taxpayers, and has the largest computerised network*

amongst the various tax administrations, the state level tax administration must co-ordinate and draw upon the same information to avoid duplication of effort and reduce compliance burden of taxpayers.

5 *The entire process of computerisation of the tax administration both at the Center and the state levels should be treated as a separate project for augmenting the institutional capacity and not a mere exercise in office modernisation.*

6 *The central government must provide full financial assistance to the state level tax administrations, CBDT and the CBEC towards this institutional capacity building through computerisation and training (both domestic and foreign). For this purpose, an adequate provision under the Plan budget must be made.*

7 *The road map to administrative preparedness for the introduction of VAT in April 2002 is presented in Table 6.1.*

[G] On Taxation of Services

1 *An interim method that should enable states to tax services with cooperation from the Centre and without the need for a Constitutional amendment could be one where the Centre may levy the service tax on them and authorise the states to administer/collect them. However, the Centre and states must first arrive at a consensus on the list of services that can be administered by the states.*

2 *The service tax collected by the states would have to first go to the Consolidated Fund of India as per Article 266(2). After that, the Centre would disburse an equivalent amount to the states. This interim method has found favour with the Chief Ministers of states with whom the Group discussed the matter.*

3 *The states should be given the powers to tax services whose consumption is of an intrastate nature.*

4 *After the initial introduction, services could be incorporated into the VAT.*

5 *The rate structure for the VAT on services should be identical to those for goods to obviate distortions in producer and consumer decisions.*

6 *The state taxes like luxury and entertainment tax on restaurants, hotels and other lodgings, professions tax, motor vehicles tax, goods and passengers tax and electricity duty should be integrated with the state level VAT.*

7 *Various public utility services that have scope for corporatisation should be brought within the state level VAT on services.*

8 *The VAT on services should be fully integrated with the VAT on goods, both in its design and administration, with an appropriate mechanism to setoff service*

input tax against goods output tax and vice versa. Therefore, a destination based, invoice credit method, dual VAT—one at the central level and another at the level of states—comprising both goods and services could be envisaged by the end of the Tenth Plan.

9 The assignment of the powers to tax services to states must be viewed as adequate compensation for revenue loss on account of abolition of the central sales tax.

[H] On State Excises on Liquor

1 There should be a two-part levy for liquor. The first part should be the excise component, which would be levied at the manufacturing level. This should be ad valorem and the base should be the maximum retail price (MRP) and not the invoice price, which would be the MRP less trade discount. The second component should comprise regulation fee/charges, which could be based on an auction mechanism as has been done in some states.

[I] On Registration Fees

1 The registration fee should not exceed one percent of the value of the property registered.

[J] On Stamp Duties

1 In the transition, stamp duties have to be continued.

2 The existing multiple rates of stamp duty should be replaced by a single rate duty of five percent of the value of the property.

[K] On Motor Vehicles Tax and Goods and Passengers Tax

1 The motor vehicles tax should be merged with the state VAT. The VAT rate for all categories of motor vehicles (both commercial and personal vehicles) should be higher by eight percentage points than the general commodity VAT rate.

2 To the extent the motor vehicle is used for personal purposes the VAT so paid will be on final consumption and accordingly, no input credit would be available to the owner of the vehicle. If the vehicle is used for commercial purposes, the VAT treatment will be same as in the case of any other capital good, i.e. the owner would be eligible to claim input credit.

3 Similarly, since the transport of goods and passenger results in consumption of services, the goods and passenger tax should be replaced by the service tax on

carriage of goods and passengers and integrated into the state VAT.

4 The existing administration for goods and passenger tax should be abolished and merged with the state level VAT.

[L] On Profession Tax and Entertainment Duty

1 The ceiling on profession tax should be increased to Rs.5,000 immediately.

2 The profession tax should be merged with the VAT in the same way as the motor vehicles tax. The same argument holds also for entertainment duty.

Macro Perspective and Scope of Tax Revenue: 2000-01 to 2006-07

A Macro Perspective and Scope of Tax Revenue: 2000-01 to 2006-07

Chapter 2

[1] Introduction

At a meeting of the Planning Commission, held for undertaking a mid-term appraisal of the Ninth Plan (September 30, 2000), the Prime Minister asked the Commission to examine the possibility of raising the growth target of the economy for the Tenth Plan, due to start in 2002-03, to 9 percent from the target of 6.5 percent of the Ninth Plan. Keeping this in mind, this chapter attempts to make appropriate projections based on an overall growth in nominal terms of 15 percent per annum during the Tenth Plan period.

It was acknowledged that such a high growth rate would require "far reaching changes in existing policies". The strategy for achieving such a target needs to spell out the sectors, sources and regions that can drive the economy onto such an ambitious growth trajectory. It also requires a re-specification of the role of government in achieving and sustaining this growth. In particular, the implications for augmenting tax revenues for financing development expenditures require to be worked out in adequate detail within a macro framework. In this context, the following important questions need to be addressed:

1 What are the sectors, which will mainly contribute towards attaining the stipulated growth target? It is clear that growth in agriculture would be rather low. The industrial sector will provide a higher growth. But on an average basis, encompassing the five years, it will probably be less than 9 percent. The residual growth has thus to come from services. As such, sectoral growth targets need to be specified keeping in view both their desirability and feasibility in order to derive the role of plan intervention to drive growth in these sectors.

2 Which are the states/regions that will mainly contribute to this growth? The inter-state growth profile indicates wide variations. Successful states have registered growth more than 4 to 5 percentage points above average, while slower or constrained states have performed almost that much below average. Should the

growth strategy have a regional focus? What would be the implications for equity and efficiency?

3 What is the role of government in this endeavour? How much of the aggregate output/savings of the economy should it draw upon for government expenditures, and what share of that should be devoted to capital expenditures, i.e. government investment. Further, what are the sectors government investment should focus on? This issue needs to be considered in the context of the persistent fall of capital expenditures over the last fifteen years.

4 In drawing upon the economy's output, how much would it be desirable/feasible for the government to draw as tax revenues, how much as non-tax revenues, and how much should it then borrow? These questions can be addressed in the context of the steady erosion of the tax-GDP ratio, the stagnation of non-tax revenues, and issues relating to sustainability of debt and fiscal deficit. An analytical framework that allows for interdependence and feedbacks among key variables is required for addressing these issues.

5 Once the tax revenue targets are determined in this framework, one can work out, starting from the base year tax-GDP ratio, the extent by which it should rise, and accordingly what is the aggregate incremental effort required, and what might be the sources for additional buoyancy.

6 The aggregate tax revenue buoyancy can then be decomposed as Centre-state targets and tax-wise targets.

These matters are taken up individually. We first address the issue as to which sector is likely to provide the targeted rate of growth.

[2] Sectoral Growth Profiles

Dividing the economy into three broad sectors, viz., agriculture and allied activities, industry (excluding construction), and services (including construction), the profile of annual growth rates since 1993-94 (year from which the new GDP series is available) indicates that the agricultural sector shows a high degree of volatility and low average growth. The industrial sector shows a peak performance rising to as high an annual growth rate at 12.82 percent (in 1995-96) but undergoes steady erosion in the closing years of the nineties due to recession. In terms of annual growth rates, the services sector is the steadiest. It has maintained a healthy growth even during the period of recession.

In working out the potential of an individual sector towards contributing to a high growth target, one needs to look at the following features characterising a sector: (i)

its share in total GDP; (ii) its average growth in recent path; (iii) the volatility of its growth rate; and (iv) its potential contribution to tax revenues. The agricultural sector is characterised by a low and falling share in GDP, a low but highly volatile growth rate, and small effective potential for contributing to the buoyancy of tax revenues. The average annual growth rate in agriculture has been around 3.34 percent (Table 2.1) and it appears that we may expect an average growth of 3.5 to 4 percent during the next few years. Since population is increasing at an average annual rate marginally above 2 percent, a growth in agricultural output of 3.5 to 4 percent should be adequate to cover and augment the availability of agricultural products in real per capita terms.

Table 2.1

Sectoral Growth Performance: 1994-95 to 1999-2000

(GDP at Factor Cost at 1993-94 Prices in percentage)

	1994-95	1995-96	1996-97	1997-98	1998-99	1999-2000	AAG1
Agriculture and Allied Services	5.01	-0.87	9.61	-1.92	7.16	1.27	3.34
Industry (exclu. Construction)	10.35	12.82	6.80	4.90	3.65	7.46	7.31
Services (inclu. Construction)	6.77	10.01	6.65	9.16	8.05	8.68	8.26
GDP at Factor Cost	**6.98**	**7.31**	**7.51**	**5.02**	**6.81**	**6.43**	**6.64**

Source *(Basic Data):National Accounts Statistics, September 1999 and Press Note, 30 June 2000 by CSO.*

Note *Average annual growth rate.*

The average growth in the industrial sector has been around 7.3 percent and it should be possible to sustain an annual growth above 8 percent in this sector. Indeed, it may need to be raised beyond 9 percent as is explained below. The key to raising aggregate growth to a level of 9 percent, nevertheless, lies in uplifting the growth in services by about 2 percentage points from an average of 8.2 percent to above 10 percent, as shown in Table 2.2. Indeed, it may need to be beyond 10 percent as is explained below.

In Table 2.3, growth rates of agriculture and industry have been pegged at 4 and 9.5 percent per annum for the period of the Tenth Plan. The growth of the services sector is derived residually so as to produce an aggregate growth of 9 percent per annum during the plan period. For the two years before the start of the new plan, aggregate growth is gradually increased in two incremental steps. The relevant details are given in Table 2.3.

As the three sectors grow in tandem according to the indicated growth rates, the pressure on even the services sector for maintaining a high growth rate begins to come down. The peak rate of growth for this sector is 11 percent after which the required rate begins to decline. This is because the share of the services sector in

aggregate output continues to increase. We also observe that if the indicated profile of the services sector is achieved, then at the end of the Tenth Plan period, this sector would account for about 60 percent of aggregate output while the share of agriculture would have fallen to below 20 percent.

We have carried out a sensitivity analysis for alternative ranges of growth rates for agriculture and industry. In particular, if agriculture grows in the range 3.5 to 4.5 percent, and industry, in the range what 8.5 to 10.5 percent, what would be the requirement in growth terms for the services to ensure an aggregate growth rate of 9 percent during the plan period. These results are summarised in Table 2.3. The critical requirement for a 9 percent aggregate growth rate turns out to be a growth in services in the range of 10 to 11 percent.

The change in the sectoral profile leading to continued increase in the share of the services sector seems imminent even if the nine percent target is not reached, as long as the service sector growth is above the average rate. Historical performance indicates that this appears to be the most likely scenario.

Table 2.2

Sectoral Shares: Percent to GDP at Factor Cost at Current Prices

	1999-00	2000-01	2001-02	2002-03	2003-04	2004-05	2005-06	2006-07
Sectoral Growth Rates (in percent)								
Agriculture and Allied Services		3.50	3.50	4.00	4.00	4.00	4.00	4.00
Industry (exclu. Construction)		7.50	8.00	9.50	9.50	9.50	9.50	9.50
Services (inclu. Construction)		8.50	9.15	11.00	10.86	10.74	10.62	10.52
Aggregate Growth Rate (in percent)		**7.00**	**7.50**	**9.00**	**9.00**	**9.00**	**9.00**	**9.00**
Nominal Amounts (at 1993-94 Prices) (Rs. Crores)								
Agriculture and Allied Services	2,93,869	3,04,154	3,14,800	3,27,392	3,40,487	3,54,107	3,68,271	3,83,002
Industry (exclu. Construction)	2,55,715	2,74,894	2,96,885	3,25,089	3,55,973	3,89,790	4,26,820	4,67,368
Services (inclu. Construction)	6,01,771	6,52,902	7,12,661	7,91,056	8,76,995	9,71,170	10,74,331	11,87,300
GDP at Factor Cost (Rs. Crores)	**11,51,355**	**12,31,950**	**13,24,346**	**14,43,537**	**15,73,456**	**17,15,067**	**18,69,423**	**20,37,671**
Shares (in percent)								
Agriculture and Allied Services	25.524	24.689	23.770	22.680	21.639	20.647	19.700	18.796
Industry (exclu. Construction)	22.210	22.314	22.417	22.520	22.624	22.727	22.832	22.936
Services (inclu. Construction)	52.266	52.997	53.812	54.800	55.737	56.626	57.469	58.268
GDP at Factor Cost	**100.000**	**100.000**	**100.000**	**100.000**	**100.000**	**100.000**	**100.000**	**100.000**
Sectoral Contribution (Share weighted growth)								
Agriculture and Allied Services		0.893	0.864	0.951	0.907	0.866	0.826	0.788
Industry (exclu. Construction)		1.666	1.785	2.130	2.139	2.149	2.159	2.169
Services (inclu. Construction)		4.441	4.851	5.920	5.953	5.985	6.015	6.443
Total		**7.000**	**7.500**	**9.000**	**9.000**	**9.000**	**9.000**	**9.000**

Source *(Basic Data): National Accounts Statistics, September 1999 and Press Note, 30 June 2000 by CSO.*

Table 2.3

Sensitivity Analysis: Alternative Configuration of Growth Rates

(Average for 2002-03 to 2006-07 in Percentage)

Agriculture	Industry	Services
4.0	9.5	10.75
4.5	9.5	10.57
5.0	9.5	10.40
4.5	9.0	10.77
4.5	9.5	10.57
4.5	10.0	10.37
4.5	10.5	10.16
5.0	10.0	10.19
5.5	10.5	9.80

[3] Regional Profile of Growth

A growth strategy that aims to increase the average growth rate by about 1.5 to 2 percentage points would require a reconsideration of the (i) regional distribution of development funds; (ii) augmentation of capital expenditures in government budgets; and (iii) focussing of capital expenditure on infrastructure. A services sector oriented growth would take place in urban centres, in large cities with strong infrastructure, in particularly, power and telecommunications.

In Table 2.4, state-wise GSDP and corresponding growth rates for the period 1995-96 to 1997-98 are given. The table classifies different states into three groups according to their per capita GSDP. A fourth group relates to special category (SC) states. An examination of the profile of growth in terms of per capita GSDP at constant prices indicates that maximum growth in the 1990s has occurred in the middle income group states and Gujarat and Maharashtra.

The states can be divided into four groups among the general category states. In the first group are *low income—low growth* states like Bihar, and Uttar Pradesh. In the second category are states, which are *low-to-middle income*, and *high growth* states like Madhya Pradesh, Rajasthan and Kerala. In the third group are states, which are *middle-to-high income* and *high growth* states, such as, Andhra Pradesh, Tamil Nadu, Gujarat and Maharashtra. In the last group are *high income—low growth* states like Punjab, Haryana. states, which have a high dependence on agriculture have been able to achieve low aggregate growth. states, which are already at high levels of income, may see their growth tapering off. On the other hand, states which have low incomes

Table 2.4

GSDP at 1980-81 Prices: Growth Profile of States

State	Per Capita GSDP (Rs.) Average (1995-96 to 1997-98)	Average GSDP (Rs.) 1995-96 to 1995-96 to 1997-98	Share in All-State GSDP (% age)	Share in Population in 1991 (% age)	Avg. Annual Growth Rate 1995-96 to 1997-97 (% age)
G C States					
Bihar	1,308.94	12,342.33	4.63	10.33	3.71
Orissa	1,826.18	6,317.33	2.37	3.79	4.40
Uttar Pradesh	1,929.00	30,256.00	11.36	16.64	4.25
Madhya Pradesh	2,226.35	16,542.67	6.21	7.91	5.11
Rajasthan	2,418.23	12,034.52	4.52	5.26	4.65
Kerala	2,675.71	8,385.00	3.15	3.49	4.99
Andhra Pradesh	2,765.78	20,067.00	7.53	7.95	8.62
Karnataka	2,974.42	14,749.67	5.54	5.39	5.25
West Bengal	3,120.98	23,431.00	8.79	8.14	6.69
Tamil Nadu	3,246.51	19,512.93	7.32	6.70	4.14
Gujarat	4,309.24	19,704.33	7.40	4.95	6.16
Haryana	4,332.73	8,043.00	3.02	1.97	4.90
Punjab	4,940.26	11,088.00	4.16	2.43	4.42
Maharashtra	5,310.31	46,202.67	17.34	9.43	5.83
Goa	7,007.09	916.78	0.34	0.14	6.66
Delhi	7,416.13	8,041.00	3.02	1.12	12.05
All GC States and Delhi	**3,149.48**	**2,57,634.23**	**96.70**	**95.64**	
S C States					
Assam	1,871.37	4,647.33	1.74	2.68	4.07
Meghalaya	2,146.37	426.91	0.16	0.21	5.73
Manipur	2,260.34	465.05	0.17	0.22	5.67
Tripura	2,296.23	751.26	0.28	0.33	8.27
Nagaland	2,580.73	351.90	0.13	0.14	7.00
Himachal Pradesh	2,794.83	1,587.39	0.60	0.62	5.62
Arunachal Pradesh	3,761.63	360.60	0.14	0.10	3.73
Sikkim	4,676.82	213.28	0.08	0.05	7.00
All SC States	**2,798.54**	**8,803.73**	**3.30**	**4.36**	
Total	**2,974.01**	**2,66,437.96**	**100.00**	**100.00**	

Notes *1 For the States of Goa, Meghalaya, Manipur, Nagaland, Himachal Pradesh and Sikkim, the GSDP data is not available for the year 1997-98. Therefore, the average of these states have been calculated for the years 1993-94, 1994-95 and 1996-97.*

2 The population figure of Delhi has been considered in calculating the total population figure.

3 Data for GSDP (at 1980-81 prices) is not available for the state of Jammu & Kashmir and Mizoram.

but considerable unutilised potential should be able to sustain high growth provided a breakthrough can be made in governance and infrastructure. Some hard realities may be observed. By and large, special category states constitute such a small share of total GDP in the economy that even if very high growth takes place in these states, they will make only a marginal difference to the aggregate growth of GDP.

A decision as to how to regionally allocate developmental funds so as to get maximum mileage out of these funds for aggregate growth would need to be taken after these

Table 2.5

Share of Plan Grants Across States

(in percentage)

State	1996-97	1997-98	1998-99	Average 1996-99
Bihar	1.79	3.83	4.76	3.46
Uttar Pradesh	11.22	10.94	9.39	10.52
Orissa	3.60	3.55	3.82	3.66
Madhya Pradesh	7.29	4.82	4.83	5.65
West Bengal	5.42	4.82	6.12	5.45
Rajasthan	4.74	5.24	5.11	5.03
Andhra Pradesh	6.84	6.77	6.63	6.75
Karnataka	3.91	3.68	3.79	3.79
Kerala	2.39	2.04	2.39	2.27
Tamil Nadu	4.05	4.59	4.17	4.27
Gujarat	2.82	2.71	2.56	2.70
Haryana	1.87	1.81	1.62	1.77
Punjab	1.51	1.40	1.59	1.50
Maharashtra	7.54	5.67	4.60	5.94
Goa	0.23	0.21	0.18	0.21
GCS—Share	**65.22**	**62.08**	**61.56**	**62.95**
Assam	7.05	6.84	7.35	7.08
Tripura	2.45	2.47	3.11	2.68
Manipur	2.23	2.25	2.33	2.27
Meghalaya	1.55	1.41	1.88	1.61
Jammu & Kashmir	10.23	13.96	11.60	11.93
Arunachal Pradesh	2.62	2.60	2.79	2.67
Sikkim	1.07	1.20	1.33	1.20
Himachal Pradesh	3.92	3.56	3.85	3.78
Mizoram	1.75	1.80	1.95	1.83
Nagaland	1.90	1.84	2.23	1.99
SCS—Share	**34.77**	**37.93**	**38.42**	**37.04**

Source *(Basic Data): Finance Accounts of States.*

Note *GCS = General Category States.*
SCS = Special Category States.

factors are taken into account. If we analyse the share of Plan grants across states for the period 1996-97 to 1998-99, we find that more than 37 percent of Plan grants have gone to the Special Category states (Table 2.5), whereas they account for less than 5 percent of population and only 3.3 percent of all state GSDP. For low income states like Bihar, Uttar Pradesh, Orissa, Madhya Pradesh, West Bengal and Rajasthan, the share of Plan grants amounted to about 33 percent whereas they account for nearly 50 percent of the population and 38 percent of GDP. Unless the allocation pattern of Plan grants is modified, ambitious growth targets are unlikely to be attained.

[4] Taxing the Growing Output

Long-term trend of the tax-GDP ratio indicates that it steadily rose from a little over 7 percent in the early 1950s to a peak of about 17 percent by the late 1980s. Since then it has steadily fallen. The estimates provided by the Eleventh Finance Commission (EFC), it stood at 14 percent of GDP in 1999-00 with respect to the new GDP series. This fall is also reflected in the incremental tax-GDP ratio as shown by the changes in aggregate tax revenue buoyancy. In Table 2.6, the buoyancy figures for each of the five decades have been summarised. It is evident that the aggregate buoyancy has steadily fallen during the last fifteen years so as to arrive at a level below unity. This reflects that the tax-GDP ratio will keep falling as growth takes place. The fall will be larger, the higher is the growth rate.

Among other reasons, an important cause for the fall in buoyancy is the sectoral shift where the share of agriculture and industry in aggregate output has steadily fallen and the share of services has steadily increased. Since most of the value added in services remains under-taxed, the buoyancy with respect to GDP would show a decline. It is also clear that, if the share of agriculture falls below 20 percent of GDP and the

Table 2.6

Aggregate Tax Revenue Buoyancies

	Aggregate Tax Revenue	Central Tax Revenue (Gross)	State Tax Revenues (Own)
1950-51 to 1959-60	1.38	1.38	1.39
1960-61 to 1969-70	1.16	1.15	1.17
1970-71 to 1979-80	1.30	1.27	1.35
1980-81 to 1989-90	1.14	1.15	1.12
1990-91 to 1998-99	0.96	0.91	1.04

Source *Report of the Eleventh Finance Commission, June 2000, p. 10.*

share of services increases to about 60 percent as was indicated earlier, the focus of additional tax effort needs to shift towards the services sector. It is this sector that can provide the needed fillip to arrest the steady decline in tax buoyancy. It will also be seen from Table 2.6 that the fall in buoyancy is relatively more in central tax revenue than in states' tax revenue. As such it is the centre which has to play the larger role in augmenting tax revenue buoyancy.

The role played by the structural changes in the composition of GDP on the falling aggregate buoyancy of tax revenue with respect to GDP is quite significant. Regressions indicate that as the share of services sector in GDP increases, the aggregate buoyancy of tax revenues falls.

The dependent variable is annual buoyancy of aggregate tax revenue. The overall sample is from 1970-71 to 1996-97. Two main explanatory variables that emerge are growth rate of GDP and the share of the services sector. Both have a negative impact on buoyancy.

If share of the services sector goes up by 1 percentage point, the aggregate buoyancy of tax revenues goes down by 0.07.

If share of the services sector goes up by 1 percentage point, the aggregate buoyancy of tax revenues goes down by 0.07.

BATR =	***5.353—0.0449***	***GRGDP—0.0704***	***SS - 0.4119 Ø BATR (-2)***
(t-ratio):	***(5.545) (-2.148)***	***(-3.140)***	***(-2.857)***

R^2 = 0.62 R^2 or adj—R2 = 0.56 DW = 2.33 F = 10.93

where	***BATR***	***= aggregate tax revenue buoyancy***
	GRGDP	***= annual growth rate of GDP***
	SS	***= share of services sector***

BATR is a stationary series with intercept without a trend
GRGDP is a stationary series with intercept without a trend
SS is a stationary series with intercept and a trend

The upshot of the argument is that as the share of services sector increases, the tax-base becomes narrower, aggregate buoyancy of tax revenues is eroded, and the tax-GDP ratio falls. As we target the 9 percent growth rate, these influences will be further accentuated unless ways and means are found for effective taxation of services.

Another important issue pertains to the inter-dependence between the buoyancies of central tax revenues and states' own tax revenues. In particular, the buoyancy of states' own tax revenues (BSOR) is also shown to be negatively related to the share of services and the buoyancy of central indirect taxes with a lag, as indicated in the regression results summarised below.

BSOR =	*5.247*	*- 0.0796 GRGDP*	*- 0.061 SS*	*- 0.21 BCI (-1)*
(t-ratio):	*(5.315)*	*(-3.831)*	*(-2.899)*	*(-1.724)*
R^2 = 0.58	*$\bar{R}^2$ = 0.52*	*DW = 1.84*	*F = 9.76*	

Here, BCI, is the annual buoyancy of central indirect taxes.

[5] Augmenting Growth: Recasting the Expenditure Priorities

An important aspect relating to the interface between the fiscal sector and aggregate output of the economy concerns the profile of government expenditures. If a growth rate of 9 percent is to be achieved and sustained, fundamental changes in the structure of government expenditure would be called for. A major feature of the inter-temporal profile of government expenditure has been the erosion of the share of capital expenditure in total government expenditure. This feature has characterised both the central budgets and the state budgets. In Table 2.7, the persistent fall of capital expenditure as percentage of GDP since the late 1980s has been highlighted.

Capital expenditure has been crowded out to very low levels both in the central and the state budgets. For increasing and sustaining a higher growth rate in the economy, it is critical that the share of capital expenditure in government budgets is increased

Table 2.7

Capital Expenditure in Government Budgets

(Percent to GDP)

	1980-81 to 1984-85	1985-86 to 1989-90	1990-91 to 1994-95	1995-96	1996-97	1997-98	1998-99	1999-00#
Centre	6.13	6.78	4.61	3.43	3.29	3.61	3.72	2.78
				3.25	*3.09*	*3.41*	*3.51*	*2.62*
State	3.79	3.21	2.57	2.29	2.01	2.2	1.97	2.06
				2.17	*1.89*	*2.08*	*1.87*	*1.95*

Source *Report of the Eleventh Finance Commission, June 2000, pp. 177-178.*

Note *1 The first three columns indicate period averages.*

2 Figures in italics indicate percent to GDP new series.

3 # Revised estimate.

by reprioritising expenditure away from revenue expenditure. However, this must not be done along conventional lines where increasing capital expenditure had merely meant increasing government investment and ownership in public sector enterprises in a wide range of sectors with low productivity.

Government investment must focus on those sectors which are relevant for the growth of the growth-augmenting sectors and should be used not for the objective of ownership but rather for leveraging private sector participation also in the same sectors. Thus, the total capital which is attracted to the concerned sectors would be significantly greater than what the government itself puts up. The sector, which has primary importance in this context, is infrastructure. It has two components: social and economic. Education and health among the social sectors, and power, telecommunications and roads among the economic sectors take the prominent position. Government expenditure should focus on these sectors. As far as the social sectors are concerned, since they are less capital intensive, a shift in the composition of revenue expenditure in favour of health and education is called for. However, since the claim of interest payments would depend on the levels of debt and fiscal deficit which, in turn, will depend on the performance on the revenue front covering both tax and non-tax revenue, the macro picture can be closed only by working out sustainable levels of debt and deficit and the corresponding burden of interest payments consistent with the expenditure targets. This is discussed in the following section.

[6] Growth Target and Sustainable Debt and Deficit

Aggregate output growth, interest rate, inherited debt stock, and the fiscal deficit along with debt that may be targeted are linked with each other and need to be conjointly considered. The responsiveness of interest rate and growth rate to fiscal deficit as a percentage of GDP is of particular importance in this context. In this section, we propose to highlight the considerations that are relevant in determining targets that are sustainable as well as mutually consistent. Appendix 2.1 delineates interrelationships among appropriate variables.

It may be argued that, in a static sense, if the economic growth rate exceeds the interest rate on debt service, then public debt should be sustainable in the sense that the fiscal deficit to GDP ratio could be stabilised. Since there is a large range of fiscal deficit to GDP ratios within which the condition may be satisfied we need an additional condition in order to determine the relevant level of fiscal deficit to GDP ratio at which it may be stabilised. This condition can be obtained by considering that a certain level of primary expenditure (non-interest government expenditure) is required to support a given rate of growth. In any case, a minimum level of primary

expenditure is needed in the system and these are rigid downwards. If a judgement can be made as to a target level of primary expenditure, the corresponding levels of interest rate, growth rate, fiscal deficit and debt to GDP ratios can be determined simultaneously. Alternatively, if the interest rate and growth rate curves can be estimated precisely, the level of primary expenditure to GDP ratio, interest rate and growth rate, and optimal debt and deficit ratios can be determined. It is often the case that the economy in reality may be far removed from such optimal levels. In such a case the desired direction of change need to be worked out.

In Tables 2.8, 2.9 and 2.10, certain combinations of alternative parameter values have been utilised in order to work out desirable levels of debt and deficit at which one may attempt to stabilise these in the medium term within the context of the Indian economy. The parameter ranges, which may be relevant in this context, may be indicated as below:

Effective Interest Rate on Government Borrowing	**10 percent ± 1 percentage point**
Revenue Receipts to GDP Ratio	**19 percent ± 2 percentage points**
Growth Rate	**8 percent ± 1 percentage point**
Inflation Rate	**6 percent ± 1 percentage point**
Interest Payment to Revenue Receipts	**30 percent ± 10 percentage points**

Accordingly, primary expenditure to revenue receipts may be considered in the range of 70 percent plus/minus 10 percentage points, as a proportion of revenue receipts.

Table 2.8

Interest Payment to GDP Ratio: Some Ranges

IP/RR	RR/GDP		
	0.17	**0.19**	**0.21**
0.20	0.034	0.038	0.042
0.30	0.051	0.057	0.063
0.40	0.068	0.076	0.084

Table 2.9

Debt-GDP Ratio: Determining Desirable Levels

[D = (ip)(1+g)/i]*

Ip*	i\	g		
		0.13	0.14	0.15
0.05	0.09	0.628	0.633	0.639
	0.10	0.565	0.570	0.575
	0.11	0.514	0.518	0.523
0.06	0.09	0.753	0.760	0.767
	0.10	0.678	0.684	0.690
	0.11	0.616	0.622	0.627

Table 2.10

Fiscal Deficit to GDP Ratio: Determining Desirable Levels

[d = D.g/(1+g)]

D\	g		
	.13	.14	.15
0.50	0.058	0.061	0.065
0.565	0.065	0.069	0.074
0.60	0.069	0.074	0.078
0.65	0.075	0.080	0.085

[7] Central and State Fiscal Profiles: Alternative Projections

In this section, we construct fiscal profiles of the centre for 2000-2001 to 2006-2007 and the state under alternative growth targets and given targets for macro aggregates such as the revenue deficit, fiscal deficit and capital expenditure. The main macro targets for the final year of the Tenth Plan are specified below:

Projections are based on an overall growth in nominal terms of 15 percent per annum. Although a break-up of this between real and inflation has not been made as far as tax revenue projections are concerned, in projecting expenditures, inflation is assumed at 5.5 percent, and the salary component has been protected with respect to this rate. The associated results are given in Appendix Tables A2.1 to A2.4.

The projections for central government's fiscal aggregates are given in Appendix Table A2.1. The growth parameters have been changed upwards as compared to the ones assumed by the Eleventh Finance Commission. The growth rates of tax revenues consistent with assumed GDP growth rate are also given in Appendix Table A2.1. For the first two years, the same buoyancies have been used as prescribed by the EFC. However, for the Plan period, the buoyancy parameters have been lowered by a small margin in view of the higher growth rate assumptions. The aggregate tax revenues of the centre are derived by utilising the same tax GDP target as set out by the EFC. For the two additional years also, the tax GDP ratio is targeted to increase so as to give a tax-GDP ratio in the terminal year of nearly 10.9 percent of GDP, with a view to eliminating the revenue deficit of the Centre also to zero by 2006-07. The revenue from a potential service tax, therefore, is residually derived and it is required to contribute a substantial amount. Along with its impact on union excise duties it would also enable the economy to reach the desired macro targets.

On the expenditure side, pensions and defence services on the non-Plan account are set to grow at 10 percent per annum in line with the EFC projection rates. The effective interest rate is set at 10 percent which is marginally higher than what was assumed by EFC in view of the higher inflation assumptions. Explicit subsidies are also allowed to grow at 10 percent. Other general services, social services and economic services are projected in terms of their salary and non-salary components. The salary component is allowed to grow at the same rate as inflation, i.e., 6 percent. The non-salary components are allowed to grow at the same rates as indicated by EFC namely, 7 percent for other general services, 15 percent for social services and 11 percent for economic services. For non-Plan grants to states, the EFC figures are used.

On the capital side, fiscal deficit has been targeted to fall to 4 percent by the end of the Plan period. Accordingly, figures for outstanding debt have been derived and after applying the effective interest rate, interest payments have been calculated. Capital expenditure is derived residually in the system and it is shown to increase to 4.6 percent of GDP by the last year of the Plan. The outstanding debt-GDP ratio is shown to fall to 41.5 percent which, along with the debt of the state governments, will force the aggregate debt to GDP ratio within the sustainable range.

The fiscal profile of the states has also been constructed for the period until 2006-07. As far as tax revenue is covered, the state tax revenue to GDP ratio is projected to rise to 6.9 percent of GDP by the terminal year of the Tenth Plan. This implies an increase 1.6 percentage points between 1999-2000 and 2006-07. For non-tax revenues also a targeted increase of 0.7 percentage point between the base year and the terminal year has been provided. Potential fiscal transfer for the states amounts to 37.5 percent of the revenue receipts of the Centre, i.e., gross tax revenue receipts and non-tax revenue receipts. The share in central taxes amount to 29.5 percent of the shareable central tax revenues, i.e., gross tax revenue receipts. Cost of collection and surcharges and cesses have been projected as part of the central fiscal profile.

On the expenditure side, interest payments are obtained by applying an effective interest rate of 11 percent on outstanding debt at the beginning of the year. Pensions,

Table 2.11

Macro Aggregates in the Terminal Year

(Percent to GDP)

Variables	1999-2000	2006-07
Revenue Deficit		
Centre	3.81	0.00
State	2.96	-0.50
Combined	6.77	-0.50
Fiscal Deficit		
Centre	5.64	4.00
State	4.71	3.00
Combined	9.84	6.50
Capital Expenditure		
Centre (Net of Repayment and Onlending)	2.62	4.60
State (Net of Repayment)	2.06	3.83
Combined	4.17	7.93
Outstanding Debt		
Centre	53.34	41.53
State	25.07	26.45

Source *(Basic Data): Appendix Table A2.1.*

Police and Election expenditures are projected to grow at 10 percent. Primary education, priority health, water supply and sanitation are derived by setting terminal year targets and evenly distributing growth in incremental steps between the base year and the terminal year. Other components of expenditure are derived by applying differential growth rates of salary and non-salary components. The salary component is set to grow at the same rate as inflation (5.5 percent). The non-salary component for general, social and economic services is set to grow respectively at 7, 15 and 11 percent per annum respectively. Revenue deficit becomes zero by 2004-05 and then converts to a surplus. Fiscal deficit is targeted to reduce to 3 percent by 2006-07. Capital expenditure, which is a residual, is shown to increase from 2.06 percent to 3.83 percent between 1999-2000 and 2006-07. The outstanding debt to GDP ratio at first increases to a peak of 27.66 percent by 2003-04 but then begins to decline by 2006-07, to 26.64 percent of GDP.

[8] Macro Tax Targets

In order to achieve the fiscal deficit and capital expenditure targets, additional revenue needs to be generated from both tax and non-tax resources. As far as tax

Table 2.12

Tax Revenue Targets

(Percent to GDP)

Tax	Tax-GDP Ratios	
	1999-2000	2006-07
Corporation Tax	1.55	2.35
Income Tax	1.38	1.88
Customs	2.47	2.44
Union Excise Duties	3.16	3.51
Service Tax	0.10	0.57
Central Taxes (Gross)	8.80	10.88
State Taxes	**5.29**	**6.90**
Total Tax Revenues	**14.09**	**17.78**

Source *(Basic Data): Appendix Tables A2.1 and A2.3.*

revenue is concerned, based on buoyancies, the following targets for major taxes, have been set (Table 2.12). These are consistent with the necessary expenditure restructuring required to sustain an ambitious growth target.

[9] Summary and Conclusions

In this chapter, the path of tax revenue for the centre and the states over the period 2000-01 to 2006-07, i.e., to the end of the Tenth Plan, has been worked out within an overall framework that accommodates a nominal growth rate of 15 percent in the Plan period. The tax-GDP ratio targets are fixed in line with the targets prescribed by the EFC. The central feature in the context of augmenting the tax-GDP ratio is identified as the growing share of the services sector. This requires suitable strategies both in spheres of indirect and direct taxes. Growth can be sustained with an increasing share of capital expenditure in government budgets focussed on social and economic infrastructure.

Appendix 2.1

Sustainability of Public Debt

In Diagram 2.1, some of the important relationships pertaining to debt sustainability are drawn together. In the fourth quadrant, combinations of debt and deficits are indicated such that they represent levels of fiscal deficit (as per cent to GDP), which will reproduce the connected level of debt year after year. This relationship depends entirely on the growth rate. Given the growth rate, this relationship indicated by a line such as OZ provides combinations of mutually consistent deficit and debt levels. The specific relationship is given by:

Deficit/Debt = g/(1+g)

While the line OZ can indicate the sustainable level of debt, given a level of deficit, or a sustainable level of deficit given a level of debt, one of these needs to be determined using other information in the system. In the first quadrant of Diagram 2.1, two reduced-form relationships are indicated: line AR indicates the interest rate as a function of fiscal deficit, given the level of other variables that might also be determinants of the interest rate. Line AR rises to the right indicating that, given other things, as government borrows more and more, the interest rate would become higher and higher. At high levels of deficit, the curve rises steeply indicating that higher and higher borrowing can be induced by offering rising interest rates at the margin. At a very high level of fiscal deficit, the curve becomes nearly vertical indicating that the risk of default has become so high that no lender is willing to lend further at any interest rate. Similarly, line BG gives the relationship between growth rate and fiscal deficit. This line rises to the right, reaches a peak, and then slides downwards, indicating that at first, while unemployed resources exist in the system, higher government expenditure financed by borrowing may lead to higher real growth, but after full employment is reached (or even before it, if government expenditures contribute less at the margin than private expenditure and borrowing happens to be crowding out private expenditures), this curve turns downwards. Levels of fiscal deficit in this quadrant can be divided into some distinct ranges and some critical points can be identified. Point “e” defines the bankruptcy point beyond which nobody would be willing to lend. The range “ac” indicates the range where deficit is sustainable where sustainability is judged from the condition that growth rate exceeds the interest rate. Throughout this range, deficit would not lead to a rising debt-GDP ratio even while a primary deficit is present. The range “ce” defines the range where deficit becomes increasingly unsustainable as the interest rate exceeds the growth rate. Point “b” defines the optimum level of deficit as it at this level that the growth rate is maximised while maintaining full employment. If the two curves g = f (d,) and i = f(d,) could be estimated precisely, the optimum level of deficit, and using the OZ curve, the corresponding level of debt could be specified precisely. Without this information one endeavours to settle down anywhere in the sustainable range by using other relevant information.

The forty five-degree lines in the third quadrant translate D (debt-GDP ratio) on to the

horizontal axis of the second quadrant. Associated with the level of debt and the relevant interest rate, the level of interest payments to GDP ratio can be indicated by the rectangles drawn using combinations of "d" and "i" in the second quadrant. Accordingly, vertical lines in this quadrant indicate interest payments for a given level of debt at varying interest rates. In this quadrant the level of primary expenditure (to GDP ratio) is also shown by a family of lines falling to the right. For any given level of revenue receipts to GDP ratio, primary expenditure would be lower, the higher is the interest payment to GDP ratio. To sustain growth at a certain level, certain minimum primary expenditure is needed, a reasonable part of which may be required in the form of capital expenditure.

Diagram 2.1

Public Debt Sustainability

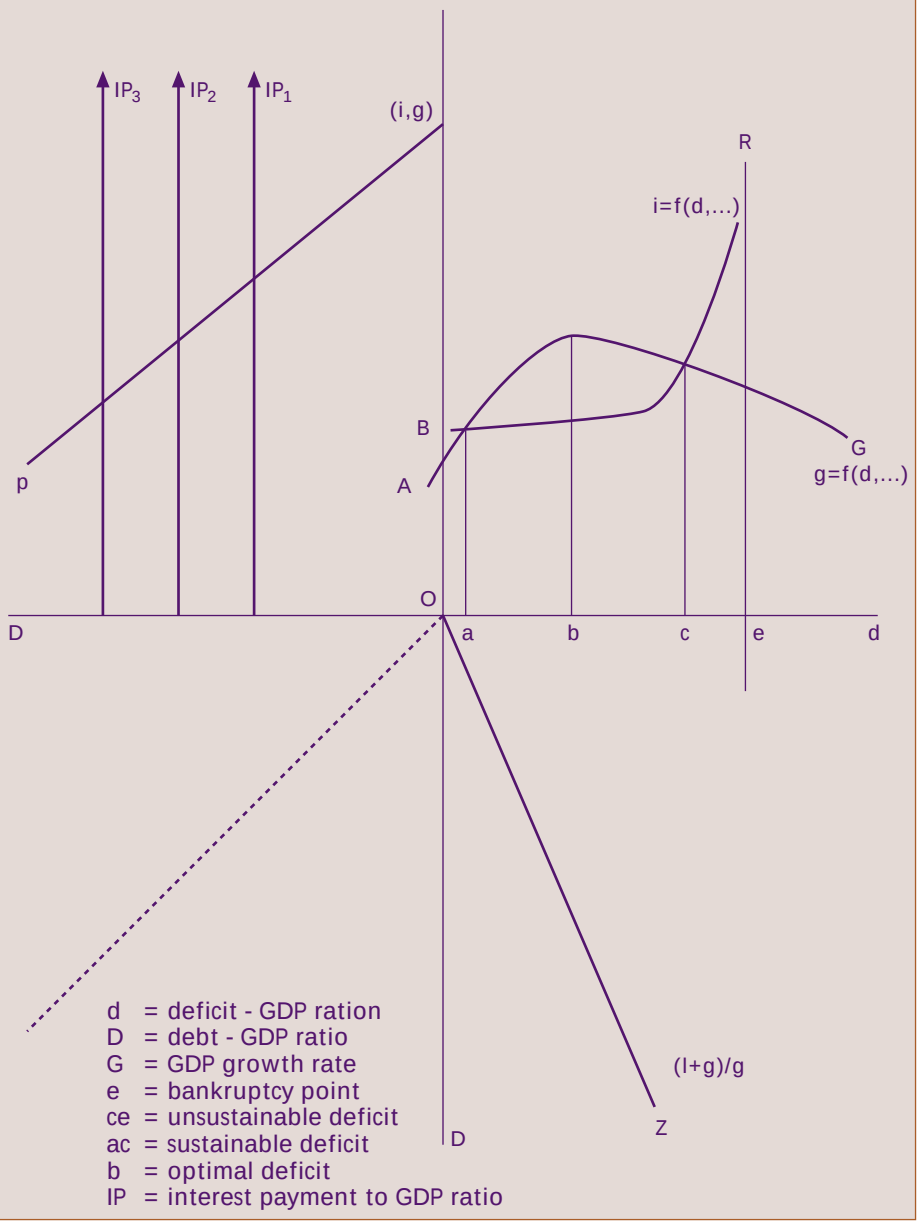

Table A2.1

Central Government: Fiscal Profile: 2000-01 to 2006-07

(Rs. Crores)

	Parameters	1999-00	2000-01
Corporation tax		29,915	37,978
Income tax		26,684	31,590
Customs		47,800	53,572
Union excise duties (basic)		61,000	71,252
Service tax		2,000	4,976
Other taxes		2,580	2,712
Gross tax revenue		1,69,979	2,02,081
Surcharges and cesses		11,316	12,463
Cost of collection	0.01	2,026	2,181
Shareable tax revenue		1,56,637	1,87,437
States share of taxes	0.295	43,510	54,060
Centre's net tax revenue		1,26,469	1,48,021
Non tax revenue		53,035	57,464
Revenue receipts (Net to Centre)		1,79,504	2,05,485
Expenditures: Non-plan		**2,04,904**	**2,28,768**
Interest payments	0.1	91,425	1,01,266
Pensions	0.1	14,304	15,843
Defence services	0.1	35,873	40,661
Other general services		12,516	13,260
Social services		6,900	6,187
Subsidies	0.1	25,692	22,800
Economic services		6,885	7,183
Non plan grants to states	0.05	6,582	17,676
Other non plan expenditure	0.05	4,727	3,892
Expenditures: Plan		**48,132**	**50,287**
Revenue Expenditure: Total		**2,53,036**	**2,79,055**
Capital expenditure (net of rep)		**50,702**	**57,389**
Total expenditure		**3,03,738**	**3,36,444**
Capital receipts		**1,24,234**	**1,34,814**
Recovery of loans	0.0733	12,736	13,539
Disinvestment		2,600	10,000
Fiscal deficit		1,08,898	107,420
Revenue deficit		73,532	73,570
Primary deficit		17,473	6,154
Outstanding debt		10,30,444	11,37,864
GDP		19,31,819	22,21,592
GDP growth rate (Real)			9.00
Price Deflator			5.50
GDP growth rate (Nominal)			15.00
Gross Tax Revenue:Targets		**8.80**	**9.10**
Growth Rate of Tax Revenues *(percent per annum)*			
Corporation tax	1.50	1.40	22.50
Income tax	1.45	1.35	21.75
Customs	1.10	1.00	16.50
Union excise duties(basic)	1.20	1.10	18.00
Other taxes	1.00	1.00	15.00

Source *(Basic Data): Report of the 11th Finance Commission & Central Budget 2000-01*

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Table A2.1

(Rs. Crores)

2001-02	2002-03	2003-04	2004-05	2005-06	2006-07
46,523	56,293	68,114	82,418	99,726	1,20,669
38,461	46,249	55,615	66,877	80,419	96,704
62,411	71,773	82,539	94,920	1,09,158	1,25,532
84,077	97,950	1,14,112	1,32,940	1,54,876	1,80,430
5,397	8,869	12,970	17,748	23,245	29,480
3,119	3,587	4,125	4,744	5,455	6,273
2,39,988	2,84,721	3,37,474	3,99,647	4,72,879	5,59,088
15,389	18,380	21,785	25,798	30,526	36,091
2,203	2,225	2,247	2,270	2,292	2,315
2,22,397	2,64,117	3,13,442	3,71,579	4,40,061	5,20,682
65,607	77,914	92,466	1,09,616	1,29,818	1,53,601
1,74,381	2,06,807	2,45,009	2,90,031	3,43,061	4,05,487
72,728	85,125	99,606	1,16,516	1,36,257	1,59,299
2,47,109	2,91,932	3,44,615	4,06,547	4,79,318	5,64,786
2,63,980	**2,94,613**	**3,29,495**	**3,69,487**	**4,15,704**	**4,69,612**
1,26,993	1,41,494	1,57,379	1,74,739	193,658	2,14,213
17,427	19,170	21,087	23,196	25,515	28,067
44,727	49,200	54,120	59,532	65,485	72,033
12,254	16,879	23,251	32,029	44,119	60,775
6,997	7,914	8,951	10,123	11,450	12,950
25,080	27,588	30,347	33,381	36,720	40,392
7,855	8,589	9,392	10,270	11,231	12,281
18,560	19,488	20,462	21,485	22,560	23,688
4,087	4,291	4,505	4,731	4,967	5,216
52,591	**61,224**	**70,238**	**79,317**	**87,911**	**95,173**
3,16,570	**3,55,837**	**3,99,733**	**4,48,804**	**5,03,616**	**5,64,786**
87,138	**1,06,699**	**1,30,478**	**1,59,307**	**1,94,173**	**2,36,244**
4,03,708	**4,62,535**	**5,30,211**	**6,08,111**	**6,97,788**	**8,01,030**
1,56,599	**1,70,603**	**1,85,596**	**2,01,564**	**2,18,471**	**2,36,244**
14,531	15,597	16,740	17,967	19,284	20,697
10,000	10,000	10,000	10,000	10,000	10,000
1,32,068	1,45,007	1,58,856	1,73,597	1,89,187	2,05,547
69,461	63,905	55,118	42,257	24,298	0
5,075	3,513	1,477	-1,142	-4,471	-8,666
12,69,932	14,14,939	15,73,795	17,47,392	19,36,579	21,42,126
25,54,831	29,38,055	33,78,764	38,85,578	44,68,415	51,38,677
9.00	9.00	9.00	9.00	9.00	9.00
5.50	5.50	5.50	5.50	5.50	5.50
15.00	15.00	15.00	15.00	15.00	15.00
9.39	**9.69**	**9.99**	**10.29**	**10.58**	**10.88**
22.50	21.00	21.00	21.00	21.00	21.00
21.75	20.25	20.25	20.25	20.25	20.25
16.50	15.00	15.00	15.00	15.00	15.00
18.00	16.50	16.50	16.50	16.50	16.50
15.00	15.00	15.00	15.00	15.00	15.00

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Table A2.2

Central Government: Fiscal Profile: 2000-01 to 2006-07

(per cent to GDP)

	Parameters	1999-00	2000-01
Taxes			
Corporation tax		1.55	1.71
Income tax		1.38	1.42
Customs		2.47	2.41
Union excise duties(basic)		3.16	3.21
Service tax		0.10	0.22
Other taxes		0.13	0.12
Gross tax revenue		8.80	9.10
Surcharges and cesses		0.59	0.56
Cost of collection	0.01	0.10	0.10
Shareable tax revenue		8.11	8.44
States share of taxes	0.295	2.25	2.43
Centre's net tax revenue		6.55	6.66
Non tax revenue		2.75	2.59
Revenue receipts (Net to Centre)		9.29	9.25
Expenditures: non-plan		**10.61**	**10.30**
Interest payments	0.1	4.73	4.56
Pensions	0.1	0.74	0.71
Defence services	0.1	1.86	1.83
Other general services		0.65	0.60
Social services		0.36	0.28
Subsidies	0.1	1.33	1.03
Economic services		0.36	0.32
Non plan grants to states	0.05	0.34	0.80
Other non plan expenditure	0.05	0.24	0.18
Expenditures: plan		**2.49**	**2.26**
Revenue Expenditure: Total		**13.10**	**12.56**
Capital expenditure(net of rep)		**2.62**	**2.58**
Total expenditure		**15.72**	**15.14**
Capital receipts		**6.43**	**6.07**
Recovery of loans	0.0733	0.66	0.61
Disinvestment		0.13	0.45
Fiscal deficit		5.64	4.84
Revenue deficit		3.81	3.31
Primary deficit		0.90	0.28
Outstanding debt		53.34	51.22
GDP (Rs.Crore)		1,931,819	2,221,592
GDP growth rate (Real)			9.00
Price Deflator			5.50
GDP growth rate (Nominal)			15.00
Gross Tax Revenue: Targets		**0.00**	**1.55**

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Source *(Basic Data): Report of the Eleventh Finance Commission & Central Budget 2000-01.*

Table A2.2

(per cent to GDP)

2001-02	2002-03	2003-04	2004-05	2005-06	2006-07
1.82	1.92	2.02	2.12	2.23	2.35
1.51	1.57	1.65	1.72	1.80	1.88
2.44	2.44	2.44	2.44	2.44	2.44
3.29	3.33	3.38	3.42	3.47	3.51
0.21	0.30	0.38	0.46	0.52	0.57
0.12	0.12	0.12	0.12	0.12	0.12
9.39	9.69	9.99	10.29	10.58	10.88
0.60	0.63	0.64	0.66	0.68	0.70
0.09	0.08	0.07	0.06	0.05	0.05
8.70	8.99	9.28	9.56	9.85	10.13
2.57	2.65	2.74	2.82	2.91	2.99
6.83	7.04	7.25	7.46	7.68	7.89
2.85	2.90	2.95	3.00	3.05	3.10
9.67	9.94	10.20	10.46	10.73	10.99
10.33	**10.03**	**9.75**	**9.51**	**9.30**	**9.14**
4.97	4.82	4.66	4.50	4.33	4.17
0.68	0.65	0.62	0.60	0.57	0.55
1.75	1.67	1.60	1.53	1.47	1.40
0.48	0.57	0.69	0.82	0.99	1.18
0.27	0.27	0.26	0.26	0.26	0.25
0.98	0.94	0.90	0.86	0.82	0.79
0.31	0.29	0.28	0.26	0.25	0.24
0.73	0.66	0.61	0.55	0.50	0.46
0.16	0.15	0.13	0.12	0.11	0.10
2.06	**2.08**	**2.08**	**2.04**	**1.97**	**1.85**
12.39	**12.11**	**11.83**	**11.55**	**11.27**	**10.99**
3.41	**3.63**	**3.86**	**4.10**	**4.35**	**4.60**
15.80	**15.74**	**15.69**	**15.65**	**15.62**	**15.59**
6.13	**5.81**	**5.49**	**5.19**	**4.89**	**4.60**
0.57	0.53	0.50	0.46	0.43	0.40
0.39	0.34	0.30	0.26	0.22	0.19
5.17	4.94	4.70	4.47	4.23	4.00
2.72	2.18	1.63	1.09	0.54	0.00
0.20	0.12	0.04	-0.03	-0.10	-0.17
49.71	48.16	46.58	44.97	43.34	41.69
2,554,831	2,938,055	3,378,764	3,885,578	4,468,415	5,138,677
9.00	9.00	9.00	9.00	9.00	9.00
5.50	5.50	5.50	5.50	5.50	5.50
15.00	15.00	15.00	15.00	15.00	15.00
3.11	**4.66**	**6.22**	**7.77**	**9.33**	**10.88**

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Table A2.3

State Government: Fiscal Profile: 2000-01 to 2006-07

(Rs. Crores)

	Parameters	1999-00	2000-01
Own Tax Revenues		1,02,168	1,22,607
Share in Central Taxes		44,789	54,060
Non-Tax Revenues		19,973	25,178
Grants		33,501	43,269
Potential Fiscal Transfers		78,290	97,329
Revenue Receipts		**2,00,431**	**2,45,114**
General Services		97,986	1,22,624
Interest Payment	0.11	44,397	64,197
Pension	0.1	22,188	24,407
Police	0.1	14,494	15,943
Election	0.1	1,120	1,232
Other General Services		15,787	16,845
Social Services		99,011	1,14,799
Education		56,826	65,933
Priority Education		25,525	31,508
Other Education		31,302	34,425
Medical & Public Health		12,482	15,247
Priority Health		3,376	5,232
Other Health		9,106	10,015
Family Welfare		2,326	2,558
Water Supply & Sanitation		5,563	7,070
Other Social Services		21,814	23,991
Economic Services		56,038	52,621
Irrigation		6,314	6,839
Roads & Bridges		4,244	6,405
Power		208	225
Transport		183	198
Others (Excl. Subsidies)		34,795	28,659
Identified Subsidies	0	10,294	10,294
C & A to Local Bodies	0.1932	4,555	5,435
Revenue Expenditure		**2,57,590**	**2,95,479**
Recovery	0.1626	5,900	6,859
Other Capital Receipts		0	0
Capital Receipts		5,900	6,859
Capital Exp. (Net of Rep.)		39,732	55,707
Revenue Deficit		57,159	50,365
Fiscal Deficit		90,991	99,212
Primary Deficit		46,594	35,016
Outstanding Debt		4,84,393	5,83,605
GDP		**19,31,819**	**22,21,592**

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Source *(Basic Data): Report of the Eleventh Finance Commissions*

Table A2.3

(Rs. Crores)

2001-02	2002-03	2003-04	2004-05	2005-06	2006-07
1,46,879	1,75,674	2,09,802	2,50,217	2,98,035	3,54,569
65,607	77,914	92,466	1,09,616	1,29,818	1,53,601
31,496	39,142	48,373	59,493	72,860	88,899
51,661	60,778	71,440	83,945	98,608	1,15,794
1,17,268	1,38,692	1,63,905	1,93,561	2,28,426	2,69,395
2,95,643	**3,53,508**	**4,22,080**	**5,03,270**	**5,99,321**	**7,12,863**
1,39,776	1,58,410	1,78,603	2,00,423	2,23,925	2,49,147
76,060	88,914	1,02,788	1,17,699	1,33,645	1,50,603
26,847	29,532	32,485	35,734	39,307	43,238
17,538	19,292	21,221	23,343	25,677	28,245
1,355	1,491	1,640	1,804	1,984	2,183
17,975	19,181	20,469	21,844	23,312	24,879
1,33,402	1,55,329	1,81,174	2,11,639	2,47,549	2,89,873
76,642	89,238	1,04,053	1,21,482	1,41,982	1,66,094
38,711	47,366	57,747	70,177	85,036	1,02,774
37,931	41,871	46,306	51,305	56,946	63,321
18,603	22,670	27,586	33,518	40,662	49,253
7,569	10,489	14,115	18,593	24,096	30,832
11,034	12,181	13,471	14,925	16,566	18,421
2,819	3,111	3,441	3,812	4,232	4,705
8,905	11,130	13,823	17,074	20,989	25,693
26,434	29,180	32,270	35,754	39,685	44,128
56,226	57,990	59,550	80,191	1,03,530	1,32,464
7,413	8,040	8,726	9,476	10,297	11,197
9,119	12,503	16,696	21,867	28,213	35,971
244	265	287	312	339	369
215	233	253	275	298	325
28,941	26,655	23,293	37,968	54,088	74,310
10,294	10,294	10,294	10,294	10,294	10,294
6,485	7,738	9,233	11,017	13,145	15,685
3,35,889	**3,79,466**	**4,28,559**	**5,3,270**	**5,88,150**	**6,87,170**
7,975	9,271	10,779	12,532	14,569	16,938
0	0	0	0	0	0
7,975	9,271	10,779	12,532	14,569	16,938
75,581	1,00,166	1,30,426	1,48,084	1,70,709	1,96,792
40,246	25,959	6,479	0	-11,171	-25,693
1,07,853	1,16,853	1,26,126	1,35,553	1,44,969	1,54,160
31,792	27,939	23,338	17,854	11,324	3,557
6,91,458	8,08,310	9,34,437	10,69,989	12,14,958	13,69,118
25,54,831	**29,38,055**	**33,78,764**	**38,85,578**	**44,68,415**	**51,38,677**

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Table A2.4

State Government: Fiscal Profile: 2000-01 to 2006-07

(per cent to GDP)

	Parameters	1999-00	2000-01
Own Tax Revenues		5.29	5.52
Share in Central Taxes		2.32	2.43
Non-Tax Revenues		1.03	1.13
Grants		1.73	1.95
Potential Fiscal Transfers		4.05	4.38
Revenue Receipts		**10.38**	**11.03**
General Services		5.07	5.52
Interest Payment	0.11	2.30	2.89
Pension	0.1	1.15	1.10
Police	0.1	0.75	0.72
Election	0.1	0.06	0.06
Other General Services		0.82	0.76
Social Services		5.13	5.17
Education		2.94	2.97
Priority Education		1.32	1.42
Other Education		1.62	1.55
Medical & Public Health		0.65	0.69
Priority Health		0.17	0.24
Other Health		0.47	0.45
Family Welfare		0.12	0.12
Water Supply & Sanitation		0.29	0.32
Other Social Services		1.13	1.08
Economic Services		2.90	2.37
Irrigation	0.1037	0.33	0.31
Roads & Bridges		0.22	0.29
Power	0.0862	0.01	0.01
Transport	0.091	0.01	0.01
Others (Excl. Subsidies)		1.80	1.29
Identified Subsidies	0	0.53	0.46
C & A to Local Bodies	0.1932	0.24	0.24
Revenue Expenditure		**13.33**	**13.30**
Recovery	0.1626	0.31	0.31
Other Capital Receipts		0.00	0.00
Capital Receipts		0.31	0.31
Capital Exp. (Net of Rep.)		2.06	2.51
Revenue Deficit		2.96	2.27
Fiscal Deficit		4.71	4.47
Primary Deficit		2.41	1.58
Outstanding Debt		25.07	26.27
GDP		**1,931,819**	**2,221,592**

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Source *(Basic Data): Report of the Eleventh Finance Commissions.*

Table A2.4

(per cent to GDP)

2001-02	2002-03	2003-04	2004-05	2005-06	2006-07
5.75	5.98	6.21	6.44	6.67	6.90
2.57	2.65	2.74	2.82	2.91	2.99
1.23	1.33	1.43	1.53	1.63	1.73
2.02	2.07	2.11	2.16	2.21	2.25
4.59	4.72	4.85	4.98	5.11	5.24
11.57	**12.03**	**12.49**	**12.95**	**13.41**	**13.87**
5.47	5.39	5.29	5.16	5.01	4.85
2.98	3.03	3.04	3.03	2.99	2.93
1.05	1.01	0.96	0.92	0.88	0.84
0.69	0.66	0.63	0.60	0.57	0.55
0.05	0.05	0.05	0.05	0.04	0.04
0.70	0.65	0.61	0.56	0.52	0.48
5.22	5.29	5.36	5.45	5.54	5.64
3.00	3.04	3.08	3.13	3.18	3.23
1.52	1.61	1.71	1.81	1.90	2.00
1.48	1.43	1.37	1.32	1.27	1.23
0.73	0.77	0.82	0.86	0.91	0.96
0.30	0.36	0.42	0.48	0.54	0.60
0.43	0.41	0.40	0.38	0.37	0.36
0.11	0.11	0.10	0.10	0.09	0.09
0.35	0.38	0.41	0.44	0.47	0.50
1.03	0.99	0.96	0.92	0.89	0.86
2.20	1.97	1.76	2.06	2.32	2.58
0.29	0.27	0.26	0.24	0.23	0.22
0.36	0.43	0.49	0.56	0.63	0.70
0.01	0.01	0.01	0.01	0.01	0.01
0.01	0.01	0.01	0.01	0.01	0.01
1.13	0.91	0.69	0.98	1.21	1.45
0.40	0.35	0.30	0.26	0.23	0.20
0.25	0.26	0.27	0.28	0.29	0.31
13.15	**12.92**	**12.68**	**12.95**	**13.16**	**13.37**
0.31	0.32	0.32	0.32	0.33	0.33
0.00	0.00	0.00	0.00	0.00	0.00
0.31	0.32	0.32	0.32	0.33	0.33
2.96	3.41	3.86	3.81	3.82	3.83
1.58	0.88	0.19	0.00	-0.25	-0.50
4.22	3.98	3.73	3.49	3.24	3.00
1.24	0.95	0.69	0.46	0.25	0.07
27.06	27.51	27.66	27.54	27.19	26.64
2,554,831	**2,938,055**	**3,378,764**	**3,885,578**	**4,468,415**	**5,138,677**

◄continued from previous page

Tax/GDP Trends in the 1990s and Future Prospects

Tax/GDP Trends in the 1990s and Future Prospects

Chapter 3

[1] Introduction

Chapter 2 has indicated the target levels of gross tax revenue, both for Centre and states separately for the terminal year of the Tenth Five Year Plan, 2006-07. While doing so, it has also indicated target levels for 2000-01 and 2001-02, the first two years of the award period of Eleventh Finance Commission (EFC) and each year of the Tenth Plan, 2002-07. Target levels have been indicated in relation to GDP[1] as well, with the latter slated to grow nominally at 15 percent per annum over 1999-2000 (New Series). The objective of this chapter is to examine these targeted tax/GDP levels in relation to historical trends as in evidence during 1989-2000.

Thus, the analysis covers the period from 1989-90 to 2000-07. The period 1989-90 to 1999-2000 relates to historical trends. For the Centre, tax figures for 1999-2000 relate to revised estimates. For the states, tax figures for 1998-99 and 1999-2000 relate to revised and budget estimates respectively. The year 1999-2000, which has been taken as the base year by EFC reports two different sets of tax figures, one relating to historical trend and the other as normatively assessed. However, normative assessment with regard to central taxes is the same as reported under historical trends. For 2000-01 and 2001-02, projections by EFC have been adjusted in light of the assumed nominal growth of GDP at 15 percent, which is higher than 13 percent assumed by EFC.

1 *GDP at market prices is used. Figures for GDP at market prices relate to the new series which, for the period 1993-94 to 1999-2000, are taken from the report of the EFC and thereafter grown at 15 percent per annum for the years that follow. For the period 1989-90 to1992-93, GDP figures (New Series) are obtained by multiplying the old series with a factor of 1.0577. The factor is obtained by averaging out the excess of GDP (New Series) over the old series for the years 1993-94, 1994-95 to 1996-97. Incidentally, a similar exercise is also performed by EFC for deriving GDP figures (Old Series) for 1997-98 to 1999-2000.*

For the Tenth Plan period, by using a simple tax/GDP model, as discussed in the previous chapter, a set of projections has been derived.

The design of this chapter is as follows. Section 2 examines tax/GDP ratios for the system as a whole as well as for Centre and states separately. Section 3 examines tax/GDP ratios for the Centre separated into customs, union excise, corporation tax and personal income tax. Section 4 examines tax/GDP ratios for the states as a whole separated into sales tax, state excises, stamps & registration duties, tax on motor vehicles, tax on goods & passengers, electricity duty, professional tax, land revenue and entertainment tax. Section 5 offers concluding observations.

[2] Gross Tax Collections of Centre and States

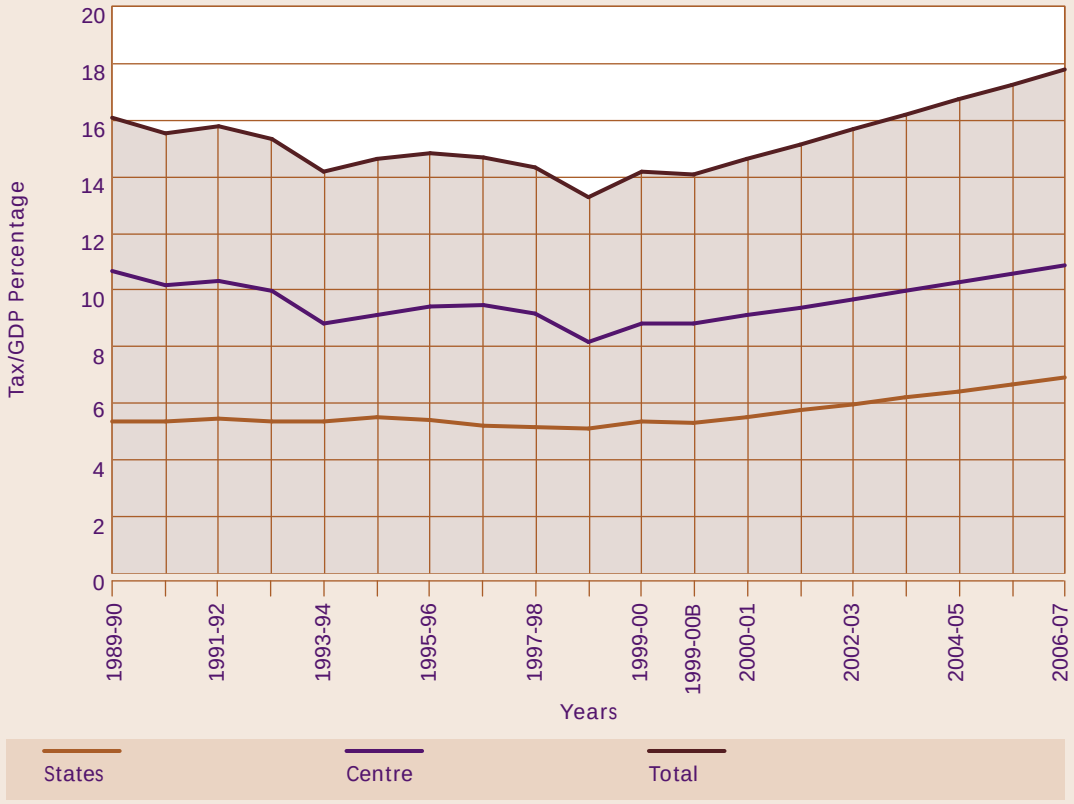
Total gross tax collections for the system as a whole in relation to GDP has come down by 1.89 percentage points from 16.07 percent in 1989-90 to 14.18 percent in 1999-2000. For the Centre, the reduction has been of the order of 1.89 percentage points from 10.69 percent to 8.80 percent and for the states, maintained at the level of 5.38 percent. While for the Centre, the decline has been steady, interspersed with few years of trend reversal, for the states the fluctuation has been within a narrow band of 0.30 percentage points. The declining ratio for the Centre has reduced its share in total tax collections from 66.5 percent in 1989-90 to 62.0 percent in 1999-2000. This is further borne out by differences in tax buoyancy, which (roughly calculated by dividing the average annual growth in tax revenues by the average annual growth in GDP) for the Centre stands at 0.85 and for the states at 1.00. Tax buoyancy for the system as a whole stands at 0.90 during the period 1989-90 to 1999-2000 (see Chart 3.1 and Tables A3.1 and A3.2).

As against this, the tax/GDP ratio is required to reach 17.78 percent in 2006-07, which is higher by 1.71 percentage points to what was attained in 1989-90 and by 3.69 percentage points to what is prescribed in the base year (1999-2000). As against the base year, for the Centre the required increase to meet the target level is 2.08 percentage points and for the states, 1.61 percentage points. In terms of buoyancy, it implies that during 2000-07, the Centre must achieve an average annual buoyancy of 1.24, states, 1.30 and the system as a whole, 1.26. While the increase in buoyancy for the entire system measures 0.36, for the Centre and states it stands at 0.39 and 0.30 respectively. However, this is still not good enough to increase the share of central taxes in total taxes which, between the base and terminal year, reduces by 1.30 percentage points.

Thus, it follows that though, in terms of relative efforts, the Group assigns a higher

Chart 3.1

Tax/GDP Trends 1989-2007 — Centre and States



responsibility to the Centre than to the states, the share of states in the gross collection of taxes in the terminal year increases with respect to the base year, thereby sustaining a secular decline in the share of central taxes as witnessed from historical trends. This is because notwithstanding a greater effort assigned to the Centre with respect to the base year 1999-2000, the final effort as projected in 2006-07 for the Centre exceeds the 1989-90 levels by a smaller amount as compared to the states.[2] If gross central tax revenues are to be restored to their 1989-90 share, the prescribed growth of central tax revenues by 2006-07 needs to be still higher. However, instead of doing that, Advisory Group has sought to focus more on state revenues, reflecting greater potential for generating higher tax revenue at the level of states.

The declining share of central tax revenues in total revenues together with an increasing share of states' share of central taxes has also implied that the Centre has been unable to strike a revenue account balance. In the projection made, Advisory Group has required a revenue effort by the Centre to arrive at a full revenue balance for the system as a whole, by 2006-07. In fact the revenue account for the entire system shows a surplus of 0.50 of GDP in the terminal year.

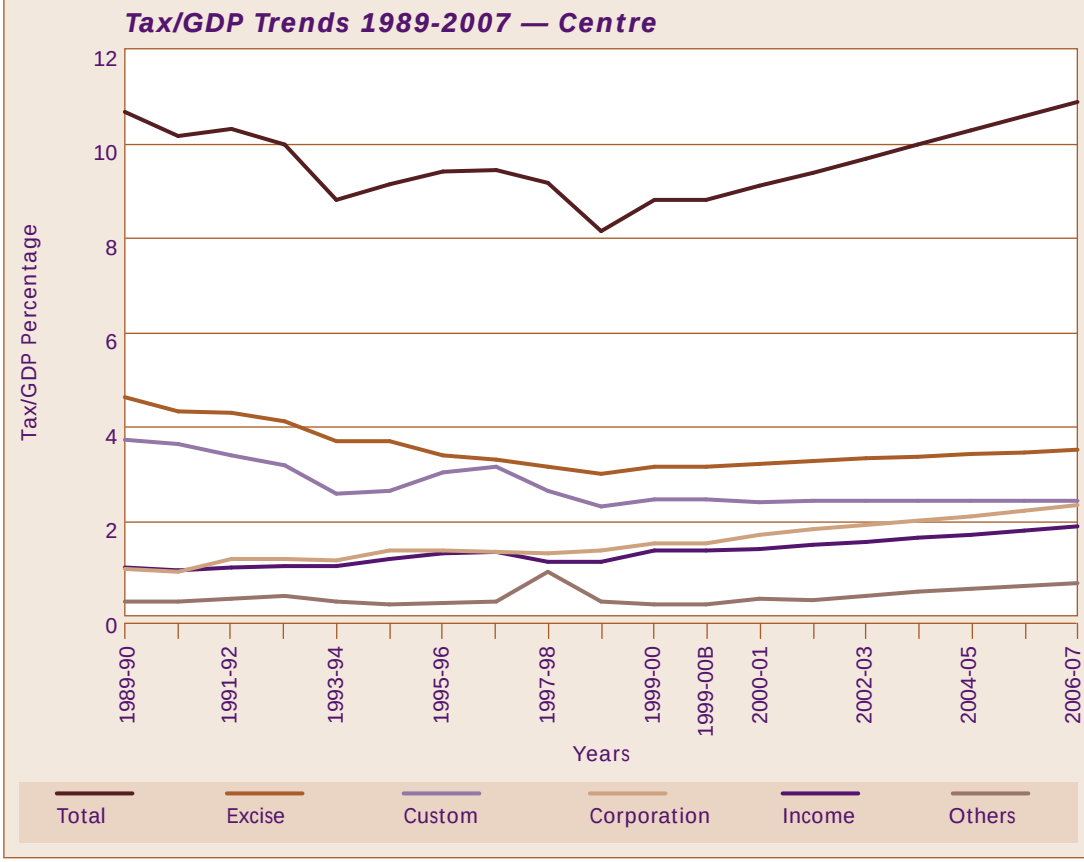
2 *This reflects the fact that the Centre's tax/GDP ratio fell between 1989-90 and 1999-2000.*

[3] Gross Tax Collection of Centre

In terms of tax/GDP ratios, the fastest growing central tax has been the corporation tax, which increased by 0.57 percentage points from 0.98 percent in 1989-90 to 1.55 percent in 1999-2000. Next to follow was personal income tax that increased by 0.34 percentage points from 1.04 percent to 1.38 percent during the same period. These growths were by and large steady. customs and union excise recorded declining trends. In relation to GDP, customs collections reduced by 1.26 percentage points from 3.73 percent in 1989-90 to 2.47 percent in 1999-2000 and union excises by 1.48 percentage points from 4.64 percent to 3.16 percent over the same period. Though a relatively better performance of corporation and income tax increased their combined weights in total central taxes from 18.9 percent in 1989-90 to 33.3 percent in 1999-2000, the combined weights of customs and union excise still remained higher despite reducing from 78.3 percent in 1989-90 to 64.0 percent in 1999-2000. Thus the combined reduction in customs and excises outweighed the enhancement in the corporation and personal income tax ratios to GDP. As a result, the overall central tax to GDP declined by 1.89 percentage points over the given period (see Chart 3.2 and Tables A3.3 and A3.4).

The improvement in the performance of corporation and personal income tax is perhaps explained by an increase in the number of assessees and better compliance

Chart 3.2



due to structural changes including reduction in the average and marginal tax rates. In fact a one-time Voluntary Disclosure Scheme (VDIS) in 1997-98, whose proceeds are included under the category "others" showed a significant jump thereby indicating a large potential for direct taxation. The below par performance of union excises is explained by lowering of rates and significant extension of the tax credit system under the MODVAT Scheme. The decline in the share of customs could be explained in terms of a steep decline in the highest rate and substantial reduction in the average effective rates. Indeed, a major reason for reduced revenue collection in both cases is that rate reductions were not accompanied by removal of concessions and exemptions. Since further reduction of custom tariffs and comprehensive extension of the tax credit system under the MODVAT-governed union excises are on the anvil, it would not be prudent to assign significant efforts to indirect taxation for the purpose of projecting the terminal year benchmarks.

As compared to base year estimates, customs have been assigned to decline by 0.03 percentage points of GDP from 2.47 percent to 2.44 percent, the latter being significantly lower than 3.73 percent achieved in 1989-90. However, union excises have been assigned a marginal growth of 0.34 percentage points from 3.16 percent in the base year to 3.51 percent in the terminal year, the latter again being significantly lower than 4.64 percent achieved in 1989-90. Corporation tax on the other hand has been assigned a significant jump of 0.80 percentage points from 1.55 percent in the base year to 2.35 percent in the terminal year, which is 50 percent more than the growth during the period 1989-2000. Personal income tax has also been treated similarly, being assigned a growth of 0.50 percentage points from 1.38 percent in the base year to 1.88 percent in the terminal year of the Tenth Plan.

Thus, an assignment of larger effort to direct taxes to almost one and one half times of 1989-2000 performance during the period 2000-07 and freezing the effort of indirect taxes to base year levels, increases the combined weight of corporation and personal income tax in total central taxes from 33.3 percent in the base year to 38.9 percent in the terminal year. The combined weight of customs and union excises reduces from 64.0 percent in the base year to 54.8 percent in the terminal year. However, the weight of "others" increases by two and a half times from 2.7 percent to 6.4 percent. In relation to GDP, the growth of "others" in fact trebles. The growth is entirely due to taxation of services, which reflects the proposed structural shift in tax policies that is expected to successfully bring in the yet neglected, highest and fastest growing share in GDP, into the tax net.

[4] Gross Tax Collection of States

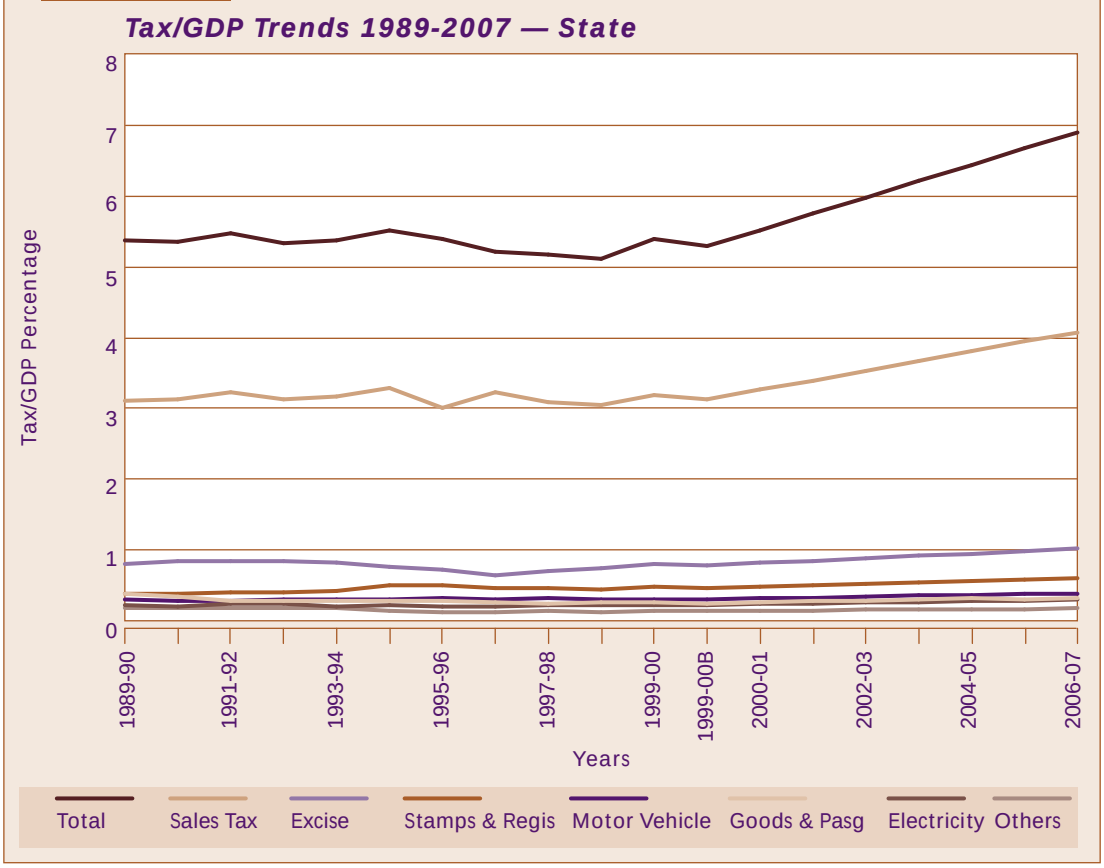
The performance of individual taxes under states' taxes has by and large been stable with negligible fluctuations on either side of the tax/GDP trend line. Sales tax and state excises, two major constituents of states' taxes only marginally increased their

weight in total states' taxes from 72.8 percent in 1989-90 to 74.00 percent in 1999-2000. Expectedly their ratios with respect to GDP also did not undergo significant changes, which for sales tax increased marginally from 3.12 percent in 1989-90 to 3.18 percent in 1999-2000. Excises followed a trend line of 0.80 percent, except for the period 1994-95 to 1996-97, where a declining trend could be explained by a policy of prohibition in a few states. However, performance of land revenue as a percentage to GDP, significantly deteriorated from 0.14 percent in 1989-90 to 0.08 percent in 1999-2000. This may be due to a major compositional shift in GDP from agriculture to services. The stagnancy of profession tax at 0.07 percent builds up a case for an extensive coverage of service taxation at the state level. (see Chart 3.3 and Tables A3.5 and A3.6)

Given the Advisory Group's base and terminal year benchmarks for state taxes consistent with the macro economic assumptions, pro-rata changes are effected on individual items of state taxes aggregated across all states and as obtained in 1999-2000 (historical trends). This builds up projections for the base year as well as the period of projection. As a result, inter-se weights of individual taxes as obtained in 1999-2000 (historical trends) get duplicated in the base year as well as each of the years of the period of projection.

Thus, sales tax and state excises that constitute 74 percent of total state taxes in 1999-2000 continue to be so in future as well. In relation to GDP, sales tax is projected to

Chart 3.3



increase from 3.12 percent in the base year to 4.07 percent in the terminal year. State excises are projected to increase from 0.78 percent to 1.02 percent. Stamps and registration from 0.47 percent to 0.61 percent. In combination, this is not infeasible in reflection of anticipated VAT reforms of states. The combined weights of the three taxes at 82.6 percent in 2006-07 have terminal year projections higher than what was achieved in 1989-90. This is consistent with the combined state tax effort projected at 6.90 percent in the terminal year exceeding 5.38 percent obtained in 1989-90 by 1.52 percentage points.

Terminal year benchmarks for sales tax and state excises in excess of what was achieved in 1989-90 may appear to be inconsistent with the understanding that the entire indirect tax structure, both for the Centre and states, is scheduled to graduate to VAT under which input tax credit would be comprehensively given. Thus, some reduction in tax collection could be expected unless final rates were appropriately adjusted upwards. However, this seemingly

Chart 3.4a

Composition of Gross Tax Collection 1989-90

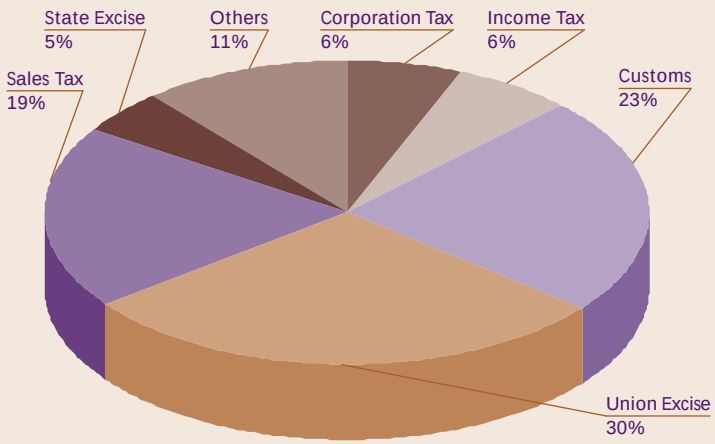


Chart 3.4b

Composition of Gross Tax Collection 1999-2000

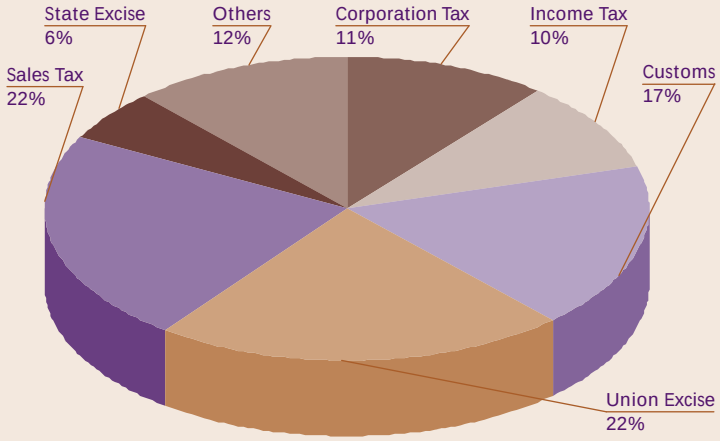
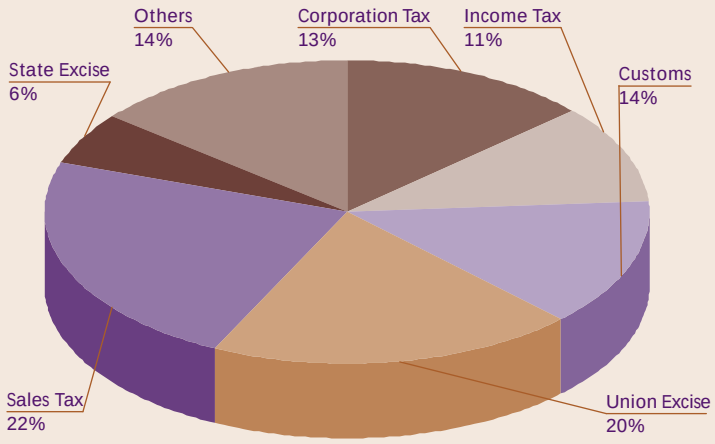


Chart 3.4c

Targeted Composition of Gross Tax Collection 2006-07



anomalous situation could be mitigated by extending the VAT beyond first point taxation. Currently sales tax in all states is primarily first point. Since value added at subsequent points is not taxed, it constitutes a good potential for augmenting the sales tax base which, if tapped successfully, could help achieve the benchmarks derived from our projections.

[5] Concluding Observations

For the system a whole, the share of union excises and customs in gross total tax collection has reduced from 30 percent and 23 percent respectively in 1989-90 to 20 percent and 14 percent respectively in 2006-07, a combined loss of 19 percent. On the flip side, the share of corporation tax, personal income tax, sales tax and state excises in gross total tax collection has increased from 6 percent, 6 percent, 19 percent points. and 5 percent respectively in 1989-90 to 13 percent, 11 percent, 22 percent and 6 percent respectively, a combined gain of 16 percent points. The balance 3 percent points gain has come from expansion of service taxes, which is reflected under "Others". "Others" would increase due to a larger contemplated coverage of services in the tax net. Thus, the loss of indirect taxes at the Centre is countered by the gain of direct taxes at the Centre, major taxes of states and service taxation. This shift in the tax composition has been in evidence in recent years and is expected to continue further to the terminal year projections for 2006-07 (See Chart 3.4a, 3.4b, 3.4c and Table A3.7). In line with this compositional change, the following policy stances emerge:

1 ***A concerted effort is required to tap the hitherto untapped potential under corporation and personal income tax as well as to target services as a tax base. Increasing the number of assessees, simplifying tax structure, reducing the tax burden to encourage compliance, and improving the efficiency of tax administration comprise thrust areas.***

2 ***A composite reduction of customs tariffs to internationally comparable levels for increased competition and global integration may be accommodated as projected growth in customs revenue in relation to GDP has been allowed to decline marginally with respect to the base year. A comprehensive central VAT may also be put in place in lieu of Union excise duties by eliminating any remaining cascading of input tax. A moderate growth of Union excise revenue as projected with respect to the base year should allow for this structural change.***

3 ***State governments hitherto slow in terms of raising tax revenue in relation to GDP must focus on two primary sources of revenue, sales tax and state excises. In this light, the intended adoption of a state VAT will provide an impetus to revenue collection, as value additions after the first point sales tax, thus far outside the tax base, would be fully tapped. Given a positive and significant growth assigned to sales tax and state excises, adoption of a state VAT at the level of states must be taken up on priority basis and at the earliest.***

Table A3.1

Gross Tax Collection of Centre and States

(Rs. Crores)

Year	GDP (Market Prices)	Tax Collections		
		Centre	States	Total
1989-90	4,83,180	51,636	25,995	77,631
% to GDP		**10.69**	**5.38**	**16.07**
Share % in Total		**66.51**	**33.49**	**100.00**
1990-91	5,66,434	57,576	30,345	87,921
% to GDP		**10.16**	**5.36**	**15.52**
Share % in Total		**65.49**	**34.51**	**100.00**
1991-92	6,52,388	67,361	35,756	1,03,117
% to GDP		**10.33**	**5.48**	**15.81**
Share % in Total		**65.32**	**34.68**	**100.00**
1992-93	7,46,649	74,637	39,868	1,14,505
% to GDP		**10.00**	**5.34**	**15.34**
Share % in Total		**65.18**	**34.82**	**100.00**
1993-94	8,59,220	75,743	46,087	1,21,830
% to GDP		**8.82**	**5.36**	**14.18**
Share % in Total		**62.17**	**37.83**	**100.00**
1994-95	10,09,906	92,294	55,735	1,48,029
% to GDP		**9.14**	**5.52**	**14.66**
Share % in Total		**62.35**	**37.65**	**100.00**
1995-96	11,81,961	1,11,224	63,865	1,75,089
% to GDP		**9.41**	**5.40**	**14.81**
Share % in Total		**63.52**	**36.48**	**100.00**
1996-97	13,61,952	1,28,762	71,102	1,99,864
% to GDP		**9.45**	**5.22**	**14.67**
Share % in Total		**64.42**	**35.58**	**100.00**
1997-98	15,15,646	1,39,221	78,289	2,17,510
% to GDP		**9.19**	**5.17**	**14.35**
Share % in Total		**64.01**	**35.99**	**100.00**
1998-99	17,62,609	1,43,797	90,221	2,34,018
% to GDP		**8.16**	**5.12**	**13.28**
Share % in Total		**61.45**	**38.55**	**100.00**
1999-2000	19,31,819	1,69,979	1,04,024	2,74,003
% to GDP		**8.80**	**5.38**	**14.18**
Share % in Total		**62.04**	**37.96**	**100.00**

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From 1993-94 to 1999-2000, GDP (MP) relates to the new series and is directly taken from the EFC report. From 1989-90 to 1992-93, for which new series is not available, old series GDP is multiplied by a factor of 1.0577. This factor is obtained by averaging out differences in old and new series for years, 1993-94 to 1996-97. EFC has also applied the same factor for converting new series to old for 1997-98 to 1999-2000. Tax collection of Centre in 1998-99 is actual and in 1999-2000, revised estimates. Tax collection of States in 1998-99 is revised estimates and in 1999-2000, budget estimates.

Table A3.2

Gross Tax Collection of Centre and States

◄continued from previous page

(Rs. Crores)

Year	GDP (MP)	Tax Collections		
		Centre	States	Total
1999-2000	19,31,819	1,69,979	1,04,024	2,74,003
% to GDP		**8.80**	**5.38**	**14.18**
Share % in Total		**62.04**	**37.96**	**100.00**
Advisory Group projections for 2000-07 using 1999-2000 as the base year				
1999-2000	19,31,819	1,69,979	1,02,168	2,72,147
% to GDP		**8.80**	**5.29**	**14.09**
Share % in Total		**62.46**	**37.54**	**100.00**
2000-01	22,21,592	2,02,081	1,22,607	3,24,688
% to GDP		**9.10**	**5.52**	**14.62**
Share % in Total		**62.24**	**37.76**	**100.00**
2001-02	25,54,831	2,39,988	1,46,879	3,86,867
% to GDP		**9.39**	**5.75**	**15.14**
Share % in Total		**62.03**	**37.97**	**100.00**
2002-03	28,38,055	2,84,721	1,75,674	4,60,395
% to GDP		**9.69**	**5.98**	**15.67**
Share % in Total		**61.84**	**38.16**	**100.00**
2003-04	33,78,764	3,37,474	2,09,802	5,47,276
% to GDP		**9.99**	**6.21**	**16.20**
Share % in Total		**61.66**	**38.34**	**100.00**
2004-05	38,85,578	3,99,647	2,50,217	6,49,864
% to GDP		**10.29**	**6.44**	**16.73**
Share % in Total		**61.50**	**38.50**	**100.00**
2005-06	48,68,415	4,72,879	2,98,035	7,70,914
% to GDP		**10.58**	**6.67**	**17.25**
Share % in Total		**61.34**	**38.66**	**100.00**
2006-07	51,38,677	5,59,088	3,54,569	9,13,657
% to GDP		**10.88**	**6.90**	**17.78**
Share % in Total		**61.19**	**38.81**	**100.00**

For the year 1999-2000, GDP figures pertaining to the new series has been taken from EFC report. On this an annual nominal growth of 15 % has been assumed to obtain figures up to 2006-07. Figures for tax revenues are obtained from the exercise conducted by the Advisory Group.

Table A3.3

Gross Tax Collection of Centre

(Rs. Crores)

Year	GDP (MP)	Tax Collections					
		Corp.	Income	Customs	Excise	Others	Total
1989-90	4,83,180	4,729	5,010	18,036	22,406	1,455	51,636
% to GDP		0.98	1.04	3.73	4.64	0.30	10.69
Share % in Total		9.16	9.70	34.93	43.39	2.82	100.00
1990-91	5,66,434	5,335	5,371	20,644	24,514	1,712	57,576
% to GDP		0.94	0.95	3.64	4.33	0.30	10.16
Share % in Total		9.27	9.33	35.86	42.58	2.97	100.00
1991-92	6,52,388	7,853	6,731	22,257	28,110	2,410	67,361
% to GDP		1.20	1.03	3.41	4.31	0.37	10.33
Share % in Total		11.66	9.99	33.04	41.73	3.58	100.00
1992-93	7,46,649	8,899	7,888	23,776	30,832	3,242	74,637
% to GDP		1.19	1.06	3.18	4.13	0.43	10.00
Share % in Total		11.92	10.57	31.86	41.31	4.34	100.00
1993-94	8,59,220	10,060	9,123	22,193	31,697	2,670	75,743
% to GDP		1.17	1.06	2.58	3.69	0.31	8.82
Share % in Total		13.28	12.04	29.30	41.85	3.53	100.00
1994-95	10,09,906	13,822	12,025	26,789	37,347	2,311	92,294
% to GDP		1.37	1.19	2.65	3.70	0.23	9.14
Share % in Total		14.98	13.03	29.03	40.47	2.50	100.00
1995-96	11,81,961	16,487	15,592	35,757	40,187	3,201	1,11,224
% to GDP		1.39	1.32	3.03	3.40	0.27	9.41
Share % in Total		14.82	14.02	32.15	36.13	2.88	100.00
1996-97	13,61,952	18,567	18,231	42,851	45,008	4,105	1,28,762
% to GDP		1.36	1.34	3.15	3.30	0.30	9.45
Share % in Total		14.42	14.16	33.28	34.95	3.19	100.00
1997-98	15,15,646	20,016	17,097	40,193	47,962	13,953	1,39,221
% to GDP		1.32	1.13	2.65	3.16	0.92	9.19
Share % in Total		14.38	12.28	28.87	34.45	10.02	100.00
1998-99	17,62,609	24,529	20,235	40,668	53,246	5,119	1,43,797
% to GDP		1.39	1.15	2.31	3.02	0.29	8.16
Share % in Total		17.06	14.07	28.28	37.03	3.56	100.00
1999-2000	19,31,819	29,915	26,684	47,800	61,000	4,580	1,69,979
% to GDP		1.55	1.38	2.47	3.16	0.24	8.80
Share % in Total		17.60	15.70	28.12	35.89	2.69	100.00

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Others essentially include service tax, tax on interest and own tax proceeds of Union Territories. However, in 1997-98 it also includes proceeds from VDIS amounting to Rs.9,799 crore (approximately). Figures for tax collection in 1999-2000 are revised estimates.

Table A3.4

Gross Tax Collection of Centre

◄continued from previous page

(Rs. Crores)

Year	GDP (MP)	Tax Collections					
		Corp.	Income	Customs	Excise	Others	Total
1999-2000	19,31,819	29,915	26,684	47,800	61,000	4,580	1,69,979
% to GDP		**1.55**	**1.38**	**2.47**	**3.16**	**0.24**	**8.80**
Share % in Total		**17.60**	**15.70**	**28.12**	**35.89**	**2.69**	**100.00**
Advisory Group projections for 2000-07 using 1999-2000 as the base year							
1999-2000	19,31,819	29,915	26,684	47,800	61,000	4,580	1,69,979
% to GDP		**1.55**	**1.38**	**2.47**	**3.16**	**0.24**	**8.80**
Share % in Total		**17.60**	**15.70**	**28.12**	**35.89**	**2.69**	**100.00**
2000-01	22,21,592	37,978	31,590	53,572	71,252	7,689	2,02,081
% to GDP		**1.71**	**1.42**	**2.41**	**3.21**	**0.35**	**9.10**
Share % in Total		**18.79**	**15.63**	**26.51**	**35.26**	**3.80**	**100.00**
2001-02	25,54,831	46,523	38,461	62,411	84,077	8,516	2,39,988
% to GDP		**1.82**	**1.51**	**2.44**	**3.29**	**0.33**	**9.39**
Share % in Total		**19.39**	**16.03**	**26.01**	**35.03**	**3.55**	**100.00**
2002-03	29,38,055	56,293	46,249	71,773	97,950	12,456	2,84,721
% to GDP		**1.92**	**1.57**	**2.44**	**3.33**	**0.42**	**9.69**
Share % in Total		**19.77**	**16.24**	**25.21**	**34.40**	**4.37**	**100.00**
2003-04	33,78,764	68,114	55,615	82,539	1,14,112	17,094	3,37,474
% to GDP		**2.02**	**1.65**	**2.44**	**3.38**	**0.51**	**9.99**
Share % in Total		**20.18**	**16.48**	**24.46**	**33.81**	**5.07**	**100.00**
2004-05	38,85,578	82,418	66,877	94,920	1,32,940	22,492	3,99,647
% to GDP		**2.12**	**1.72**	**2.44**	**3.42**	**0.58**	**10.29**
Share % in Total		**20.62**	**16.73**	**23.75**	**33.26**	**5.63**	**100.00**
2005-06	44,68,415	99,726	80,419	1,09,158	1,54,876	28,700	4,72,879
% to GDP		**2.23**	**1.80**	**2.44**	**3.47**	**0.64**	**10.58**
Share % in Total		**21.09**	**17.01**	**23.08**	**32.75**	**6.07**	**100.00**
2006-07	51,38,677	1,20,669	96,704	1,25,532	1,80,430	35,753	559,088
% to GDP		**2.35**	**1.88**	**2.44**	**3.51**	**0.70**	**10.88**
Share % in Total		**21.58**	**17.30**	**22.45**	**32.27**	**6.39**	**100.00**

"Others" significantly include service tax, which increases its weight as it approaches the terminal year of the Tenth Plan. Projections

Table A3.5

Gross Tax Collection of States

(Rs. Crores)

Year	Tax Collections			
	Prof-essonal	Land Revenue	Stamps & Reg.	Sales Tax
1989-90	360	690	1,845	15,060
% to GDP	**0.07**	**0.14**	**0.38**	**3.12**
Share %	**1.38**	**2.65**	**7.10**	**57.93**
1990-91	436	607	2,112	17,667
% to GDP	**0.08**	**0.11**	**0.37**	**3.12**
Share %	**1.44**	**2.00**	**6.96**	**58.22**
1991-92	443	636	2,654	21,064
% to GDP	**0.07**	**0.10**	**0.41**	**3.23**
Share %	**1.24**	**1.78**	**7.42**	**58.91**
1992-93	491	617	2,978	23,349
% to GDP	**0.07**	**0.08**	**0.40**	**3.13**
Share %	**1.23**	**1.55**	**7.47**	**58.57**
1993-94	543	732	3,555	27,301
% to GDP	**0.06**	**0.09**	**0.41**	**3.18**
Share %	**1.18**	**1.59**	**7.71**	**59.24**
1994-95	619	1,141	5,091	33,154
% to GDP	**0.06**	**0.11**	**0.50**	**3.28**
Share %	**1.11**	**2.05**	**9.13**	**59.49**
1995-96	681	1,326	5,898	35,477
% to GDP	**0.06**	**0.11**	**0.50**	**3.00**
Share %	**1.07**	**2.08**	**9.24**	**55.55**
1996-97	907	1,074	6,267	43,927
% to GDP	**0.07**	**0.08**	**0.46**	**3.23**
Share %	**1.28**	**1.51**	**8.81**	**61.78**
1997-98	904	1,091	7,026	46,813
% to GDP	**0.06**	**0.07**	**0.46**	**3.09**
Share %	**1.15**	**1.39**	**8.97**	**59.80**
1998-99	1,181	1,306	7,838	53,690
% to GDP	**0.07**	**0.07**	**0.44**	**3.05**
Share %	**1.31**	**1.45**	**8.69**	**59.51**
1999-2000	1,327	1,530	9,105	61,454
% to GDP	**0.07**	**0.08**	**0.47**	**3.18**
Share %	**1.28**	**1.47**	**8.75**	**59.08**

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Source *RBI report on State Finances, various states.*

Note *States includes only 25 States and not Union Territories. Union Territories stand included in the tax collection of Centre. Tax collections for 1998-99 relate to revised estimates and for 1999-2000, budget estimates.*

Table A3.5

◄continued from previous page

(Rs. Crores)

Tax Collections						
Excise	Motor Vehicle	Goods & Pasg	Electricity	Entert-ainment	Others	Total
3,864	1,415	905	1,084	428	344	25,995
0.80	**0.29**	**0.19**	**0.22**	**0.09**	**0.07**	**5.38**
14.86	**5.44**	**3.48**	**4.17**	**1.65**	**1.32**	**100.00**
4,795	1,566	1,062	1,185	431	484	30,345
0.85	**0.28**	**0.19**	**0.21**	**0.08**	**0.09**	**5.36**
15.80	**5.16**	**3.50**	**3.91**	**1.42**	**1.59**	**100.00**
5,439	1,837	1,136	1,596	349	602	35,756
0.83	**0.28**	**0.17**	**0.24**	**0.05**	**0.09**	**5.48**
15.21	**5.14**	**3.18**	**4.46**	**0.98**	**1.68**	**100.00**
6,265	2,194	1,278	1,748	464	484	39,868
0.84	**0.29**	**0.17**	**0.23**	**0.06**	**0.06**	**5.34**
15.71	**5.50**	**3.21**	**4.38**	**1.16**	**1.21**	**100.00**
7,106	2,583	1,480	1,726	522	539	46,087
0.83	**0.30**	**0.17**	**0.20**	**0.06**	**0.06**	**5.36**
15.42	**5.60**	**3.21**	**3.75**	**1.13**	**1.17**	**100.00**
7,747	3,081	1,483	2,242	447	730	55,735
0.77	**0.31**	**0.15**	**0.22**	**0.04**	**0.07**	**5.52**
13.90	**5.53**	**2.66**	**4.02**	**0.80**	**1.31**	**100.00**
8,516	3,726	1,508	2,377	440	3,916	63,865
0.72	**0.32**	**0.13**	**0.20**	**0.04**	**0.33**	**5.40**
13.33	**5.83**	**2.36**	**3.72**	**0.69**	**6.13**	**100.00**
8,805	4,117	1,663	2,718	606	1,018	71,102
0.65	**0.30**	**0.12**	**0.20**	**0.04**	**0.07**	**5.22**
12.38	**5.79**	**2.34**	**3.82**	**0.85**	**1.43**	**100.00**
10,756	4,749	1,996	3,194	665	1,095	78,289
0.71	**0.31**	**0.13**	**0.21**	**0.04**	**0.07**	**5.17**
13.74	**6.07**	**2.55**	**4.08**	**0.85**	**1.40**	**100.00**
13,156	5,204	2,091	3,854	680	1,221	90,221
0.75	**0.30**	**0.12**	**0.22**	**0.04**	**0.07**	**5.12**
14.58	**5.77**	**2.32**	**4.27**	**0.75**	**1.35**	**100.00**
15,459	5,903	2,677	4,424	743	1,402	1,04,024
0.80	**0.31**	**0.14**	**0.23**	**0.04**	**0.07**	**5.38**
14.86	**5.67**	**2.57**	**4.25**	**0.71**	**1.35**	**100.00**

Table A3.6

Gross Tax Collection of States

(Rs. Crores)

Year	Tax Collections			
	Prof-essonal	Land Revenue	Stamps & Reg.	Sales Tax
1999-2000	1,327	1,530	9,105	61,454
% to GDP	**0.07**	**0.08**	**0.47**	**3.18**
Share %	**1.28**	**1.47**	**8.75**	**59.08**
Advisory Group projections for 2000-07 using 1999-2000 as the base year				
1999-2000	1,328	1,533	8,991	60,279
% to GDP	**0.07**	**0.08**	**0.47**	**3.12**
Share %	**1.30**	**1.50**	**8.80**	**59.00**
2000-01	1,594	1,839	10,789	72,338
% to GDP	**0.07**	**0.08**	**0.49**	**3.26**
Share %	**1.30**	**1.50**	**8.80**	**59.00**
2001-02	1,909	2,203	12,925	86,659
% to GDP	**0.07**	**0.09**	**0.51**	**3.39**
Share %	**1.30**	**1.50**	**8.80**	**59.00**
2002-03	2,284	2,635	15,459	1,03,648
% to GDP	**0.08**	**0.09**	**0.53**	**3.53**
Share %	**1.30**	**1.50**	**8.80**	**59.00**
2003-04	2,727	3,147	18,463	1,23,783
% to GDP	**0.08**	**0.09**	**0.55**	**3.66**
Share %	**1.30**	**1.50**	**8.80**	**59.00**
2004-05	3,253	3,753	22,019	1,47,628
% to GDP	**0.08**	**0.10**	**0.57**	**3.80**
Share %	**1.30**	**1.50**	**8.80**	**59.00**
2005-06	3,874	4,471	26,227	1,75,841
% to GDP	**0.09**	**0.10**	**0.59**	**3.94**
Share %	**1.30**	**1.50**	**8.80**	**59.00**
2006-07	4,609	5,319	31,202	2,09,196
% to GDP	**0.09**	**0.10**	**0.61**	**4.07**
Share %	**1.30**	**1.50**	**8.80**	**59.00**

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Note *The Advisory Group has projected each State's tax revenue on an aggregate basis. In this table, however aggregate State tax revenue has been separated into various items in the same proportion as these obtain in 1999-2000. As such, inter-se shares of each tax item remain the same throughout the Tenth Plan period as well as 2000-01 and 2001-02.*

Table A3.6

◄continued from previous page

(Rs. Crores)

Tax Collections						
Excise	**Motor Vehicle**	**Goods & Pasg**	**Electricity**	**Entert-ainment**	**Others**	**Total**
15,459	5,903	2,677	4,424	743	1,402	1,04,024
0.80	**0.31**	**0.14**	**0.23**	**0.04**	**0.07**	**5.38**
14.86	**5.67**	**2.57**	**4.25**	**0.71**	**1.35**	**100.00**
Advisory Group projections for 2000-07 using 1999-2000 as the base year						
15,121	5,824	2,656	4,393	715	1,328	1,02,168
0.78	**0.30**	**0.14**	**0.23**	**0.04**	**0.07**	**5.29**
14.80	**5.70**	**2.60**	**4.30**	**0.70**	**1.30**	**100.00**
18,146	6,989	3,188	5,272	858	1,594	1,22,607
0.82	**0.31**	**0.14**	**0.24**	**0.04**	**0.07**	**5.52**
14.80	**5.70**	**2.60**	**4.30**	**0.70**	**1.30**	**100.00**
21,738	8,372	3,819	6,316	1,028	1,909	1,46,879
0.85	**0.33**	**0.15**	**0.25**	**0.04**	**0.07**	**5.75**
14.80	**5.70**	**2.60**	**4.30**	**0.70**	**1.30**	**100.00**
26,000	10,013	4,568	7,554	1,230	2,284	1,75,674
0.88	**0.34**	**0.16**	**0.26**	**0.04**	**0.08**	**5.98**
14.80	**5.70**	**2.60**	**4.30**	**0.70**	**1.30**	**100.00**
31,051	11,959	5,455	9,021	1,469	2,727	2,09,802
0.92	**0.35**	**0.16**	**0.27**	**0.04**	**0.08**	**6.21**
14.80	**5.70**	**2.60**	**4.30**	**0.70**	**1.30**	**100.00**
37,032	14,262	6,506	10,759	1,752	3,253	2,50,217
0.95	**0.37**	**0.17**	**0.28**	**0.05**	**0.08**	**6.44**
14.80	**5.70**	**2.60**	**4.30**	**0.70**	**1.30**	**100.00**
44,109	16,988	7,749	12,816	2,086	3,874	2,98,035
0.99	**0.38**	**0.17**	**0.29**	**0.05**	**0.09**	**6.67**
14.80	**5.70**	**2.60**	**4.30**	**0.70**	**1.30**	**100.00**
52,476	20,210	9,219	15,246	2,482	4,609	3,54,569
1.02	**0.39**	**0.18**	**0.30**	**0.05**	**0.09**	**6.90**
14.80	**5.70**	**2.60**	**4.30**	**0.70**	**1.30**	**100.00**

Table A3.7

Gross tax Collection of Centre & States 1989-2000 ...

(Rs. Crores)

Year	GDP (MP)	Tax Collections							
		Centre						States	
		Corp-ration	Income	Custom	Excise	Others	Total	Prof-essonal	Land Rev.
1989-90	4,83,180	4,729	5,010	18,036	22,406	1,455	51,636	360	690
% to GDP		0.98	1.04	3.73	4.64	0.30	10.69	0.07	0.14
Share %		6.1	6.5	23.2	28.9	1.9	66.5	0.5	0.9
1990-91	5,66,434	5,335	5,371	20,644	24,514	1,712	57,576	436	607
% to GDP		0.94	0.95	3.64	4.33	0.30	10.16	0.08	0.11
Share %		6.1	6.1	23.5	27.9	1.9	65.5	0.5	0.7
1991-92	6,52,388	7,853	6,731	22,257	28,110	2,410	67,361	443	636
% to GDP		1.20	1.03	3.41	4.31	0.37	10.33	0.07	0.10
Share %		7.6	6.5	21.6	27.3	2.3	65.3	0.4	0.6
1992-93	7,46,649	8,899	7,888	23,776	30,832	3,242	74,637	491	617
% to GDP		1.19	1.06	3.18	4.13	0.43	10.00	0.07	0.08
Share %		7.8	6.9	20.8	26.9	2.8	65.2	0.4	0.5
1993-94	8,59,220	10,060	9,123	22,193	31,697	2,670	75,743	543	732
% to GDP		1.17	1.06	2.58	3.69	0.31	8.82	0.06	0.09
Share %		8.3	7.5	18.2	26.0	2.2	62.2	0.4	0.6
1994-95	10,09,906	13,822	12,025	26,789	37,347	2,311	92,294	619	1,141
% to GDP		1.37	1.19	2.65	3.70	0.23	9.14	0.06	0.11
Share %		9.3	8.1	18.1	25.2	1.6	62.3	0.4	0.8
1995-96	11,81,961	16,487	15,592	35,757	40,187	3,201	1,11,224	681	1,326
% to GDP		1.39	1.32	3.03	3.40	0.27	9.41	0.06	0.11
Share %		9.4	8.9	20.4	23.0	1.8	63.5	0.4	0.8
1996-97	13,61,952	18,567	18,231	42,851	45,008	4,105	1,28,762	907	1,074
% to GDP		1.36	1.34	3.15	3.30	0.30	9.45	0.07	0.08
Share %		9.3	9.1	21.4	22.5	2.1	64.4	0.5	0.5
1997-98	15,15,646	20,016	17,097	40,193	47,962	13,953	1,39,221	904	1,091
% to GDP		1.32	1.13	2.65	3.16	0.92	9.19	0.06	0.07
Share %		9.2	7.9	18.5	22.1	6.4	64.0	0.4	0.5
1998-99	17,62,609	24,529	20,235	40,668	53,246	5,119	1,43,797	1,181	1,306
% to GDP		1.39	1.15	2.31	3.02	0.29	8.16	0.07	0.07
Share %		10.5	8.6	17.4	22.8	2.2	61.4	0.5	0.6
1999-2000	19,31,819	29,915	26,684	47,800	61,000	4,580	1,69,979	1,327	1,530
% to GDP		1.55	1.38	2.47	3.16	0.24	8.80	0.07	0.08
Share %		10.9	9.7	17.4	22.3	1.7	62.0	0.5	0.6

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Table A3.7

(Rs. Crores)

Tax Collections									
States									
Stamps & Reg.	Sales Tax	Excise	Motor Vehicle	Goods & Pasg	Elec-tricity	Entert-ainment	Others	Total	Total All
1,845	15,060	3,864	1,415	905	1,084	428	344	25,995	77,631
0.38	**3.12**	**0.80**	**0.29**	**0.19**	**0.22**	**0.09**	**0.07**	**5.38**	**16.07**
2.4	**19.4**	**5.0**	**1.8**	**1.2**	**1.4**	**0.6**	**0.4**	**33.5**	**100.0**
2,112	17,667	4,795	1,566	1,062	1,185	431	484	30,345	87,921
0.37	**3.12**	**0.85**	**0.28**	**0.19**	**0.21**	**0.08**	**0.09**	**5.36**	**15.52**
2.4	**20.1**	**5.5**	**1.8**	**1.2**	**1.3**	**0.5**	**0.6**	**34.5**	**100.0**
2,654	21,064	5,439	1,837	1,136	1,596	349	602	35,756	1,03,117
0.41	**3.23**	**0.83**	**0.28**	**0.17**	**0.24**	**0.05**	**0.09**	**5.48**	**15.81**
2.6	**20.4**	**5.3**	**1.8**	**1.1**	**1.5**	**0.3**	**0.6**	**34.7**	**100.0**
2,978	23,349	6,265	2,194	1,278	1,748	464	484	39,868	1,14,505
0.40	**3.13**	**0.84**	**0.29**	**0.17**	**0.23**	**0.06**	**0.06**	**5.34**	**15.34**
2.6	**20.4**	**5.5**	**1.9**	**1.1**	**1.5**	**0.4**	**0.4**	**34.8**	**100.0**
3,555	27,301	7,106	2,583	1,480	1,726	522	539	46,087	1,21,830
0.41	**3.18**	**0.83**	**0.30**	**0.17**	**0.20**	**0.06**	**0.06**	**5.36**	**14.18**
2.9	**22.4**	**5.8**	**2.1**	**1.2**	**1.4**	**0.4**	**0.4**	**37.8**	**100.0**
5,091	33,154	7,747	3,081	1,483	2,242	447	730	55,735	1,48,029
0.50	**3.28**	**0.77**	**0.31**	**0.15**	**0.22**	**0.04**	**0.07**	**5.52**	**14.66**
3.4	**22.4**	**5.2**	**2.1**	**1.0**	**1.5**	**0.3**	**0.5**	**37.7**	**100.0**
5,898	35,477	8,516	3,726	1,508	2,377	440	3,916	63,865	1,75,089
0.50	**3.00**	**0.72**	**0.32**	**0.13**	**0.20**	**0.04**	**0.33**	**5.40**	**14.81**
3.4	**20.3**	**4.9**	**2.1**	**0.9**	**1.4**	**0.3**	**2.2**	**36.5**	**100.0**
6,267	43,927	8,805	4,117	1,663	2,718	606	1,018	71,102	1,99,864
0.46	**3.23**	**0.65**	**0.30**	**0.12**	**0.20**	**0.04**	**0.07**	**5.22**	**14.67**
3.1	**22.0**	**4.4**	**2.1**	**0.8**	**1.4**	**0.3**	**0.5**	**35.6**	**100.0**
7,026	46,813	10,756	4,749	1,996	3,194	665	1,095	78,289	2,17,510
0.46	**3.09**	**0.71**	**0.31**	**0.13**	**0.21**	**0.04**	**0.07**	**5.17**	**14.35**
3.2	**21.5**	**4.9**	**2.2**	**0.9**	**1.5**	**0.3**	**0.5**	**36.0**	**100.0**
7,838	53,690	13,156	5,204	2,091	3,854	680	1,221	90,221	2,34,018
0.44	**3.05**	**0.75**	**0.30**	**0.12**	**0.22**	**0.04**	**0.07**	**5.12**	**13.28**
3.3	**22.9**	**5.6**	**2.2**	**0.9**	**1.6**	**0.3**	**0.5**	**38.6**	**100.0**
9,105	61,454	15,459	5,903	2,677	4,424	743	1,402	1,04,024	2,74,003
0.47	**3.18**	**0.80**	**0.31**	**0.14**	**0.23**	**0.04**	**0.07**	**5.38**	**14.18**
3.3	**22.4**	**5.6**	**2.2**	**1.0**	**1.6**	**0.3**	**0.5**	**38.0**	**100.0**

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... and Comparisons with Projections 2000-07

(Rs. Crores)

Year	GDP (MP)	Tax Collections							
		Centre						States	
		Corp-ration	Income	Custom	Excise	Others	Total	Prof-essonal	Land Rev.
1999-2000	19,31,819	29,915	26,684	47,800	61,000	4,580	1,69,979	1,328	1,533
% to GDP		**1.55**	**1.38**	**2.47**	**3.16**	**0.24**	**8.80**	**0.07**	**0.08**
Share %		**11.0**	**9.8**	**17.6**	**22.4**	**1.7**	**62.5**	**0.5**	**0.6**
2000-01	22,21,592	37,978	31,590	53,572	71,252	7,689	2,02,081	1,594	1,839
% to GDP		**1.71**	**1.42**	**2.41**	**3.21**	**0.35**	**9.10**	**0.07**	**0.08**
Share %		**11.7**	**9.7**	**16.5**	**21.9**	**2.4**	**62.2**	**0.5**	**0.6**
2001-02	25,54,831	46,523	38,461	62,411	84,077	8,516	2,39,988	1,909	2,203
% to GDP		**1.82**	**1.51**	**2.44**	**3.29**	**0.33**	**9.39**	**0.07**	**0.09**
Share %		**12.0**	**9.9**	**16.1**	**21.7**	**2.2**	**62.0**	**0.5**	**0.6**
2002-03	29,38,055	56,293	46,249	71,773	97,950	12,456	2,84,721	2,284	2,635
% to GDP		**1.92**	**1.57**	**2.44**	**3.33**	**0.42**	**9.69**	**0.08**	**0.09**
Share %		**12.2**	**10.0**	**15.6**	**21.3**	**2.7**	**61.8**	**0.5**	**0.6**
2003-04	33,78,764	68,114	55,615	82,539	1,14,112	17,094	3,37,474	2,727	3,147
% to GDP		**2.02**	**1.65**	**2.44**	**3.38**	**0.51**	**9.99**	**0.08**	**0.09**
Share %		**12.4**	**10.2**	**15.1**	**20.9**	**3.1**	**61.7**	**0.5**	**0.6**
2004-05	38,85,578	82,418	66,877	94,920	1,32,940	22,492	3,99,647	3,253	3,753
% to GDP		**2.12**	**1.72**	**2.44**	**3.42**	**0.58**	**10.29**	**0.08**	**0.10**
Share %		**12.7**	**10.3**	**14.6**	**20.5**	**3.5**	**61.5**	**0.5**	**0.6**
2005-06	44,68,415	99,726	80,419	1,09,158	1,54,876	28,700	4,72,879	3,874	4,471
% to GDP		**2.23**	**1.80**	**2.44**	**3.47**	**0.64**	**10.58**	**0.09**	**0.10**
Share %		**12.9**	**10.4**	**14.2**	**20.1**	**3.7**	**61.3**	**0.5**	**0.6**
2006-07	51,38,677	1,20,669	96,704	1,25,532	1,80,430	35,753	5,59,088	4,609	5,319
% to GDP		**2.35**	**1.88**	**2.44**	**3.51**	**0.70**	**10.88**	**0.09**	**0.10**
Share %		**13.2**	**10.6**	**13.7**	**19.7**	**3.9**	**61.2**	**0.5**	**0.6**

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Note *Advisory Group projections for 2000-07 using 1999-2000 as the base year.*

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Table A3.7

(Rs. Crores)

Tax Collections									
States									
Stamps & Reg.	Sales Tax	Excise	Motor Vehicle	Goods & Pasg	Elec-tricity	Entert-ainment	Others	Total	Total All
8,991	60,279	15,121	5,824	2,656	4,393	715	1,328	1,02,168	2,72,147
0.47	**3.12**	**0.78**	**0.30**	**0.14**	**0.23**	**0.04**	**0.07**	**5.29**	**14.09**
3.3	**22.1**	**5.6**	**2.1**	**1.0**	**1.6**	**0.3**	**0.5**	**37.5**	**100.0**
10,789	72,338	18,146	6,989	3,188	5,272	858	1,594	1,22,607	3,24,688
0.49	**3.26**	**0.82**	**0.31**	**0.14**	**0.24**	**0.04**	**0.07**	**5.52**	**14.62**
3.3	**22.3**	**5.6**	**2.2**	**1.0**	**1.6**	**0.3**	**0.5**	**37.8**	**100.0**
12,925	86,659	21,738	8,372	3,819	6,316	1,028	1,909	1,46,879	3,86,867
0.51	**3.39**	**0.85**	**0.33**	**0.15**	**0.25**	**0.04**	**0.07**	**5.75**	**15.14**
3.3	**22.4**	**5.6**	**2.2**	**1.0**	**1.6**	**0.3**	**0.5**	**38.0**	**100.0**
15,459	1,03,648	26,000	10,013	4,568	7,554	1,230	2,284	1,75,674	4,60,395
0.53	**3.53**	**0.88**	**0.34**	**0.16**	**0.26**	**0.04**	**0.08**	**5.98**	**15.67**
3.4	**22.5**	**5.6**	**2.2**	**1.0**	**1.6**	**0.3**	**0.5**	**38.2**	**100.0**
18,463	1,23,783	31,051	11,959	5,455	9,021	1,469	2,727	2,09,802	5,47,276
0.55	**3.66**	**0.92**	**0.35**	**0.16**	**0.27**	**0.04**	**0.08**	**6.21**	**16.20**
3.4	**22.6**	**5.7**	**2.2**	**1.0**	**1.6**	**0.3**	**0.5**	**38.3**	**100.0**
22,019	1,47,628	37,032	14,262	6,506	10,759	1,752	3,253	2,50,217	6,49,864
0.57	**3.80**	**0.95**	**0.37**	**0.17**	**0.28**	**0.05**	**0.08**	**6.44**	**16.73**
3.4	**22.7**	**5.7**	**2.2**	**1.0**	**1.7**	**0.3**	**0.5**	**38.5**	**100.0**
26,227	1,75,841	44,109	16,988	7,749	12,816	2,086	3,874	2,98,035	7,70,914
0.59	**3.94**	**0.99**	**0.38**	**0.17**	**0.29**	**0.05**	**0.09**	**6.67**	**17.25**
3.4	**22.8**	**5.7**	**2.2**	**1.0**	**1.7**	**0.3**	**0.5**	**38.7**	**100.0**
31,202	2,09,196	52,476	20,210	9,219	15,246	2,482	4,609	3,54,569	9,13,657
0.61	**4.07**	**1.02**	**0.39**	**0.18**	**0.30**	**0.05**	**0.09**	**6.90**	**17.78**
3.4	**22.9**	**5.7**	**2.2**	**1.0**	**1.7**	**0.3**	**0.5**	**38.8**	**100.0**

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Reform of Direct Taxes

Reform of Direct Taxes

Chapter 4

[1] Introduction

There has been a significant increase in direct tax revenue in terms of GDP during the 1990s. The budget of 1997-98 introduced a reduction of income tax rates to internationally comparable levels following the decades old practice of a very high rate structure. Nevertheless, there are many incentives that continue to exist within the prevailing structure. Given the need for direct tax revenues enunciated in Chapter 3, resource mobilisation through direct taxes should focus on base expansion, though selected other measures are also recommended, including the rationalisation of rates.

Our analysis and recommendations on direct taxes are based on the law as it existed prior to its amendment by the Finance Act, 2001. The recommendations in this chapter were sent to the government as part of our interim report for consideration during the 2001-02 budget exercise. Some of the proposals in the Finance Bill, 2001 like the abolition of surcharge, reduction of the dividend tax, withdrawal of exemption of interest in ECB, reduction in the amount of exemption u/s 80L are consistent with our recommendations. However, a large number of proposals in the Finance Bill, 2001 relating to further expansion in the scope of provisions relating to tax holidays for infrastructure, broadbased returns, internet services, power generations, transmission "disc" networks, developers of Special Economic Zones and Industrial Parks, tea industry and roll-out of capital gains it could seriously undermine the government's efforts to mobilise resources through direct taxes for the Tenth Plan and are therefore directly in conflict with the spirit of our recommendations.

[2] Rates of Personal Income Tax

The rates of tax are an important determinant of the compliance behaviour of taxpayers and hence revenue collection. These also affect the economic behaviour of taxpayers i.e. choice between work and leisure and the choice between consumption and savings. The design of the tax rate schedule—progressivity—also signals the re-distributive policy of government. Hence, the need to redesign a rate schedule which is equitable and efficient.

The principle of equity requires that a person with a higher income should pay a relatively higher proportion of his income as tax. This could be achieved by providing for a high basic exemption limit and/or high marginal rates of tax. However, a high basic exemption limit has the effect of keeping a large number of taxpayers outside the tax net. Therefore, it becomes necessary to provide for high marginal rates of tax with an objective of generating revenue. This, however, causes a relatively higher distortion in the economic behaviour of taxpayers and therefore, promotes inefficiency.

The equity of the tax schedule is also distorted if it imposes additional tax burden resulting from "bracket creep" of income due to inflation. This is because, an individual may be dragged into a higher tax bracket just because his nominal income has increased though his real income may have remained the same or even decreased. This phenomenon is also referred to as "fiscal drag". Accordingly, in designing the rate schedule it is important to ensure the following:

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 service 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 minimise distortions arising out of bracket creep;

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

Personal income tax rates in India were at their peak in 1973-74, with the exemption limit at Rs.5,000, the minimum marginal rates of tax at 10 percent, and the maximum marginal rate of tax rising to 85 percent spread over eleven tax slabs. Additionally there was also a surcharge at the rate of 10 percent in cases where the total income was below Rs.15,000 and at the rate of 15 percent in other cases. Therefore the “effective” maximum marginal statutory rate was 97.75 percent. The progressivity of the tax system was very high. This is measured by the variation of tax liability for different levels of taxable income. This coefficient of variation was then at a high of

1.06 (Table 4.1). Since then the progressivity of the tax rate schedule has declined substantially to 0.64 (Chart 4.1). Further, given the large number of tax slabs, the progressivity of the tax system was also distorted due to bracket creep. Clearly, the design of the tax rate schedule was neither economically efficient nor equitable, nor amenable to voluntary compliance.

Since then there has been a steady increase in the exemption limit, decrease in the maximum marginal rate of tax and reduction in the number of tax slabs. As a result, the design of the tax rate schedule has been made relatively more efficient. Since the

Table 4.1

Progressivity of the Personal Income Tax Schedule

Average tax Liability for Assumed Level of taxable Income at 1999-2000 prices

Fin. Year	Income Levels					
	50000	60000	75000	100000	120000	150000
1973-74	1.68	3.23	4.79	7.52	9.38	12.81
1974-75	2.21	4.04	6.12	8.72	10.75	13.83
1975-76	0.00	1.84	5.22	8.59	10.78	21.55
1976-77	0.00	1.63	4.60	7.58	9.57	12.38
1977-78	0.00	0.00	5.61	6.51	8.88	12.50
1978-79	0.00	0.00	5.99	6.98	9.26	13.03
1979-80	0.00	4.38	7.10	8.32	10.99	15.12
1980-81	0.00	0.00	7.57	7.24	10.52	14.76
1981-82	0.00	0.00	3.07	10.56	14.54	19.73
1982-83	0.00	0.00	5.29	12.22	16.23	21.52
1983-84	0.00	1.36	6.72	13.68	18.24	23.59
1984-85	0.00	2.70	7.01	12.96	17.10	11.34
1985-86	0.00	0.33	5.26	11.08	14.24	17.39
1986-87	0.00	2.04	6.63	12.40	15.33	18.27
1987-88	0.00	4.05	8.58	13.94	16.61	20.98
1988-89	1.71	5.59	10.16	15.12	17.60	22.52
1989-90	3.15	6.79	11.39	16.04	18.37	24.41
1990-91	4.26	7.77	12.22	16.66	19.78	23.82
1991-92	3.07	6.28	11.02	16.15	20.12	26.99
1992-93	4.67	8.51	12.81	18.39	21.99	25.59
1993-94	1.75	4.79	7.83	12.73	15.60	18.48
1994-95	0.00	2.30	5.84	10.28	13.56	16.85
1995-96	0.00	1.88	5.50	10.97	14.14	17.32
1996-97	0.10	3.42	6.78	12.59	15.49	18.44
1997-98	0.68	2.23	4.46	8.34	10.29	12.23
1998-99	0.00	1.30	4.68	8.51	10.43	12.34
1999-00	0.00	1.83	5.87	9.90	11.92	13.93
2000-2001	0.56	2.97	6.77	10.58	12.48	15.69
2001-2002	0.97	2.48	3.98	6.46	8.72	10.97

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number of tax slabs has been reduced substantially, the distortion in the equity of the schedule arising due to bracket creep has also been considerably minimised. And, there has been a steady decline in the progressivity of the schedule.

The decline in the progressivity over the years is partly due to the sharp reduction in the maximum marginal rate of tax and failure to adjust the tax slabs to inflation. For example, the exemption limit of Rs.5,000 in 1973-74 is equivalent to Rs.50,000 at current prices in 2001-2002. However, the exemption limit was increased to Rs.50,000 in 1998-99 itself i.e. 3 years in advance. Therefore, the increase in the exemption limit

Table 4.1

Average tax Liability for Assumed Level of taxable Income at 1999-2000 prices

Income Levels						Coefficient of
175000	200000	300000	500000	1000000	2000000	Variation
15.01	17.45	28.27	43.66	64.72	79.24	1.06
16.67	20.08	31.43	44.55	60.77	68.89	0.94
25.69	27.97	38.12	66.13	71.56	74.28	0.94
14.73	17.01	25.90	37.00	50.53	58.27	0.96
15.38	18.35	27.57	39.82	53.65	61.32	0.99
16.00	19.26	28.17	40.59	54.15	61.58	0.97
18.43	22.12	31.40	44.07	57.63	64.82	0.90
18.80	21.95	31.00	42.19	54.05	60.03	0.91
23.19	25.80	34.55	45.25	55.63	60.81	0.86
24.73	27.14	36.56	47.36	56.68	61.34	0.81
26.65	29.49	39.39	50.05	58.78	63.14	0.78
16.15	28.35	36.78	46.23	54.05	57.96	0.83
19.79	22.32	28.21	36.35	43.17	46.59	0.77
21.20	23.55	29.03	37.30	43.65	46.82	0.72
23.98	26.23	32.21	40.33	46.41	49.46	0.68
25.31	27.39	33.70	41.22	46.86	49.68	0.64
27.09	29.11	35.87	43.12	48.56	51.28	0.61
29.27	31.21	38.78	45.67	50.83	53.42	0.60
29.54	31.87	39.91	46.35	51.17	53.59	0.62
31.02	34.14	41.43	47.26	51.63	53.81	0.57
23.31	26.00	32.27	37.28	41.04	42.92	0.64
18.73	27.10	31.40	34.84	37.42	38.71	0.70
19.81	22.33	28.22	32.93	36.47	38.23	0.69
21.52	23.83	29.22	33.53	36.77	38.38	0.64
13.35	15.43	20.29	24.17	27.09	28.54	0.68
14.48	16.42	20.95	24.57	27.28	28.64	0.69
16.66	18.70	23.47	27.28	30.14	31.57	0.67
18.38	20.39	25.09	28.86	31.68	33.09	0.64
12.26	14.21	19.47	23.68	26.84	28.42	0.72

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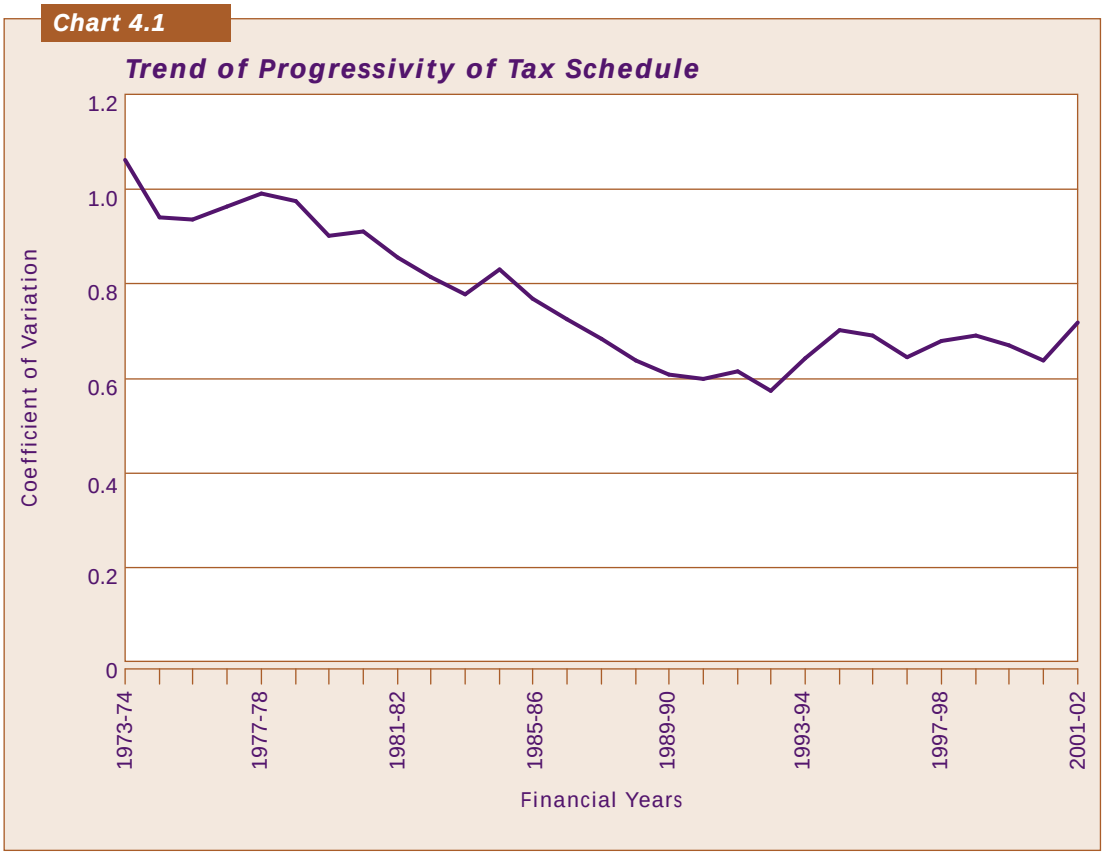
Chart 4.1



has out paced inflation.[1] The tax rates of 10 percent and 20 percent were applicable for incomes up to Rs.10,000 and Rs.20,000 respectively, in 1973-74. The inflation adjusted corresponding income levels are Rs.1,00,000 and Rs.2,00,000 in 2001-2002.[2] Contrast this with the existing corresponding income levels of Rs.60,000 and Rs.1,50,000 and these are substantially lower than the inflation-indexed levels thereby resulting in an increase in the real tax liability.

In view of the above, we recommend that the personal income tax rate schedule be revised along the lines indicated in Table 4.2.

This change will eliminate the current surcharge. In future, government must desist from imposing surcharge since these have the effect of increasing the marginal rates of tax which adversely affect compliance. The revenue gain from such discretionary changes is always illusory. In any case all such levies should only be through adjustment in the basic tax rates to avoid complexities in tax calculations.

The effect of this proposal will also be to broaden the base of the various slabs and

1 *However, this is not true for all years since exemption limit has not been adjusted for inflation on a year-to-year basis.*

2 *This is based on expected rate of inflation for 2000-2001 and 2001-2002, and then rounded off to the nearest '0000.*

Table 4.2

Proposed Personal Income Tax Structure

Income levels	Tax rates
Below 50000	Nil
50001—100000	10 percent of the income in excess of Rs.50,000
100001—200000	Rs.5,000 plus 20 percent of the income in excess of Rs.1,00,000
Above 200000	Rs.25,000 plus 30 percent of the income in excess of Rs.2,00,000

significantly reduce the adverse effect arising out of bracket creep due to inflation. Further, the proposed schedule will also enhance progressivity, as indicated in Table 4.1 between 2000-01 and 2001-02. The smaller taxpayers will be encouraged to declare higher incomes without being subjected to a higher marginal rate of tax. The impact on tax liability at different levels of taxable income will be as indicated in Table 4.3. Also, though the new schedule will result in revenue loss of Rs.6,000 crores at the current level of compliance, this theoretical revenue loss should be more than neutralised in reflection of an expected improvement in compliance due to the change in structure.

Table 4.3

Impact of Changes in Tax Schedule

Taxable Income	Existing Liability			New Liability			Relief
	Basic	Surcharge	Total	Basic	Surcharge	Total	
50,000	0		0	0	0	0	0
60,000	1,000		1,000	1,000	0	1,000	0
75,000	4,000	400	4,400	2,500	0	2,500	1,900
1,00,000	9,000	900	9,900	5,000	0	5,000	4,900
1,25,000	14,000	1,400	15,400	10,000	0	10,000	5,400
1,50,000	19,000	1,900	20,900	15,000	0	15,000	5,900
2,00,000	34,000	5,100	39,100	25,000	0	25,000	14,100
2,50,000	49,000	7,350	56,350	40,000	0	40,000	16,350
5,00,000	1,24,000	18,600	1,42,600	1,15,000	0	1,15,000	27,600

[3] Tax Base

[A] Widening of the Tax Base

At present, the Income Tax Act is riddled with tax concessions, which take the form of full or partial exemptions, deductions, and tax holidays (see Table A4.I). These concessions may have been justified in the era when the marginal tax rates were exorbitantly high. However, over the years the marginal tax rates have been steadily reduced substantially and we have recommended further reduction in both the personal tax rates and the corporate tax rates. It is therefore, 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.

Tax incentives are generally profit based and therefore their value depends on the size of the profit. The value of the incentive increases with the increase in profit. Arguably, they end up benefiting those who need the least. To this extent these are also inequitous. Accordingly, the bulk of the revenue foregone is likely to have no beneficial impact on the objective, which it seeks to serve and so the ratio of benefits to cost is likely to be low.

Tax incentives being profit based, encourage only those enterprise engaged in low risk activity. In fact, these are of little benefit to major capital-intensive projects, which have long gestation period and are not likely to make profit in the initial years.

Tax incentives by their very nature represent a revenue cost for the government. For the most part, this revenue cost is wasted because the incentives go to investments that would have been made in any event. It is argued that foreign/ domestic direct investment in countries in transition to a market oriented economy would not occur without the incentive, and so there is no real revenue cost. However, experience has shown that there is investment in short term, high profit projects. Because these projects would occur even if there were no tax incentives, the tax incentive is a pure windfall to them. Incentives have been subject to serious tax avoidance, which has added greatly to their revenue cost.

The revenue impact of tax incentives, in theory, is tied to new activity. Thus the revenue impact is generally low in the initial years but grows over time as more firms become eligible. Where buildup of unused deductions and losses are allowed it also reduces the predictability of the government's revenue stream. Firms, which do not expect to use their deductions in time, seek ways of transferring them to firms with current taxable income, often in the form of transactions that entailed a lower cost of financing for the tax deductions. Thus, the deductions earned in one sector reduced the taxable income of another. Loss trading mechanisms such as leasing are frequently used in this context.

Tax incentives introduce complexity into the tax system, because the rules themselves

are complex and because tax authorities react to the tax planning that inevitably results from their introduction by putting into place anti-avoidance measures. This complexity imposes costs on administrators and taxpayers and increases the uncertainty of the tax results. Uncertainty can deter the investment the incentives are intended to attract.

Tax incentives provide an extra challenge to tax administrators, who must first verify that the incentive has been applied correctly. Verification can be difficult if complex calculations are involved which is generally the case. Second, administrators must ensure, that the activity or firm actually qualifies for the incentive. This process can be complicated if concepts and definitions are vague or ambiguous. Third, tax officials must ensure that the amounts eligible for the incentive are correctly reported. The need to carry these assessments essentially to verify that no tax, or a reduced amount, is payable diverts resources from other administrative tasks, which can be ill afforded given the shortages of trained staff that exist in most developing countries. Hence, tax incentives are particularly burdensome for the tax administration.

A large number of tax incentives are discretionary and often entail some form of preapproval of the authorities. Approval process is generally time consuming and cumbersome. The authorities can obtain the detailed information necessary for evaluation only from companies that have an incentive to portray it in an advantageous manner. In the real world of politics it is difficult to deny the incentives to companies that are promising to create employment. Moreover, discretionary incentives are an invitation to corruption. Finally, an approval process undermines the tax system's transparency, which is probably the most important criterion of companies making the investments. For these reasons the track record of discretionary incentives is not encouraging.

The potential market and the low-cost labour is an attraction for investment in developing countries but other considerations inhibit large-scale investment, such as uncertainty in the policy stance of governments, political instability, and inadequate legal set-up. Further, to prospective investors, the general features of the tax system (tax base, tax rates etc) are more important than tax incentives. Taxpayers expect to be able to predict the tax consequences of their actions, which requires clear laws that are stable over time. In many developing countries, the tax laws are not clearly written and are subject to frequent revision, which makes long term planning difficult for business and adds to the perceived risk of undertaking major capital-intensive projects. The administration of the law is as important as the law itself, and it is clear that tax administrations in developing countries often have difficulty in coping with sophisticated investors, whether in providing timely and consistent interpretations of the law or in enforcing the law appropriately. Therefore, what is required is fundamental reform of the economic and institutional situation. Tax incentives attempt to overcome these handicaps thereby pushing fundamental reform to the background.

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.

Tax incentives are in the nature of subsidies and since most developing countries do not account for these as tax expenditures, they escape closer scrutiny of its effect both by public and parliament. Because of this, these are also perceived as politically easier alternative to expenditure of funds. Hence, tax incentives do not provide for a transparent fiscal management system.

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. These should be discouraged and wherever necessary political environment created to purge the tax statute of such incentives. 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.

The various incentives/deductions in the statute listed out in Appendix 4.1 can be broadly classified into the following:

1 Incentives for investment in financial assets
2 Incentives for encouraging external borrowings
3 Exemption/concessional treatment of perquisites
4 Incentives for industrial development
5 Incentives for export of goods and services
6 Incentives for social sector
7 Incentives for non-profit organisations
8 Incentives for regional development
9 Exemption for income of Funds
10 Exemption for remuneration from foreign sources
11 Other incentives.

Our recommendations are indicated in the Appendix 4.1. However, in the sections below we have also separately discussed some of these classes of exemptions.

[B] Incentives for Investment in Financial Assets

Conceptually, in contrast to an expenditure tax, the personal income tax includes savings in its base. 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. Therefore, in effect, the decision to save is also determined by the marginal rate of personal income tax. Hence, income tax is sometimes said to comprise a disincentive against savings. However, this

theoretical under-pinning does not necessarily find support in available empirical evidence which indicates that given the pre-tax rate of return, taxation or exemption from taxation have no significant effects on savings.

Nevertheless, in India, like many other countries, tax relief is provided for savings in specified assets. It is provided in the form of tax credit on savings in the form of such assets. Tax credit is government by Section 88, deductions are covered by Section 80L, and exemptions are allowed under Sections 10(11) and 10(15) of the Income Tax Act 1961. In addition, under certain specific schemes, tax relief is also allowed as deduction of savings from taxable income under Chapter VIA and exemption from long term capital gains tax. In general, assets in incentive schemes are totally exempt from wealth tax.

[i] Section 88

Since 1968-69, incentives took the form of exemption to whole or part of the fund out of current income invested in specified financial assets subject to monitoring limits. This provision was contained in Section 80C of the Income Tax Act. It covered funds saved or set-aside for fairly long periods of time in life insurance policies, deferred annuity policies, provident funds superannuation funds and 10 years or 15 years cumulative time deposits with post offices. In other words, the relief was granted at the marginal rate of tax applicable to the taxpayer.

Subsequently, scope of the provision was also enlarged by the inclusion of investments in National Savings Certificates VI and VII issues (with effect from the assessment year 1983-84). Later, from assessment year 1988-89 the scope of the provision was further enlarged to provide that payments, upto a maximum of Rs.10,000 per year, made towards cost of purchase or construction of a new residential house property, would also qualify for deduction. This deduction was available for payments made towards any installment or part payment of the amount due under any self financing or other scheme of any development authority, housing board, etc., or to a company or co-operative society of which the taxpayer is a member. The deduction was also allowed for repayment of amounts borrowed from the government, any bank, LIC and certain other categories of institutions engaged in carrying on the business of providing long term finance for construction or purchase of houses in India. The overall limit and the proportion of the qualifying amount entitled to deduction remained unchanged. The amount eligible and permissible for deduction u/s 80C (at the time of its removal from statute) was Rs.40,000 and Rs.20,200 respectively. A higher eligible limit of Rs.60,000 was provided for authors, playwrights, artists, actors, musicians or sportsmen and the maximum permissible deduction in their case worked out to Rs.28,200.

From assessment year 1991-92, the existing Section 88 replaced the incentive provisions under Section 80C. Under the new scheme the taxpayer was allowed a rebate of 20 percent of the investment in the forms specified in Section 80C. The

rate of the tax rebate was determined at the minimum marginal rate of personal income tax then prevailing.

The scope of Section 88 has been expanded continuously since then (Appendix 4.2). Further, the amount of tax rebate has also increased from Rs.10,000 (w.e.f. assessment year 1991-92) to Rs.12,000 (w.e.f. assessment year1993-94), to Rs.14,000 (w.e.f. assessment year 1997-98) to Rs.16,000 from assessment year 2001-02. The rate at which the tax rebate is calculated continuous to be twenty percent even though the minimum marginal rate of tax has reduced to ten percent.

[ii] Section 80L

Section 80L was introduced by the Finance Act, 1967, originally with a view to encouraging investments in the shares of Indian companies and, perhaps, also to mitigating the double taxation of dividends for the smaller shareholders. The Finance Act, 1970 substantially enlarged the scope of this Section by including government securities, debentures issued by specified co-operative societies or institutions, investments in units of the UTI, deposits with banking companies or co-operative banks and deposits with financial corporations engaged in providing long-term finance for industrial development. The scope of Section 80L was also increased by the inclusion of interest on National Savings Certificates (VI, VII and VIII issues), and bonds issued by certain public sector undertakings carrying interest generally at the rate of 13 per cent or more. However, from assessment year 1998-99, the exemption for dividend income has been taken out of the purview of Section 80L since the whole of the dividend income is now exempt in the hands of the shareholders. Therefore the very rationale for introducing the provision ceases to exist.

At present, the amount of deduction permitted under Section 80L is Rs.12,000 with an additional separate deduction of Rs.3,000 for income from government securities. The maximum deduction available under Section 80L is, therefore, Rs.15,000. The same has now been reduced to Rs.12,000 by the Finance Act, 2001.

[iii] Savings of capital gains

Sections 54, 54B, 54D, 54EA,and 54EB of the Income Tax Act provide for deduction from income if capital gains from specified sources are invested in certain forms of investment/assets.

[iv] Other savings incentives

Apart from these major incentives for savings, the statute also provides for unlimited exemption of income from investment under the various provisions of Section 10. Similarly, deductions from income are also allowed under sections 80CCC, 80D, 80DD, 80DDB, and 80E for specified investment.

[v] Evaluation

The wide array of savings oriented tax incentives under the Income Tax Act is depicted in Appendix 4.2. The scope of the incentives to savings under the income tax has been gradually enlarged over the years. The limits on permissible investments and eligible deductions have also been raised. The general intent of the scheme is to encourage the disposition of savings in forms readily accessible to the government/public sector companies. However, it can be said that most of the concessions were introduced on an ad hoc basis from time to time without adequate examination of the total impact of the different schemes put together. Taken as a whole, the scheme does not seem to satisfy or fit in with any definite set of principles.

(a) Impact on efficiency

1 While investment (or saving) under Section 88 is rewarded, disinvestment (dissaving) is not brought under charge. The incentives are available not necessarily for saving but also for mere diversion of funds from one form of investment to another and that too for mere locking up of 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 dissavings remain untaxed. Therefore, there is a bias in favour of investment in short term instruments. To this extent, it creates serious distortions in the allocation of savings. The tax rebate, for repayment of installments of housing loans made by taxpayers to specified institutions encourages debt as against "equity" financing. This increases the transaction cost in the economy and is therefore wasteful.

2 In any scheme of incentives for savings, it is desirable that the investments which are being encouraged should have broadly similar rates of return. Any variation in the rates should only be on account of differences in the holding period, risk or some overriding considerations of priority for particular sectors. While the major consideration behind the 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 rates 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 delinking rates of return from holding periods, the public sector crowds out the private sector through offers of quick and perceptibly safer returns. To the extent there is wasteful use of resources by the public sector, such incentives exacerbate waste.

3 Deduction of net investment and allowing deduction of income from such investment are broadly equivalent in that each is sufficient to achieve treatment of saving as under a proportional expenditure tax. Yet assets such as National Savings Certificates and provident funds enjoy both deductibility of investment (under Section 88) and of interest earnings (under Sections 80L and 10(11) or 10(12) respectively). This leads to inordinately high effective

rates of return to these assets (Table 4.4). 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 Finally, 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 The granting of exemption 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 that 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 bond and other instruments, income from which is exempt from income tax without any limit, as is the case under Section 10 of the Income Tax Act, leads to unjustified distortion.

Table 4.4

Rates of Return for Selected Assets with & Without Tax Concessions

	Holding Period	Relief u/s 10/80L/88	Types of return	Marginal Income tax rate 0.0	10.0	22.0	34.5
National Savings Certificate (VIII)	6	88, 80L	A	11.50	17.47	20.16	24.01
			N	11.50	10.35	8.97	7.53
Public Provident Fund	15	88, 80L	A	11.00	14.07	16.24	19.33
			N	11.00	9.90	8.58	7.21
Unit Linked Insurance Plan	15	88, 80L	A	14.25	17.74	20.46	24.37
			N	14.25	12.83	11.12	9.33
Post Office Time Deposit Account	3	80L	A	11.00	12.22	14.10	16.79
			N	11.00	9.90	8.58	7.21
Post Office Time Deposit Account	5	80L	A	11.50	12.78	14.74	17.56
			N	11.50	10.35	8.97	7.53
Indira Vikas and Kisan Vikas Patra	5.5		A	13.43	13.43	13.43	13.43
			N	13.43	12.09	10.48	8.80
Financial Institutions Bonds	3		A	10.00	10.00	10.00	10.00
			N	10.00	9.00	7.80	6.55
Financial Institutions Bonds	5		A	11.00	11.00	11.00	11.00
			N	11.00	9.90	8.58	7.21

Note *A refers to actual, N refers to no concessions.*

(b) Impact on equity

1 One consequence of the present scheme is that where the concessions take the form of deduction from income as in the case of Section 10, Section 80L and the provisions relating to roll-over of capital gains tax, they 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.

2 The provisions discriminate between taxpayers and non-taxpayers in as much as the rates of return are significantly lower for non-taxpayers.

3 To the extent exemption is allowed for roll over of capital gains, the scheme is biased in favour of taxpayers with income from 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 roll over provisions are biased in favour of the rich thereby distorting the vertical equity of the tax structure.

4 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 any meaningful taxpayer education and assistance program by the tax administration. Appendix 4.1 is indicative of the complexity and, therefore, the likelihood of uneven information regarding many incentives.

5 The tax rebate for repayment of installments of housing loans made by taxpayers to specified institutions tends to favour the richer taxpayers since the incentive can, in addition, be subjected to the criticism that it discriminates against both those who build houses out of taxed savings and others who are forced to borrow from private sources on account of circumstances beyond their control (their areas are not served by housing finance institutions or they cannot put up the necessary security or collateral and are not government servants). Further, the manner in which the concessions for savings are offered tends to favour the richer tax payers.

Our recommendations are as follows:

1 Given the distortionary effects on both efficiency and equity of the tax system, and the restructuring of the tax rate schedule proposed, abolition of tax incentives under Sections 80CCC, 88, 80L,and 10(15) of the Income Tax Act is recommended.

2 The tax concessions under Sections 80D, 80DD, 80DDB and 80E of the Income Tax Act should be given in the form of tax credit rather than in the form of

deductions for savings/investment. The rate of tax credit should be restricted to 10 percent, being the minimum marginal rate of personal income tax. The rebate should be further subjected to a ceiling equal to ten percent of the maximum investment permissible under the respective provisions.

3 Since the computation of capital gains provides for inflation adjustment of cost of the asset and relief from higher marginal rate of tax due to bunching of gains (it is taxed at 20 percent), the roll over provisions under Sections 54, 54B, 54D, 54EA,and 54EB of the Income Tax Act should be done away with.

The proposals have the effect of reducing distortions, improving equity and enabling better compliance. Further, they also expand the tax base and result in an increase in tax revenue to the extent of Rs.7,700 crores according to estimates. However, this does not take into account the impact of the changes through the Finance Act, 2001. To this extent, the revenue loss is overestimated.

[C] Incentives for External Borrowings

Section 10 of the Income Tax Act provides a large number of exemptions in respect of interest paid on foreign borrowings, whether from non-resident Indians or other foreign entities. These exemptions have been listed in Appendix 4.1.

The purpose of these deductions is ostensibly to mobilise external debt at a concessional rate. However, it is doubtful whether the tax concession in effect fulfils this objective. The interest received by the lender is liable to tax in the country of his residence[3]. To the extent the interest payment is taxed in the host country, the tax so paid is allowed to be credited against the tax liability in the country of residence. Therefore, any exemption from tax liability in the host country does not benefit the lender in any way. Hence, it is unlikely that the lender would cut interest rate on such lending. In fact, the result is that the host country loses tax revenue without the benefit of lower interest burden.

Further, these exemptions may have been justified when the tax rates in India were relatively higher than those in the lender's country of residence. As a result, the lender could not have availed credit for the full amount of taxes paid in India. However, with tax rates having been reduced substantially, such possibility ceases to exist.

In view of the above, we recommend that all such provisions as listed in Appendix 4.I should be deleted. The Finance Act, 2001 proposes to withdraw this exemption for interest on external commercial borrowings on or after June 1, 2001.

3 This is so only in cases where there is no tax treaty or the tax treaty does not provide for tax sparing. The Indian tax treaty with USA, Germany, and Italy do not provide for tax sparing. The Indian treaties with UK, France, Singapore and Australia provide for tax sparing in respect of this incentive. However, since the bulk of the external commercial borrowing is from USA, our analysis holds good.

[D] Exemption for Income of Funds

At present, Section 10 of the Income Tax Act provides for exemption of income of various Funds. This exemption is provided on the premise that the Funds are mere conduits through which income flows ultimately to the beneficiaries. Accordingly, tax liability, if any, is fully borne by the beneficiaries. However, another alternate model for taxation of income of the Funds is to tax the income in the hands of the fund but exempt the same from further taxation in the hands of thousands of beneficiaries. This is administratively more simple but considerably inequitous in as much as all beneficiaries bear the same tax liability irrespective of their individual marginal rates of tax.

In India, the income of the funds is exempted both in the hands of the Fund as well as in the hands of the beneficiary. The only economic rationale for such double exemptions could be the appropriative high rates of tax then prevailing. With marginal rates of tax having been reduced substantially over the years, this rational ceases to exist.

In view of the above and keeping in view the ease of administration we recommend that the income of the funds (other than mutual funds) should be taxed in the hands of the funds while the beneficiaries should continue to enjoy the exemption. However, since most beneficiaries of the funds covered in Section 10 of the Income Tax Act would be relatively smaller taxpayers, the rate of tax applicable to such funds may be at 10 percent, being the minimum marginal rate of personal income tax rate.

[E] Exemption for Foreign Income and Remuneration

Sections 10(8), 10(8A), 10(8B), and 10(9), of the Income Tax Act provide for exemption of foreign income and remuneration received by a consultant either from a foreign government or an international organisation subject to certain conditions. We do not find any rationale for these exemptions. In fact in USA the income of employees of both the World Bank and the International Monetary Fund is also subjected to personal income tax, which is borne by the two organisations. ***Remunerations, being income should be subjected to tax irrespective of the source from which it is derived. We therefore, recommend the deletion of these provisions.***

[F] Incentives for Foreign Exchange Earnings/Export of Goods and Services

Sections 10A, 10B, 80HHB, 80HHBA, 80HHC, 80HHD, 80HHE, 80HHF, 80-O, 80R, 80RR and 80RRA of the Income Tax Act provide for incentive for foreign exchange earnings/ export of goods and services. These incentives are provided to neutralise the adverse impact of poor infrastructure, regime an administered and distortionary input tax regime on input cost and a controlled foreign exchange regime on international competitiveness. However, with reform of the input tax regime and decontrol of the foreign exchange regime, the handicap is considerably reduced. It will further reduce

as economic reforms continue. In view of this, the government has, through the Union Budget, 2000, already announced the phased withdrawal of these incentives (except Sections 10A and 10B) over a period of five years. We welcome this initiative.

Sections 10A of the Income Tax Act provide for exemption of income from export of goods and computer software by units located in Free trade zones, technology parks, and special economic zones. These special areas enjoy a substantially higher quality of infrastructure facilities and a relatively less distortionary input tax regime. Therefore, the impediments to international competitiveness and therefore to exports are relatively less than those suffered by units operating from outside these zones. Since the government has already taken a decision to phase out the export related concessions to units outside of these special zones, we see no valid reason for the continuation of the special income tax regime for units in the special economic zones.

Similarly, Section 10B allows a deduction of profits and gains derived by a "hundred percent export oriented undertaking" from the export of goods and computer software. For this purpose, a "hundred percent export oriented undertaking" has been defined to mean an undertaking which has been approved as a hundred percent export-oriented undertaking by the Board appointed in this behalf by the central government in exercise of the powers conferred by Section 14 of the Industries (Development and Regulation) Act, 1951, and the rule made under that Act. It is obvious that the tax concession under Section 10B is a premium on export licensing; in other words, the government has introduced the export-licensing regime through the back door. This is inconsistent with the overall policy of trade liberalisation. It is also biased against undertakings which export almost whole of their output but have not been approved by the Board.

In view of the above, we recommend the phased withdrawal of both Section 10A and 10B of the Income Tax Act along the lines of Section 80HHC. In other words the concession would be available at the successively reduced rates for the next five years after which it would cease to exist.

[G] Incentive for Regional / Industrial Development

In India, industrial enterprises established in backward areas receive income tax incentives. These are of different magnitudes and for different durations. The main features of existing system of backward area tax incentives offered in India are discussed below. First, income tax incentives for backward areas are being granted only to industrial enterprises and not the enterprises of other sectors e.g. service sector. It is unclear why the policy makers see industries alone as a source of development and not any of the service sectors. The eligibility of only industrial enterprises for backward area incentives is economically inefficient as it distorts investment in the services sector. Second, the backward area incentives are granted to industrial enterprises at different rates, depending upon the form of organisation of the enterprise—co-operative societies, for example, receive more generous incentives, than the corporate enterprises, while unincorporated enterprises receive the least

favourable incentives amongst them all. The incentive is therefore, not neutral to the form of organisation. Third, small differences seem to have been created under the Income Tax act between income tax incentives offered to enterprises established in backward districts of Category A or those of Category B (The former are considered a bit less backward than the latter, based on the "derived" averages of selected sets of quantitative criteria). Finally, the scope and definition of backward areas has been widened greatly over time. In F.Y 1990-91, eight states of North Eastern region (Arunachal Pradesh, Assam, Manipur, Meghalaya, Mizoram, Nagaland, Sikkim and Tripura) were covered and the availability of tax incentives in these states was restricted only to industrial enterprises existing in the Integrated Infrastructure Development Centers and Industrial Growth Centers. Moreover, other backward states and Territories (Jammu and Kashmir, Himachal Pradesh, Goa, Andaman and Nicober Islands, Dadar and Nagar Haveli, Daman and Diu, Lakshadweep, and Pondicherry) as well as districts in other, less backward, states of India (such as Andhra Pradesh, Bihar, Gujarat, Kerala, Madhya Pradesh, Maharashtra, Orissa, Rajasthan, Uttar Pradesh, and West Bengal) have been added to the list of beneficiaries. This ever-expanding definition and scope of backward areas in recent years has complicated tax administration and generally eroded the income tax revenues. Further, the criterion used to select /identify backward areas is also inefficient.

The fundamental cause of backwardness often lies in the persistence of one or more of the following basic factors which are essential to the growth of economic activity:

1 Availability of raw materials.
2 Adequate roads and other transport facilities.
3 Skilled labour supply.
4 Adequate consumer markets.
5 Availability of credit and other banking facilities.
6 Adequate supply of power, water, telecommunication and other public utilities.

It is these factors, which determine the profitability necessary to motivate investors. Non-availability of the above-mentioned factors can lead to such serious cost disadvantages to investors and entrepreneurs of such localities and regions which no amount of profit linked tax incentives can compensate. It is only when cost disadvantages are relatively marginal, and taxation itself is seen as imposing an additional cost disadvantage, that income tax reliefs or incentives could be—could be but not necessarily always are—a useful tool for assisting the industrialisation of backward areas. However, experience all over the world clearly shows that tax incentives fail to promote industrialisation if the inherent cost disadvantages for an investor resulting from the above mentioned lacunae are large and substantial. In such situations, the removal of the basic obstacles to private investment, through public infrastructure development, rather than income tax incentives tend to help and need to receive the top most priority.

If income tax incentives offered to industrial enterprises in backward areas had been effective, there would be (a) a significant growth in industrial investment; (b) a large growth in the number of factories in such areas; (c) a perceptible growth in

Table 4.5

Industrial Investment Proposals: August 1991—December 1998

(Industrial Entrepreneur Memorandum (IEM) and Letters of Intent (LOI))

	Number	Proposed Investment (Rs.Crore)	Percentage of Total	Employment (% of Total)	Implemented Investment (IEM Only) (Rs. Crore)
Assam	89	5,343	2.79	0.78	24
Andaman and Nicobar	9	332	0.05	0.04	0
Arunachal Pradesh	6	39	0.01	0.07	0
Goa	329	4,629	0.84	0.95	148
Himachal Pradesh	379	8,125	1.63	2.14	128
Jammu and Kashmir	70	503	0.13	0.72	458
Manipur	0	0	0.00	0.00	0
Meghalaya	14	254	0.04	0.02	1
Mizoram	0	0	0.00	0.00	0
Nagaland	6	159	0.02	0.03	0
Tripura	4	1,040	0.16	0.02	0
Pondicherry	367	5,370	1.84	0.96	200
Sikkim	10	30	0.00	0.04	0
All India	**38,385**	**7,57,316**	**100.00**	**100.00**	**1,23,945**

Source *Ministry of Industry, Annual Report 1998-99.*

employment. Gandhi et al examine the effectiveness of the backward area incentives, by reviewing the "Before and After" data on selected key industrial development indicators.

Unfortunately the non-availability of relevant industrial data for the backward areas/districts of the country, benefiting from income tax incentives, does not permit a detailed analysis of this issue. However, as most of the backward districts, combining Category "A" and Category "B", belong to four states (Bihar, Madhya Pradesh, Rajasthan and Uttar Pradesh), one can study the growth in these, along with the available data of 11 other backward states for which income tax incentives have been made available since the early 1990's, to assess the effectiveness of the available income tax incentives in promoting industrialisation.

Table 4.5 contains the data on the numbers of industrial investment proposals made in different backward areas and the growth of investment and employment promised in relation to them and compares these with the investment actually realised.

The contrast is extremely disappointing, to say the least. In 7 states, in fact, the implementation rate was nil altogether.

Table 4.5 also shows that the emergence of new investment proposals in the North-East states is practically nil during the nineties, despite complete tax holiday for ten consecutive years under 10 C, except in Assam. In Assam, several letters of intent have been signed in respect of licensed sector (petrochemical units). The situation is far more worse with respect to the implementation of these proposals.[4]

Table 4.6 gives the data on the nominal investment per factory and shows how it grew at a higher rate during the second period (1990/91-1997/1998) only in four out of ten backward states (Assam, Goa, Himachal Pradesh and Jammu and Kashmir) when compared with the first period (1984/85-1990/1991). The evidence is mixed for backward districts in non-backward states of Bihar, Madhya Pradesh, Rajasthan and Uttar Pradesh too, where only two states show improvement.

While this picture may seem encouraging to some, it must be borne in mind that these

Table 4.6

Growth in Nominal Investment per Factory

(percent per annum)

	1990-91 over 1984-85	1997-98 over 1990-91
All India	**16.33**	**12.56**
Backward States		
Assam	16.40	19.54
Goa	-4.86	25.04
Himachal	-3.26	16.61
Jammu & Kashmir	1.75	3.36
Manipur	73.38	-49.74
Meghalaya	293.12	-15.83
Tripura	55.23	-2.95
Pondichery	33.51	14.14
Andaman	122.74	-2.50
Dadra & Nagar Haveli	N.A	27.19
Non-backward States with Backward Districts: Select List		
Bihar	16.36	7.50
Madhya Pradesh	6.05	11.62
Rajasthan	7.16	5.28
Uttar Pradesh	13.98	32.02

Source *Annual Survey of Industries: Summary Result For Factory Sector (various issues).*

4 *It may be noted that signing of IEM or LOI is not mandatory to set up a new factory. As a result, the findings in table 1 and table 6 seem to be contradictory in nature. Usually a major investment proposal is approved after the signing of an IEM or a LOI. No such formality is required for tiny plants.*

data relate to nominal investments and not real investments. In fact, the rate of nominal investment per factory in the second regime in many cases may well be much smaller, or even negative, if the data were adjusted for inflation.

Similarly analysis of industrial investment in the backward states/areas) indicates that except in Assam and Pondicherry, the rate of industrial investment declined during the nineties (the average of 1992-93 and 1997-98) in all backward states and in Bihar, Madhya Pradesh and Rajasthan (Table 4.7). The decline in the rate of investment is much more severe when compared with 1984-85 and 1990-91 and when compared to the rate of investment for the country as a whole.

However, the number of industrial factories seem to have grown faster in the backward states in the second period as compared to the first period, no such evidence seem to exist for the backward districts in non-backward states (Table 4.8).

Similarly, the growth in the level of industrial employment was higher in six out of ten backward states during the second period as against the first period. On the other hand, the rate of growth of employment seems to have registered a decline in the backward districts (Table 4.9).

Table 4.7

Rate of Investment (Gross Capital Formation/Output)

(Per cent)

	1984-85	1990-91	1992-93	1997-98	Average 84 & 90	Average 92 & 97
All India	**11.87**	**12.88**	**16.49**	**13.11**	**12.37**	**14.80**
Backward States						
Assam	8.83	8.85	9.31	17.42	8.84	13.37
Goa	19.43	5.50	16.24	9.18	12.47	12.71
Himachal	37.45	14.17	23.39	23.03	25.81	23.21
Jammu & Kashmir	17.50	6.45	5.38	6.15	11.97	5.76
Manipur	12.33	96.85	14.08	-15.37	54.59	-0.64
Meghalaya	-1.86	111.43	32.22	-4.46	54.79	13.88
Tripura	4.43	32.73	7.82	5.77	18.58	6.79
Pondichery	12.72	15.11	18.90	9.74	13.92	14.32
Andaman	0.79	49.71	15.25	21.99	25.25	18.62
Dadra & Nagar Haveli	NA	6.46	4.91	15.23	NA	10.07
Non backward States with Backward Districts: Select List						
Bihar	13.40	13.09	15.12	9.19	13.25	12.15
Madhya Pradesh	25.89	14.82	22.79	12.64	20.35	17.72
Rajasthan	24.14	14.77	15.52	10.39	19.45	12.96
Uttar Pradesh	12.30	11.69	16.35	34.44	11.99	25.39

Source *Annual Survey of Industries: Summary Result for Factory Sector (various issues).*

Table 4.8

Growth in Factories

(percent per annum)

	1990-91 over 1984-85	1997-98 over 1990-91
All India	**2.20**	**2.94**
Backward States		
Assam	-1.76	2.61
Goa	-0.68	6.32
Himachal	4.88	10.54
Jammu & Kashmir	-10.01	8.32
Manipur	3.87	3.55
Meghalaya	0.00	4.22
Tripura	-0.55	0.06
Pondichery	6.37	7.09
Andaman	4.12	6.03
Dadra & Nagar Haveli	NA	15.70
Non backward States with Backward Districts: Select List		
Bihar	-3.76	-0.47
Madhya Pradesh	1.12	0.93
Rajasthan	3.77	5.85
Uttar Pradesh	4.72	0.22

Source *Annual Survey of Industries: Summary Result For Factory Sector (various issues).*

In the light of the above empirical analysis, Gandhi et al conclude that "the evidence of growth of backward areas promoted by income tax incentives is at best mixed and it would not be unfair to conclude that, if the primary objective of these incentives was to boost private industrial investment in backward districts/states, the results have not been very encouraging. The growth of industry in a particular region depends more on the level of physical infrastructure available in the area, access to banks and other institutions providing finance, the size of the consumer market, the level of urbanisation, the law and order situation and the quality of skilled and unskilled manpower available in the area. Once these have been made available, then and only then income tax incentives can be expected to play any role, and even then perhaps a marginal role, if at all."

While revenue loss on account of the backward area allowance is not readily available, guesstimate of such loss is about Rs.356 crores on account of this incentive in the selected backward states covered in the Study. In reality, however, the amount of revenue lost could be somewhat higher as the estimate does not include the revenue foregone from industries in the backward districts of the non-backward states. Furthermore, to the extent these incentives may have been abused by some tax-exempt taxpayers, and much tax administration effort may have been spent on administrating these incentives, the monitoring and investigating of income tax

Table 4.9

Growth in Employment

(percent per annum)

	1990-91 over 1984-85	1997-98 over 1990-91
All India	**0.62**	**2.78**
Backward States		
Assam	-0.67	4.96
Goa	0.42	6.74
Himachal	8.96	3.50
Jammu & Kashmir	-18.05	17.51
Manipur	5.02	22.37
Meghalaya	0.43	2.10
Tripura	-0.43	-4.12
Pondichery	12.21	7.78
Andaman	-0.08	3.14
Dadra & Nagar Haveli	NA	17.51
Non backward States with Backward Districts: Select List		
Bihar	0.51	-3.84
Madhya Pradesh	1.02	1.50
Rajasthan	1.55	2.67
Uttar Pradesh	0.88	-0.39

Source *Annual Survey of Industries: Summary Result for Factory Sector (various issues).*

abuses by large tax paying income earners may have been ignored. The effective revenue forgone may, thus, have been somewhat higher.

The tax incentives have also been subjected to abuse. Instances of abuse have been indicated in depth in the Report of the Comptroller and Auditor-General of India—Direct taxes (1998).

It is important to note that inspite of tax incentives the development process in the backward areas has failed to take off. The government having provided these incentives is lulled into complacency. The need to create urgent infrastructural facilities in these areas is pushed into the background, so typical of any such tax incentives.

The experience in the case of other similar provisions like Section 80IA is no different since the design of the incentive is similar and the revenue loss far greater in view of its wide coverage. It would not be feasible for the government to undertake any meaningful reform of the direct tax structure if such incentives continue to exist on the statute.

Experience in many countries of the world shows that income tax incentives are a poor

instrument of encouraging economic activity and that income tax incentives to remove the backwardness of a backward state/districts/areas are no exception. This is amply out by the empirical analysis in Gandhi, et al. This is primarily because the bottlenecks to development in such areas tend to be so basic that no amount of tax incentives can compensate for those structural handicaps. Only a well-thought out strategy of public investment—developed on a case-by-case basis and geared towards removing specific obstacles inhibiting economic development of individual areas—can provide the solution. The economic case for the grant of tax incentives remains extremely weak while the case for a good public investment strategy strong.

In view of the above we recommend that the tax incentives through the provisions of Sections 80-IA and 80-IB should be deleted. Since the benefit of reduced tax rates will flow with immediate effect, the benefit of these provisions for the remaining unutilised period should be terminated even in the case of existing eligible taxpayers. In other words, if a taxpayer has availed of the tax concession for only six years, he should not be allowed of the benefit in the remaining four years.

[H] Widening of the Base in Respect of Taxpayers Deriving Income From Salaries

Under the Income Tax Act, a taxpayer is allowed a deduction of a certain percentage of his salary income subject to a maximum amount as standard deduction in the computation of his salary income chargeable to income tax. This standard deduction is allowed in respect of expenditure incidental to the employment of the taxpayer. The evolution of this standard deduction is indicated in Table 4.10 below.

As would be seen, the levels of standard deduction have increased substantially over the years both in terms of the percentage and the overall ceiling. It is difficult to accept that a salary taxpayer incurs as high as thirty three and one third percent of his salary income as expenditure incidental to his employment i.e. on books and other publications necessary to perform his duties. Experience and anecdotal information tells us that the expenditure on such items is generally less than five percent.

It is also well known that most employers provide extensive library facilities and reimbursement to senior employees for expenditure on books and periodicals. In fact in the government, the expenditure by senior officers on newspapers is reimbursed. In the case of the corporate sector, the expenditure on newspapers and periodicals is an allowable business deduction without being treated as a perquisite in the hands of the employee.

In addition, in the case of most salaried taxpayers, the valuation of perquisites continues to be vexatious. Therefore, the taxable base for employees is substantially lower than the real base.

Further the provision of a standard deduction to salaried taxpayers over and above the basic exemption limit is iniquitous in as much as non-salaried taxpayers with similar

level of income is subjected to a higher level of tax. It also encourages people to seek employment rather than be self-employed.

Table 4.10

Standard Deduction Over the Years

Assessment Year	Standard Deduction
Upto 1974-75	Any amount not exceeding Rs.500, expended by the taxpayer on the purchase of books and other publications necessary for the purpose of his duties
1975-76 to 1980-81	In respect of the expenditure incidental to the employment of the taxpayer
1981-82	A standard deduction on a presumptive basis which is the least of, Rs.3,500 or an amount calculated in the following manner: • 20 percent of the salary if the salary does not exceed Rs.10,000 • Rs.2,000 plus 10 percent of the amount by which the salary exceeds Rs.10,000 if the salary exceeds Rs.10,000
1982-83	A sum equal to twenty percent of the salary or Rs.5,000, whichever is less.
1983-84	A sum equal to twenty five percent of the salary or Rs.5,000,whichever is less.
1984-85	A sum equal to twenty five percent of the salary or Rs.6,000,whichever is less.
1987-88 to 1988-89	A sum equal to twenty five percent of the salary or Rs.10,000, whichever is less.
1989-90 to 1992-93	A sum equal to thirty-three and one-third percent of the salary or Rs.12,000, whichever is less.
1993-94	A sum equal to thirty-three and one-third percent of the salary or Rs.12,000, whichever is less. If the taxpayer is a woman, and her income from salary is Rs.75,000 or less, a deduction of a sum equal to thirty three and one-third percent of the salary or Rs.15,000, whichever is less.
1994-95 to 1996-97	A sum equal to thirty-three and one-third percent of the salary or Rs.15,000, whichever is less. If the taxpayer is a woman, and her income from salary is Rs.75,000 or less, a deduction of a sum equal to thirty three and one-third percent of the salary or Rs.18,000, whichever is less.
1997-98	For taxpayers whose income from salaries does not exceed Rs.60,000, a deduction of a sum equal to thirty three and one-third percent of the salary or Rs.18,000, whichever is less. For taxpayers whose income from salaries exceeds Rs.60,000 a deduction of a sum equal to thirty three and one-third percent of
	the salary or Rs.15,000, whichever is less. If the taxpayer is a woman, and her income from salary is Rs.75,000 or less, a deduction of a sum equal to thirty three and one-third percent of the salary or Rs.18,000, whichever is less.
1998-99	A deduction of a sum equal to thirty three and one-third percent of the salary or Rs.20,000, whichever is less.
1999-2000 to 2001-2002	For taxpayers whose income from salaries does not exceed Rs.1,00,000, a deduction of a sum equal to thirty three and one-third percent of the salary or Rs.25,000, whichever is less. For taxpayers whose income from salaries exceeds Rs.1,00,000 but does not exceed Rs.5,00,000, a deduction of a sum equal to thirty three and one-third percent of the salary or Rs.25,000, whichever is less. No deduction is allowed in cases where the salary exceeds Rs.5,00,000.

The present graded rates of standard deduction introduce complexity in the tax statute and therefore, impose additional burden on both the taxpayer and the tax administration.

The Group notes with some alarm that the Union Budget 2001-02 has, contrary to our recommendations in the Interim Report, raised the maximum level of the standard deduction to Rs.30,000. While it is true that the level has oscillated over time, the level of Rs.500 in 1974-75 would be equivalent to approximately Rs.5,000 in current terms. ***However, reflecting the changes in the Union Budget 2001-2002, it is imperative that the ceiling be brought down to Rs.15,000 in the next budget.*** This reflects the fact that, at present, transport allowance is being given as a separate deduction, which was not the case prior to assessment year 1998-99 and most employers provide at their expense the facilities of books and periodicals. Further, it cannot be overemphasised that the goal of resource mobilisation becomes more difficult to achieve with increasing base erosion. This will reduce the inequity between the employed and self-employed and will also be revenue enhancing. The additional liability on this account will be more than met by the reduction in rates of personal income tax proposed by us.

[I] Income from Self-Occupied House Property

Upto assessment year 1986-87, the determination of the annual value of the owner occupied dwelling house involves three successive operations. Firstly, the annual value is determined in the manner as if the property were let out to tenants. The full municipal taxes payable are to be deducted in such computation. Secondly, the amount of annual value so determined was reduced by one-half of such value or Rs.3,600, whichever is less. This deduction was commonly referred to as the allowance for new construction. Thirdly, if such balance exceeded 10 percent of the total income minus income from self-occupied property (but without deductions allowable under Chapter VI-A), the excess was to be disregarded. In other words, a notional annual value was imputed to the benefit flowing from self-occupation of the house property. Accordingly, full allowance by way of deduction was made for ground rent, repairs and maintenance, interest on borrowed capital and similar other items of expenditure.

However, from assessment year 1987-88, the notional annual value imputed to the benefit flowing from self-occupation of the house property is deemed to be nil. Accordingly, it was also provided that no deduction for the various items of expenditure would be allowed except a small amount of Rs.5,000 towards interest on borrowed capital. While non-deductibility of the various items of expenditure is consistent with the matching principle that expenditure relating to a particular item/source of income should be allowed only if the income is liable to tax in the economic/accounting sense, the allowability of interest expenditure upto Rs.5,000 is a deviation from this principle. This is, therefore, in the nature of a tax subsidy. Such a tax subsidy is both iniquitous and inefficient. It is biased against self-financing and encourages borrowing. Further, since the deduction is income based, it confers a substantially larger tax subsidy to a richer taxpayer. Similarly it also encourages a taxpayer to keep the property vacant rather than offer it in the property market for rent.

These problems have been further compounded by the increase in the ceiling from Rs.5,000 to Rs.1,00,000 in assessment year 2001-2002. The increase far exceeds the inflation during this period. It is indeed curious that the Finance Bill, 2001, proposes to enhance this limit to Rs.1,50,000. In fact even the existing level only benefits taxpayer in the higher tax brackets. A taxpayer in the lower tax bracket cannot afford to incur such a large interest liability and yet keep the house property under self-occupation. Given this tax subsidy, the effective interest rate on large loans for construction/purchase of houses is substantially lower for larger taxpayers relative to smaller taxpayers[5].

In view of the above, we recommend that the provisions relating to allowability of interest on capital borrowed for construction/purchase of a property, which is under self-occupation, should be deleted to rationalise the tax base.

[4] Harmonisation of Personal and Corporate Income Taxes

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 upto 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.

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.

5 *Since the repayment capacity of smaller taxpayers is relatively less than that of the large taxpayers, the small taxpayers can have accessibility to relatively small amounts of loan.*

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 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.

The system of taxation of companies independently of shareholders, however, causes misgivings as it tends to be iniquitous in that no discrimination is made between shareholders with varying incomes. Theoretically, the corporate income should be attributed to the shareholder and subjected to tax at the corresponding personal income tax rate with credit for share of the corporate tax liability. This means that under no circumstances, the corporate tax liability should exceed the maximum marginal rate of personal income tax. Taxation of profits in the hands of the company and again in the hands of the shareholders without any relief for the tax paid by the company—"double taxation"—has been assailed also on efficiency grounds since, given the imperfections of the capital market and lack of perfect foresight on the part of equity holders, it creates a bias in favour of retention and thereby inhibits the flow of corporate surpluses into the capital market and thus, their efficient use. It also imparts a bias against equity capital by subjecting distributed profits to tax twice, apart from involving a discrimination against the corporate form of business organisation. Hence attempts have been made to relieve the burden of double taxation through various devices, such as giving some credit to shareholders for the tax paid by companies or by taxing the distributed profits at a lower rate.

In India, corporations are taxed on their profits and dividends are taxed a second time in the hands of the corporation as distribution tax. However, no credit is given to the shareholders either for the corporate tax or distribution tax liability. The rate of distribution tax was increased from 10 percent with a add on surcharge of 10 percent to 20 percent plus a surcharge of 10 percent in the 2000-01 budget. This step exacerbated double taxation and has worsened the efficiency and equity characteristics of income taxation. Since the distribution tax is not attributed to the shareholders, the present scheme of taxation of dividends is particularly burdensome for foreign investors. They have to bear the additional burden of taxation of the dividend in their country of residence without being able to avail any credit paid by the corporation.

We recommend that the corporate tax rate should, under no circumstances, exceed

the maximum marginal tax liability under the personal income tax (inclusive of surcharge). Accordingly, the existing corporate tax rate should be lowered to 30 percent in line with the recommendation made under the personal income tax. This will also make the rate internationally more comparable.[6]

We also recommend the abolition of the distribution tax on dividends in view of our recommendation on MAT on companies in the following Sections and the empirical analysis of the effective rate of corporate tax liability. The Finance Bill, 2001, proposes to roll back the rate of distribution tax to 10 percent which comprises a right step forward. But it falls short of comprehensive reform that the Group suggests in restructuring the MAT, of which the dividend tax reform would comprise a part.

At present, the tax rate on foreign companies is 48 percent. Traditionally, this rate has been kept at 10-percentage point higher than the tax rate for domestic companies. This differential is maintained to recoup the potential loss on account of the non-declaration of dividends in India by foreign companies. Since we have proposed the abolition of dividend distribution tax, there will be no further justification for maintaining the differential. ***Accordingly, we also recommend that the tax rate for foreign companies be reduced to the level recommended for domestic companies i.e. to the level of 30 percent.***

[5] Presumptive Tax: A Minimum Alternate Tax (MAT) on Companies

[A] Justification for Presumption

Presumptive taxation involves the use of indirect means to ascertain tax liability, which differ from the usual rules based on taxpayer accounts. The term "presumptive" is used to indicate that there is a legal presumption that the taxpayers' income is no less than the amount resulting from application of the indirect method. This presumption may or may not be rebuttable. The concept covers a wide variety of alternative means for determining the tax base, ranging from methods of reconstructing income based on administrative practice, which can be rebutted by the taxpayer, to true minimum taxes with tax bases specified in legislation.

6 *The corporate rate of tax is 30 percent in China, South Africa, Thailand, Indonesia, 28 percent in South Korea and Malaysia and 35 percent in Argentina, Russian Federation and Sri Lanka. Developed countries also have a corporate tax rate in the range of 30 percent to 35 percent.*

Generally, presumptive techniques are employed for a variety of reasons. One is simplification, particularly in relation to the compliance burden on taxpayers with very low turnover (and the corresponding administrative burden of auditing such taxpayers). A second is to combat tax avoidance or evasion (which works only if the indicators on which the presumption is based are more difficult to hide than those forming the basis for accounting records). Third, by providing objective indicators for tax assessment, presumptive methods may lead to a more equitable distribution of tax burden, when normal account based methods are unreliable because of problems of taxpayer compliance or administrative corruption. Fourth, rebuttable presumptions can encourage taxpayers to keep proper accounts, because they subject taxpayers to a possibly higher tax burden in the absence of such accounts. Fifth, presumptions of the exclusive type can be considered desirable because of their incentive effects—a taxpayer who earns more income will not have to pay more tax. Finally, presumptions that serve as minimum taxes may be justified by a combination of reasons (revenue needs, fairness concern, and political or technical difficulty in addressing certain problems directly as opposed to doing so through a minimum tax).

Presumptive methods can be rebuttable or irrebuttable. Rebuttable methods are those under which the income presumptions can be rebutted, if taxpayers can prove that their actual income was lower than the presumed income. Rebuttable methods include administrative approaches to reconstructing the taxpayers income, and may or may not be specifically described in the statute. If the taxpayer disagrees with the result reached, the taxpayer can appeal by proving that his or her actual income, calculated under the normal tax accounting rules, was less than that calculated under the presumptive method. Irrebuttable methods are those under which the presumptions are irrebuttable, which means that the taxpayer is not allowed to claim (and prove) that his actual income was lower than the presumptive income. Therefore, the irrebuttable presumptive assessments should be specified in the statute or in delegated legislation. Because they are legally binding, they must be defined precisely.

Irrebuttable presumptions can be divided into two types: minimum tax and an exclusive tax. A minimum tax is a floor revenue contribution from the largest potential taxpayers, generally corporate, who are best placed to exploit loopholes. This floor revenue is determined on a "desired" base for taxation, which is not itself measured but is inferred from simple indicators which are more easily measured than the base itself. In other words, the tax liability is no less than that determined under the presumptive rules. The minimum alternate tax (MAT) on companies in India is, therefore, only one of the many forms of presumptive tax.

Under the exclusive tax, the tax liability is determined under presumption alone, even if the regular rules might lead to a higher liability. An example is a tax on agricultural income based on the value of land, with no reference to actual crop experience for the year.

Exclusive presumptions are administratively simpler than presumptions of the minimum tax type, because minimum tax presumptions require two tax bases to be calculated and compared. While exclusive presumptions have the advantage of

simplicity and minimal disincentive effects, they suffer from a lack of equity. Taxpayers with substantially differing amounts of actual income must pay the same amount of tax if their presumptive tax base is the same. A large number of countries have introduced minimum tax on companies in some form or the other.

[B] Rationale for MAT

Corporate tax legislation all over the world, no matter how streamlined at the outset, acquires an adhesive accretion of special concessions and provisions over time because the corporate sector constitutes a focused interest group with financial backing. A secondary interest group develops, in the form of tax planners skilled in the art of tax minimisation within the framework of what is legally permissible. Profit-making zero tax companies are a worldwide phenomenon. An indirect attack from the flank through presumptive taxation may succeed where a direct attempt to expunge special concessions may fail, and serves also to plug evasion, which is possible and does occur even at the upper end of the business spectrum. An example is transfer pricing by multinationals to take advantage of cross country differences in corporate tax rates; it is far easier to put a floor on such practices through presumption than to attempt a direct attach through construction of arm's length prices.

One of the main reasons for erosion of the tax base is the provision relating to accelerated rate of depreciation for general category of machineries on their written down value. The rate is determined on the basis of estimated replacement cost which in turn is related to the economic life of the asset and the inflationary increase in the cost of the asset over its life cycle. For administrative ease, most assets are lumped together as a block and depreciation allowed at the general rate. In effect the depreciation is neither related to the true economic life of the asset nor to the asset specific inflation in the cost of the asset. As a result the depreciation allowance becomes too generous—often substantially greater than the allowance under commercial accounting, resulting in a total erosion of the tax base—giving rise to the phenomenon of zero tax companies. Such companies result in imposing a relatively higher marginal rate of corporate tax on other companies to raise a given amount of tax revenues. The higher is the marginal rate of tax, the greater is the distortion in the economic behaviour. Therefore, a minimum alternate tax at the average tax liability across taxpayers (which is generally lower than the marginal rate of tax) enables to keep the marginal tax rate low and therefore minimise distortions. Further, the existence of zero tax companies is inequitous in as much as a company with relatively higher real income bears a lower tax burden.

Excessive depreciation allowance also results in overcapitalisation. It encourages mergers and amalgamations often not justified on economic grounds. To the extent depreciation allowance provides tax shield, it distorts private investment behaviour. The distortion is further exacerbated if the allowance is generous. Allowing depreciation on replacement cost is tantamount to adjusting for inflation in the cost of the assets. Since none of the other heads of income and expenditure is adjusted for inflation, it is biased against investment in sectors where the amount of fixed assets is

relatively low (e.g. the services sector). Therefore, a measure designed for administrative ease and compliance generates inefficiency and inequity in the system. Hence, the need to restrict the adverse consequences without sacrificing simplicity. The minimum alternate tax (MAT) fulfils this need.

A tax on profits is subject to wide fluctuations depending upon the fortune of companies. As a result the flow of revenues to the exchequer is disrupted and the government has to resort to ad-hoc discretionary measures. Such changes in the tax laws build up expectations that have a dampening effect on investment decisions. A minimum alternate tax provides the necessary stability.

[C] MAT Base: International Experience

A variety of economic bases and methods of calculation is used to provide presumption of income. For example, certain presumptions are based exclusively on the taxpayers' net wealth or on the value of the assets used in his business. Others are based on the gross receipts of the enterprise. Still others are based on visible signs of wealth. Standard assessment methods use several key factors and indices of profitability, which vary by activity, to determine the taxpayer's income.

A presumptive tax that is used in lieu of the corporate tax on net profits is a tax on gross receipts. Such a tax avoids the difficulties of measuring such sophisticated concepts as depreciation in calculating net profit. This tax has been found to be effective in terms of revenue yield and ease of administration. Francophone African countries have been pioneers in the establishment of minimum corporate income taxes. This tax can be credited against the regular corporate tax, but no refunds are allowed if the minimum tax exceeds the corporate tax. The minimum tax based on gross receipts is equivalent to a simple presumption of income. For example, if the corporate tax rate in a country that applies this system is equal to 40 percent of net profits and the minimum tax is equal to 1 per cent of gross receipts, authorities are acting as if all corporations earn a minimum net taxable income equal to 2.5 percent of their gross receipts. As an example outside Africa, in 1983 Colombia established a general presumption of net income based on gross receipts, applicable to all taxpayers, individual and corporate, except those whose main sources of income are wages and salaries. The law presumes that net income amounts to at least 2 percent of gross receipts.

The presumptions based on gross receipts are not a panacea for tax administrations attempting to improve taxpayer compliance. In most developing countries concealment of gross receipts is a favoured method of tax evasion. Presumptions of income based on gross receipts thus mainly affect taxpayers who cannot easily conceal gross receipts (e.g. large corporations). As a result of such presumptions, corporations with genuine losses are treated in the same manner as corporations that artificially reduce their profits by such methods as manipulating transfer prices. All corporations with the same turnover pay the same tax. For smaller enterprises that have previously concealed a portion of their gross receipts and continue to do so, the introduction of

a presumption of net income based on turnover is of little consequence and has no material effect on their tax liability.

The income tax legislation of several countries includes presumptions of income based on visible signs of wealth. These presumptions apply only to individuals. In some countries, such as Brazil and Peru, the tax department is empowered, in somewhat general terms, to presume income higher than those reported by taxpayers on the basis of visible signs of wealth. It is left to the administration to decide which signs of wealth to use and what level of income to attach to them. In other countries, including France, Italy and several francophone African countries, presumption based on visible signs of wealth are carefully specified in the Income Tax Act. The signs of wealth that must be considered are described and each is assigned an income equivalent. Such signs of wealth usually include the taxpayer's main and secondary residences, number of domestic servants, automobiles, yachts, private planes and race horses.

In practice, presumptions based on visible signs of wealth have proved difficult to apply. When they are established in general terms, tax administrators are hard pressed to decide which signs of wealth to use as a basis for the presumption and how to establish the income equivalent of each. In those countries in which both the signs of wealth and their income equivalent have been specified in the statute, the inflexibility of the provisions may lead to considerable unfairness. Recognising these problems, tax departments tend to apply these presumptions cautiously and only when additional assessments cannot be supported by other means. One of the areas in which such presumptions have proved useful is in supporting assessments on illegal incomes, such as those derived from racketeering and drug trafficking.

Several countries, including Argentina, Colombia, Mexico, and Venezuela, have adopted minimum taxes based on a fixed percentage of the assets of a business. The economic rationale for the assets tax is that investors can expect ex-ante to earn a specified average rate of return on their assets. A minimum asset-based levy on corporations or individuals with offset against actual income tax involves presumption by definition, since it as a minimum, carries an efficiency incentive. Until the prescribed benchmark rate of return is attained, the incremental tax on income actuals is zero. Firms or individuals introduces a partial hiatus between tax liability and income actuals. A presumptive levy, even earning rates of return on assets below the minimum presumed pay an implicit tax on income actuals at a rate higher than the prevailing corporate income tax rate, which increases the greater the performance shortfall. In Bolivia, such a tax replaced for a time the corporate income tax; that is, it was an exclusive presumption. The tax base varies from gross assets (Argentina) to net assets—assets minus debts (Colombia)—with the Mexican tax taking a middle position whereby certain debts are deductible. Of course, such taxation could be considered unfair because the ex-post return will differ from what was expected. Moreover, the minimum asset tax can discourage risky investments under circumstances where it denies the taxpayer the benefits of carrying over the losses resulting from the investment. Similarly the asset tax may not be desirable in countries, which have a large number of sick public sector companies. In such cases, the institutional and structural rigidities in the economy inhibit free exit. Given the fact that most adversely

affected by this would be the sick public sector companies such a tax would pose serious problems of cash flow and aggravate the problem of recovery. The unpaid tax liability could inhibit privatisation.

Whatever be the choice of the measure for MAT there are clearly two requirements for the revenue success, in terms of total corporate collections, of a MAT. First, the threshold minimum presumptive income should be such that, when expressed as a rate of return on corporate assets, it must be proximate to the average pre-levy rate of corporate return. In other words, the threshold minimum rate of return on assets must be near enough to, preferably at, the average pre-levy rate of corporate return, to serve as an adequate efficiency incentive. Secondly, the design or administration of the tax has to carry an incentive for accurate reporting of actual income by providing for a carry forward provision. This preserves the incentive for accurate reporting, although perhaps less effectively for companies which expect to perform consistently at or above the presumptive threshold.

[D] Nature and Proposed Changes in the Indian MAT

The direct tax system in India is characterised by a whole set of tax incentives. These incentives have the effect of greatly reducing the tax base. The existing tax incentives generate misallocations of resources both within and between branches of industry. Ideally one would like to start with a clean slate, and introduce a tax system that was, insofar as possible, neutral as among the affected activities. The existing incentives stand in the way of achieving greater neutrality, and are particularly troublesome because of the great variety of provisions. Given the fact of the distortions represented by existing incentives, the idea of a minimum tax has great appeal and therefore the same was first introduced as Section 115J in the scheme of corporate taxation by the Finance Act, 1987. Although not presumptive in design the intent of computing minimum taxable income at 30 percent of book profits was to combat base erosion through avoidance. The "book-profit" was defined as commercial profits subject to specified adjustments. Reflecting an income tax rate of 50 percent, the minimum tax liability was fixed at 15 per cent of the book profit. However, the provision was deleted after a brief life by the Finance Act, 1990 ostensibly for the reason that a large number of incentives including the investment allowance had been withdrawn from the statute.

With the withdrawal of the MAT in 1990, the phenomenon of zero tax companies continued and in 1996, it was once again considered necessary to re-introduce the MAT as Section 115J through the Finance Act, 1996. The base was larger than the one in the erstwhile provision in as much as profits on foreign exchange earnings were not exempted. However, under intense pressure from business interest groups, the exemption was introduced in the subsequent year along with the provision for carry forward and set off of excess of MAT liability over "actual" liability against any excess of “actual” liability over the MAT liability in the subsequent five years. Since then the law has been amended by the Finance Act, 2000 to introduce Section 115JB, which provides for a minimum tax of 7.5 percent of the book profit (defined as the

commercial profits). A major shortcoming of the MAT provisions is the fact that it continues to be based on the reported income unmindful of the widely prevalent practice of under reporting. Therefore, these provisions are based on a weak foundation and fail to serve the very objective, which it intended to achieve.

While there has been a drastic cut in corporate tax rates since 1987, incentive provisions continue to exist on the statute. Hence, the effective rate of corporate tax is considerably lower than the statutory rate of 38.5 percent. Empirical analysis of the financial results of 1293 profit making companies out of a sample of 1816 companies effective corporate tax rate for the year ending March 31, 2000 is summarised in Table 4.11. The effective tax liability of the profit making companies under the corporate tax regime prevailing in assessment year 2000-2001 is only 25.95 percent of the profits before tax and 0.91 percent of the net worth. Contrast this with the statutory corporate tax rate of 38.5 percent and the erosion of the tax base due to incentives becomes too obvious. However, with the change in the scheme of MAT and the increase in the dividend distribution tax through the Union Budget, 2000, the effective rates have increased to 28.15 percent and 0.99 percent of profits before tax and net worth, respectively, for assessment year 2001-2002 (financial year 2000-2001). Inspite of this increase, it continues to remain far below the statutory corporate tax rate of 38.5 percent. The new provisions of MAT do not fully resolve the problem of the gap between the statutory tax rate and the effective tax liability. Hence the need for further improvement in MAT.

Experience has shown that book profit, despite the definition in the statute, is easily manipulated insofar as it is amenable to accounting changes/practices and subject to the existing tax incentives. It has been argued before the Group that MAT based on "book profits" could continue if the plethora of incentives were withdrawn and the rates of depreciation under the tax law aligned with commercial rates. We are not quite impressed with this argument since the reported commercial profits are substantially lower than the "real" profits on account of low accounting standards and anecdotal information relating to large-scale evasion in the corporate sector though under-reporting of transactions. Hence the need for an alternative base. The base of the minimum tax should be chosen so as to provide a plausible estimate of the taxable capacity of the company, reflected comprehensively in the ability to earn (designed to successfully average its ability to pay). The base to which the minimum tax would apply must therefore be something other than reported commercial profits. For example, total assets, fixed assets, total sales and net worth are possible alternatives. Of these, net worth is conceptually the closest to that of income. Thus, there arises the likelihood that a minimum tax based on sales would sharply discriminate against services and one based on total assets would work sharply against the financial sector (for example, banks) and heavy industry (for example, steel and aluminium). The variability of any one measure as an appropriate base for a minimum tax suggests that the use of some combination might be preferable. A combination of both stock and flow components could comprise such a measure. This combination could be, say, a percentage of the net worth plus a percentage of the dividend distributed. This minimum tax could be allowed to be carried forward for set off against future liability in excess of the minimum tax. This combination is both economically efficient and

equitous. It carries an efficiency incentive as in the case of the gross assets tax since it is closely linked to the minimum presumed rate of return on the owner's capital. The incremental tax under this method on actual income is zero until the minimum presumed rate of return is reached. The greater the performance shortfall, the greater is the excess of the implicit tax rate on income actual over the prevailing corporate tax rate.

Since the design provides for offset against MAT payable in years other than the current year, it serves three basic functions. It provides legal protection against the charge that the levy is unrelated to the ability to pay. Secondly, it mitigates the severity of the levy since it would grant relief in the subsequent years. Thirdly, it provides an incentive for the accurate reporting of returns even in years where actuals exceed the minimum threshold. Therefore, the method is also inter-temporally efficient.

The method is neutral between retained earnings and dividend distribution. To the extent dividends are distributed, they suffer a higher rate of tax in the year of distribution. If the company chooses to retain its earnings it will be penalised by the capital market and still end up paying tax on it since it would result in an accretion to the net worth. Even though the rate of tax on the net worth is substantially low, the discounted future liability is almost equivalent to the present liability on dividends. Thus both consumption and unproductive savings will be penalised.

Table 4.11

Effective Tax Liability under Alternative Corporate Tax Regimes*

Assessment Year	Tax Regime			Corporate Tax Liability		Total Tax Liability (incl Dividend Tax	
	Corporate tax		Dividend Tax Rate	as %age of PBT	as %age of Net Worth	as %age of PBT	as%age of Net Worth
	Rate	MAT					
2000-2001	38.5%	30% of book profit as minimum income	11%	23.64	0.83	25.95	0.91
2001-2002	38.5%	7.5% of book profit as minimum tax	22%	24.22	0.85	28.15	0.99
Plan-I (2002-2003)	35%	7.5% of book profit as minimum tax	22%	22.10	0.71	25.68	0.82
Plan-II (2002-2003)	30%	7.5% of book profit as minimum tax	22%	19.08	0.61	22.66	0.72
Plan-III (2002-2003)	30%	Sum of 0.75% of net worth and 10% of dividend distributed, as minimum tax	NIL	31.08	1.09	31.08	1.09

** The estimates relate to 1293 profit making companies out of the sample of 1816 companies*

Source *Group's calculations based on CMIE data of Companies for the year ending 31st march 2000*

Another consequence of the proposed method is its impact on equity. Since depreciation is an allowable deduction in the computation of taxable income, the company benefits from the tax shield that it provides. Therefore, there is an inherent bias in favour of the manufacturing sector vis-à-vis the services sector. Since the benefit from tax shield will either be distributed or retained within the company and both suffer taxation, under this method it helps reduce the bias against the services sector.

The combined measure of stock and flow as a base is also substantially unaffected by inflation. To the extent the value of net worth is eroded by inflation, the real tax loss is partly compensated by the capital gains tax paid by shareholders. Further, if the assets are revalued periodically, the increase in their value is reflected in an increase in the net worth. If a company chooses otherwise, it will end up paying a substantially larger liability on liquidation.

We therefore recommend that a minimum tax on corporations be continued to be levied. However, the base of the MAT should be changed from book profit to a combination of net worth and dividend distributed.[7] We recommend the minimum alternate tax on corporation should be a tax equal to the aggregate of 0.75 percent of adjusted net worth and 10 percent of dividend distributed. In view of the base for MAT recommended, there would not be any separate tax on dividend distributed by the companies. The adjusted net worth for tax purposes would be the capital employed by the company. The definition of capital employed would be the same as was in the case of Section 80J of the Income Tax Act. The minimum tax should continue to allow carry forward and set off against future income tax liability, as provided in Section 115JAA of the Income Tax Act. To facilitate the multinationals to avail of tax credit in the country of their origin, the income tax paid by the company should be allowed to be credited against the MAT liability (and not the other way round). However, no refund should be granted if the MAT liability is less than the income tax liability. Our choice of the definition of adjusted net worth is influenced by the consideration of administrative ease. Several judicial pronouncements (including judgments by the apex court) exist on the definition of capital employed and, therefore, would serve well to both taxpayers and the administration. If a pronouncement is not really acceptable, the definition could be suitably amended.

An analysis of the distributional effect of corporate tax reform (reduction in corporate tax rate, change in the base for MAT and the abolition of dividend distribution tax) based on the financial results of a sample of 1816 companies (including 523 loss making companies) for the year ending March 31, 2000, is summarised in Table 4.12. As would be evident there would be a substantial increase in the effective tax liability; from 33.89 percent to 39.92 percent of the profits before tax and 0.90 percent to 1.06 percent of net worth. The contribution of these companies (assuming there financial performance for the year 1999-2000 will continue) to corporate tax will increase from Rs.16,532 crores to Rs.19,474 crores registering an increase of 17.8 percent. The bulk

7 *The adjusted networth for tax purposes would be the average of capital employed as on the first day and the last day of the previous year.*

Table 4.12

Distributional Effect of Corporate Tax Reform

(Rs. Crores)

Profits Before Tax (PBT)	Number of Companies	Total Profits Before Tax (TPBT)	Total Net Worth (TNW)	Total tax Liability (incl. Dividend Tax)		Total tax Liability (incl. Dividend Tax) as %age of TPBT		Total tax Liability (incl. Dividend Tax) as %age of TPBT	
				Existing	Proposed	Existing	Proposed	Existing	Proposed
PBT<=0	523	-9,952.27	1,63,723.55	41.16	1,239.90	-0.41	-12.46	0.03	0.76
0<PBT<=1crs	345	121.15	7,998.73	29.26	67.86	24.15	56.01	0.37	0.85
1crs<PBT<=5crs	365	900.02	28,509.01	225.00	271.76	25.00	30.19	0.79	0.95
5crs<PBT<=10crs	150	1,071.85	23,373.61	262.88	268.09	24.53	25.01	1.12	1.15
10crs<PBT<=50crs	273	6,261.90	1,83,320.30	1,545.33	1,904.34	24.68	30.41	0.84	1.04
50crs<PBT<=100crs	68	4,909.93	1,70,151.60	1,195.12	1,612.93	24.34	32.85	0.70	0.95
100crs<PBT<=500crs	72	15,511.86	5,57,121.46	4,373.71	5,248.51	28.20	33.84	0.79	0.94
> 500crs	20	29,958.05	7,01,516.51	8,859.20	8,860.17	29.57	29.58	1.26	1.26
Total	**1,816**	**48,782.49**	**18,35,714.77**	**16,531.66**	**19,473.55**	**33.89**	**39.92**	**0.90**	**1.06**

Source *Group's calculations based on CMIE data of Companies for the year ending 31st march 2000.*

of the increase in tax liability would be at the lower end; at present 523 loss making companies having a net worth of Rs.1,63,724 crores contribute only 0.03 percent of their net worth to corporate tax. Their liability will increase to 0.76 percent of their net worth but would continue to be lower than the average liability of the corporate sector. This will induce these loss making companies to improve their efficiency and financial performance or in the alternative release the economic assets which they have been holding. Similarly, the tax liability of top twenty companies whose profits before tax is greater than Rs.500 crores would remain unchanged inspite of the reduction in the corporate tax rates and the abolition of the tax on dividend distribution. Their liability would continue to be relatively higher than the average liability.

The additional revenue gain from the redesigning of the existing MAT on companies is estimated to be Rs.7,000 crores after adjusting for tax loss on the abolition of dividend tax. In the long run, the revenue impact of the MAT is through the buoyancy it imparts to collections under the conventional corporate tax, resulting from the efficiency and accurate reporting incentives, rather than in terms of direct collections under the MAT head which, especially in the presence of carry forward, can be a very small part of the total. It is important to stress this, because the low share of MAT collections in the total can easily become a wrong argument for deleting it, which should be resisted at all cost by the authorities.

[6] Taxation of Charitable Trusts/Institutions[8]

A large number of countries provide for tax concessions for charitable donations. There are two theoretical justifications for this. First is the familiar notion that the activities charity finances are not private in the strict sense. Contributions to social and educational organisations not only benefit the donors but others. In other words, these donations create positive externalities. Second, this tax concession allows the flourishing of many non-profit organisations (NPOs) which, in turn, mitigates government's inability to provide adequate amounts and range of public goods.

[A] Rationale for Tax Concessions and Role of NPOs

The major effect of tax concessions for charitable contributions is through the tax-price. The tax-price is defined as unity for those who do not itemise deductions from income when calculating taxes and one minus the marginal tax rate for those who itemise their deductions. An increase in marginal tax rates lowers the "price" of giving and therefore may increase contributions. How much they increase will depend upon the price elasticity of giving, defined as the percent change in contributions caused by a one percent change in the price. If this elasticity is greater than unity then allowing a tax deduction for contributions is "efficient" in the sense that less is lost to the exchequer than is gained by charities through increased contributions. Moreover, tax concessions for charitable contributions have "equity" implications, depending upon the magnitude of price and income elasticity of donations across income groups. Empirical analysis reveals that tax concessions for charity have been efficient. However, price elasticities are higher in higher income groups implying serious equity implications.

Two main characteristics of NPOs are as follows:

1 Public benefit purpose: The first characteristic is that the organisation operates primarily for some purpose other than private gain. The emphasis here is not on avoiding the generation of profit (in the sense of an excess of revenues from all sources over expenses of all types), but rather on the existence of a substantial public benefit purpose. This is often referred to as the "principal purpose" test.

2 Non-distribution of surplus: It is barred from distributing its net earnings, if any, to individuals who exercise control over it, such as members, officers, directors, or trustees. This characteristic is popularly referred to in the literature as the "non-distribution constraint".

*8 This note draws heavily on the report **An Analysis of Tax Concessions for Charitable Contributions and Trusts/Institutions** (NIPFP, October 2000) prepared by Arbind Modi and Hiranya Mukhopadhyay.*

The proliferation of NPOs in certain areas of activity and not in others can be explained by numerous factors. Some important factors are described below.

1 Response to government failure (Public Goods argument): In a democracy, which makes choices by voting, a significant proportion of the population believes that the level of public services is too low. As a consequence, some of the dissatisfied people make charitable contributions to private organisations willing to produce incremental units of the collective goods or services. In effect, the NPOs are mainly conduits that efficiently convert donations into services demanded by donors.

2 Response to contract failure: Subject to certain conditions, profit-seeking firms will supply goods and services at the quantity and price that represent maximum social efficiency. Among the most important of these conditions is that consumers can, without undue cost or effort, (a) make a reasonably accurate comparison of the products and prices of different firms before any purchase is made, (b) reach a clear agreement with the chosen firm concerning the goods or services that the firm is to provide and the price to be paid, and (c) determine subsequently whether the firm complied with the resulting agreement and obtain redress if it did not. In many cases these requirements are reasonably well satisfied. However, either because of the circumstances under which the product is purchased and consumed or to the nature of the product itself, consumers may be incapable of accurately evaluating the goods promised or delivered. As a result, they will find it difficult to locate the best bargain in the first place or to enforce their bargain once made. In such circumstances, market competition may well provide insufficient discipline for a profit-seeking producer; the producer will have the capacity to charge excessive prices for inferior goods. As a consequence, consumer welfare will suffer considerably.

NPOs are granted exemption because they have no income/profit in the sense in which that term is used in tax laws. It is argued that any effort to use ordinary tax accounting to define taxable income for an NPO leads to complications. The concept of taxable income developed for business organisations simply cannot be carried over to NPOs in any meaningful way. However, these difficulties are often overstated. To begin with, many NPOs derive all or nearly all of their income from sales of goods or services that they produce. For such organisations it would be possible to use the same tax accounting that is applied to business firms, i.e. taking receipts from sales as the measure of gross income and permitting the usual deductions for expenses incurred in producing the goods or services sold. The resulting net earnings figure could be taxed just as in the case of a business firm.

Another argument against taxing the income of NPOs is that, in the long run, NPOs will necessarily have no net profits, since, by virtue of the non-distribution constraint, they must ultimately spend all of their income for the purposes for which they were formed, and hence their total expenses must ultimately equal their total income. The strength of this argument depends on several factors, including the detailed accounting conventions employed.

Tax exemption serves to compensate NPOs for the difficulties that they have in raising capital, and such a capital subsidy can promote efficiency when employed in those industries in which non-profit firms serve consumers better than their for-profit counterparts. This is an efficiency rationale for exemption. NPOs lack access to equity capital since, by virtue of the non-distribution constraint; they cannot issue ownership shares that give their holders a simultaneous right to participate in both net earnings and control. Consequently, in raising capital, NPOs are limited to three sources: debt, donations, and retained earnings. These three sources may, in many cases, prove inadequate to provide an NPO with all of the capital that it needs.

It is argued that if tax exemption is to be administered, three conditions should be satisfied before exemption is granted to an NPO in a given industry:

1 Non-profit firms in the industry must not have expanded to the point at which the productivity of the capital they employ is lower than the before-tax rate of return being earned on capital in other industries. This is known as the technical efficiency criteria.

2 From the consumers' viewpoint, non-profit firms must be more efficient producers of the service than the firms motivated by profits because of contract failure. This is known as the economic efficiency criteria. And

3 The non-profit firm should be able to generate investible funds through internal sources.

As a practical matter, it is not feasible to condition tax exemption for NPOs on the basis of the tax administration's judgement as to whether capital investment among non-profit firms in particular industries has exceeded the efficient level. Such a criterion would be extremely difficult to administer. Consequently, the best that can be done in this area is to focus primarily on the last two criteria.

[B] Modifications Needed in India

In India, the various provisions of the Income Tax Act 1961 provide for numerous exemptions to NPOs distinguished on the basis of their respective areas of operation. Appendix Table 4.3 lists various tax concessions. Sections 10(23C)(i) to (iii a) and Sections 10(23C)(iii ab) to (iii ae) do not impose any kind of non-distribution constraint and therefore are clearly designed inefficiently. These provisions are also inequitable in as much as the NPOs enjoying exemption under these provisions [except Sections 10(23C)(i) to (iii a)] co-exist with for-profit organisations in their respective areas of operations.

The design of the provisions of Sections 11 to 13 is clearly intended to meet the efficiency criteria for NPOs. These provisions provide for restrictions on the distribution of any part of the income to settlers/owners/trustees and on self-indulgence by managers. However, the provisions confer inequitable benefits in so far as the

exemption is enjoyed by NPOs which compete with for-profit firms in their areas of operation, as is generally the case.

There is considerable overlapping of the provisions of Sections 11 to 13 and Sections 10(23C)(iv) to (vi a) in the sense that non-profit organisations covered under the latter provisions are also eligible for exemption under the former without subjecting themselves to the guidelines of the distributions constraint or accumulation constraint or the compliance burden of having to file annual tax returns. Therefore, the existence of two separate sets of exemption provisions for the same organisation is inequitable. Clearly, there is a case for uniformity in the designing of the two provisions.

Revenue loss under Section 80G, which allows deduction for charitable donations to pre-specified organisations, for the financial year 1996-97 (assessment year 1997-98), directly available from the All India Income Tax Statistic, is estimated to be Rs.715 crores, i.e., about 2 percent of direct tax collection. An indirect estimate has also been made to work out the revenue-foregone figure arising from exempt income of charitable trusts/institutions. By applying the direct tax to non-exempt GDP ratio of 4.29 percent in the economy as a whole to the GDP from health, education and religious activities during 1996-97, the revenue foregone is estimated to be Rs.2,216 crores. Therefore, total revenue foregone on these two accounts is almost Rs.3,000 crores, which is 8.15 percent of total direct tax revenue, and 0.23 percent of aggregate GDP. Applying this proportion on the GDP for 1999-2000, total revenue foregone is estimated to be Rs.4,417 crores. Of which roughly Rs.1,100 crores (2 percent of direct tax revenue) could be attributed to Section 80G and the balance Rs.3,317 crores on account of exemption to NPOs. The revenue foregone in 2000-01 could be as high as Rs.5,750 crores.

The present system, under which donations are deducted from gross income, have been empirically found to be efficient because the revenue loss is likely to be less than exemption induced total donation. However, since price elasticity varies across income groups, the provisions are inequitous. The existing provisions produce tax subsidies that increase with income. Therefore, the simplest alternative is to provide for a tax credit, which reduces the income tax liability of the donor by a designated proportion of his contributions. This could be set by the legislature at the minimum marginal rate of tax of 10 percent on equity considerations. There is also no compelling reason to set a quantitative limit either in absolute terms or as a fraction of the gross income, as is presently set under Section 80G.

Given the current scheme of tax exemption for NPOs under the Income Tax Act, both donative and commercial NPOs can, and do, avail of the benefit even though there is no justification in the case of commercial NPOs. Therefore the law should be amended to provide the tax exemption only to donative NPOs. Further, to avoid any controversy on the definition of a donative NPO, it is recommended that the same may be defined as one where 90 percent of the annual receipts is through donations (including lump-sum aid unrelated to any specific activity/project). The corpus donations should be treated as receipts in the year in which it is received. Consequently, it would not be necessary to impose any further conditions on the nature and purpose of their

business activity. Further all provisions should be brought under one section with explicit non-distributional constraint and uniform compliance requirements/burden.

[7] Issues in Direct Tax Administration

In the most ideal law-abiding society, people would pay the taxes they owe, and tax administration would amount to little more than the provision of facilities for citizens to discharge this responsibility. No such country exists, or is ever likely to exist. Further, resources available with the tax administration are limited and therefore no tax administration can play the role of a policeman for every potential taxpayer. Hence, compliance with tax laws must be created, cultivated, monitored and enforced. A responsible tax administration must be effective and efficient in this task.

Effective tax administration requires establishing an environment, in which citizens are induced to comply with tax laws voluntarily. People would comply with the tax laws so long as they feel that non-compliance may cost more, that is, that the penalties likely to be suffered in case evasion is detected exceed the tax to be paid. Compliance is unlikely to be high if the belief prevails that evasion can be practiced with impunity. The free-rider instinct is universal and an element of coercion seems inherent. How effectively the tax administration can foster compliance would depend ultimately upon their perceived ability to detect and bring tax offenders to book, namely, unregistered taxpayers, stop filers, tax evaders and delinquent taxpayers. The tax administration must deal with all these categories of taxpayers simultaneously; otherwise non-compliance will shift to the gap where the administration exercises weaker control.

Efficient tax administration requires that its task be performed at minimum cost to the community. Tax systems all over the world have, therefore, tended to move towards regimes in which taxpayers themselves determine and report—in other words, "self-assess"—their tax liability and pay the amount due without any special prodding from tax authorities. But self assessment will result in high compliance only if accompanied by (i) action of the tax administration that lend credibility to the sanctions prescribed in the law against non-compliance and (ii) quality service to taxpayers.

Therefore, the functions of the tax administration are (1) to detect and penalise non-compliance; and (2) to facilitate voluntary compliance through the provision of quality taxpayers' service. These functions comprise the following separable component activities:

1 Taxpayers' education and service

2 Collection of information

3 Collation of information

4 Dissemination of information

5 Storage and retrieval of information

6 Verification (appraisal/assessment of information)

7 Collection of taxes

8 Taxpayers' grievances redressal system.

Each of these activities must create the synergies for an efficient and effective tax administration which assists the taxpayers to comply with his obligations and persuades him to continue to improve his compliance, mainly because he is aware that the administration is capable of detecting his non-compliance. For this purpose, the tax administration must be able to coordinate and adapt in time the organisational structure and its resources.

Traditionally, the role of the tax administration has been to enforce the tax laws and provide at least minimal taxpayer service. This was understandable in the context of a small potential taxpayer base and the then prevalent practice of administrative assessment. Over time, as the taxpayer base expanded and the scheme of self-assessment introduced, it became necessary for the tax administration to also facilitate compliance through the provision of quality taxpayer service. In most developing countries this shift in role focus is suspiciously viewed as abandonment of its traditional role of enforcement and softening of the tax administration. Most employees unable to reconcile to their new role continue to resist this shift in the role perception from an enforcement officer to a facilitator.

Tax evaders in most countries, particularly developing countries, can be classified into two categories. The first category relates to those who fail to comply because of information asymmetry (lack of information) and the tax administration's failure to provide this information. Recourse to private sources (tax practitioners) for information entails a relatively high compliance burden. These evaders are sitting ducks for the tax administration and entail a high administrative burden if pursued individually. The second category relates to those who refuse to comply because of deficiencies in the taxpayers information system and supporting institutional setup. Therefore, these also exist because of information asymmetry (lack of information with taxpayers). The compliance burden in this category is relatively low. The first category constitutes the majority of tax evaders but account for a relatively small proportion of taxes evaded. The existence of the first category of evaders creates a general climate of non-compliance. Tax evasion being contagious it spreads wildly. Since the second category is hard to nab and the first category is a sitting duck, the tax administration tends to prey on the first category for easy success. The second category continues to thrive under the umbrella of the first category. It is, therefore, efficient for the tax administration to provide quality taxpayer service and reduce the size of

the first category. The limited resources hitherto deployed in the pursuit of the first category could be substantially released and redeployed to the task of tackling the second category.

The provision of quality taxpayer service must therefore be directed towards provision of information on when and how to comply. A taxpayer has the statutory responsibility to comply with the requirements of the tax laws by specified dates. Often these dates need to be reminded since they vary depending upon the nature of the statutory responsibility. For example the due date for filing tax return in the case of a salaried employee is 30th June while the statutory date for payment of first installment of advance tax is 15th September. Similarly, the taxpayer needs to be informed about how to comply. For example, what does a taxpayer have do to comply, how does he obtain a tax return and how does he fill up the tax return (since he may not have information on what is the tax law). The taxpayer needs to know various other similar issues, which need to be addressed by the tax administration. More often than not, a common refrain has been the non-availability of tax return forms. The genesis of this problem seems to be the government rule that all tax return forms must be printed in government press. The cost to the exchequer for sustaining the public sector printing press is extremely high in as much as it creates a poor public image of the tax administration and an excuse for taxpayers at the margin to shirk their filing obligations. The tax administration has to then follow up such non-compliance with notices thereby exerting pressure on its limited resources. Keeping in view the needs of the taxpayer and the computerisation program underway, we recommend the following for immediate implementation:

The sources of information used by the tax administration to build up an information system may be classified into three main categories:

1 Taxpayers' Declaration: Under the system of self-assessment, the taxpayer forms the basic source of information. The taxpayer provides information to the tax administration through returns and accompanying documents. These returns contain valuable information on the taxpayer and his activities. All this information can potentially be used to help gauge the taxes due from the taxpayer. In this regard, it is necessary to address the problem of the design of the return forms, filing requirements and policy, making returns available and sanctions against non-filing of taxpayer declaration. Since any recommendations on this aspect can be made effective only from financial year 2002-2003, we propose to make recommendations in this regard in our final report.

2 Information returns: this is a more widely used device to collect information. Information returns are declarations filed with the tax administration by persons required to report details of their financial dealings with other taxpayers. Information returns often require listing of all transactions of a certain kind e.g., payments of corporate dividends or transactions beyond a magnitude of other kinds with other taxpayers during a certain period. A wide variety of sources of information can be imagined which could be reached by the tax administration through the device of information returns.

Under the extant procedure, the Central Information Branch functioning under the Director General (Investigation) within the Directorate of Income Tax (Investigation), spread all over the country, collects from predetermined sources information relating financial transactions from various external and internal sources. Sources of information to be tapped in a financial year, are laid down by the CBDT in its instruction No.1943 dated August 22,1997. The Director General of Income Tax (Investigation) is empowered to revise the ceilings of the monetary limits fixed by the Board for collection of information. Currently, about 37 broad categories of external and internal sources are listed in the long-term action plan for information collection, formulated by the CBDT. Sections 133B (power to call for information) and 131 (power regarding discovery, production of evidence, etc) constitute the main legal base for the process. Under Section 133(6) of the Income Tax Act, firms, companies, dealers, brokers, agents, banks, etc., can be called upon to provide the names and addresses of persons engaged in transactions with them. The information so collected is collated and then disseminated by the CIB to the assessing officers for verification in the respective cases.

The process starts with the collection of information, mainly from external sources. However, there are several hurdles in this area. First, the flow of information is not automatic in the sense that the CIB first issues letters to various agencies, calling for information under sub-section (6) of Section 133 of the Income Tax Act. Though the instruction identifies the sources of information to be tapped during the year, the specific firms, dealers, brokers, banks, companies, etc., required to be tapped for this purpose are left to the discretion of the officer in the field formation, with the result that the coverage of most sources tapped is incomplete. Secondly, even where information is called for under Section 133(6), not all agencies respond promptly. In such cases summons under Section 131 are issued. Even then, many agencies try to stall or even resist communication of information. Refusal to part with information by banks and some other financial institutions is a case in point. This strains CIB's resources and delays verification and dissemination of information. Thirdly, because of limited manpower and infrastructure—including, importantly, the lack of automation and also the long delays in furnishing information, the CIB is not able to collect information from even the major external sources every year. The inability to collect annually comprehensive information from all or at least the major sources dilutes the efficacy of CIB verifications.

Under the Income Tax Act, deduction at source is required to be made from specified categories of payments like salaries, interest, commission etc. The deductor is required to file with the TDS circles in the Department annual returns relating to deduction of tax at source. These information returns also form one of the important sources of information.

3 Information and evidence collected by the Department during the course of investigation: In addition to information from taxpayers' return and other information returns, a large volume of information also gets collected during assessment, searches and seizures and survey operations.

If the large volume of information that any tax administration receives is to be meaningfully utilised for determining under-reporting or non-reporting of income in tax returns, it is necessary that the information is properly collated, disseminated and verified. At present, because of lack of computerised information system and the absence of a permanent identification system, the information collected is wasted. Even though the permanent identification system in the form of PAN has been introduced there is still no requirement to quote PAN either on economic transactions or on documents/papers submitted to the tax administration. This affects collation, dissemination and verification. The limited success of one-by-six scheme in widening the tax base substantially is also partly attributable to this. This also inhibits the department's ability to identify non-filers.

Further, since there is no requirement under law to quote PAN on tax returns, the system is seriously handicapped in dealing with stop filers. The number of registered taxpayers has undoubtedly increased rapidly from 140 lakh at the beginning of 1996-97 to 250 lakh at the end of 1999-2000. However, the number of stop filers continues to remain at a high of about 72 lakh. This constitutes about 29 percent of registered taxpayers[9] and has considerably eroded the impact of widening of the tax base. The Department estimates to recover Rs.2,800 crores annually from pursuing these stop filers. This should provide the necessary impetus to the tax buoyancy (about ten percent increase in the buoyancy seen in 1999-2000). The much publicised widening of the tax base could become an exercise in futility if the Department fails to vigorously pursue the stop filers.

Similarly, the delinquent accounts have risen from Rs.28,970 crores at the beginning of 1996-97 to a high of Rs.55,000 crores at the end of 1999-2000 (see Table 1). The outstanding arrears are almost equal to the annual tax collections. Bulk of these arrears is locked up in appeals at various stages. Yet a large part of the arrears are irrecoverable: the arrear entries in a large number of cases do not contain even the minimum details like the address of the taxpayer. We are also told that there are numerous instances where the same arrear is reflected as outstanding in the Arrear register of two different assessing officers. The genesis of these problems lies in the absence of a computerised information system.

A large proportion of the taxes are collected through TDS. This will continue to occupy prominence in view of the fact that the system provides a continuous flow of resources to the exchequer during the year and also counteracts tax evasion. However, the ability of the system to counteract tax evasion has been seriously hampered in the absence of a computerised information system. Any further increase in the scope of the TDS provisions should only be done after full computerisation of the existing system and consolidating the gains from the existing provisions.

Another aspect relating to collection of taxes is the collection of information regarding tax payments. At present, a taxpayer has to fill three copies of a challan for making any tax payment in the bank. One copy of the challan is returned to the

9 *Internationally, it is considered a serious problem if the stop filers exceed 10 percent.*

taxpayer as acknowledgement of receipt of tax payments and two other copies are sent to the two different units of the Department: one for the Central Treasury Unit (CTU) in the computer centre and another to the Zonal Accounts Office. The information in the millions of challans received every month is than manually keyed into the computer for building up the data base for tax payments. This manual exercise is cumbersome and not free from errors and delay throwing up opportunities for taxpayer grievances. Further, monitoring of tax payments is also adversely affected. The requirement of filling multiple copies of challan is also burdensome for taxpayers.

Similarly, in the absence of collation and dissemination of information, the effectiveness of the scrutiny process is also adversely affected—it is impossible to design a selection process which is not only fair but also appear to be fair and therefore inspire confidence in the tax system. There have been complaints of corruption in the selection of cases for scrutiny. As a reaction to this the Central Board of Direct Taxes has now publicly announced its decision to virtually abandon the scrutiny process except in certain cases where specific information of incorrect income reporting exist. Such a strategy is not conducive to maintaining a minimum deterrence level, which is the key to promoting voluntary compliance.

The storage and retrieval of information (more commonly known as record keeping) is in a dismal state. Every expert Committee has commented adversely on the existing system. There have been newspaper reports of records being stored in bathrooms. Such dismal state of affairs becomes a fertile ground for corruption and harassment to taxpayers.

The perception from a discussion with a cross section of people is that the response of the tax administration to taxpayers' grievances is substandard. This is particularly relating to issuance of refunds and tax clearance certificates. Over the years, the scope of the TDS provisions has expanded resulting in greater number of refund claims. Given the manual system of processing returns, there is considerable delay in processing refund claims, which in turn results in rent-seeking behaviour. We understand that such grievances would be resolved with the induction of technology, which has now got a boost with employees of the income tax department withdrawing their resistance to computerisation of the business processes.

We are informed that the department is currently in the process of restructuring to facilitate large-scale induction of information technology. The training of staff is currently in progress and the resistance of staff to the process of computerisation has been withdrawn. Consequent to the induction of technology, the department expects to mobilise about Rs.10,000 crores on account of its enhanced capability to deal with stop filers and from recovery of tax arrears. The government has directed the CBDT to enter into an MOU with the government for enhanced revenue, better taxpayer service and greater accountability. This is consistent in the international trend and greater transparency in governance.

During our visit to offices of the income tax department in Chennai and Calcutta, we found visible signs of enthusiasm amongst officers and staff to computerisation. We

are quite optimistic about the potential of the tax administration to raise the direct tax-GDP ratio envisaged in this Report. However, we are afraid that the process of computerisation and the effectiveness of the tax administration could be seriously constrained by inadequate number of computers for staff members, lukewarm response of the telecommunication authorities to provide lease line facilities for networking of the computers in the different offices of the tax department spread over 450 towns/cities and inadequate and inflexibility in the use of financial and human resources. The process of restructuring is expected to be in place by the beginning of the next fiscal year.

In the light of the above, we recommend the following steps for immediate action:

1 ***The department must introduce voice message system to remind taxpayers of important dates. Under this system, the recorded message could be automatically activated when the telephone handset is picked up.***

2 ***The department must sell pre-formatted programmed floppy diskettes through retail outlets, and should have all the help features required to comply with the law. Such floppy diskettes could be designed for return forms, TDS forms and other information returns. The taxpayer would be required to enter the data only without the need to make any calculations. He could submit the same to the tax administration along with a hard copy, if necessary.***

3 ***The department should be allowed to print the tax return forms through private printing press and the power to place orders for the printing must be fully delegated to the head of the department in the field. There should be no obligation on the tax administration to undertake centralised printing by the government press.***

4 ***Instead of specifying the sources of information to be tapped every year, the CBDT should prescribe a long-term plan indicating the sources from which information should be gathered. In this regard, the Board should be empowered to make rules to require some classes of persons to furnish information in respect of certain major items, in a prescribed performa. The classes of persons could include persons who are authorised to issue licenses and sales tax exemption forms, give telephone connections, etc. For example, to begin with, the person responsible for registering industrial units should be required to furnish an annual return containing details of all registered units. In the subsequent years, they could be required to furnish details of only the new registrations during the year. Similarly, the telephone authorities could be required to furnish details of the new telephone connection each year. Since the responsibility would be cast upon the information return filer to file the relevant information return by the due date, the existing problem of identifying the information return filers and having to issue summons for collection of information would be considerably reduced. Further, information from a particular source would be uniform across the country and a continuous flow would be ensured over time.***

5 The information must be procured in a prescribed form on a magnetic media and should be sent directly to the CIB.

6 The government must immediately notify that no document, in particular, return of income, challans, information returns, rectification applications and appeals, should be received by the tax administration where the PAN is not quoted.

7 Further, the government must also notify the categories of transactions where PAN should be quoted. It should be mandatory to quote PAN in all banking transactions without which the bank should be prohibited from undertaking the transaction. We do understand that this could pose some problem in the rural sector but since income tax offices are across the are spread over 450 centers across the country and allotment of PAN is now online, a one time visit to the income tax office for obtaining the PAN should be construed as a cost towards discharging social responsibilities.

8 The department should immediately identify the stop filers and issue notices for filing of tax return. There is no reason why this exercise should be delayed given the fact that this is one of the main planks for restructuring. We believe that the department is unable to issue notices because the Taxpayer Master File is itself deficient. If this is indeed so, immediate steps must be taken to reconstruct the taxpayers master file. The pursuit of the stop filers must become a part of the annual action plan with immediate effect.

9 In the case of arrears, a large of entries relates very small amounts where the cost of recovery far exceeds the benefit. A policy decision should be taken at the government level to write off arrears above a certain amount, particularly, in all cases where the identity of the taxpayer is doubtful. This will enable the Department to concentrate on large arrears, which could be pursued vigorously.

10 As regards, scrutiny assessment, we appreciate the concern of the department to reduce corruption in the identification of cases for scrutiny. However, the department must maintain a credible minimum deterrence level. Therefore, care should be taken to ensure that a certain minimum percentage of taxpayers are annually scrutinised but the scheme for selection of cases is absolutely secret but fair.

11 The system of income tax clearance certificate under Section 230 of the Income Tax Act should be replaced by the simple requirement of quoting PAN. The requirement of obtaining income tax clearance before leaving the country must also be done away with immediate effect. It should be sufficient for citizens of India to quote their PAN to airline/shipping agency. As regards, non-citizens are concerned, the department should depend on the mechanism of international cooperation and assistance envisaged under the Double Taxation Avoidance Agreements with large number of countries. Since the flow of tourists from countries with which India does not have a DTAA is limited, revenue loss, if any, would be negligible and can therefore be ignored. This will enhance the

worldwide image of the country and will also encourage flow of tourists to the country. This will reduce a large number of public grievances.

12 *Given the system of collection of information regarding tax payments discussed above, we recommend that the banks receiving tax payments should be compulsorily required to furnish the data on a magnetic media which could be immediately uploaded on to the computer system of the tax administration. The department should introduce this system from April 1, 2001. Once this is implemented, it should not be necessary for the taxpayer to fill multiple copies of challans. Further, the department should also explore the feasibility of using smart cards for collection of taxes.*

13 *The government should provide funds for immediate procurement of high speed computers for all the Tax Assistants in the department so that the processing of returns, issue of refunds and assistance to taxpayers is immediately computerised. Any delay in providing them with high speed personal computers will nullify the effect of computer training due to inadequate hands-on experience.*

14 *With regard to lease-line facilities, we recommend that the matter should be accorded highest priority and therefore taken up at the ministerial level. Implementation should be overseen by a committee comprising of representatives from both the income tax department and the telecommunication department. The full potential of computerisation of the tax administration can only be realised with the successful networking of the workstations to facilitate matching of information.*

15 *We welcome the decision of the government to enter into a Memorandum of Understanding with the Central Board of Direct Taxes. We believe this will enhance accountability and responsibilities of both parties to the MOU. However, we must caution that the benefits of the MOU would not be realised fully if the rights and obligations of all parties to the MOU and the supporting institutions are not clearly specified. The MOU must (i) specify detailed performance measures for the tax administration, the revenue targets to be achieved, and the amount of resources (both human and financial) that would be made available by the government to the tax administration; (ii) assign to the Central Board of Direct Taxes the complete control over the management and deployment of resources (both human and financial) consistent with the overall guidelines of the government on the management and deployment of such resources; and (iii) indicate the penalty leviable in the event of non-performance.*

16 *Consequent to the decision to induct large-scale technology in the tax administration, it is important to identify sources, which are a drag on the productivity of the tax administration. Further, the tax administration would need a large number of qualified and trained computer personnel to process the growing volume of information that is expected to flow. It is therefore important that the relatively less productive work force be identified for retraining and*

redeployment as computer personnel. Two such categories relate to the employees in the cadre of notice servers and peons. We recommend that the employees in these two categories should be encouraged to acquire the requisite computing skills. On successful attainment of the skill, they could be placed in the equivalent scale of Tax Assistant (Rs.4,000-100-6,000). The vacancy created at the level of peons and notice servers should, thereafter, be abolished. This will enhance the data entry capacity of the department and increase productivity.

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List of Incentives Under the Income Tax Act

	Section	Nature of Tax Concession	Who are Entitled	Recommend-ation	Class of Exemp
1	10(1)	Agricultural income	Any assessees	To be dealt in the Final Report	—
2	10(2)	Amount received out of family income, or in case of impartible estate, amount received out of income of family estate	Individuals as member of HUF	To be continued	—
3	10(2A)	Partner's share in total income of firm	Partner of a firm	To be continued	—
4	10(3)	Receipts of casual and non-recurring nature (Rs.5,000 in aggregate) [limit in case of winnings from races including horse races: Rs.2,500]	Any assessees	Provide for a tax credit of Rs.500	—
5	10(4) (i)	Interest on securities or bonds notified by the Central Government including premium redemption of such bonds	Non-resident	Delete	2
6	10(4)(ii)	Interest received on Non-resident (External) Account	Person resident out-side India (as defined in FERA) & person who has been permitted to maintain said account by RBI	Delete	2
7	10(4B)	Interest on notified savings certificates issued by the Central Government and subscribed to in convertible foreign exchange	Individual (Indian citizen or person of Indian origin, who is a non-resident)	Delete	2
8	10(5)	Leave travel concession or assistance (subject to prescribed conditions and limited to amount actually spent)	Individual—Salaried employee	Delete	3
9	10(5B)	Perquisite of income-tax paid by the employer in respect of the salary income of certain technicians from abroad (subject to certain conditions)	Individual—Salaried employee who was not resident in India in any of the 4 financial years immediately preceding the financial year in which he arrived in India	Delete	3
10	10(6) (l)	Passage moneys/value of free or concessional passage received, subject to prescribed conditions	Individual—Salaried employee (non-citizen of India)	Delete	3
11	10(6)(ii)	Remuneration received by specified diplomats and their staff	Individual (non-citizen of India)	To be continued	3
12	10(6) (vi)	Remuneration received as employee of foreign enterprise for services rendered during stay in India (subject to certain conditions)	Individual—Salaried employee (non-citizen of India)	Delete	10
13	10(6) (viii)	Remuneration received for services rendered in connection with employment on a foreign ship (subject to certain limits)	Individual—Salaried employee (non-resident, non-citizen of India)	To be continued	3

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	Section	Nature of Tax Concession	Who are Entitled	Recommend-ation	Class of Exemp
14	10 (6) (xi)	Remuneration received as employee of foreign Government in connection with his training in government offices/statutory undertakings, etc.	Individual—Salaried employee (foreign citizen)	Delete	3
15	10 (6A)	Tax paid by Government or Indian concern on royalty/fees for technical services from government or Indian concern under agreement which either relates to a matter included in the industrial policy of the Government and is in accordance with that policy or is approved by Central Government.	Foreign company	Delete	11
16	10(6B)	Tax paid by Government or Indian concern under terms of agreement entered into by Central Government with Government of foreign State or international organisation on income derived from government or Indian concern, other than income by way of salary, royalty or fees for technical services	Non-resident (other than company) or foreign company	Delete	11
17	10(6BB)	Tax paid by Indian company, engaged in the business of operation of aircraft, who has acquired an aircraft or its engine on lease, under an approved (by Central Government) agreement entered into after 31.03.1997 but before 01.04.1999, on lease rental/income	Government of foreign State or foreign enterprise	Delete	11
18	10(6C)	Income by way of fees for technical services rendered in India or abroad in projects connected with security of India pursuant to agreement with Central Government	Notified foreign company	Delete	11
19	10(7)	Foreign allowances or perquisites paid or allowed by Government to its employees posted abroad	Individual—Salaried employee (Indian citizen)	To be continued	10
20	10(8)	Foreign income and remuneration received from foreign government for services rendered in connection with any co-operative technical assistance programmes and projects in accordance with agreement entered into by Central Government and foreign Government (subject to certain conditions)	Individual	Delete	10
21	10(8A)	Foreign income and remuneration received by consultant (agreement relating to his engagement must be approved) out of funds made available to an international organisation (agency) under a technical assistance grant agreement between that agency and the Govt of a foreign State.	Non-Indian citizen/Indian citizen who is not ordinarily resident in India/non-resident, engaged by the agency for rendering technical services in India	Delete	10

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	Section	Nature of Tax Concession	Who are Entitled	Recommend-ation	Class of Exemp
22	10(8BB)	Foreign income and remuneration received by an employee of the consultant referred to in section 10(8A)	Non-Indian citizen/Indian citizen who is not ordinarily resident in India (contract of service must be approved by the prescribed authority before commencement of service	Delete	10
23	10(9)	Income of any member of family of any individual [referred to in Section 10(8), 10(8A) or 10(8)B)] which accrues or arises outside India and is not deemed to accrue or arise in India and which is subject to tax in that foreign country.	Individual	Delete	10
24	10(10)(I)	Death-cum-retirement gratuity received by Government servants	Individual—salaried employee	To be continued	3
25	10(10)(ii)	Gratuity received under the Payment of Gratuity Act, 1972 (maximum Rs.3,50,000)	Individual—Salaried employee	To be continued	3
26	10(10) (iii)	Any other gratuity received by employee/legal heirs on retirement, termination of services, death, etc., limited to half month's salary for each year of completed service (subject to certain conditions) [maximum limit Rs.350,000]	Individual—Salaried employee	To be continued	3
27	10(10A)	Payment in commutation of pension received from government/Private employer (subject to certain limits)/ LIC Fund u/s 10(23AAB)	Individual—Salaried employee	To be continued	3
28	10(10AA)	Amounts by way of encashment of unutilised earned leave on retirement limited to 10 months salary subject to certain conditions) [maximum limit Rs.2,40,000]	Individual—Salaried employee	Delete	3
29	10(10B)	Retrenchment compensation [maximum limit under proviso (ii) is Rs.5,00,000]	Individual—Workman	To be continued	3
30	10(10BB)	Payments made under Bhopal Gas Leak Disaster (Processing of Claims) Act, 1985 and any scheme framed thereunder (subject to certain conditions)	Any assessee	To be continued	11
31	10(10C)	Payment received (not exceeding Rs.5,00,000) on voluntary retirement in accordance with scheme framed in accordance with prescribed guidelines [in case of companies (other than public sector companies)/co-operative societies, scheme should be approved by Chief Commissioner/Director general]	Individual—Employee of a public sector company, any other company, an authority established under a Central, State or Provincial Act, a local authority, co-op societies, universities, IITs &notified institutes of management	To be continued	3

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	Section	Nature of Tax Concession	Who are Entitled	Recommend-ation	Class of Exemp
32	10(10D)	Any sum received under a life insurance policy including bonus on such policy but excluding sums received u/s 80DDA(3) and under a Keyman insurance policy	Any assessee	To be continued	3
33	10(11)	Payment from public provident fund/statutory provident fund	Individual/Hindu Undivided family	To be continued	3
34	10(12)	Accumulated balance payable to employee participating in recognised provident fund (subject to certain conditions)	Individual—Salaried employee	To be continued	3
35	10(13)	Payment from approved superannuation fund in specified circumstances and subject to certain limits	Individual	To be continued	3
36	10(13A)	House rent allowance (subject to certain limits)	Individual—Salaried employee	Delete	3
37	10(14)	Prescribed allowances or benefits	Individual—Salaried employee	To be continued	3
38	10(14A)	Exchange risk premium received from person borrowing foreign currency (subject to certain conditions)	Public financial institution	Delete, tax premium at a concessional rate in line with the taxation of premium in the case of general insurance companies	11
39	10(15) (i)	Interest premium on redemption, or other payment on notified securities, bonds, certificates, and deposits, etc. (subject to notified conditions and limits)	All assessees	Delete	1
40	10(15) (iib)	Interest on notified Capital Investment Bonds	Individual/HUF	Delete	1
41	10(15) (iic)	Interest on notified Relief Bonds	Individual/HUF	Delete	1
42	10(15) (iid)	Interest on notified bonds purchased in foreign exchange (subject to certain conditions)	Individual—NRI/ nominee or survivor of NRI/individual to whom bonds have been gifted by NRI.	Delete	2
43	10(15) (iii)	Interest on securities	Issue Department of Central Bank of Ceylon	To be continued	2
44	10(15) (iiia)	Interest on deposits made with schedule bank with approval of RBI	Bank incorporated abroad	Delete	2

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	Section	Nature of Tax Concession	Who are Entitled	Recommend-ation	Class of Exemp
45	10(15)(iv)(a)	Interest received from Government or from local authority on moneys lent, etc., from sources outside India	All assessees who have lent money, etc., from sources outside India	Delete	2
46	10(15)(iv)(b)	Interest received from industrial undertaking in India on moneys lent to it under a loan agreement	Approved foreign financial institution	Delete	2
47	10(15)(iv)(c)	Interest at an approved rate received from Indian industrial undertaking on moneys lent or debt incurred in a foreign country in respect of purchase outside India of raw materials, components or capital plant and machinery, subject to certain limits and conditions	All assessees who have lent such money, or in favour of whom such debt has been incurred	Delete	2
48	10(15)(iv)(d)	Interest received at an approved rate from specified financial institutions in India on moneys lent from sources outside India	All assessees who have lent such moneys	Delete	2
49	10(15)(iv)(e)	Interest received at approved rate from other Indian financial institutions or banks on moneys lent for specified purposes from sources outside India under approved loan agreement.	All assessees who have lent such moneys	Delete	2
50	10(15)(iv)(f)	Interest received at approved rate from Indian industrial undertaking on moneys lent in foreign currency from sources outside India under approved loan agreement	All assessees who have lent such moneys	Delete	2
51	10(15)(iv)(fa)	Interest payable by scheduled bank, on deposits in foreign currency when acceptance of such deposits by bank is approved by RBI	Non-resident or individual/ HUF who is not ordinarily resident in India	Delete	2
52	10(15)(iv)(g)	Interest received at approved rate, from Indian public companies eligible for deduction under Section 36(1) (viii) and formed with main object of providing long-term housing finance, on moneys lent in foreign currency from sources outside India under approved loan agreement	All assessees	Delete	2
53	10(15) (iv)(h)	Interest received from any public sector company in respect of notified bonds or debentures and subject to certain conditions.	All assessees	Delete	1
54	10(15) (iv)(i)	Interest received from Government on deposits in notified scheme out of moneys due on account of retirement	Individual—Employee of Central government/State Government/Public sector company	Delete	1
55	10(15)(v)	Interest on securities held in Reserve Bank's SGL A/c No. SL/DH-048 and Deposits made after 31.3.1994 for benefit of victims of Bhopal Gas Leak Disaster held in such account with RBI or	Welfare commissioner, Bhopal Gas Victims, Bhopal	To be continued	11

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	Section	Nature of Tax Concession	Who are Entitled	Recommend-ation	Class of Exemp
		with notified public sector bank			
56	10(15)(vi)	Interest on Gold Deposit Bonds issued under the Gold Deposit Scheme, 1999 notified by Central Government	All assessees	Delete	1
57	10(15A)	Any payment made by an Indian company, engaged in business of operation of aircraft, to acquire an aircraft or an aircraft engine on lease from the Government of a foreign State or a foreign enterprise (person who is non-resident) under approved agreement entered into on or after 01.04.1999. However, payment made for providing spares, facilities or services in connection with operation of lease aircraft is excluded	Foreign State/Enterprise	Delete	11
58	10(16)	Education scholarship	Individual	To be continued	6
59	10(17)(I)	Daily allowance	Individual—Member of Parliament/State Legislature/Committee thereof	Delete	3
60	10(17)(ii)	Any allowance received by MP under Members of Parliament (constituency Allowance) Rules, 1986	Member of Parliament	Delete	3
61	10(17)(iii)	All other notified allowances not exceeding Rs.2,000 per month received by MLA	Individual Member of State Legislature/ Committee thereof	Delete	3
62	10(17A) (I)	Amount received in pursuance of award (whether in cash or kind) instituted in public interest by Central/State Government or approved award instituted by other body	Any assessee	To be continued	11
63	10(17A)(ii)	Reward (whether in cash or kind) received from Central/State Government for approved purposes in public interest	Any assessee	To be continued	11
64	10(18)	Pension received by an individual who has won specified/notified gallantry awards and family pension received by any family member of such individual.	Individual—Central State Government employee or his family member	To be continued	11
65	10(19A)	Notional annual value of any one palace occupied by former ruler	Individual	Delete since it is no more relevant.	11
66	10(20)	Specified incomes of a local authority	Local authority	Delete	7
67	10(20A)	Income of housing boards etc.	Statutory corporation	Delete	7
68	10(21)	Income of approved scientific research associations subject to certain conditions	Scientific Research Association	Delete	7
69	10(22B)	Income of notified news agency set up in India solely for collection and distribution of news	News agencies	Delete	11

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	Section	Nature of Tax Concession	Who are Entitled	Recommend-ation	Class of Exemp
		(subject to certain conditions)			
70	10(23)	Income of notified sports or games associations or institutions (subject to certain conditions)	Sports and games associations and institutions	Delete	7
71	10(23A)	Income of approved professional bodies other than income from house property, income received for rendering specific services & income by way of interest or dividends (subject to certain conditions)	Professional associations	Delete	7
72	10(23AA)	Income received on behalf of regimental fund or non-public fund established by armed forces.	Regimental fund or non-public fund	Delete	9
73	10(23AAA)	Income of approved fund established for notified purposes for welfare of member employees or their dependents (subject to certain conditions)	Approved fund	Delete	9
74	10(23AAB)	Income of fund set up by LIC under an approved pension Scheme (subject to certain conditions)	Fund set up by LIC	Delete	9
75	10(23B)	Income of institution existing solely for develop-ment of khadi or village industries (subject to certain conditions)	Public charitable trust/registered society	Delete	7
76	10(23BB)	Income of authority established for development of kahdi or village industries	Authority established under State or Provincial Act	Delete	7
77	10(23BBA)	Income of a body or authority established for administration of public religious or charitable trusts or endowments, etc.	Body/authority established, constituted or appointed under Central, State or Provincial Act	Delete	7
78	10(23BBB)	Income of EEC from interest, dividends or capital gains from investment of funds under specified scheme	European Economic Community	To be continued	11
79	10(23BBC)	Income of SAARC Fund for Regional Projects set up by Colombo Declaration issued on 21.12.1991	SAARC Fund for Regional Projects	To be continued	11
80	10(23C)(i) to (iia)	Income received by any person on behalf of specified Prime Minister's Funds or National foundation for communal harmony	Any person concerned	To be continued	11
81	10(23C) (iiiab)	Income of any university or other educational institution existing solely for educational purposes and not for purposes of profit & which is wholly or substantially financed by the Government	University/other educational institution	Delete	7
82	10(23C) (iiiac)	Income of any hospital or other medical treatment institution existing solely for philanthropic purposes and not for purposes of profit, & which is wholly or substantially financed by the Government	Hospital/Nursing Home, etc.	Delete	7

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	Section	Nature of Tax Concession	Who are Entitled	Recommend-ation	Class of Exemp
83	10(23C) (iiiad)	Income of any university or other educational institution existing solely for educational purposes and not for purposes of profit, if the aggregate annual receipts do not exceed one crore rupees	University/other educational institution	Delete	7
84	10(23C) (iiiae)	Income of any hospital or other medical treatment institution existing solely for philanthropic purposes & not for purposes of profit, if the aggregate annual receipts do not exceed one crore rupees	Hospital/Nursing Home, etc	Delete	7
85	10(23C) (iv)/(v)	Income received by any notified charitable fund or institution and notified public religious/charitable trust or institution (subject to certain conditions)	Charitable/Religious trusts and institutions	Delete	7
86	10(23C)/(vi)	Income of any university or other educational institution existing solely for educational purposes and not for purposes of profit, other than those mentioned in Sections 10(23C)(iiiab) and 10(23C)(iiiad) and which is approved by the prescribed authority	University/other educational institution	Delete	7
87	10(23C) (via)	Income of any hospital or other medical treatment institution existing solely for philanthropic purposes and not for purposes of profit, other than those mentioned Sections 10(23C)(iiia) and 10(23C)(iiiae) and which is approved by the prescribed authority	Hospital/Nursing Home, etc	Delete	7
88	10(23D)	Income of Mutual Fund registered under SEBI Act, 1992 and notified Mutual Fund set up by public sector bank or public financial institution or authorised by RBI, subject to notified conditions	Mutual Fund registered under SEBI Act, 1992, & Notified Mutual Fund set up by public sector bank or financial institution or authorised by RBI	To be continued	9
89	10(23E)	Income of notified Exchange Risk administration fund set up by public financial institutions (subject to certain conditions)	Exchange Risk Administration Fund	Delete	9
90	10(23F)	Dividends or long-term capital gains of approved venture capital fund/venture capital company from investments made before 1.4.1999 by way of equity share in a venture capital undertaking (subject to certain conditions)	Approved venture capital fund / venture capital company	Delete	9
91	10(23FA)	Any income by way of dividends, other than dividends referred to in Section 115-O, or long-term capital gains of approved venture capital funds and venture capital companies from investments made by way of equity share in a	Approved venture capital fund / venture capital company	Delete	9

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	Section	Nature of Tax Concession	Who are Entitled	Recommend-ation	Class of Exemp
		venture capital undertaking (subject to certain conditions) (exemption is not available in respect of investments made after 31.3.2000			
92	10(23G)	Income by way of dividends, other than dividends referred to in Section 115-O, interest or long term capital gains of an infrastructure capital company from investments made on or after 1-6-1998 by way of shares or long term finance in any approved enterprise wholly engaged in the business of (i) developing, (ii)maintaining and operating any infrastructure facility and which satisfies the prescribed conditions	Infrastructure capital fund or infrastructure capital company	Delete	9
93	10(24)	Income of trade union under the heads 'Income from house property" and "Income from other sources"	Registered trade union/associations of registered trade unions	Delete	7
94	10(25)	Income on securities and capital gains on sale of securities held by provident fund to which Provident Funds Act, 1925 applies/income received by trustees on behalf of recognised provident fund, approved superannuation fund, approved gratuity fund and deposit linked insurance fund in certain cases	Retirement benefit funds	Delete	9
95	10(25A)	Income of ESI Fund set up under ESI Act, 1948	Employees State Insurance Fund	Delete	9
96	10(26)	Specified income of member of specified Scheduled Tribes residing in specified areas	Individual (member of specified Scheduled Tribe)	Delete	6
97	10(26B)	Income of Central/State Corporation of Government financed body, institution of association established for promoting interests of members of Scheduled Castes, Scheduled Tribes and /or Backward Classes	Government corporation/body, institution or association wholly financed by Government	Delete	6
98	10(26BB)	Income of corporation established by Government for promoting interests of members of minority community	Government corporation	Delete	6
99	10(27)	Income of certain co-operative societies formed for promoting the interests of Scheduled Castes/Scheduled Tribes members	Co-operative societies	Delete	6
100	10(29)	Income of marketing authorities	Statutory corporation	Delete	7
101	10(29A)	Income accruing or arising to the Coffee Board, the Rubber Board, the Tea Board, the Marine Products Export Development Authority, the Agricultural and Processed Food Products Export Development Authority and Spices Board	Respective Boards and Authorities	Delete	7

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	Section	Nature of Tax Concession	Who are Entitled	Recommend-ation	Class of Exemp
102	10(30)	Subsidy received from or through Tea Board under notified scheme for replantation/replacement of tea bushes etc.(subject to certain conditions).	All assessees (engaged in business of growing/ manufacturing tea in India)	Delete	11
103	10(31)	Subsidy received from or through concerned Board under notified scheme for replantation / replacement of rubber/coffee/cardamom plants, etc. (subject to certain specified conditions)	All assessees (engaged in business of growing / manufacturing rubber/ coffee, etc., in India)	Delete	11
104	10(32)	Income of minor child clubbed u/s 64(IA) to the extent of Rs.1,500 per child	Any Individual	Delete	—
105	10(33)	Dividends declared/paid by domestic companies and any income of a unit holder received from (a) UTI or (b) a mutual fund specified under Section 10(23D).	All assessees	To be continued	—
106	10A	Income of industrial units situated in free trade zones, electronic hardware technology parks or software technology park (subject to certain conditions and clarifications)	All assessees	Delete	5
107	10B	Income from a 100 per cent export oriented undertaking (subject to certain specified conditions)	All assessees	Delete	5
108	10C	Profits & gains from an industrial undertaking which begins to manufacture/produce any article or thing after 31-3-1998 in any Integrated Infrastructure Development Centre or Industrial Growth Centre located in the North Eastern Region	All assessees	Delete	5
109	11	Income from Property held for charitable or religious purposes (subject to certain conditions)	Charitable/religious /trust /institution	Delete this & redesign the provision along the lines recommended for taxation of non-profit organisation	7
110	13A	Specified income of political parties	Registered political parties	Delete this & redesign the provision along the lines recommended for taxation of non-profit organisation	7

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	Section	Nature of Tax Concession	Who are Entitled	Recommend-ation	Class of Exemp
111	16(i)	Standard deduction is to be computed as under: • Where income from salary (before allowing standard deduction) is Rs.1,00,000 or less—One third of salary or Rs.25,000, whichever is less • Where income from salary (before allowing standard deduction) exceeds Rs.1,00,000 but does not exceed Rs.5,00,000—Rs.20,000 • Where income from salary (before allowing standard deduction) exceeds Rs.5,00,000-Nil	Salaried assessees	Rationalise	3
112	16(ii)	Entertainment allowance [actual or at the rate of 1/5th of salary, whichever is less] [limited to Rs.5,000 for Government employees and Rs.7,500 for non-Government employees] (subject to certain conditions)	Salaried assessees	Delete	3
113	16(iii)	Employment tax	Salaried assessees	To be continued	—
114	23(1) first proviso	Taxes levied by local authority and bone by owner if paid in relevant previous year	All assessees	To be continued	—
115	24(1)(i)	Repairs and collection expenses [1/4th of the annual value	All assessees	To be continued	—
116	24(1)(ii)	Insurance premium	All assessees	To be continued	—
117	24(1)(iv)	Annual charge [not being capital charge or charge voluntarily created by assessee	All assessees	To be continued	—
118	24(1)(v)	Ground rent	All assessees	To be continued	—
119	24(1)(vi)	Interest on borrowed capital	All assessees	To be continued	—
120	24(1)(vii)	Land revenue or any other tax levied by state Government	All assessees	To be continued	—
121	24(1)(ix)	Vacancy allowance [subject to certain conditions]	All assessees	To be continued	—
122	24(1)(x)	Unrealised rent [subject to certain conditions] In respect of one self-occupied property, these deductions are not admissible, except interest on borrowed capital up to a maximum of Rs.1,00,000 vide proviso to Section 24(2). [This is available also in respect of cases covered under sub-Section (3) of Section 23]	All assessees	Delete provision relating to allowability of interest on borrowed capital for self-occupied property.	—
123	30	Rent, rates, taxes, repairs and insurance for premises	All assessees	To be continued	—
124	31	Repairs & insurance of machinery, plant & furniture	All assessees	To be continued	—
125	32	Depreciation on buildings, machinery, plant or furniture, know—how, patents, copyrights, trademarks, licenses, franchises, or any other business or commercial rights of similar nature,	All assessees	To be continued	—

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	Section	Nature of Tax Concession	Who are Entitled	Recommend-ation	Class of Exemp
		being intangible assets—Prescribed percentage on WDV in the case of any block of assets			
126	33A	Development allowance—50 percent of actual cost of planting (subject to certain conditions and limits)(planting should have been completed before 1-4-1990)	Assessees engaged in business of growing and manufacturing tea in India	Delete	—
127	33AB	Tea Development Account—Amount deposited in account with National Bank (Special Account) or in Tea Deposit Account in accordance with approved scheme or 20% of profits of business, whichever is less (subject to certain conditions)	Assessees engaged in business of growing and manufacturing tea in India	Delete	—
128	33ABA	Amount deposited in Special Account with SBI/Site Restoration Account or 20 per cent of profits, whichever is less (subject to certain conditions)	Assessees carrying on business of prospecting for, or extraction or production of petroleum or natural gas or both in India	Delete	—
129	33AC	Reserves for shipping business—Amount not exceeding 50 per cent of profits derived from business of operation of ships computed under the head Profits & gains of business of profession' as is debited to Profit & Loss account & credited to reserve account to be utilised in specified manner	Government company or Indian public company having main object of carrying on business on business of operation of ships	Delete	—
130	35	Expenditure on scientific research for certain specific purposes (subject to certain conditions)	All assessees	To be continued	—
131	35A	Expenditure incurred before 1.4.1998 on acquisition of patent rights or copy-rights [equal to appropriate fraction of expenditure on acquisition to be deducted in fourteen equal annual installments beginning with previous year in which such expenditure has been incurred] (subject to certain conditions)	All assessees	To be continued	—
132	35AB	Lump sum payment made in any previous year relevant to assessment year commencing or before 1.4.1998 for acquisition of technical know-how [consideration for acquisition to be deducted in six equal annual installments (3 equal annual installments where know-how is developed in certain laboratories, universities and institutions)] (subject to certain conditions)	All assessees	To be continued	—
133	35ABB	Expenditure incurred for obtaining licences to operate telecommunication services either before commencement of such business or thereafter at	All assessees	To be continued	—

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	Section	Nature of Tax Concession	Who are Entitled	Recommend-ation	Class of Exemp
		any time during any previous year			
134	35AC	Expenditure by way of payment of any sum to a public sector company/local authority/approved association or institution for carrying out any eligible scheme or project	All assessees	Delete	7 7
135	35CCA	Payment to associations/institutions for carrying out rural development programmes (subject to certain conditions)	All assessees	Delete. Make it a part of Section 80G	
136	35CCB	Payment to approved associations/institutions for carrying out approved programmes of conservation of natural resources or afforestation (subject to certain conditions)	All assessees	Delete. Make it a part of Section 80G	7
137	35D	Amortisation of certain preliminary expenses [deductible in 5 equal annual installments] (subject to certain conditions)	Indian companies and resident non-corporate assessees	To be continued	—
138	35DD	Amortisation of expenditure incurred after 31.3.1999 in case of amalgamation or demerger in the hands of an Indian company (one-fifth of such expenditure for 5 successive previous years) (subject to certain conditions)	Indian Company	To be continued	—
139	35E	Expenditure on prospecting, etc., for certain minerals [deductible in ten equal annual installments] (subject to certain conditions)	Indian companies and resident non-corporate assessees engaged in prospecting, etc., for minerals	To be continued	—
140	36(1) (l)	Insurance premium covering risk of damage or destruction of stocks/stores	All assessees	To be continued	—
141	36(1) (ia)	Insurance premium covering life of cattle owned by a member of co-operative society engaged in supplying milk to federal milk co-operative society	Federal milk co-operative societies	To be continued	—
142	36(1) (ib)	Medical insurance premium paid by cheque to insure employee's health under an approved scheme framed by GIC of India	All assessees as employers	To be continued	—
143	36(1) (ii)	Bonus or commission paid to employees	All assessees	To be continued	—
144	36(1) (iii)	Interest on borrowed capital	All assessees	However, interest liability during the pre-comm-encement period & for acquiring capital assets should not be allowed as revenue	—

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	Section	Nature of Tax Concession	Who are Entitled	Recommend-ation	Class of Exemp
				expenditure. This liability should be required to be capitalised. The amendment to the law must be clarificatory so that the department's point in existing cases does not fall through.	
145	36(1) (iv)	Contributions to recognised provident fund and approved superannuation fund [subject to certain limits and conditions]	All assessees as employers	To be continued	—
146	36(1) (v)	Contributions to approved gratuity fund [subject to certain limits and conditions]	All assessees as employers	To be continued	—
147	36(1) (va)	Contributions to any provident fund or superannuation fund or any fund set up under Employees' Sate Insurance Act, 1948 or any other fund for welfare of such employees, received from employees if the same are credited to the employee'' accounts in relevant fund or funds before due date	All assessees as employers	To be continued	—
148	36(1) (vi)	Allowance in respect of animals which have died or become permanently useless [subject to certain conditions]	All assessees	To be continued	—
149	36(1) (vii)	Bad debts which have been written off as irrecoverable [subject to limitation in the case of banks and financial institutions]	All assessees	To be continued	—
150	36(1) (viia)	Provision for bad and doubtful debs • Up to 5 percent of total income before making any deduction under this clause and chapter VI-A, and up to 10 per cent of aggregate average advances made by its rural branches • Up to 5 per cent of total income before making any deductions under this clause and Chapter VI-A	Certain scheduled banks and non-scheduled banks but other than foreign banks. Foreign banks/ Public financial institutions/State financial corporations/State industrial investment corporations	To be continued	—
151	36(1) (viii)	Amounts transferred to special reserve [subject to certain conditions and maximum of 40 per cent of profits derived from business of providing long-term finance for specified purposes]	Financial corporations, public companies of specified nature and corporations providing	Delete	4

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	Section	Nature of Tax Concession	Who are Entitled	Recommend-ation	Class of Exemp
			long-term finance for development of infrastructure facility		
152	36(1) (ix)	Expenditure for promoting family planning amongst employees (deductible in 5 equal annual installments in case of capital expenditure)	Companies	To be continued	—
153	36(1) (x)	Contributions towards notified Exchange Risk Administration Funds	Public financial institutions	To be continued	—
154	36(1) (xi)	Expenditure incurred wholly and exclusively by the assessee on or after the Ist April, 1999 but before the Ist April, 2000 in respect of a non-Y2k compliant system, owned by the assessee and used for the purposes of his business or profession, so as to make such system Y2K complaint computer system.	All assessees	This can now be deleted.	—
155	37(1)	Any other expenditure [not being personal or capital expenditure and expenditure mentioned in Sections 30 to 36] laid out wholly and exclusively for purposes of business or profession	All assessees	To be continued	—
156	37(2B)	Advertisement in souvenir, brochure, tract, pamphlet etc., of political party	All assessees	To be continued	—
157	42(1)	In case of mineral oil concerns allowances specified in agreement entered into by Central Government with any person (subject to certain conditions and terms of agreement)	Assessees engaged in prospecting for or extraction or production of mineral oils	To be continued	—
158	42(2)	In case of mineral oil concerns expenditure incurred remaining unallowed as reduced by proceeds of transfer	Assessees whose business consists of prospecting for or extraction or production of petroleum & natural gas & who transfers any interest in such business	To be continued	—
159	43B	Any sum which is actually paid, relating to 9I) tax/duty/cess/fee levied under any law, (ii) contributions to provident fund/superannuation fund/gratuity fund /any fund for employees' welfare.(iii) bonus/commission to employees and (iv) interest on loan/borrowing from any public financial institution, State Financial Corporation or State Industrial Investment corporation/interest payments to scheduled banks on term loans. Deduction will not be allowed in year in which liability to pay is incurred unless actual payment is	All assessees	Since the pro-vision is a devi-ation from accrual method of accounting to the cash system of accounting in respect of pay-ments covered under this provision, there	—

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	Section	Nature of Tax Concession	Who are Entitled	Recommend-ation	Class of Exemp
		made in that year or before the due date of furnishing or return of income for that year.		is no rationale for allowing payments made after the close of the previous year but before the due date for filing of tax return, as deduc-tion in the earlier previous year. This introduces unnecessary burden on the tax administra-tion & also complicates compliance. In any case what is paid after the close of the financial year, can always be claimed as deduction in the subsequent year.	
160	44A	Expenditure in excess of subscription, etc., received from members (subject to certain conditions and limits)	Trade, professional or similar association	To be continued	—
161	44c	Head office expenditure (subject to certain conditions and limits)	Non-resident	To be continued	—
162	48(i)	Expenditure incurred wholly and exclusively in connection with transfer of capital asset	All assessees	To be continued	—
163	48(ii)	Cost of acquisition of capital asset and of any improvement thereto (indexed cost of acquisition and indexed cost of improvement, in case of long-term capital assets)	All assessees	To be continued	—
164	54	Long term capital gains on sale of residential house and land appartment thereto invested in purchase/construction of another residential house (subject to certain conditions and limits)	Individual/HUF	Restrict it to a case where the taxpayer on the date of the tran-sfer does not own any other	6

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	Section	Nature of Tax Concession	Who are Entitled	Recommend-ation	Class of Exemp
				house property.	
165	54B	Capital gains on transfer of land used for agricultural purposes, by an individual or his parents, invested in other land for agricultural purposes (subject to certain conditions and limits)	Individual	To be continued	11
166	54D	Capital gains on compulsory acquisition of land or building forming part of an industrial undertaking invested in purchase/construction of other land /building for shifting /re-establishing & under-taking or setting up new industrial undertaking (subject to certain conditions and limits	Any assessee	To be continued	6
167	54EA	Net consideration on transfer of long-term capital asset made before 1-4-2000 invested in specified bonds, debentures, share of a public company or units of notified mutual funds (subject to certain conditions and limits)	Any assessees	Delete	1
168	54EB	Long-term capital gains on transfer of any long-term capital asset made before 1-4-2000 invested in specified long-term assets (subject to certain conditions and limits)	Any assessees	Delete	1
169	54F	Net consideration on transfer of long term capital asset other than residential house invested in residential house (subject to certain conditions and limits)	Individual/HUF	Restrict it to a case where the taxpayer on the date of the transfer does not own any other house property.	6
170	54G	Capital gain on transfer of machinery, plant, land or building used for the purposes of the business of an industrial undertaking to a non-urban area) invested in new machinery, plant, building or land, in the said non-urban area, expenses on shifting, etc. (subject to certain conditions and limits	Any assessee	To be continued	6
171	57(i)	Any reasonable sum paid by way of commission or remuneration for purpose of realising dividend	All assessees	To be continued	—
172	57(i)	Any reasonable sum paid by way of commission or remuneration for the purpose of realising interest on securities	All assessees	To be continued	—
173	57(ia)	Contributions to any provident fund or super-annuation fund or any fund set up under Employees' State Insurance Act, 1948 or any other fund for welfare of employees, if the same are credited to employees' accounts in relevant funds	All assessees	To be continued	—

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	Section	Nature of Tax Concession	Who are Entitled	Recommend-ation	Class of Exemp
		before due date			
174	57(ii)	Repairs, insurance and depreciation of building, plant and machinery and furniture	Assessees engaged in business of letting out of machinery, plant & furni-ture & building on hire	To be continued	—
175	57(iia)	In case of family pension, 33 1/3 per cent of such pension or Rs.15,000, whichever is less	Assessees in receipt of family pension on death of employee being mem-ber of assessee's family	To be continued	—
176	57(iii)	Any other expenditure (not being capital expenditure)expended wholly and exclusively for earning such income	All assessees	To be continued	—
177	80CCC	Contributions to certain pension funds of LIC (up to Rs.10,000) (subject to certain conditions)	Individual	Provide for a tax credit at the rate of 10%upto a maximum of Rs.1,000.	1
178	80D	Medical insurance premia (up to Rs.10,000) (Subject to certain conditions)	Individual/HUF	Provide for a tax credit at the rate of 10%upto a maximum of Rs.1,000.	6 6
179	80DD	Deduction of Rs.40,000 where any expenditure has been incurred for the medical treatment (including nursing), training & rehabilitation of a handicapped dependant or any amount is paid or deposited under any scheme framed in this behalf by the LIC or the Unit Trust of India	Resident Individual/HUF	Provide for a tax credit at the rate of 10%upto a maximum of Rs.4,000.	
180	80DDB	Expenses actually incurred on medical treatment of specified diseases and ailments subject to certain conditions.	Resident Individual/HUF	Provide for a tax credit at the rate of 10 percent upto a maximum of Rs.4,000	6
181	80E	Amount paid out of income chargeable to tax by way of repayment of loan or interest on loan taken from financial institution/approved chari-table institution/approved charitable institution for pursuing higher education (subject to certain conditions) (maximum deduction: Rs.25,000 in a year: for a maximum period of 8 years).	Individual	Provide for a tax credit at the rate of 10% upto a maximum of Rs.4000	6
182	80G	Donations to certain approved funds, trusts, charitable institutions/donations for renovation or repairs of notified temples, etc.	All assessees	Provide for tax credit at the rate of 10%of the	7

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	Section	Nature of Tax Concession	Who are Entitled	Recommend-ation	Class of Exemp
				contribution.	
183	80GG	Rent paid in excess of 10% of total income for furnished/unfurnished residential accommodation (subject to maximum of Rs.2,000 p.m. or 25% of total income, whichever is less) (subject to certain conditions)	Individuals not receiving any house rent allowance	Delete	3
184	80GGA	Certain donations for scientific, social or statistical research or rural development programmes or conservation or natural resources or afforestation or for carrying out an eligible project or scheme or National Urban Poverty Eradication Fund (subject to certain conditions)	All assessees not having any income chargeable under the head 'Profits and gains of business and profession"	Merge with Section 80-G	7
185	80HH	Profits from newly established industrial under-takings or hotel business in backward areas where manufacture has commenced before 1-4-1990 (20 per cent of profits)(subject to certain conditions)	All assessees	Delete since no more required on the statute.	4
186	80HHA	Profits from newly established small scale industrial undertakings in certain areas where manufacture has commenced before 1-4-1990 (20 per cent of profits)(subject to certain conditions)	All assessees	Delete since no more required on the statute.	4
187	80HHB	Profits from projects outside India (50% of profits) (subject to certain condition)(w.e.f. 1-6-1999 assessee to furnish certificate from chartered accountant that deduction has been correctly claimed)	Indian company/ non corporate resident assessees	Already under phase out.	5
188	80HHBA	Profits and gains from execution of certain housing projects aided by World Bank (50% of profits)(subject to certain conditions)	Indian company/ non corporate resident assessees	Delete. the source of the funding should not be any criterion for exemption	6
189	80HHC	Profits derived from export of specified goods or merchandise if sale proceeds are receivable in convertible foreign exchange (100 percent of profits)(subject to certain conditions)	Indian company/non corporate resident assessees engaged in business of export	Already under phase out.	5
190	80HHD	Income of approved hotels/tour operators or of travel agents for services provided to foreign tourists if receipts are in convertible foreign exchange and subject to specified conditions (50 per cent of profits of such services plus 50 percent of such profits of the relevant previous year debited to profit and loss account and credited to reserve account)	Indian company/non corporate resident assessees	Already under phase out.	5

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	Section	Nature of Tax Concession	Who are Entitled	Recommend-ation	Class of Exemp
191	80HHE	100% of profits derived from export out of India of computer software or its transmission from India to a place outside India by any means or in providing technical services outside India in connection with the development or production of computer software(subject to specified conditions)	Indian company / non corporate resident assessees	Already under phase out.	5
192	80HHF	100% of profits and gains derived from export transfer of film software television software, music software and television news software, including telecast rights, proceeds of which are received in convertible foreign exchange (subject to certain conditions)	Indian company/non corporate resident assessees	Already under phase out.	5
193	80I	Profits from industrial undertakings, ships hotels and cold storage plants set up after 31-3-1981 (subject to certain conditions and limits)(available up to assessment year 1991-1992)	All assessees	Delete	4
194	80IA	Profits and gains from industrial undertakings engaged in infrastructure facility, telecommuni-cation services, industrial park, power undertakings, etc.	All assessees	Delete	4
195	80IB	Profits and gains from industrial undertakings, cold storage plant, hotel, scientific research & development, mineral oil concern housing projects, cold chain facility, ships, etc.	All assessees	Delete	4
196	80JJA	Entire income from business of collecting and processing or treating of biodegradable waste for generating power or producing bio fertilisers, bio pesticides or other biological agents or for producing bio-gas, making pellets or briquettes for fuel or organic manure (for 5 consecutive assessment years)	All assessees	Delete	4
197	80JJAA	30 per cent of additional wages paid to new regular workmen employed in the previous year for 3 assessment year relevant to the previous year in which such employment is provided (subject to certain conditions)	Indian company	Delete	11
198	80L	Interest on Govt. securities, interest on NSC VI/VII Issue, interest on NSC VIII Issue, interest on notified bonds/debentures, interest on deposit under NSS, interest on deposits under Post Office (Time Deposits)/(Recurring Deposits) Schemes, interest on deposit under PO (Monthly Income account) Rules, interest on bank deposits/deposits	Individual/HUFs	Delete	1

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	Section	Nature of Tax Concession	Who are Entitled	Recommend-ation	Class of Exemp
		with financial corporation, etc. (maximum limit for assessment year 1997-98 onwards: Rs.12,000 (in addition, special deduction of Rs.3,000 is allowed in case of interest on Government securities)			
199	80O	Any income received by the assess from the Government of a foreign State or foreign enterprise in consideration for use outside India of any patent, invention, design or registered trade mark, etc., in convertible foreign exchange and brought into India in accordance with any law (50 per cent of income) (subject to certain conditions)	Indian companies/Non-corporate resident assessees	Already under phase out.	5
200	80P	Specified incomes [subject to varying limits specified in sub-Section (20]	Co-operative societies		11
201	80Q	Profits from business of publication of books (20 percent of profits)(subject to certain conditions) [for five years commencing from assessment year 1992-1993]	Any assessee	Delete	11
202	80QQA	Professional income of authors of text books in India languages (25 percent of income) (subject to certain conditions)	Resident individuals	Delete	11
203	80R	Remuneration from certain foreign sources in the case of professors/ teachers, etc. 75% of such remuneration as is brought into India in convertible foreign exchange with 6 months (for extended period) from the end of the previous year) (subject to certain conditions)	Individuals-Indian citizens	Already under phase out.	5
204	80RR	Professional income from foreign sources in certain cases (75% of such income as is brought into India in convertible foreign exchange within 6 months (for extended period) from the end of previous years)(subject to certain conditions)	Resident individuals authors, playwrights, artistes, musicians actors and sportsmen	Already under phase out.	5
205	80RRA	Remuneration received in foreign currency for services rendered outside India (75% of such remuneration as is brought into India in convertible foreign exchange within 6 months (for extended period) from the end of the previous year (subject to certain conditions)	Individuals-Indian citizens	Already under phase out.	5
206	80U	Income of partially or totally blind, mentally retarded, or physically handicapped persons as specified in rule 11D (subject to maximum of Rs.40,000)	Resident individuals	Provide for tax credit at the rate of 10% upto a max of Rs.4,000.	6
207	88	Rebate at the rate of 20%on investment made in certain specified categories of savings instruments.	• Individual • HUF	Delete	1

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Appexdix 4.2

Provisions for Incentiives for Savings

	Section	Nature of Instrument	Who are Entitled
1	10(4) (i)	Interest on securities or bonds notified by the Central Government including premium redemption of such bonds	Non-resident
2	10(4)(ii)	Interest received on Non-resident (External)Account	Person resident out-side India (as defined in FERA) & person who has been permitted to maintain said account by RBI
3	10(4B)	Interest on notified savings certificates issued by the Central Government and subscribed to in convertible foreign exchange	Individual (Indian citizen or person of Indian origin, who is a non-resident)
4	10(15) (i)	Interest premium on redemption, or other payment on notified securities, bonds, certificates, and deposits, etc. (subject to notified conditions & limits)	All assessees
5	10(15) (iib)	Interest on notified Capital Investment Bonds	Individual/HUF
6	10(15) (iic)	Interest on notified Relief Bonds	Individual/HUF
7	10(15) (iid)	Interest on notified bonds purchased in foreign exchange (subject to certain conditions)	Individual—NRI/ nominee or survivor of NRI/ individual to whom bonds have been gifted by NRI.
8	10(15) (iii)	Interest on securities	Issue Department of Central Bank of Ceylon
9	10(15) (iiia)	Interest on deposits made with schedule bank with approval of RBI	Bank incorporated abroad
10	10(15) (iv)(h)	Interest received from any public sector company in respect of notified bonds or debentures and subject to certain conditions.	All assessees
11	10(15) (iv)(i)	Interest received from Government on deposits in notified scheme out of moneys due on account of retirement	Individual—Employee of Central government/State Government/Public sector company
12	10(33)	Dividends declared/paid by domestic companies & any income of a unit holder received from (a) UTI or (b) a mutual fund specified under Section 10(23D).	All assessees
13	54	Long term capital gains on sale of residential house and land appurtenant thereto invested in purchase/construction of another residential house (subject to certain conditions and limits)	Individual/HUF
14	54B	Capital gains on transfer of land used for agricultural purposes, by an individual or his parents, invested in other land for agricultural purposes (subject to certain conditions and limits)	Individual
15	54D	Capital gains on compulsory acquisition of land or building forming part of an industrial undertaking invested in purchase/construction of other land/building for shifting/re-establishing said undertaking or setting up new industrial undertaking(subject to certain conditions and limits)	Any assessee

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	Section	Nature of Instrument	Who are Entitled
16	54EA	Net consideration on transfer of long-term capital asset made before 1-4-2000 invested in specified bonds, debentures, share of a public company or units of notified mutual funds (subject to certain conditions and limits)	Any assessees
17	54EB	Long-term capital gains on transfer of any long-term capital asset made before 1-4-2000 invested in specified long-term assets (subject to certain conditions and limits)	Any assessees
18	80CCC	Contributions to certain pension funds of LIC (up to Rs.10,000) (subject to certain conditions)	Individual
19	80D	Medical insurance premia (up to Rs.10,000) (Subject to certain conditions)	Individual/HUF
20	80DD	Deduction of Rs.40,000 where any expenditure has been incurred for the medical treatment (including nursing), training and rehabilitation of a handicapped dependant or any amount is paid or deposited under any scheme framed in this behalf by the LIC or the Unit Trust of India	Resident Individual/HUF
21	80DDB	Expenses actually incurred on medical treatment of specified diseases and ailments subject to certain conditions.	Resident Individual/HUF
22	80E	Amount paid out of income chargeable to tax by way of repayment of loan or interest on loan taken from financial institution/approved charitable institution/approved charitable institution for pursuing higher education (subject to certain conditions) (maximum deduction: Rs.25,000 in a year: for a maximum period of 8 years).	Individual
23	80L	Interest on Govt. securities, interest on NSC VI/VII Issue, interest on NSC VIII Issue, interest on notified bonds/debentures, interest on deposit under NSS, interest on deposits under Post Office (Time Deposits)/(Recurring Deposits) Schemes, interest on deposit under PO (Monthly Income account) Rules, interest on bank deposits/deposits with financial corporation, etc. (max limit for assessment year 1997-98 onwards: Rs.12,000 (in addition, special deduction of Rs.3,000 is allowed in case of interest on Govt. securities)	Individual/HUFs

24	88	• Life insurance premium for policy:
		  • in case of individual, on life of assessees, assessees spouse and any child of assessees
		  • in case of HUF, on life of any member of the HUF
		• Sum paid under a contract for a deferred annuity:
		• In case of individual, on life of individual, individual's spouse and any child of the individual
		• Sum deducted from salary payable to Government servant for securing deferred annuity or making provision for his wife/children [qualifying amount limited to 20% of salary]
		• Contributions made under Employees Provident Fund Scheme
		• Contribution to Public Provident Fund account in the name of:
		  • In case of individual, such individual or his spouse or any child of such individual
		  • In the case of HUF, any member of the family
		• Contribution by an employee to a recognised provident fund
			® Individual
			• HUF

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	Section	Nature of Instrument	Who are Entitled

		• Contribution by an employee to an approved superannuating fund
		  • Sum deposited in Post Office Savings Bank (cumulative Time Deposit)—10 year or 15 year account in the name of:
		  • In case of individual, such individual or a minor of whom he is the guardian
		  • In the case of HUF, any member of the family
		• Subscription to any notified security or notified deposit scheme of the Central government.
		• Subscription to notified savings certificates [National Savings Certificates (VIII Issue)]
		  • Contribution for participation in Unit-linked Insurance Plan of UTI:
		  • In case of an individual, in the name of the individual, in the name of the individual, his spouse or any child of such individual
		  • In case of a HUF, in the name of any member thereof
		• Contribution to notified unit linked insurance plan of LIC Mutual Fund [Dhanaraksha 1989]
		  • In the case of an individual, in the name of the individual, his spouse or any child of such individual in the case of a HUF, in the name of any member thereof
		• Subscription to notified deposit scheme or notified pension fund set up by National Housing Scheme [Home Loan account scheme]
		• Certain payments (up to Rs.10,000) for purchase/construction of residential house property
		• Subscription to notified schemes of 9a) public sector companies engaged in providing long-term finance for purchase/construction of houses in India for residential purposes/(b) authority constituted under any law for satisfying need for housing accommodation (other than schemes interest where under qualified for tax rebate under Section 80L)
		• Sum paid towards notified annuity plan of LIC
		• Subscription to any units of any notified Mutual Funds or the UTI up to maximum of Rs.10,000
		• Contribution by an individual to any pension fund set up by any notified Mutual Fund or by the UTI
		• Subscription to equity shares or debentures forming part of any approved eligible issue of capital made by a public company or public financial institutions
		• Subscription to any units of any approved mutual fund referred to in Section 10(23D) provided amount of subscription to such units is subscribed only in "eligible issue of capital" referred to above.
		Amount of tax rebate is 20 percent qualifying amount (max Rs.60,000) (Rs.70,000 in case of authors, playwrights, artistes, musicians, actors or sportsmen) of deposits. Tax rebate of 100% of tax payable or Rs.10,000, whichever is less.	

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Incentives for Charitable Trusts

Incentive (Section)	Eligibility	Conditions	Duration & Rate of Relief
10(23BBA)	Income of the authorities or bodies constituted by the Central, State or Provincial Act for the administration of public, religious, charitable trusts, endowment or societies for religious or charitable purposes.	Income of the societies, trusts or endowments referred under this section is not exempt from tax.	100% for the unlimited period.
10(23C)	Income of: (a) certain national funds, (b) charitable funds or institutions notified by the Central Government, (c) religious trusts or religious institutions notified by the Central Government, (d) educational institutions, and (e) hospitals.	**Conditions for (b) and (c):** • Application must be made in Form 56. • Income must be applied wholly for the purpose for which it has been established. Exemption is not available for business income not directly related to the primary objective(s). • Can invest only in pre-specified instruments specified in Section 11(5). • Exemption is available for voluntary contribution subject to the condition that such contributions are not held otherwise than in any one or more of the modes specified in Section 11(5). **Conditions for (d) and (e):** • These institutions are existing solely for these purposes and not for profit. • Wholly or substantially financed by the Government or the aggregate receipts do not exceed Rs.1 crore or it is approved by the CBDT subject to the conditions mentioned above for (b) and (c). • Exemption is available for voluntary contribution subject to the condition that such contributions are not held otherwise than in any one or more of the modes specified in Section 11(5).	100% for the unlimited period.
11, 12 and 13	Income of a charitable trust. Charitable purpose is defined under Section 2(15) as relief of the poor, education, medical relief and the advancement of any other object of general public utility.	• The property from which income is derived should be held under a trust and wholly for charitable or religious purpose. • The trust should not be created for the benefit of any particular religious community or case. • Benefits should not accrue to a specified person or a group of specified persons. • Exemption is confined to only such portion of the trust's income which is applied to charitable or religious purpose. • Voluntary contributions or donations will be deemed to be part of income derived from property held under trust with some	100% for the unlimited period.

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Incentive (Section)	Eligibility	Conditions	Duration & Rate of Relief
		minor exceptions. • Charitable trusts or institutions must use at least 75 per cent of the income for charitable or religious purpose to avail full exemption. • Application of income may fall short of 75 per cent if a part of income is saved for future use in India subject to the approval of the authority. Such income so accumulated or set apart will not be included in the total income of the trust in the year of receipt. • Trusts may be granted an extended time to spend the unused income. • Subject to some pre-specified conditions, a capital gain will be regarded as having been applied for religious or charitable purpose. • The account of the trust should be audited. • The trust shall apply for registration with the commissioner. • A charitable trust or institutions can carry out business activities if business activities are incidental to the attainment of its objectives and separate books of accounts are maintained. • Funds of such institutions may be invested only in pre-specified saving instruments.	
80G	Donations to pre-specified charitable trusts or funds.	• No upper limit for the qualifying amount. However, for certain donations qualifying amount in excess of 10 per cent of the adjusted gross total income of the assessee is ignored. • Double deduction is not permissible. A donor cannot claim deduction under Section 80G as well as under Section 35. • Proper proof of payment must be submitted to claim deduction.	100% deduction (entire qualifying amount) from income for the unlimited period for sixteen pre-specified donations. 50% of the qualifying amount for another ten pre-specified donations for unlimited period.

Reform of Indirect Taxes

Reform of Indirect Taxes

Chapter 5

[1] Introduction

The structure of excise duty, which emerged in the early 1980s could not be considered rational and conducive to growth of the economy. The problems included: many tax rates with wide spread, many exemptions, tax cascading, the discretion of the Finance Minister to make ad hoc changes in the duty rates, and complex administrative procedures. Reform of the excise system began in earnest in the mid 1980s. The excise duty reforms focused on mitigation of tax cascading, rationalisation of duty rates, and simplification of rules and procedures. As a first step at mitigating tax cascading, a scheme of MODVAT credit, though with limited scope, was introduced in 1986. This permitted the manufacturers to avail of tax credit for the excise duty paid on their purchase of specified raw materials (and not capital goods) used in the manufacturing of specified goods. Over time, scope of the MODVAT scheme was enlarged to reduce tax cascading by expanding the list of inputs as well as end products eligible for MODVAT credit (Table 5.1). The rate structure has been rationalised along with reduction in the number of rates and their spread. Rules and procedures have been simplified, though much remains to be done.

[2] Prevailing Structure of Central Excises

[A] Rates, Base, Valuation and Credit

Goods subjected to excise duty are only those goods which are specified in the schedules to Central Excise Tariff Act, 1985 (CETA). The authority for levy of excise

Table 5.1

Major Changes in the Coverage of Raw Material & Capital Goods under MODVAT

Year	Coverage
1986-87	MODVAT introduced for selected raw materials when used in production of specified goods.
1987-88	Most of the raw materials covered under MODVAT
1988-89	Minor expansion in the coverage of MODVAT
1989-90	Minor expansion in the coverage of MODVAT
1990-91	Minor expansion in the coverage of MODVAT
1991-92	Minor expansion in the coverage of MODVAT
1992-93	Minor expansion in the coverage of MODVAT
1993-94	Capital goods, petroleum products and specified spun yarns covered under MODVAT
1994-95	Small scale industrial (SSI) enterprises given the option to pay normal excise duty in place of concessional duty.
1995-96	1 The scheme extended to cut tobacco, plastic woven sacks, specified textiles and equipments. 2 Scope of SSI concessions enlarged. Turnover limit for availing SSI concessions raised from Rs.2 crore to Rs.3 crore. 3 Conditions of matching raw materials/capital goods with output for allowing MODVAT credit, withdrawn.
1996-97	1 MODVAT credit in respect of some capital goods has been denied. 2 In the case of processed textile fabrics, a deemed MODVAT credit has been allowed, without production of duty paying documents. 3 The scope of availing MODVAT credit in the case of production of exempt goods supplied to specified buyers such as 100% EOUs has been extended. 4 The rule for reversal of MODVAT credit in respect of exempted final product has been simplified to 20% of value of such goods. 5 When the manufacturer clears inputs or partially processed inputs for job work, MODVAT credit availed of on this account should be reversed. 6 MODVAT credit on the basis of invoices issued by third and subsequent dealers denied to check evasion. 7 In the case of invoices issued by the second stage dealer, credit will be admissible only if the same has been signed by the proper officer. 8 Mandatory penalty of 100% and interest to be charged in case of wrong availment of MODVAT credit on inputs.
1997-98	1 Duty rates have been restructured with basic rates of 8, 13 and 18%. 2 Some exemptions have been withdrawan. 3 Exemption scheme for SSIs has been modified with exclusion of certain goods from it's purview. If MODVAT credit is not availed then duty rates are 0, 3 and 5% respectively on clearances upto Rs.30 lakh, next Rs.20 lakh and next Rs.50 lakh. 4 Accumulated MODVAT credit, as on 1.3.1997, with the manufacturers of bulk drugs to lapse. 5 MODVAT credit allowed to the extent of 75% of the CVD paid on goods imported under project imports. 6 Invoices issued by the depot or consignment agent of an importer made eligible for availing credit.

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Table 5.1

Major Changes in the Coverage of Raw Material & Capital Goods under MODVAT

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Year	Coverage
1998-99	1 MODVAT credit in respect of inputs restricted to 95% of the excise paid on inputs, with effect from June 2, 1998. 2 Exemption scheme for SSIs has been liberalised. Duty rates have been modified to 0 and 5% respectively on clearances upto Rs.50 lakh and next Rs.50 lakh. SSI benefit has been extended to computers while withdrawan on copper alloys. 3 Maximum retail sale price (MRP) based assessment has been extended to many products such as chocolates, malt extract, pan masala and glazed tiles.
1999-00	1 MODVAT credit in respect of inputs restored to 100%. 2 The restriction on taking MODVAT credit to the extent of 10% or the amount of CVD in respect of certain petrolium products has been removed. 3 The scope of capital goods credit has been extended to duty paid on certain machines. 4 The exemption in respect of independent processors of yarn has been withdrawan. The duty is fixed at Rs.5 per Kg. with no benefit of MODVAT credit. 5 The excise duty on packaged tea has been withdrawan. However, on bulk tea, a duty of Rs.2 per Kg. has been imposed. 6 Eleven existing excise rates have been compressed into three: 8,16 and 24% with two non-rebatable special duty rates: 6 and 16% to make up for the existing rates of 30 and 40%. 7 MRP based assessment has been extended to 27 more products. 8 SSIs have been allowed to pay duty on monthly basis instead of daily. 9 The discretion to grant ad hoc exemptions has been given up, excepting in the case of goods for security, strategic or charitable purposes.
2000-01	1 MODVAT has been renamed as CENVAT with a single CENVAT rate of 16%. In addition there will be non-rebatable special duty at the rates of 8, 16 or 24%. 2 MODVAT credit extended to all inputs except high speed diesel (HSD) oil & motor spirit (petrol). 3 MODVAT credit would be available in respect of all finished goods except matches. 4 MODVAT credit has been extended to all capital goods. Restriction of 75% in respect of capital goods credit (for CVD) on project imports has been removed. The condition of installation has been removed. However, availment of capital goods credit has to be spread over two years.

Source *Budgets of Union Government of India, for different years.*

duties is through Entry 84, List I, Seventh Schedule and Entry 97 of the same list. Entry 84 empowers central government to levy duty of excise on all articles produced or manufactured in India excluding alcohol for human consumption. Entry 97 gives residuary powers under the Union List. A taxable event is the act of manufacture, though duty can be collected at a later stage such as clearance from depot. Classifications are matched upto four digits with customs tariffs.

There is a multiplicity of levies. These are:

1 Central Value Added Tax (called CENVAT) and special duty of excise.

2 AED(ST): Additional Duty of Excise (Goods of Special Importance) Act, 1957. This is in lieu of sales tax on sugar, fabrics, tobacco products.

3 Additional duty on motor spirit (petrol) and diesel.

4 AED (T&T): Additional Duty of Excise (Textiles and Textiles Articles), 1978—on fibres, yarns and fabrics—to subsidise controlled cloth scheme.

5 Cesses leviable under miscellaneous enactments.

For the levy of central excise duty, there has to be manufacture. "Manufacture" is defined in Section 2(f) of Central Excise Act, and includes any process:

1 Incidental or ancillary to the completion of a manufactured product, and

2 Which is specified in relation to any goods in the section or chapter notes, as amounting to manufacture. This is an extended definition. For example, labelling or repacking is "manufacture" with respect to medicines.

The Supreme Court has held that even if a process covered by the extended definition does not appear to amount to manufacture in conventional sense of the term, the definition would still be constitutionally valid under Entry 97 of List I (if not under Entry 84) (Ujagar Prints Case).

But in general, the twin test is (a) new articles should come into existence; and (b) it should be marketable.

There are various control methods used:

Types of Excise Control

• Physical Control	— For cigarettes
• Compounded Levy	— Stainless steel patti, embroidery
• Collection at point of consumption	— Only for molasses where the user pays the duty
• Production based levy	— Independent processors processing fabric. Duty is determined by the capacity of the stentering machine
• Self Removal Procedure (Since 1968)	— All other goods.

There is a multiplicity of exemptions. Though the tariff rates are prescribed in the schedule of CETA, the effective rates can be lower because of exemption. The types of exemptions are:

- Exemption/concessional rates for small scale industry (SSI).
- Specified products of village industry, and marketed with the assistance of KVIC.
- Specified goods made in rural areas—areas comprised in a village as defined in the land revenue records.
- Specified goods supplied to public funded research institutions, non commercial institutes, universities.
- Goods produced by ordinance factories, defence related exemptions.
- Goods donated to National Defence Fund.
- Specified goods produced without the aid of power.
- All goods made in factories in the North-East and commencing production after December 24, 1997 or old units having substantial expansion (25 percent and more) after December 24, 1997.
- Tea cleared by factories belonging to cooperative society.
- A number of food products—khandsari sugar, bread, spices, coffee, certain unbranded food items.
- Fertilizers, cereals, edible oils.
- Aircraft, ship, boat etc.
- Ready made garments.
- Clocks, watches of Maximum Retail Price (MRP) upto Rs.500 per piece.
- Electric bulbs of MRP upto Rs.20 each.

This is not an exhaustive list.

Exemptions relating to small scale industry (SSI) apply to units in the following way:

1 Total clearance of excisable goods for home consumption (excluding exempted goods) not exceeding Rs.3 crores in preceding financial year.

2 Does not apply to goods produced with the brand name of others (except KVIC brands, or state/National Small Industries Cooperative brands)

There are two schemes regarding clearances in a financial year.

1 For units opting for CENVAT Credit:
- 0-100 lakhs[1] — 60 percent of normal rate
- exceeding 100 lakhs — normal rate

2 For units not opting for CENVAT Credit:
- 0-100 lakhs — nil
- exceeding 100 lakhs — normal rate

The rate structure is as follows. Most goods are taxed at the main rate of 16 percent. Higher rates existed until Budget 2000-01: 40 percent for panmasala, aerated water, chewing tobacco, and motor vehicles for less than 6 persons; 32 percent for cosmetics

1 *Just increased from 50 to 100 lakhs in 2000.*

and toiletries, tyres, polyester yarn, air conditioners, and motor vehicles for 6-12 persons; 24 percent for cement, carpets and floor coverings, tiles, and two wheelers. These rates have now been combined at 32 percent, a measure in the right direction. Others attract lower rates such as cotton and wool yarn and kerosene. Though the non-16 percent rates pertain only to a selected number of goods, the administration of multiple rates is not amenable to financial control methods (based on a self removal procedure) that have primarily replaced physical controls. ***The creation of an additional rate of 4 percent for selected items (with an option to pay 16 percent with input credit which were exempted earlier, in the 2001-02 budget has added some complexity into the system. A better method would have been to simply tax them at the 16 percent rate with input tax credit.***

The value for assessment is based on transaction price which is the price actually paid or payable i.e. the invoice price, and includes all payments by reasons of or in connection with sale but does not include duty of excise, sales tax actually paid, or actually payable on such goods.

Various situations arise from this practice.

1 Sales to non related persons where price is the sole consideration. Transaction price is the "value":
   - Applies to both clearances from factory and depot. In respect of sales from depots, the duty is payable at the factory but the relevant value is the value prevailing at or about that time at the depot.

2 Price is not the sole consideration—for example, raw materials are supplied by buyer:
   - Value will include the cost of money value of such consideration.

3 Goods used captively:
   - Value will be 115 percent of cost of production.

4 Goods sold through related persons:
   - Value will be the transaction value of the sale through related persons.

5 Sales from depot etc.:
   - Value will be the normal transaction values of such goods sold from such place.

6 Any other case:
   - To be determined using reasonable means consistent with the above principles.

Valuation may be based on tariff values which government may fix independent of sale price, but this method is rarely used now. For more than 70 items, it is based on MRP, being used more and more on items which are subject to declaration of retail sales price under the standards of Weights and Measures Act, 1976. However, there is

an abatement varying between 30-55 percent of MRP in price fixation. For most items, assessment is based on transaction price. This is the general pattern for assessment.

There is a production based levy for independent processors. It applies to textile fabrics processed by independent processors and the duty liability depends on chamber capacity of the machine, and on the average values of the fabrics, which is decided by the previous year's clearance of processed fabrics. No input/capital goods tax credit is given.

For exports, all the taxes paid are refunded. For example, for export under rebate, duties already paid are refunded, for both (1) duty paid on finished goods; and (2) duty paid on inputs used in finished goods.

For export under bond, for (1) removing finished goods without payment of duty and (2) processing raw materials without payment of duty, the procedure is as follows:

1 Examination is generally carried out at port. But there is an option for examination in the factory under excise supervision.

2 Documents needed are: (a) Form AR-4 for "Application for Removal"; (b) excise invoice; and (c) shipping bill at the point of export.

Rebate is given, or bond discharged, on proof of export. The proof of export generally is a customs endorsed copy of Form AR-4 and the shipping bill. Rebate can be given by the Maritime Commissioner where available or the jurisdictional excise officer.

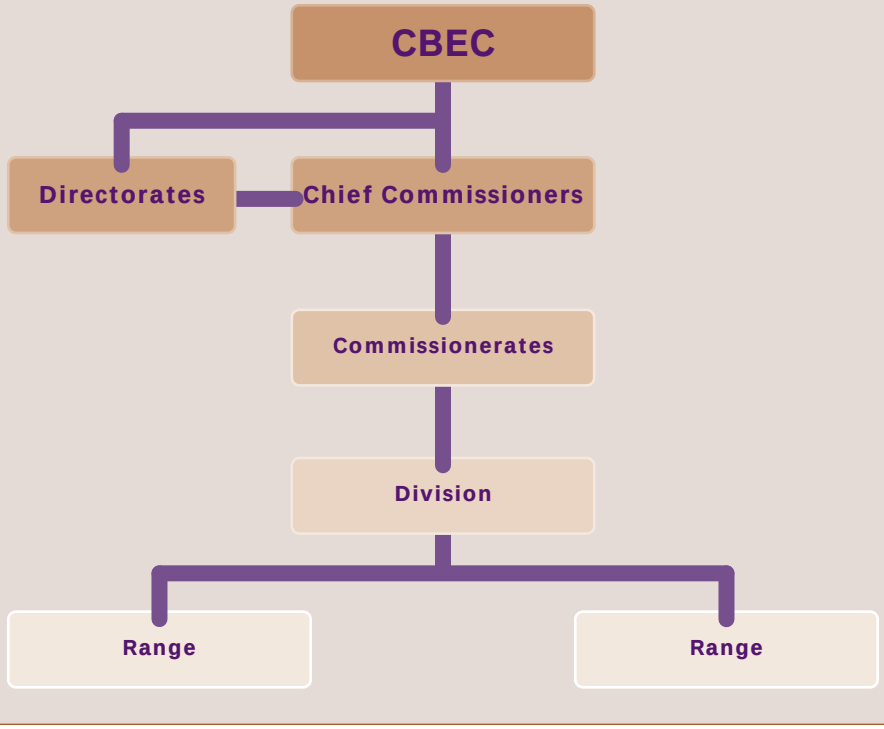
CENVAT credit is given for CENVAT duty, not for Special Excise Duty (SED) applicable to selected consumer goods. Credit is also given for AED (ST), AED (T&T) and additional duty under Customs Tariff Act, 1975 known as Countervailing Duty (CVD). Almost all goods (except matches) are covered under the CENVAT Scheme. Inputs include all goods (except HSD and petrol) and fuel used in or in relation to manufacture (whether directly or indirectly). Credit is given for capital goods used in the factory of manufacture but excludes office equipment. Credit for capital goods is given in two stages—50 percent in the first and 50 percent in the next year. No input tax credit is given if inputs are used for making exempt products (some exceptions are exports and clearances to Export Oriented Units (EOU's). No declaration for availing is necessary. Credit can be taken on the strength of excise invoices of purchase. Credit is given instantly on receipt of goods. Credit can be used for payment of duty on any final product, or on inputs cleared as such. Normally no cash refund of credit is given. A facility exists for sending inputs, partially processed, to job worker without reversal of credit, and for sending inputs directly to job worker. There is an exemption on intermediates produced capitively. Credit on inputs manufactured in the North-East fall under a special exemption scheme and is allowed to users even though no duty is effectively paid on such inputs.

[B] Structure of Excise Administration

The organisation of administration is shown in Diagram 5.1.

Diagram 5.1

Organisation of Excise Administration



Every manufacturer:

1 Needs to be registered before commencing production, of whom there are more than 100,000 approximately. He is given an ECCN based on the Permanent Account Number (PAN) given by Income Tax Department. But SSI units, (upto Rs.1 crore turnover) do not need any registration. However, they have to file a declaration when their clearances reach a level of Rs.10 lakhs less than the exemption limit.

2 Has to file a classification declaration giving details of products and rates of duty.

3 Has to give a price declaration if the sale is through related persons, or where price is not the sole consideration.

4 Has to pay the duty every fortnight—for clearances between 1-15th by the 20th, and for clearances between 16-30th by the 5th of next month. For March, there is a separate provision for the second fortnight. In case of cash payment, it can be only through nominated banks. There remains a need to have the facility to make payments through any bank. SSI units can make monthly payments and need to do so by 15th of the next month.

5 Has to file a monthly return of assessment through Form RT-12 (Quarterly for SSI units) and monthly CENVAT return of CENVAT availment. No statutory records are prescribed. But records kept must document all production, use of inputs, sales, purchases etc. A self removal procedure is allowed.

Checks by officers are conducted through:

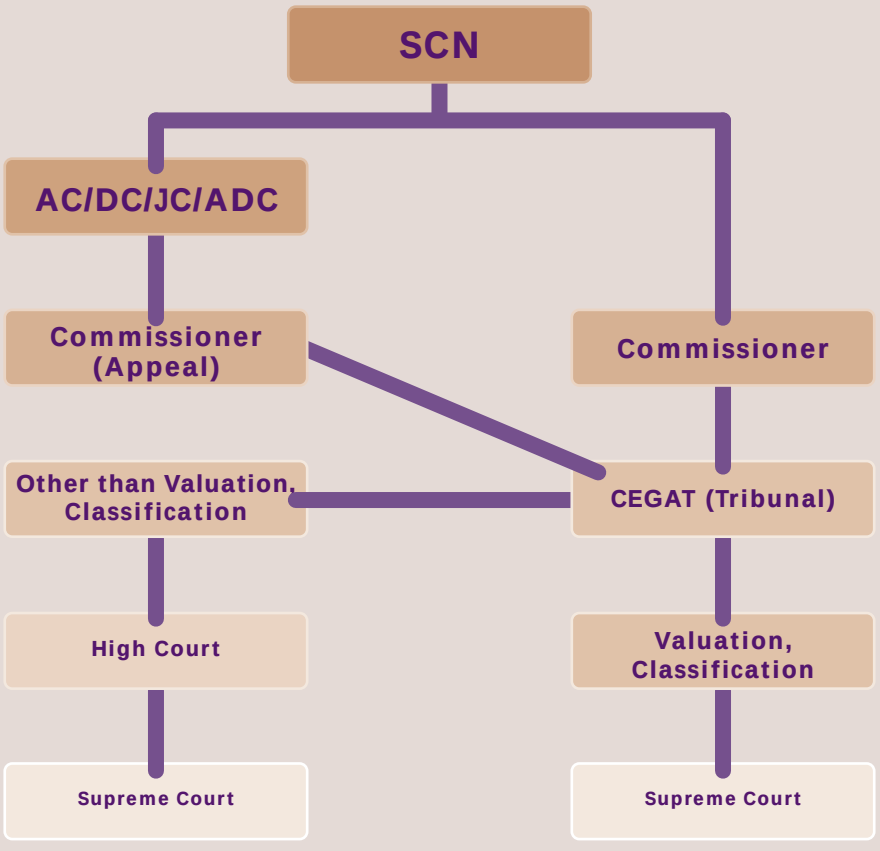
- Scrutiny of assessment returns;
- Inspection/visits by officers;
- Audit; and
- Anti-evasion measures.

With liberalisation, audit has an increasing role to play. For this, there is a need to have trained staff, and develop techniques of audit selection so as to focus on suspect units. Also, anti-evasion needs to be strengthened with stress on intelligence gathering.

Finally, the sequence involved in dispute settlement is depicted in Diagram 5.2.

Diagram 5.2

Sequence of Events Involved on a Dispute Settlement



[3] Revenue Productivity of Excises

There seems to be the perception that excise duty reforms have had an adverse effect on its yield. Although the revenue from excise has been growing (column 2, Table 5.2), its growth has been lower than that of gross domestic product (GDP). During the reform period, revenue from excise[2] to GDP ratio has declined by 1.05 percentage points. The ratio declined from 3.81 percent in 1986-87 to 2.76 percent in 1999-2000 (column 2, Table 5.3). This was accompanied by sharp declines in the growth of revenue in some of the years such as 1993-94, 1995-96 and 1997-98 (column 2, Table 5.4). This has been the cause of concern for the government since excise duty has been the mainstay of the central government.

Table 5.2

Revenue from Excise and MODVAT Credit

(Rs. Crores)

Year	Net Revenue	MODVAT Credit on			Gross Revenue	GDP at Market Prices New Series	Capital Goods as %age of Total
		Inputs	Capital Goods	Total			
1986-87	11,960	1,914	0	1,914	13,874	3,13,580	0.00
1987-88	13,047	2,820	0	2,820	15,867	3,55,417	0.00
1988-89	15,012	3,809	0	3,809	18,821	4,23,497	0.00
1989-90	17,339	5,279	0	5,279	22,618	4,87,740	0.00
1990-91	19,606	6,496	0	6,496	26,102	5,68,772	0.00
1991-92	23,092	7,965	0	7,965	27,572	6,53,298	0.00
1992-93	25,702	10,840	0	10,840	36,542	7,47,387	0.00
1993-94	26,368	11,896	0	11,896	38,265	8,59,220	0.00
1994-95	31,328	20,639	1,048	21,687	53,014	10,09,906	4.83
1995-96	33,895	28,115	1,841	29,956	63,851	11,81,961	6.15
1996-97	38,151	32,042	2,180	34,222	72,373	13,61,952	6.37
1997-98	41,450	32,562	2,624	35,186	76,636	15,15,646	7.46
1998-99(RE)	45,726	32,272	3,217	35,489	81,215	17,62,609	9.06
1999-00(RE)	53,245	38,778	4,866	43,644	96,889	19,31,819	11.15

Notes *1 Revenue from union excise duty is taken exclusive of additional duties on textiles and high speed diesel oil, additional duties in lieu of sales tax, and cesses.*

Sources *1 Economic Survey (1999-2000), Government of India, Ministry of Finance, Economic Division.*
2 National Accounts Statistics (2000), Central Statistical Organisation, Government of India.

2 Excluding additional duties and cesses. The ratio of revenue from these duties and cesses to GDP has also declined by more than 0.5 percentage points. It declined from about 1.0 percent in mid. 1980s to about 0.45 percent by late 1990s.

Table 5.3

Revenue from Excise and MODVAT Credit as Percentage of GDP

Year	Net Revenue	MODVAT Credit on			Gross Revenue
		Inputs	Capital Goods	Total	
1986-87	3.81	0.61	0.00	0.61	4.42
1987-88	3.67	0.79	0.00	0.79	4.46
1988-89	3.54	0.90	0.00	0.90	4.44
1989-90	3.56	1.08	0.00	1.08	4.64
1990-91	3.45	1.14	0.00	1.14	4.59
1991-92	3.53	1.22	0.00	1.22	4.22
1992-93	3.44	1.45	0.00	1.45	4.89
1993-94	3.07	1.38	0.00	1.38	4.45
1994-95	3.10	2.04	0.10	2.15	5.25
1995-96	2.87	2.38	0.16	2.53	5.40
1996-97	2.80	2.35	0.16	2.51	5.31
1997-98	2.73	2.15	0.17	2.32	5.06
1998-99(RE)	2.59	1.83	0.18	2.01	4.61
1999-00(RE)	2.76	2.01	0.25	2.26	5.02

Table 5.4

Revenue from Excise and MODVAT Credit

(Percent)

Year	Net Revenue	MODVAT Credit on			Gross Revenue	GDP at Market Prices New Series
		Inputs	Capital Goods	Total		
1986-87	NA	NA	NA	NA	NA	NA
1987-88	9.09	47.36	NAP	47.36	14.37	13.34
1988-89	15.06	35.08	NAP	35.08	18.62	19.15
1989-90	15.50	38.58	NAP	38.58	20.17	15.17
1990-91	13.07	23.06	NAP	23.06	15.40	16.61
1991-92	17.78	22.63	NAP	22.63	5.63	14.86
1992-93	11.30	36.09	NAP	36.09	32.53	14.40
1993-94	2.59	9.74	NAP	9.74	4.71	14.96
1994-95	18.81	73.49	NAP	82.30	38.55	17.54
1995-96	8.19	36.22	75.67	38.13	20.44	17.04
1996-97	12.56	13.97	18.41	14.24	13.35	15.23
1997-98	8.65	1.62	20.37	2.82	5.89	11.28
1998-99(RE)	10.32	-0.89	22.60	0.86	5.98	16.29
1999-00(RE)	16.44	20.16	51.26	22.98	19.30	9.60

Notes *NAP = Not applicable; NA = Not available.*

The objective here is to examine revenue implications of the excise duty reforms and suggest measures to stimulate growth of revenue without any or with minimum adverse consequences for the economy.

Section A describes the changes carried out in the excise system. It contains an overview of the expansion in the coverage and structure of MODVAT credit scheme and the reforms carried out in the structure of excise duty rates. Section B attempts to analyse the revenue impact of modifications in the scheme of MODVAT credit and the structure of excise duty. Section C provides some explanations based on administrative factors.

[A] Development of MODVAT Scheme and Restructuring of Duty Rates

[i] MODVAT scheme (Now known as CENVAT)

Under the system of excise duty, inputs are relieved of the burden of taxation through the scheme referred to as modified value added tax (MODVAT) credit scheme that operates on the principle of value added tax (VAT). As discussed earlier, the scheme was introduced in 1986 and made applicable to some specified inputs when used in the production of specified end products. Over time, its scope has been enlarged. High-speed diesel (HSD) oil, motor spirit (petrol), and matches are still not covered by this scheme, denying the benefit of tax relief to their users. Currently, the excise duty collected from the commodities covered by the MODVAT scheme accounts for about 90 percent of the total excise duty. As against this, the excise from MODVAT commodities accounted for only about 30 percent in 1986-87.

The major changes carried out in the MODVAT credit scheme are indicated in Table 5.1. On capital goods, MODVAT credit has been allowed with effect from 1994-95. The restriction of 75 percent in respect of capital goods credit (for countervailing duty (CVD) payable on imports) on project imports has been removed with effect from 2000-01. Because of revenue considerations, with effect from January 1, 1996, availing of the credit in respect of capital goods was postponed until the goods were put to use in the production process. Further, with effect from 2000-01, availing of the credit in respect of capital goods has to be spread over two years. The condition of "put to use" was withdrawn in the process of simplification by the budget 2000-01. Regarding inputs, scope of MODVAT credit has been enlarged over time to mitigate tax cascading though the process was not free from certain set backs. A restriction was imposed in 1998-99 on the MODVAT credit that could be availed of in respect of inputs: it was restricted to 95 percent but was restored to 100 percent with effect from the year 1999-2000.

The maximum retail sale price (MRP) based assessment has been extended to many products in the years 1998-99 and 1999-2000 implying a reduced scope for under-valuation.

Small scale industry (SSI) exemptions have been enlarged over time (Table 5.1). Turnover limit for availing of SSI concessions was raised from Rs.2 crore to Rs.3 crore in 1995-96. The value of sales (clearances) subject to concessional duty was raised from Rs.50 lakh to Rs.100 lakh with duty rates as 0, 3 and 5 percent respectively on sales upto Rs.30 lakh, next Rs.20 lakh and next Rs.50 lakh, with effect from 1997-98. The concessional duty rates were further revised in 1998-99 to 0 and 5 percent respectively on sales upto Rs.50 lakh and next Rs.50 lakh. Recently, during October 2000, the rate of 5 percent has also been reduced to nil implying full exemption of sales upto Rs.100 lakh. Also, with effect from 1994-95, SSI enterprises are given the option to pay duty if they intend to be covered by the MODVAT scheme. This provision benefits those SSI enterprises that intend to attract taxable manufacturers to buy their products and claim MODVAT credit in turn. Currently, such units have to pay 60 percent of the duty otherwise applicable upto clearance limit of Rs 1 crore.

[ii] Restructuring of duty rates

The excise duty rates have been substantially modified or restructured in the last one and a half decades in the process of tax reforms in the country. Prior to 1990s, the duty rates were many: ad valorem, specific, and ad valorem plus specific. The ad valorem rates varied from 0 percent to above 200 percent. In the 1990s, following the submission of reports by the Tax Reforms Committee (1991, 1992 and 1993), attempts have been made to rationalise the structure of excise duty. The peak rate of ad valorem duty has been lowered and most of the specific duties have been converted into ad valorem duties. By 1995-96, the number of duty rates was reduced to nine, with a spread from 10 percent to 50 percent. In addition, there were a few specific and ad valorem plus specific duty rates. During 1998-99, there were 11 ad valorem rates varying from 5 to 40 percent though there were some exceptions. Some products continue to be subject to specific duties.[3] During 1999-2000, the existing 11 duty rates were compressed into 3 (8 percent, 16 percent and 24 percent). In addition, non-MODVAT (non-rebatable) special duty rates (6 percent and 16 percent) were introduced. These rates were used to make up for the previously existing rates of 30 and 40 percent by combining rebatable and non-rebatable rates (24+6 = 30; 24+16 = 40). Thus, a three-rate VAT system was put in place with some exceptions. In 2000-01 MODVAT was renamed as CENVAT with further restructuring of the duty rates. The three MODVAT rates have been replaced by a single CENVAT rate of 16 percent though there are several exceptions as has been already described. In addition, there are three non-rebatable special duty rates (8 percent, 16 percent and 24 percent). The special duty rates are used to replace previously existing rates of 24 percent, 30 percent and 40 percent by combinations of CENVAT and non-rebatable special duty: 16+8, 16+16 and 16+24 respectively.

3 *Refers to higher or lower of ad valorem and specific duties.*

[B] Revenue Implications of Excise Duty Reforms

[i] Factors affecting revenue

The growth rate of net excise revenue (that is actual collection) would depend on the growth rates of both gross revenue and MODVAT credit.[4] A faster growth rate of MODVAT credit as compared to that of gross revenue would have dampening effects on the growth rate of net revenue. In other words, a rise in the ratio of MODVAT credit to gross revenue would suggest that the net revenue would grow at a rate lower than that of gross revenue. Therefore, for identifying the factors responsible for the rise or decline in the growth rate of net revenue, it should be useful to analyse the ratio of MODVAT credit to gross revenue, and the growth of gross revenue. As the factors affecting growth of gross revenue may differ from those affecting MODVAT credit, an analysis of growth of these factors may be expected to give rise to varied policy perspectives.

Factors affecting gross revenue include changes in (i) the rate structure, (ii) tax base, (iii) exports, and (iv) under reporting of clearances. The reduction in the tax rates of many commodities as well as raising the ceiling for the provision of allowing concessions to the SSI (from a turnover of Rs.2 crore to Rs.3 crore) along with liberalisation of the exemption would have tended to lower the growth rate of gross revenue. A faster rise in exports as compared to output can also be expected to lower the growth rate of gross revenue, as exports are exempt from excise duty.

As net revenue is gross revenue net of MODVAT credit, all the factors affecting gross revenue and MODVAT credit would impact upon net revenue. As discussed earlier, the factors affecting MODVAT credit include: (i) extension of MODVAT credit to raw materials as well as capital goods; (ii) elimination of the requirement to match inputs with particular outputs for availing MODVAT credit; and (iii) provision of allowing MODVAT credit on capital goods on the basis of purchase irrespective of when it is put to use (this provision was withdrawn with effect from January 1, 1996 but restored by the budget 2000-01).

[ii] Revenue growth

The growth of gross revenue cannot be said to be unsatisfactory as the ratio of gross revenue to GDP has not declined during the reference period, that is 1986-87 to 1999-2000 (column 6, Table 5.3). In fact, the ratio has increased over time from 4.42 percent in 1986-87 to 5.02 percent in 1999-2000. This is not surprising, as the revenue neutral duty rates are supposed to be higher to yield higher gross revenue when the set off provisions in respect of duty paid on inputs are

4 *Actual revenue collections from excises are referred to as net revenue, and net revenue plus MODVAT credit is referred to as gross revenue from excises.*

liberalised. This however did not seem to have compensated for loss in revenue arising from liberalisation of set off provisions in respect of duty paid on inputs and SSI exemptions, as the ratio of net revenue to GDP has registered a sharp decline during the reform period. The ratio has declined from 3.81 percent in 1986-87 to 2.76 percent in 1999-2000 (column 2, Table 5.3). The decline in the net revenue to GDP ratio can be fully explained in terms of the rise in the MODVAT credit to GDP ratio that has increased by 1.65 percentage points as against 1.05 percentage points decline in the former. The MODVAT credit to GDP ratio has increased from 0.61 percent in 1986-87 to 2.26 percent in 1999-2000 (column 5, Table 5.3). The rise in this ratio can be attributed largely to the liberalisation of MODVAT credit provisions relating to inputs. The ratio of MODVAT credit on inputs to GDP has increased from 0.61 percent in 1986-87 to 2.01 percent in 1999-2000 (column 3, Table 5.3). Although the provision of allowing MODVAT credit in respect of capital goods has caused concern, the loss in revenue on this account does not appear to be significant. It was only 0.1 percent of GDP in 1994-95 that has increased to 0.25 percent of GDP in 1999-2000 (column 4, Table 5.3). This suggests that the MODVAT credit on capital goods was no more than 10 percent of the total MODVAT credit. It would mean that the small saving in tax revenue on account of spread of the MODVAT credit on capital goods over two years may not be worth the complications caused in administration and compliance.

The above findings are corroborated by the growth rate analysis and buoyancy coefficients of gross revenue, MODVAT credit and net revenue. Growth of MODVAT credit is found to be greater than that of gross revenue in most of the

Table 5.5

Net Revenue from Excise and MODVAT Credit as %age of Gross Revenue

Year	Net Revenue	MODVAT Credit on		
		Inputs	Capital Goods	Total
1986-87	86.21	13.79	0.00	13.79
1987-88	82.23	17.77	0.00	17.77
1988-89	79.76	20.24	0.00	20.24
1989-90	76.66	23.34	0.00	23.34
1990-91	75.11	24.89	0.00	24.89
1991-92	83.75	28.89	0.00	28.89
1992-93	70.33	29.67	0.00	29.67
1993-94	68.91	31.09	0.00	31.09
1994-95	59.09	38.93	1.98	40.91
1995-96	53.08	44.03	2.88	46.92
1996-97	52.71	44.27	3.01	47.29
1997-98	54.09	42.49	3.42	45.91
1998-99(RE)	56.30	39.74	3.96	43.70
1999-00(RE)	54.95	40.02	5.02	45.05

Table 5.6

Buoyancy Coefficients & Allied Statistics of Excise Duty: 1986-87 to

Variable Name	Constant	Buoyancy Coefficient	t-stat (Constant)	t-stat (Buoyancy Coefficient)	R^2
Net Revenue	-0.63	0.79	-2.82	48.59	0.99
Modvat Credit on Inputs	-13.37	1.67	-12.84	21.81	0.98
Total Modvat Credit	-14.21	1.73	-14.17	23.53	0.98
Gross Revenue	-4.21	1.09	-10.65	37.39	0.99
Net Revenue inclusive of additional duties etc.	0.24	0.74	0.96	40.26	0.99
Gross Revenue inclusive of additional duties etc.	-3.04	1.01	-9.41	42.52	0.99
Additional Duties & cesses	1.80	0.50	2.57	9.68	0.89

years, affecting the growth of net revenue (columns 2, 5, and 6, Table 5.4). From Table 5.6, it would be noted that buoyancy of gross revenue with reference to GDP is slightly greater than one implying that the growth in gross revenue has been almost the same as the growth in GDP. On the other hand, buoyancy coefficients of total MODVAT credit and MODVAT credit on inputs are 1.73 and 1.67 respectively. Consequently, the buoyancy of net revenue is 0.79, which is much below unity. Clearly, low buoyancy of net revenue is attributable largely to faster expansion of MODVAT credit, particularly in respect of inputs.

[C] Explanations Based on Administrative Factors

A substantially faster growth in the MODVAT credit vis-à-vis growth of gross revenue has caused concern regarding the potential misuse of MODVAT credit invoices. According to a survey study, in many areas of MODVAT administration where physical control has been replaced by financial control, lapses have taken place according to a 1997 NIPFP study. Beside the procedural/technical offences, major violations have included: (i) undervaluation of goods, (ii) availing of credit on exempted final products, (iii) non-reversal of credit in respect of returned rejected inputs, (iv) availing of credit in respect of basic customs duty, (v) misuse of the facility of job work, (vi) availment of credit twice on the same invoice, (vii) availing of credit without payment of duty, and (viii) availing of credit by using fraud/fake documents. On the basis of discussions with well-informed persons, it has been learnt that the revenue loss on account of these factors would be around 10 percent of revenue from excise duty. It is also the perception that some loss occurs because of the exempted sector (including SSI) that facilitates misuse of MODVAT credit invoices. In this respect it is important to note that the goods flow in one direction and the invoices flow in another direction. As the exempted sector has no interest in MODVAT credit invoices, the invoices

relating to their purchases are being misused by the non-exempted sector. ***Thus, rationalisation of the exemption for SSI would go a long way in checking evasion of excise duty.***

[4] Measures to be Undertaken in Excises

[A] Manufacture—Need to Change the Definition

As indicated earlier, manufacture as defined in Section 2(f) of the Central Excise Act, includes any process:

1 incidental or ancillary to the completion of manufactured product; and

2 which is specified in relation to any goods in the section or chapter notes of the Schedule to the Central Excise Tariff Act, 1985.

This is an inclusive definition and the test, commonly used whether manufacture for the purpose of levy of excise duty has taken place or not, is to check:

1 Whether a new commercial product has come into existence; and
2 Whether the product is marketable.

It is thus not the nature of the process or activity which determines the issue, but the end result of that process or activity, i.e., whether or not a different product comes into existence.

Certain processes have been defined as amounting to "manufacture" in respect of specific commodities. Thus, for example:

1 In case of tea waste, blending, sorting, packing or re-packing into smaller containers amounts to “manufacture”.

2 Labelling or re-labelling of containers and re-packing from bulk packs to retail packs of preparations of vegetables, fruits, nuts etc. amount to manufacture.

3 Cutting, slitting, perforation of photographic plates, films or rolls amounts to manufacture.

4 Bleaching, mercerising, dyeing, printing, twisting, texturising, and doubling fabrics amount to manufacture.

The Constitutional validity of the deemed manufacturing provision has been tested

and upheld in courts of law. It appears that the deemed "manufacture" provision might be permitted to be accepted by the Supreme Court as long as there is a "nexus" between the process and actual manufacture. Taking an extreme case, if the legislature defines "trading in goods" as "amounting to manufacture", such provision is not likely to be upheld by the Courts.

These deeming provisions are, however, only for selective items. Consequently, when there is no such definition, such activity like labelling or printing a brand name may not amount to manufacture. This may give incentive to produce goods in one factory and give them a brand name outside. In that case, the value addition will escape payment of excise duty. In a recent case, it was held by the apex court that, where manufacture is complete at some stage and excise duty is leviable at that stage, duty has to be paid on the value of the goods being cleared for marketing if the assessee subjects the goods to further processes before marketing, even though such subsequent processes may not amount to manufacture.

As a logical extension, there is no reason why such value addition done outside the factory should not be charged to excise duty so long it is done on behalf of the manufacturer. In fact, it will be appropriate if any process, which results in value addition, is charged to CENVAT (the 16 percent basic rate) thought it may be necessary to test its constitutionality.

The definition of manufacture must be made wide enough for the entire value addition to be charged to duty. This can be done by providing that all processes which are undertaken before marketing the products, by or on behalf of the manufacturer, should amount to manufacture. This would deter the industry to segregate the manufacturing activities so as to avoid tax.

[B] Abolish the Concept of Manufacture from MODVAT

While the excise duty is on manufacture, the credit given under the MODVAT scheme need not be based on manufacture since it is in the nature of an exemption and not the levy itself. At present the scheme is based on manufacture so that all the uncertainties in the definition of manufacture have made the scheme complicated and litigation prone. If MODVAT is made to be based on plain value addition but not necessarily due to manufacture, then it can be much less prone to litigation and take a form closer to a full-fledged VAT. Excise and VAT are different in essence in that, in excise the value addition due to manufacture only can be taxed (if input credit is allowed) while in VAT the tax has to be on value addition due to any reason and not necessarily manufacture.

To achieve the removal of controversies so far as MODVAT is concerned and to introduce full VAT at the same time, we need to allow the input credit on the basis of "use in the factory" rather than on the basis of "use in manufacture of final products". The concept of use in manufacture, directly or indirectly, still occurs in the definition of inputs and of capital goods. The latest CENVAT rules define capital goods

as some listed goods "used in the factory of the manufacturer". This is the correct approach. But the inputs are defined as some listed goods "used in or in relation to the manufacture of final products whether directly or indirectly". Here the concept of manufacture comes in with all the negative implications of uncertainty and possibilities of litigation, some of which we have discussed above. Interestingly the definition of capital goods incorporated the use-concept for the last two years after the NIPFP suggested it in a 1996 report to the Ministry of Finance to that effect. So it is now a tested concept since no misuse has been reported. ***It is the right time to introduce the use-concept in respect of other inputs as well, which should eliminate all the controversies associated with the concept of manufacture at least for the purpose of allowing MODVAT credit.***

[C] Procedural Reforms for MODVAT

MODVAT procedures, before the 2000-01 budget were so complicated that "it has become a monster", according to a retired Member of the Tribunal. The largest number of violations is basically procedural. They get solved only at the level of the Tribunal. NIPFP conducted a study on the basis of data from January 1994 to July 1995 gathered from field formations. It was found that 87 percent of offences were procedural, 7 percent were substantial where duty was evaded and 6 percent were of a fraudulent nature. On the basis of wide ranging discussions with trade and officers it was suggested that it was necessary to free the officers from too many (87 percent) procedural cases so that they can concentrate on detection of substantial and fraudulent cases which will generate revenue. For this the following reforms are necessary:

1 ***Make MODVAT available to all goods, and have a negative list for items for which credit is not to be given, such as, petrol, diesel, paint and building material used in the factory building, items used in the office, air conditioner used in the office, car, computer used in the office etc. The list can be modified, though with some restrain.***

2 ***The artificial distinction between capital goods and inputs for purposes of credit should be abolished. Capital goods are also inputs and there is no need to keep separate definitions and rules for them. This change in the concept of input will solve many problems, which are affecting the system adversely. Thus, there should be no distinction between input duty and capital goods duty. The capital goods duty can now be taken only in two instalments. The earlier provision of full credit in one instalment should be restored.***

3 ***Routine checks of returns and accounts are not yielding results. We have also noticed that offences regarding the dealers have not been detected on any large scale though it is widely believed that there are many such cases. So intelligence based checks such as checking the numbers of trucks carrying the goods should be resorted to.***

4 ***The CENVAT rules have been simplified in this year's budget. This includes doing away with declarations. It may be useful to issue a circular that procedural violations should not be punished as long as there is no revenue loss. The Assistant Commissioners and Commissioners should be given the power to condone such violations. At present all such cases travel up to the Tribunal.***

[D] Tariff Reform

[i] Rates of central excise

The number of rates has come down over a period of time as desirable. There has been some discussion over moving towards a single rate of excise. However, a single rate, say 20 percent, is likely to end up with a large number of exemptions. A two-rate structure should be feasible and administratively simple, as there will be fewer exemptions. It has not been feasible to work out a revenue neutral two-rate structure due to lack of information. ***It seems, however, that 16 percent and 28-30 percent is a possible structure, especially in combination with removal of exemptions.***

The second reform relates to a reduction in the number of exemptions. The enormity of exemptions can be seen from the fact that in any standard publication of Tariff of 720 pages, 220 pages are devoted to exemptions and 500 for the actual tariff. This is only a rough estimation. What is interesting to note is that while the exemptions are nearly 75, each exemption has so many entries that the actual coverage is quite large. For SSI alone there are 5 exemptions. For job work there are 5. For export purposes there are 20. With respect to effective rates there are 259 entries for exemptions[5] with 52 conditions and 7 lists containing hundreds of items in each list. Even when conditions are not there, the descriptions are conditional such as "for use in leather industry".

An intensive effort is necessary to eliminate exemptions, many of which are given for populist purposes. It is also necessary to combine the many exemptions on the same subject. Undoubtedly, the exemptions when given, initially work for some specific purposes, and this purpose would be best known to the government. But it is quite likely that many of the exemptions, by now, would have outlived their utility. This is all the more so in view of an exemption limit of Rs.1 crore under the SSI exemption scheme. Continuance of the full exemption would in fact be against the interest of small scale units. For example, full exemption for tooth powder, henna powder, pencil sharpeners etc. can only be to the disadvantage of SSI units making these products.

On textiles, generally SSI exemption is not available. But there is a very large number of exemptions with a view to provide relief to the cottage industry sector,

5 *Notification no 6\2000 C.E dt 1.3.2000*

handlooms, processing without power, cooperative bodies, decentralised nature of fabrics and yarn processing. There is a need to look into the whole structure and, in this context, ***the Group's suggestion is that the earlier MODVAT scheme for textile processors should be restored, and the production based levy should be withdrawn. The other full exemptions available to textiles can be brought under the SSI exemption scheme and the full exemptions can be withdrawn.***

Thus, recommendations for reform in the excise tariff are: (a) move towards a two-rate structure; (b) rationalise exemptions by abolition and merger; (c) reduce conditions in the exemptions; and (d) gradually cover more items under the 16 percent rate so that classification problems are minimised.

[ii] Multiplicity of levies

The various types of duties have already been described above, as Central Excise Duty (including CENVAT), Special Excise Duty, Additional Excise Duty on motor spirit (petrol) and diesel, Additional Excise Duty on textiles & textile articles fibres, yarn, fabrics, and cesses leviable under miscellaneous enactments.

Separate accounts are to be maintained for each of these levies increasing both administrative and compliance costs. It is also difficult to work out the total effective duty in view of the fact that CENVAT credit is not given for all types of levies. ***It is suggested that there should be only one levy under the Central Excise Act. There is no reason why textile, sugar etc. should be outside the purview of sales tax at the state level. Just like any other excisable goods, only the central excise duty should be charged, while states should be free to levy sales tax on these items also.***

[E] CENVAT and Taxation of Services

Despite the growing share of services in GDP, only a very small percentage is captured under the tax net currently, the rest escaping taxation. One reason for this narrow base has been the fact that services are not mentioned in the constitution as a taxable entity. Even though services therefore fall in the residual category which lies with the Centre, the Centre never took up the matter until recently. The early choice of selected services for taxation met with severe opposition and led to a national strike by road transporters in 1997. Since then, a few other services have been included for taxation at 5 percent, though without any input tax credit.

This selective approach to service taxation has to be given up in favour of a more comprehensive approach. Recently the Revenue Department constituted an advisory group to look into the matter which has submitted its report. It has suggested a uniform service tax rate structure at 5 percent and giving input tax credit/offset within the service sector only. The tax would apply over a threshold of Rs.10 lakh turnover to keep out the unorganised sector and small service providers. Some rationalisation has

been suggested in that the separate taxes on luxury hotels and restaurants, inland travel and foreign travel would be merged into the service tax. The additional revenue potential of the proposed new service tax is Rs.3,500 crore.

The tax would cover: rail, road, water and air transport and operators of goods and passengers; storage and warehousing; post and telecommunications; banking and financial services excluding lending, borrowing and other financial internediary services; construction and maintenance of buildings, roads, rail, rail beds, bridges, waterways, reservoirs, hydroelectric projects and the like; construction (n.e.s.); hotels and restaurants; business services (except information technology related and enabled services); education services (excluding primary education when provided by government and government aided institutions); health and medical services (excluding primary healthcare provided by governemnt); and media services.

A distinct negative list—services that would not be taxed—is to be specified. These include: public services provided by government; public utility services—generation and distribution of power, water sewerage and other essential services; government owned medical hospitals and diagnostic and pathological laboratories; government run or aided schools, colleges, research laboratories, defence, space, atomic energy and oceanic research; government run or aided welfare organisation, refugee rehabilitation centres, earthquake and flood relief, jails and reformatories; transactions between employer and employee either as a service provider, recipient or vice versa; services which are exported outside India in respect of which payment is received in India in convertible foreign exchange and where such foreign exchange is not repatriated from or sent outside India.

These recommendations comprise a cautious beginning for comprehensive service taxation. It is a move in the right direction though ***it would be better to begin with a larger base and higher rate and to integrate services with the CENVAT right from the start. Several steps would remain to be taken during the Tenth Plan period. The first is to integrate the service tax with CENVAT***. The group suggested that this be done by 2003-04, but it apparently did not specify details regarding a timetable or mechanisms to be put in place. Until integration of goods and services under one taxable output base, allowing for input tax offset for the use of both goods and services as inputs, is achieved, the Centre would not have a meaningful VAT. The ramification would be a continuation of tax induced distortions and low revenue potential. Indeed, the revenue potential of the proposed service tax is quite low. A rapid expansion in the scope of the tax is therefore essential.

The second essential step is to address the issue of taxation of services by the states. This is important in the context of the VAT at the level of the states. Currently, several states are considering the introduction of the VAT on April 1, 2002 and the other states are expected to be brought into the fold. A remaining lacuna in the process is the transformation of the central sales tax (CST) on interstate trade. states have decided to abolish the CST over a period of four years and have indicated to the central government that the latter should compensate the revenue loss.

This is not a good solution since such compensation would effectively retain the origin principle of interstate sales taxation (see Executive Summary), and alternative solutions need to be discussed. ***The best available would be for the Centre to allow services to be taxed by the states.*** It may be worth recalling that initiating the VAT in a limited way, with its application only to selected goods and to different baskets of goods by different states—with a stamp of approval from the Centre—has led to procrastination, slowdown, and confusion in the entire VAT process. ***To obviate similar problems in integrating the service tax with CENVAT, an exact roadmap for the process of integration needs to be designed.*** The eventual VAT structure would comprise a larger base and higher rate of tax. Only then the VAT itself would be appropriately revenue productive and services could be sufficiently brought under the tax net. Otherwise, revenue needs for the Tenth Plan would have to be met primarily from direct taxes and the role of indirect taxes would become even narrower.

Thus, the role of services in revenue generation cannot be ignored even in the short run and this Group is of the opinion that the integration of services with CENVAT should be accomplished in the Budget of 2002-03. Once services are included in the tax base, no distinction should be made between service tax and CENVAT. All manufacturers should be allowed to take not only credit of CENVAT, but also credit of service tax paid. Similarly, a service taxpayer should be allowed to take credit of all excise duties, and also of the service tax paid. Unless this is done, a move towards unified goods and service tax, which is prevalent in all developed countries adopting VAT, would be difficult.

[F] SSI Exemption Scheme

Under the small scale industry (SSI) exemption scheme, which covers almost all the items specified in the Central Excise Tariff, two separate streams of exemption have been given to SSI units depending on whether the manufacturer: (1) wants to avail of input tax credit under the CENVAT scheme or (2) not.

The two streams do not give the same amount of benefit. If we take the second stream, assuming that the input and the output both attract the same CENVAT rate of 16 percent, and taking the value addition to be of the order of 10 percent, it may be seen that the manufacturer can go up to Rs.130 lakhs and the duty liability can be discharged from the accumulated credit.

This is because the unit is paying a negative rate of duty on value addition since, while his inputs have been taxed at 16 percent, the output pays a duty of 9.6 percent upto the first Rs.100 lakhs. There is no reason why a subsidy should be given and why such units should have additional benefits, which are not available to units which have opted for full exemption.

To remove this aberration, our recommendations are:

1 There should not be any concessional rate of duty for SSI units opting to take

CENVAT credit. They should be at par with any non-SSI unit.

2 *If the above suggestion is not acceptable, the duty payable for such SSI units upto Rs.100 lakhs should be so adjusted that when the clearance level reaches Rs.100 lakhs, the input duty credit is more or less exhausted. This can be achieved by fixing the duty rate for units upto Rs.100 lakhs at 85 percent—90 percent of the normal duty.*

3 *The third option is that the credit lying unutilised should be made to lapse as soon as the clearance from the unit crosses Rs.100 lakhs in a financial year.*

The exemption for SSI units is meant only for them and there is no reason why larger units should be given the benefit. At present, tax exemption for SSI units is available so long as total clearance of excisable goods in the preceding financial year did not exceed Rs.3 crores. However, there is a rider that goods fully exempted from excise duty, including goods exported, will not be taken into consideration for determining the eligibility of Rs.3 crores. To illustrate, butter is fully exempted from excise duty. If a manufacturer of butter with a turnover of Rs.10 crores starts manufacturing biscuits also, he need not pay, if he so chooses, any excise duty on biscuits upto a value of Rs.1 crore. It is proper that benefits of SSI exemption should depend on the total turnover and not on turnover of non-exempted goods only. ***So the suggestion is that there should be no exclusion of the exempted goods for determining the eligibility under the SSI exemption scheme.***

Further, it is recommended that if an item is covered under the SSI exemption scheme, there should not be any other exemption for such items. It is also the Group's view that, in general, there should not be any separate unconditional exemption for goods which are covered under the SSI exemption scheme. This will of course, be subject to the condition that such goods are not generally made in the small scale sector. To illustrate, fertilizers are exempted and are also covered under SSI exemption scheme. But since fertilizers are generally made in large units, and there is also the price retention scheme, it may not be possible to withdraw this particular exemption. Subject to similar exceptions, generally SSI exemption scheme should replace the individual exemptions.

In the working of the SSI exemption scheme, there is decidedly a great risk to revenue—not because of the high exemption limit—but because of the complete absence of documentation. Today, a SSI unit, whose clearances were less than Rs.90 lakhs last year (or less than Rs.90 lakhs this year for new units), does not have to make any declaration to the Cental Excise Department. This means that the SSI unit need not keep any record of production or clearance, facilitating availment of exemption even beyond Rs.1 crore. There is revenue loss on other accounts also. As explained earlier, the exemption to SSI units is a great source of MODVAT misuse, whereby the MODVAT invoices are traded without movement of any goods. ***It is imperative that exempted SSI units must maintain all records of production, clearance etc. though they need not file any returns. They must declare at least once to the Department about their existence, products etc.*** Such units will not be visited by excise officers so long they are

exempted, without a specific information of misuse. To help really small units, which are basically family affairs, it can be provided that the exemption from declaration/maintenance of records will apply only to units with a turnover of say Rs.15-20 lakhs. All other units must maintain full accounts, even though they are exempted upto Rs.1 crore.

[G] Valuation

Under the new valuation provisions, excise duty is to be charged on the basis of transaction value. This is a fundamental departure from the past, when valuation was based on the concept of normal wholesale price. Section 4 now seeks to accept different transaction values so long as these are based on purely commercial considerations. Consistent with principles of the VAT, it enables valuation of goods for excise purposes on value charged as per commercial practices. The applicability of transaction value for the purpose of assessment requires the following:

1 The goods are sold by an assessee for delivery at the time of "place of removal". The term "place of removal" has been defined basically to mean a factory or a warehouse;

2 The assessee and the buyer of the goods are not related; and price is the sole consideration for the sale.

Transaction value is the price actually paid or payable for the goods when sold. It includes any amount the buyer is liable to pay to or on behalf of the assessee by reason of or in connection with the sale The payments may be made at the time of sale or at any other time. Such payments include but are not limited to: (i) advertising; (ii) publicity; (iii) marketing and selling; (iv) storage; (v) outward handling; (vi) servicing; (vii) warranty; (viii) commission, or (ix) any other matter. It does not include amount of excise duty or sales tax or any other taxes actually paid or payable on such excisable goods.

Though the new valuation provisions appear to be adequate, there are still some problems in respect of goods which are cleared from a factory to its depots where the sale will take place. But the duty is to be paid only at the factory. In a proper VAT, the duty should be on the basis of the price at which the goods will be sold from the depot. But, probably because of administrative considerations, some simplifications have been made. It can be appreciated from the departmental instructions given below.

If the goods are not sold at the factory gate or at the warehouse but are transferred by the assessee to his depots or consignment agents or any other place for sale, the assessable value in such case for the goods cleared from factory/warehouse shall be the normal transaction value of such goods at the depot, etc. at or about the same time on which the goods as being valued are removed from the factory or warehouse.

By way of illustration, if an assessee transfers a consignment of paper to his depot from Delhi to Agra on July 5, 2000, and that variety and quality of paper is normally being sold at the Agra depot on July 5, 2000 at a transaction value of Rs.15,000 per tonne to unrelated buyers, where price is the sole consideration for sale, the consignment cleared from the factory at Delhi on July 5, 2000 shall be assessed to duty on the basis of Rs.15,000 per tonne as the assessable value. Assuming that on July 5, 2000 there were no sales of that variety from Agra depot but the sales were effected on July 1, 2000, then the normal transaction value on July 1, 2000 from the Agra depot to unrelated buyers, where price is the sole consideration, shall be the basis of assessment.

This creates an aberration, as it is difficult to verify or know at the time of clearance of goods from a factory to its depot as to what the value was at the depot at the point of clearance from the factory. This is a deemed value. The solution lies in making the depot a duty paying agency, so that, as and when the goods are cleared from a depot, duty is paid on the transaction value. The number of depots may be large, but the checks would be account-based only, and could be checked by audit groups at regular intervals.

In such cases, the movement of goods from factory to depot could be regulated in two ways:

1 On payment of duty on a notional value, and the depot will take credit of this duty.

2 Without payment of duty, and duty will be paid by the depot on clearance.

The administration should not be difficult as a large number of SSI units have gone outside excise control in view of the increase in exemption limit to Rs.1 crore. This step will facilitate the movement towards a full-fledged VAT.

Not all goods are covered by this transaction value. There is a number of goods which are assessed on the basis of the MRP. A certain percentage is allowed as abatement from the MRP for determining the value on which the duty is to be paid. The system of abatement is probably based on weighted average calculations. The department needs to look into whether any abatement is needed at all, or consider a uniform abatement to take care of the duty element alone.

[H] Dutiability of Complete Plant Erected at Site

An issue which has become controversial is the excisability of a plant which has been erected on site, even though the individual parts have already paid duty. In order to attract excise duty the goods manufactured must be marketable. If they are intermediate products that are not marketable, or if they are embedded on the earth like immovable property, they are not marketable. Then they do not have to pay excise duty. Paper plants and power plants, for example, were regarded as immovable property and so not marketable, being embedded on the earth. All the judgements of

the Tribunal and even the Supreme Court were along these lines. Chemical plants embedded on the earth were held to be immovable property and thus not excisable.[6] There are similar judgements about lifts, elevators, escalators, weighing machines, overhead travelling cranes and many others where the Tribunal and courts have invariably taken the view that plants and machinery being fixed on the earth are immovable property and are not marketable and so not excisable.

The Supreme Court unsettled this premise in the case of Sirpur Paper Mills vs CCE 1998(97)ELT 3 SC by holding that paper making machine is not "immovable property as something attached to the earth like a building or a tree" though it was "embedded on a concrete base to make a permanent fixture".The Court observed that some parts were bought out items and some manufactured at site, and the whole turn key project was erected at site. The implication of this judgement is that, since all plants are erected at site from some bought out items and some manufactured items, and since they are also mounted on a concrete base, they will all attract duty once again after they are assembled at site as a plant.

The Central Board of Excise and Customs (CBEC), issued a circular (Order no 53\2\98 cx dt 2.4.98) under Section 37B of the Excise Act, which has a binding effect on the officers. It asks the officers to charge duty if the plants are not embedded on the earth like a "building or a tree". All factories and plants are partially like a building or a tree, as they cannot be removed without breaking them. This has resulted in issuing demands by officers. Litigation is rife. How much of breakage is permissible so as to call it marketable is a question of fact, which is now before the officers and Tribunal.

However, in the meantime, some other parties have gone to the Supreme Court which has effectively reversed the position taken by the Sirpur judgement in three subsequent judgements namely (i) Duncan Industries vs state of U.P. JT 1999 (9) SC421; (ii) Silical Case ELT Vol. 108 Page A58; (iii) Tribuni Engineering vs CCE 2000 (120) ELT 273 (SC).

The criterion followed in these later judgements being different and contrary to the one in the Sirpur case, the net effect is that the Sirpur judgement is superseded for all practical purposes.

Since a very large number of demands, running into hundreds of crores, is still pending, the immediate action that the CBEC should take is to change the Circular (Order no 53\2\98 cx dt 2.4.98) under Section 37B of the Excise Act and issue a fresh

6 *In the case of Gujarat Machinery vs CCE, 1983 ELT 825(T) and also in the case of Chemical Vessels Fabricators Ltd 1982ELT 92. Mono Vertical Crystallises attached to the earth were adjudged as immovable property by the Supreme Court in the case of Mittal Engineering Works, 1996(88) 622SC. Mechanical plants and machinery were held as immovable property in the case of Tata Robins Fraser vs CCE m 1990(46)ELT 562(T). Steel tube mill was held as goods attached to earth and so immovable property by the Supreme Court in the case of Quality Steel Tubes vs CCE, 1995(75) 17SC.*

one indicating that when the plant and machinery are embedded on the earth permanently and not on a common base, they should be considered as immovable property and not be charged to excise duty. It should be clarified that the Sirpur judgment has been practically superseded. At the same time it should be made clear that it would be applicable to all pending cases. In fact, the problem would appear to be confined to only areas where the plant and machinery are not installed/erected in a factory. This is because there is already an exemption for capital goods manufactured in a factory and used within the factory of production. Government may, to remove all doubts, issue an exemption for plant and machinery installed/erected at site.

[I] Frequency of Tax Payment

The new system of payment of excise duty which has delinked payment of duty from clearances is a welcome step consistent with administration of VAT. But this may not be enough, and it may be considered whether the present system of fortnightly payment should be replaced by one of monthly payment. This will enhance liquidity of the manufacturing units. The monthly payment of duty will also ensure fewer accounting problems both for the Department and for manufacturers, since today there is a provision for excluding a taxpayer from the fortnightly payment scheme if he fails to pay within the stipulated dates. Thus an officer is to check every fortnight that the amounts have been paid within the statutory period for each fortnight. The fortnightly payment scheme highlights the commitment of the authorities to make accountal simple for the assessees and to rely entirely on his documents. This certainly indicates a movement towards an account based audit. The CBEC has already introduced a new auditing system known as E.A 2000 based on sound accounting and auditing principles. With liberalisation, the emphasis has shifted to audit and anti-evasion, rather than interfering in the day to day business activities of the manufacturers. Further simplification is needed in some areas in this regard.

In selective cases like removal of defects in goods supplied to the user, there is a set procedure allowing entry of such goods subject to maintenance of proper accounts. But, there are instances where goods manufactured by an assessee are returned to the factory on various considerations like rejection by buyer, break down of the transport etc. In these cases, the party has to obtain approval of the Chief Commissioner before such goods can be brought to the factory. This is a time consuming process and the assessee has to be constantly in touch with the central excise officers before he can bring those goods into the factory. ***When the records of the assessee are considered good enough for accountal of all manufacture and clearance, there is no reason why permission should be needed before re-entry of goods in specific circumstances. Accounts should be maintained for all such re-entry and, on the basis of self declaration or simple intimation to the Department, the manufacturer should be able to bring back duty paid-goods into the factory for any reason.***

Another important issue which arises today is that large manufacturers procure parts/components which are used both for manufacture and also for sale as spares. They would like to get these goods, and subject them to quality checks before they are

used or sold. This is to ensure that all spare parts adhere to the specifications. Such manufacturers would like to maintain a certain quality for all their spare parts. There is no specific provision for entry of such goods which are meant for further sale (trading activities). Approval of the Department is needed, which generally is not given. There is a need for relaxation and, so long as proper accounts of goods for use and for sale are maintained, the purpose will be served. There can be a deterrent penalty in case of misuse.

[J] Issuance of "Protective Demand"

A practice, which has been in vogue for a long time is that when an audit objection is raised by the staff of the Comptroller and Auditor General (CAG) a "protective demand" is issued so that the demand is not time-barred. This is so even if the staff has followed the classification instruction given in the circular of the CBEC.[7] The Supreme Court has held in a recent case that the staff is bound by the circular of the CBEC. Therefore, to raise a demand when the circular has been followed is questionable. Indeed, otherwise it continue to affect the business of the manufacturer who receives such a demand, quite adversely.

The course of action that has been advocated by the Finance Ministry is that in view of the latest judgement of the Supreme Court, the CAG should not insist on issuing the protective demand so long as the assessing officer has followed the circular of the Board. Since the CAG cannot be bound by the Board's circular, the change due to his objection can be made to apply prospectively and not retrospectively.

It seems the CAG has agreed to the idea and a circular (444\10\99 CX dt. 12.3.99) has now been issued by the CBEC from file no. 201\01\99-CX 6. The circular says that ***the issue of protective demands in contradiction to 37B order\circular would upset the basic purpose of bringing uniformity and therefore the CAG has agreed that the assessing officer should not raise protective demand if it goes against the Section 37B order.***

Past judgements indicate that, in the eye of law, there is no distinction between instructions issued under Section 37B or those issued without reciting Section 37B. So the circular now issued which has restricted the issue only to the instructions issued under Section 37B will leave enough room for issuing the demands when the instructions are not under Section 37B. The Departmental officers as well as the Audit officers will only go by the exact word of the circular that no demand can be issued when the Department has followed the Section 37B circular. There is no another problem now that the Board has practically stopped issuing Section 37B circulars since we find that in the circulars issued in the last so many years, there is no circular under the Section 37B. There is also no circular on the customs side under Section 151A.

7 *Paper Products Ltd. vs. CCE 119(112)765 SC*

The net result is that this good move is practically a nullity since there are no circulars issued under Section 37B at least for so many years. What is more important, the present circular No. 444 does cover the other orders of the Board which are binding as much as the Section 37B orders. ***This is a big lacuna, which can be addressed in the following manner:***

1 ***Have a discussion with the CAG and also include the circulars issued without reciting Section 37B.***

2 ***Start issuing Section 37B circulars once again and cover all the existing circulars, (at least the ones on classification and valuation which involve issuing protective demand) by reissuing them by reciting Section 37B. That will give an opportunity to re-examine all the existing circulars and withdrawing them if any has become otiose.***

3 ***Follow the same principle on the customs side. As of now there is no circular on the customs side. A circular on the same line should be issued for customs immediately.***

4 ***Amend Section 37B of Excise law and Section 151A of Customs law so that the Appellate commissioners are bound by the Board's circular under Sections 37B or 151A. If the Appellate Commissioner gives a different ruling from the Section 37B order, which one will the Assistant Commissioner follow. The Supreme Court has said that the higher judicial decision has to be followed, otherwise a stricture for the Court would be issued. At the same time, since the Section 37B order has to be followed, the junior officers are perplexed. In order to stave off such situations and to bring in uniformity, Section 37B and Section 151A must be appropriately amended.***

[K] Exports—Multiplicity of Schemes

The aim of export promotion schemes is to strip export goods of all duties (both Excise and Customs). But to achieve this, there is a multiplicity of schemes and procedures which certainly result in administration difficulties in monitoring. The following schemes are available to achieve duty free status for export goods:

1 Payment of drawback on exports. There can be an "all industry rate" which is worked out by averaging the value of inputs and rates of duties on such inputs, and input-output ratios. Any exporter can claim this drawback at these prescribed rates. Another route is brand rate for those exports where no all industry rate is available or where the all industry rate is inadequate for a particular manufacturer. These rates can have both excise and customs duty components.

2 Exports under bond. Here the goods can be exported without payment of excise duty on the finished goods and also on inputs for such finished goods.

3 Exports under claim for rebate of duty.

4 Export Promotion Scheme: New capital goods, including computer software systems, may be imported under the Export Promotion Capital Goods (EPCG) Scheme.

5 Duty Exemption/Rermission Scheme: The Duty Exemption Scheme enables import of inputs required for export production. The Duty Remission Scheme enables post export replenishment/remission of duty on inputs used in the export product.

Under the Duty Exemption Scheme, an advance licence is issued for duty-free import of inputs subject to actual user condition. They can be issued for: (a) physical exports; (b) intermediate supplies; and (c) deemed exports.

The Duty Remission Scheme consists of the Duty-Free Replenishment Certificate (DFRC) and the Duty Entitlement Passbook Scheme (DEPB).

Duty Free Replenishment Certificate (DFRC): This is issued to a merchant-exporter or manufacturer-exporter for the import of inputs used in the manufacture of goods without payment of Basic Customs Duty, Surcharge and Special Additional Duty. However, such inputs are subject to the payment of Additional Customs Duty equal to the Excise Duty at the time of import.

6 Duty Entitlement Passbook Scheme (DEPB): For exporters not desirous of going through the licensing route, an optional facility is given under DEPB. The objective of DEPB is to neutralise the incidence of customs duty on the import content of the export product. The neutralisation is provided by way of grant of duty credit against the export product.

Under the DEPB, an exporter may apply for credit, as a percentage of FOB value of exports, made in freely convertible currency. The credit is available against such export products at rates specified by the Director General of Foreign Trade.

The holder of DEPB has the option to pay additional customs duty, if any, in cash as well.

The exports made under DEPB are not entitled for drawback. The additional customs duty paid in cash on inputs under DEPB can be adjusted as CENVAT credit. However, where the additional customs duty is adjusted from DEPB, no benefit of CENVAT is admissible.

A unit falling under export promotion schemes such as Export Oriented Unit (EOU), Export Processing Zone (EPZ), Electronic Hardware Technology Park (EHTP), Software Technology Park (STP) may import without payment of duty all types of goods, including capital goods, as defined in the statute, required by it for manufacture, services, trading etc. provided they are not prohibited items of imports in the Indian Tariff Classification (Harmonised System) (ITC/HS). EOU/EPZ/EHTP/STP units may

procure goods required by them for manufacture, services, trading or in connection therewith, without payment of duty from bonded warehosues in the DTA set up under the statute. They may import, without payment of duty, all types of goods for creating a central facility for use by software development units in STP/EHTP/EPZ. The central facility for software development can also be accessed by units in the DTA for export of software.

In our view, too many options tend to create problems for administration as it is difficult to monitor the exemptions linked to export obligations over the years. For instance, when there is a facility to export under bond, the option to clear on payment of duty which is subsequently rebated may not be necessary, particularly where the drawback route is also available. Besides, the payment of rebate also takes time.

Similarly, in the case of exports, the DEPB route does not appear to be necessary when the DFRC, DEEC, and Drawback are available. Besides, this may not be compatible with WTO conventions. ***There is a need to evaluate whether the duty foregone on these schemes (around 35-40 percent of net customs revenue) is really compatible with export growth. With the introduction of special economic zones, and the scheme for EOU/FTZ, it needs to be considered if only the following schemes should suffice: (1) DERC; (2) DEEC; (3) export under bond; (4) Drawback; (5) EPCG schemes; and (6) special scheme for gem/jewellery/diamonds.***

CCCN classifications applicable to the customs tariff are harmonised with excises. Nevertheless, since excises relate to the concept of manufacture which is not the case in CCCN, some indefiniteness in the identification of particular products tends to arise on the excise side. In these selective cases, the tendency for such matters to end up in litigation would be minimised if appropriate and specific definitions are included in the excise tariff. For example, in the case of "waste and scrap", the interpretation of "waste" has created some confusion which should be resolved with appropriate definition.

[5] Reduction of Customs Duty Exemptions

Though the total of 103 exemptions may not be considered a big number by itself, the number of items in each of the exemptions makes the whole system complicated. Prior to the Union Budget 2000-01, one exemption which gave the effective rates of various commodities (16\2000 cus dated 1.3.2000) had 346 entries, with 33 lists and 83 conditions. This notification ran into 81 pages. Though this was the longest, the other notifications were quite lengthy. Together they comprised a complicated structure not only for importers, but they also posed a serious problem for appraising officers who are entrusted to finalise the classification as quickly as possible. There were 22 export-related exemptions, 20 exemptions for licence related schemes, 9 for re-imports and so

on. The huge lists took away the generic character of the tariff. To a great extent, it reflected lists supplied by different administrative ministries in their endeavour to show that they are rendering appropriate service to that segment of industry with which they are concerned. The Union Budget 2000-01 did not improve the situation. Presently, the general notification for effective rates is 17/2001 Customs which has 378 entries thereby increasing the number of entries as in the case of excises.

Since there is a provision for a rate of duty which is uniform, it would be much more simple and transparent to give a general lower rate of duty to the leather industry and crude oil refining industry than to give exemptions to specified 200 to 300 machines and parts thereof. There is much scope for improvement on the above line. However the most important need in this regard is to reduce exemptions drastically. This will broaden the tax base as well while allowing the authorities to reduce the tariff rate in general.

Specific suggestions for removal of exemptions are made below.

1 ***50\96 & 76\96 cus dated 11.9.96 Exemption for materials for R&D for which elaborate procedure and certificate necessary. The industry may as well pay for this.***

2 ***122\93 cus dated 14.5.93 giving exemption to hotels for capital goods (as found in Table) has no justification. Five-star hotels usually use these, which should be able to bear the cost.***

3 ***A large number of exemptions such as 29\97 dated 1.4.97 and 32\97 cus which have been given under the EPCG Scheme to capital goods are being enjoyed by different industries. Even five-star hotels have been given this. The revenue forgone is reportedly huge and enforcement of demand against defaulters is proverbially ineffective. The indigenous capital goods industry has been badly affected by lack of demand. Though these exemptions have been issued under the request of the Commerce Ministry, they should be reviewed immediately.***

4 ***There are twenty exemptions under the Advance Licence Scheme and the Pass Book Scheme which have huge lists attached to them. During our visits to ports and offices we found that the assessing officers ask for catalogues in a large number of cases ostensibly to verify these lists. So long as these long lists are there in the exemptions, this trend will continue which makes much of computerisation ineffective. The scope of corruption also increases. These exemptions should be reviewed and they should be restructured by combining them, making the descriptions more generic and abolishing many of the schemes, which are overlapping in their scope. The revenue foregone should be weighed against the probable gain in exports.***

5 ***The general exemption 16\2000 cus dated 1.3.2000 which has 346 entries. It means there are 346 exemptions. A close study shows that many populist items are there which have no economic justification. They are the following (serial numbers and tariff entries in brackets):***

Cows, bulls, poultry stock etc (1, 1), frozen semen, frozen equipment etc(6, 5), planting materials like oil seeds, vegetable seeds (8, 6 to 12), cashew nuts (11, 8), fruits (12, chapter 8 has got so many rates like 15, 25, 35, 40 and 50 which can be made into one, abolishing the exemption at 25%), chocolate preparations (35, 18.06—why should chocolate preparations be charged a less duty of 15 percent than the tariff rate of 35 percent?), prawn feed (48, 23), dietary soya fibre (47, 23), instruments for silicone breast prosthesis (317, 90), spodumene ore (50, 25), chemicals for the manufacture of Centchroman (64, 28), iodine for manufacture of potassium iodate (65, 2801), several chemicals such as Zirconium oxide, Gebberalic acid (64 to 81,—28 and 29, if these exemptions are removed all chemicals will attract the same rate of duty), paper for packing grapes (123, 48), machinery (178 to 290 Chapters 84 and 85—large number of exemptions and lists and conditions in this area have made classification very complicated. Only two rates 25 percent and 15 percent would be sufficient and no exemptions given. ***There are also many exemptions for telecommunications, which are unwarranted. These exemptions should be removed. The long lists and conditions should be shortened. Finally exemptions for leather and textile industry should be examined with circumspection. They have been enjoying exemption for long and should be eliminated.***

[6] Zero-Rate Customs Duty

A sluggish performance of the capital goods industry has been worrying economists recently and one has to find the reason why the growth is so slow. In 1999-2000, industrial production increased by 8 percent as against 3.9 percent in the previous year, which is cause for some relief. Even the manufacturing sector grew by 9 percent in 1999-2000 compared to 4.3 percent in the previous year. But this buoyancy was because of higher growth of intermediate goods (15 percent) and consumer durables (12.2 percent) in 1999-2000. A non-achiever was the capital goods sector, which achieved just 4.8 percent growth in 1999-2000 compared to 11.8 percent in 1998-1999 and 9.3 percent in 1996-1997. 2000/01 figures were reported at even lower levels. The index of industrial production (IIP) for July 2000 indicated an overall year-on-year growth rate of 4.3 percent, down significantly from last year.

Technologically, the capital goods industry is not exactly lagging behind. It has built sophisticated manufacturing facilities and acquired comprehensive state-of-the-art technology and expertise to manufacture a complete range of equipment required for core sector industries such as power, oil, gas, refinery, transmission and infrastructure. They have made investments partly by borrowing funds from international organisations and partly from local resources.

The cost disadvantage of local industry is largely due to inadequate infrastructure,

local taxes such as octroi and entry tax and higher cost of financing, which together amount to about 23 percent and may even go up to 32 percent in some cases. The World Bank guidelines for "preference for domestically-manufactured goods" stipulates a price preference of 15 percent or customs duty, whichever is lower.

The customs duty has been brought down to zero by the following method. Earlier, when customs notification number 84/97 dated 11/11/97 waived customs duty on all goods imported by the United Nations or an international organisation for execution of projects financed by them and approved by the government of India, the exemption was restricted to social sectors like health, sanitation, family planning, education and similar others.

The Finance Ministry amended the above notification vide notification number 85/99 dated 6/7/99. This later notification allowed import of all goods at zero duty for execution of projects financed by the United Nations, World Bank and other such international organisations. The scope of the notification has been widened to projects under the core sector such as power, fertiliser, coal, road, port and others. Even contractors associated with infrastructure projects like road building have been allowed to import goods at zero duty. Thus the tariff barrier, that is the protective customs duty, available to the domestic capital goods industry prior to July 6, 1999 has been removed. To site an example, hydraulic excavator, for which the normal import duty is 53.38 per cent can now be imported by contractors on the certification of the surface transport ministry at zero customs duty.

Since the rate of duty under the above notification is nil, the benefit of price preference available to the domestic manufacturers as per World Bank guidelines is being denied by project authorities like Power Grid and NTPC. The recent report of about 10 per cent price preference for indigenous companies for supply of plants equipment and commissioning of gas-based mega power plants of the NTPC is a local affair and not connected with the above issue.

The concerned customs duty rate structure is presently the following:

Items	Customs duty %
Captive power plants of 5MW or more, Power transmission projects of 66 kV and above, other industrial plants Projects including Oil and Gas.	25%+16% CV
Fertiliser, Refining of crude petroleum, Coal mining, Power generation projects including Gas turbine power projects (excluding power plants set by project engaged in activities other than power generation)	5%+ 16%
Mega power projects, all items covered under Notification numbers 84\97 and 85\99	0%+nil

The rate structure reveals that capital goods for different projects enjoy a lower rate of duty then the average tariff rate which is acceptable under a normal tariff structure. However, those covered under the notifications enjoy zero duty which has given rise to an unequal competition os sorts.

The logic forwarded in favour of contiuing these exemptions is two fold. One is that the World Bank or other multilateral UN agencies would accept to bear the basic cost of the project but not the customs duty. This argument is fallacious. The World Bank may as well fund the project cost and the importer pay for the customs duty. The second argument is that if the customs duty is included, the project cost will increase. This argument is also untenable.

We recommend the following:

1 ***All the different rates of customs duty may be equalised and brought to 20 per cent.***

2 ***The basic tariff rate should be reduced from 25 percent to 20 percent. This will reduce the need for giving very large number of exemptions, which now exist in the machinery chapters in the customs tariff. These exemptions are full of long lists and longer conditions, which have made the working of the tariff extremely difficult exercises. The fact that in spite of so many exemptions, neither the power sector nor other industrial sectors have done well proves that giving exemptions is not the best way to boost them.***

3 ***The countervailing duty (CVD) of 16 percent should be levied uniformly. There should be no exemption from CVD either.***

4 ***If the zero customs duty allowed under this Notification 85/99 is removed, then automatically the 15 percent price preference allowed under the World Bank guideline will return.***

5 ***The exemption of 4 percent special additional duty (SAD) should be removed, and imports for fertiliser, coal mining, power generation projects as well as for setting up of crude petroleum industry, should be brought under the purview of SAD.***

All these measures will ensure the creation of a level playing field between the indigenous capital goods industry and foreign suppliers of capital goods. At that stage, if the indigenous capital goods industry cannot perform then they who would of course have to accept the consequences of competition.

[7] Export Valuation

In the 2000-01 Budget the valuation in Central Excise has been made into a transaction value, already indicated. It was earlier based on the concept of deemed value. FERA Section 18 and FEMA Section 7 use the term "full export value" which in effect is transaction value. On the import side in customs, it has been based on the concept of transaction value since 1988. But on the export side in customs it still continues to be deemed value though many officers take it to be transaction value. In the Duty Exemption Passbook Scheme, it is transaction value as per Public Notice 143\97 dated 16.10.97 issued by the Commissioner Exports, Mumbai. Since Public Notices in legal matters are issued under the instructions of the CBEC, it indicates that there is some confusion about whether the valuation in exports is on the deemed value or transaction value. It is understood from discussions with various people that there is lack of uniformity in practice followed by different officers which result in uncertainty and even harassment.

It is pertinent to note that the WTO Agreement on customs valuation deals with value of imported goods and is silent on export valuation. Article 1 of the WTO Agreement specifically states that "the customs value of imported goods shall be the transaction value". So we have the option to adopt the transaction value.

The suggestion is therefore that an "Explanation" should be added to Section 14(1) of the Customs Act to make it clear that it is transaction value that should be used. That will also be in consonance with the principle followed in respect of the other valuations. At the same time it is also more reasonable, given the fact that international prices vary from transaction to transaction reflecting different circumstances.

There is also doubt whether Section 14(1) is applicable even for goods where they are non-dutiable. (Duty refers to export duty.) There is one judgement in the context of DEEC Scheme, which says that it is applicable even under those circumstances. So the uncertainty should be ended by clarifying in the form of an "Explanation" that it applies also for non-dutiable goods. If the above is done then it will not be necessary to frame rules for export valuation. This will result in less number of rules which is better.

[8] Selected Administration Issues

[A] Clearance of Cargo

Delay in the clearance of imported cargo in ports and airport cargo stations is a major

source of complaint by trade and industry. Delay of course increases the cost of production. The other adverse effects are congestion in the ports leading to under-utilisation of port facility as well as corruption. In fact if the ports are decongested by quick clearance of cargo, they could handle much more cargo than currently. Such improvement should reduce the need to invest enormous sums for constructing new ports.

The Group visited a major port and examined the process of computerisation of import cargo, EDI (electronic data interface), instructions on the Fast Track Clearance Scheme and, finally, the actual clearance of goods in the dockyard. In spite of the overall computerised set up and the claim made at various levels that clearance of goods was very fast, it was found that many queries were being raised in a routine manner which delay the clearance of goods. On one day alone there were 54 queries, 42 percent of which only asked for catalogues, 25 percent asked for provisional duty bond without indication of the reason for asking such bonds and the rest for chemical tests, other documents etc. The average number of bills of entries (clearance documents) being in the region of 300 per day, the percentage of queries came to nearly 18 percent a day. Calling for catalogues is necessary partially because there are a lot of exemptions even now, but also because the assessing officers tend to want to establish contact with importers for reasons which could be suspect.

In sum, the so-called Fast Track Clearance Scheme is highly restricted and has not produced the desired result. It continues with the old system of examining goods when they are imported under the export promotion schemes. The facility of non-examination has been given to those who have an "unblemished record". However, in Central Excise self-removal and self-assessment facilities are universally applicable. But in Customs they are severely restricted. The result is that it is hardly availed of.

To make clearance speedy and to decongest the ports the following steps should be taken:

1 ***In Canada, Netherlands, the United Kingdom and the United states, importers self-classify, value and remove the goods. The goods are not examined except when intelligence warrants physical checking. In India too goods should not be examined, and only targeted goods should be checked on the basis of intelligence.*** This should be allowed to manufacturer-importers irrespective of previous cases against them as is the case of Central Excise. Post—auditing should be carried out based on data recorded in the computer. For this the intelligence collection machinery should be strengthened.

2 Classification is done in the Customs House and clearance is done in the docks. There are computer terminals in the docks where the same data are available as in the Customs House. The importers have to go the Customs House for taking the bills of entry and then again to the docks for clearance. ***This can be simplified if the assessing officers are available in the docks and Bank transactions are made possible there. In that case the importer can come to the docks, take the bill of entry, pay the duty and clear the goods all at one place.*** Even now one deputy

collector was found at the dock office. If necessary one additional collector could also be placed there to sort out the day to day problems. It is a question of finding some more office space in the docks, which is not difficult. This system will definitely bring the procedure of clearance of goods nearer to the aspiration of a "single window clearance".

3 ***Another way to expedite the clearance of goods is to reduce exemptions. It must be admitted that even if the assessing officers are honest and diligent, they have to satisfy themselves about the correctness of classification. This becomes difficult with so many exemptions in the tariffs. Recommendations regarding reduction in exemptions have already been made above.***

[B] Modifications Applicable to Both Customs and Excise

[i] Advance ruling on classification

The government has made a law for advance rulings for excise and also customs in the 1999 Finance Act according to which, a binding ruling will be given for the NRIs by an authority which will be presided over by a retired Supreme Court judge. The scheme has incorporated all sorts of judicial formalities. CRPC and CPC have been made applicable, as it will be like a court.

The proper course of action in this respect is to make the CBEC give the advance rulings. The CBEC has a group of technical experts who can advise it on such matters. What is important is uniformity and certainty. An excess of judicial procedures hampers economic progress, though it may benefit particular professionals such as lawyers and solicitors. Further the advance rulings should also be made available to all and not be restricted to NRIs alone.

[ii] Stop the flurry of remanding the cases

Frequent remanding of cases by the Tribunal has become a cause for harassment to the industry. It is not objected to by the lawyers for obvious reasons and it gives easy disposal to the authority passing the order. The incidence of remand has reached such proportions that, in a large percentage of the cases, the party cannot expect a final order. Under all sorts of pretexts, the cases are being remanded to the subordinate authorities. It is not possible to get authentic data on the number of cases being remanded. But ***there is no doubt that the incidence of such cases is very high. Remanding by Commissioners has been stopped in the 2001-02 Budget but remanding by the Tribunal also has to be tackled in a proper manner. In the case of the Tribunal, the data can be collected through the office of the Senior Departmental Officer and the matter can be brought to the notice of the Revenue Secretary.***

[iii] Add appropriate explanations in exemptions

Many doubts and controversies can be avoided if Explanations are added to remove the doubts. Examples will make the point clear. There was an exemption for boiler designed for agricultural and municipal waste as per notifications 121\81 C.E. and 205\88 C.E. A certificate was also to be produced from the Chief Inspector of Boilers. These notifications were sources of litigation on the issue as to whether the boiler was to be designed exclusively for these wastes. An easy solution to such problems would be to incorporate an Explanation in the notification that it was not to be exclusively designed, as it was later decided by the Tribunal. ***More use of Explanations as soon as controversies come to light or at the initial stages of drafting the notification, should reduce litigation significantly.***

[iv] Amend the law prohibiting "Unjust Enrichment"

Section 115B of the Excise Act and Section 12B of the Customs Act deny "refund in cases of unjust enrichment". Unjust enrichment is considered to be caused by a refund to a manufacturer (or importer) from the tax administration (based on a subsequent claim by the manufacturer) when a higher tax has already been realised by the manufacturer from his customers. The customers may be too numerous for the manufacturer to give refunds to them. This should not be a justification for the tax administration to keep the revenue. ***Hence, the provision to deny refunds to the manufacturer by the tax administration should be removed, and the law appropriately amended.***

Reflecting a particular prevailing market form, price could be construed to be separated from cost. At moments, products may be sold at a high profit or at a loss when the cost may not be fully covered. Thus, the initial higher tax realised may not reflect that the tax burden has been passed on in every case. The higher tax collected by the manufacturer or importer may not therefore reflect unjust enrichment. Especially, in the context of globalisation, it is important not to restrain firms from remaining competitive in the markets in which they operate.

[v] Preventing proliferation of litigation in customs and excise

Litigation in indirect taxes is a part of the overall litigation process in the country. Therefore it would be proper to begin by ascertaining the general situation first.

More than a decade back the then Chief Justice of India, Shri P N Bhagwati, said in considerable anguish that the judiciary was crumbling under the load of mounting arrears. A statement by the then Minister of Law in 1998 was to the effect that the pendency in courts had reached a figure of 2-3 crores. In fact a recent (end 2000) statement was made by Sri Arun Jaitley, the present Law Minister that there are 4.04 crore cases pending in all courts and that, in the High

Courts, the arrears are 34 lakhs. A fair share of these cases in the High Courts must be relating to Customs and Excise. We have to add to that the cases before the Cegat, Appellate Commissioners and the adjudicating authorities to get the full measure of all litigation.

Pendency in Customs and Excise has two aspects. One is the judiciary and the other is the Department of Customs and Excise. On the side of the judiciary, very long delays in deciding the cases leads to filing of more cases on the same undecided issue. If the issues were decided in the courts quickly, then others would take the law as guide and settle the cases. The reasons for the delay in deciding the cases in the Courts and in the Tribunal have to be discussed, therefore.

The main reason for pendency is the very low rate of disposal of cases by the courts and the Tribunal. One of the reasons is the granting of too many adjournments. The second is the absence of functional courts dealing only with fiscal offences. Third, there should be some courts for deciding old cases. Once a case is two years old there should be a fixed judge for deciding such cases. Otherwise old cases are neglected and new ones, which are easier, are disposed of. The above reasons have been confirmed by the 1990 report of the Arrears Committee headed by Justice Mallimath. He gave the following reasons amongst others: (a) litigation explosion; (b) accumulation of first appeals; (c) inordinate concentration of work in the hands of some members of the bar; (d) lack of punctuality among judges; (e) granting of unnecessary adjournments; (f) indiscriminate closure of courts; (g) indiscriminate resort to writ jurisdiction; (I) inadequacy of classification of cases; and (h) inordinate delay in supply of certified copies of judgements.

Coming to the issue of the Department, it is quite obvious that it should make the system of classification and valuation simpler so that the scope of litigation is less. Some specific suggestions are the following:

1 MODVAT Now the largest number of cases is in respect of admissibility of MODVAT. This is mainly because of the concept of manufacture. Once the criterion is changed from "manufacture" to "use in the factory" in the case of inputs, as has been accepted in respect of capital goods matters should improve. Second, the distinction between capital goods and inputs should be abolished and that will bring down the number of controversial issues. Third, MODVAT should be extended to all goods and a negative list should be developed where MODVAT is not to be granted.

2 Introduce More Definitions in the Tariff If there are many rates, exemptions and conditions, defining goods becomes imperative for the purpose of imposing the correct amount of tax. To ward off controversies, statutory definitions have been introduced in many cases. They are binding even if they are "artificial" in nature. In fact they have to be artificial in many cases reflecting the very nature of goods that need to be defined. When there is

no statutory definition, the definition in market parlance has to be followed. In the absence of any of the above definitions, to help in coming to the correct understanding in the market or to help in ascertaining the proper scientific definition, there is a place for the use of ISI definition also. ***It is advisable to introduce more statutory definitions in the tariffs to lessen the controversies in regard to identification of goods for the purpose of classification.***

An example where such definition is necessary is "waste and scrap". We could readily locate the following cases reported in recent times: 1) Scrap of rubberised bid wires and rubberised steel belt fabrics obtained during manufacture of tyres—held not excisable; 2) Nickel waste arising in the process of manufacture of articles of Nickel—held as excisable; 3) Waste and scrap of steel and pig iron arising during manufacture of railway parts—held as not scum but excisable; 4) Scrap arising in the course of dismantling of railway locomotives—held as not excisable. Other cases where definitions are necessary can be found by referring the matter to field formations.

3 File Less Appeals Department should file less appeals before the Tribunal and the Supreme Court. There are far too many cases where appeals are filed. The percentage of cases where the Department wins is relatively low. Recently the Department has lost several cases before the Supreme Court when it filed appeal against a larger bench decision of the Tribunal. Routine filing to appeals must stop.

4 Change in Objective Last but not the least, the mindset of officers has to change from being purely pro-revenue to neutral. They should be encouraged to give a correct decision rather than tending to err in favour of revenue. This is of course easier said than done. A practical method will be for the Board to emphasise this in a clearly worded circular.

With the above changes, litigation is likely to come down substantially.

A Review of State Taxes

A Review of State Taxes

[1] Introduction

This chapter attempts to review the overall performance of state taxes; points towards the main lacunae in prevailing state level tax administration, analyses the preparation across states for VAT implementation and makes appropriate recommendations.

The separation of taxing powers between the Centre and states enjoins a collective effort on both forms of governance to record tax collections as close as possible to the available potential. In this respect, if respective shares of central and state tax collection are any indication, states seem to have applied a relatively larger effort to garner tax resources. This has been in evidence since early 1990's when the states's share in total tax collection increased from 33.5% in 1989-90 to 38% in 1999-2000. Upon closer examination it is revealed, however that more than states' applying extra effort in relation to GDP, it is the deterioration of Centre's performance in relation to GDP, which has accounted for a larger share of states tax resources.

Thus, while gross central taxes in relation to GDP fell from 10.69 to 8.80 percentage points, state's own tax revenue remained by and large stationary at 5.38 percentage points. Clearly, maintenance of performance is not enough and this has prompted both the Eleventh Finance Commission and this Advisory Group to assign higher targets for states for their terminal year projections. Thus, Eleventh Finance Commission seeks an improvement of state taxes to 6.44% of GDP in 2004-05 and the Advisory Group assuming the same pace of improvement arrives at a target of 6.90% in 2006-07. An improvement of the order of 1.52 percentage points envisaged by the Advisory Group over the period 2000-07 is no small task. Higher revenue mobilisation is crucially contrigent on the widening of the tax base and modernising tax administration. To make this improvement possible, we outline the road map for reform of the state level taxes in the following sections.

[2] Sales Tax Reform and Advantages of a VAT

[A] Present Position

Taxes on goods are levied in India in various forms and at different levels of government. Taxes on sale and purchase of goods (commonly known as sales tax) other than newspaper belong to the states. The sales tax forms the main source of revenues for states, comprising about 60 percent of the total tax revenue of the states. However, overtime the regime of sales tax in the states is characterised by the following basic problems:

1 "First point" taxation at the manufacturer and importer levels leads to a narrow base due to the exclusion of the value addition at the subsequent stages of trade, from the taxable base. It also leads to discrimination amongst goods, depending on the number of stages they go through in the course of production and trade, and also the relative proportion of value added at the subsequent stages of sale. It is also not possible to discriminate between purchases for intermediate use and those for final consumption. This results in cascading, excess burden and distortions in economic decisions. It also faces definitional and evaluation problems.

2 Sales tax is constricted also by the exclusion of services from its purview. The state can levy tax only on a few specified services like luxuries, entertainment, amusements, betting and gambling, and on goods and passengers carried by road and inland waterways. However, the general power to tax services does not lie with states. This has been a source of acute problems in taxing even the sale of goods where the sale takes place as an integral part of providing a service.

3 Multiplicity of levies, rates and concessions results in lack of transparency, hairsplitting distinctions among commodities and breeds excessive litigation and economic distortions. With a narrow base the tax rates also have to be high to garner the same amount of revenue in comparison to what would be otherwise needed. High rates tend to induce evasion, and also generate pressures for concessions and exemptions for particular sectors of the economy and sections of the community. In turn, this leads to multiplicity of tax rates, with distinctions drawn between commodities that are difficult to draw in practice, resulting in an excess burden from disputes relating to classification.

4 Wide divergence in the structure and procedures across states creating handicaps for doing business in more than one state. Each state has its own legislation, with its own taxable base, rates, formulae for tax calculations and reporting requirements.

5 Taxation of inter-state sales on origin basis permits tax exporting. The levy of a tax on inter-state sales through the mechanism of central sales tax (CST) distorts the

location of industries and the flow of internal trade impedes the growth of a common market in the country.

6 Absence of coordination and lack of information sharing among the states leads to a high level of tax evasion on inter-state transactions.

It is, therefore, well recognised that internal trade transactions (in both excises and the sales tax) have been a source of inequity as well as distortion and inefficiency in economic decisions and resource allocation impeding growth and the competitive strength of Indian industry. It entails high cost of compliance and of administration. In the context of the prevailing situation the reform of the sales tax has become an overriding priority. If the tax reforms are to be revenue neutral, if the decisions of economic agents are to be unaffected by distorting elements, and if a common market is to be established to facilitate free flow of trade, there is no alternative but to design a system whereby domestic consumption could be taxed comprehensively but without giving rise to the complexities and inefficiencies that mask the existing structure. ***It is now well accepted that the best way to go about this task would be to have a value added tax (VAT).*** Nevertheless, while awaiting the introduction of a state-level VAT, a beginning should be made by streamlining the existing sales taxes further. Though states recently introduced floor rates for the sales tax, further reform can be achieved by abolishing the turnover tax and entry tax wherever they continue to exist, and reducing concessions and incentives from the prevailing sales tax structures.

[B] Why a VAT is Needed

In its purest form, VAT is a tax that is levied on the value added along different stages of production and distribution of a commodity or service. Therefore, it is a tax on the sum total of value added, i.e., equal to the value of a commodity or service. In this sense, it should be equivalent to a retail sales tax that is collected only at the retail stage. But the retail sales tax is difficult to collect because there are too many retailers of various sizes. The VAT, instead, can be collected at earlier stages of production in fragments and can end at the retail stage. But the total collected from the VAT should be exactly the same as if collected only from the retailers of the commodity concerned.

[i] Eliminates cascading effect

The VAT is preferred because the VAT minimises distortions. The simple excises or the turnover taxes result in the unintended effect of (i) taxing an output (together with its input content) more than once; as well as (ii) applying a tax on the earlier paid input tax leading to cascading. It causes producers to move their capital or resources away from the production of one output to another one which does not suffer from cascading. The VAT, because it gives credit for input tax earlier paid, avoids the distortion as represented by misallocation or redirection of resources from one economic activity to another. Therefore, it does not alter producers' decisions to produce particular commodities which, in

general, should reflect the demands from consumers. However, for this benefit to occur, the VAT must give credit for raw materials and capital goods.

[ii] Eases administration

Although there are feasible options for limiting the impact of cascading, the utility of multi-point VAT goes much beyond that. Arresting cascading could be considered important to a regime of VAT. Nevertheless, the institution of VAT in fact should be conceived also as an instrument of tax administration—an administration that checks evasion through a self monitoring feature,[1] and an account based audit system that is regarded as superior to the system of physical verification. The latter already having fallen into disrepute for causing distress to tax filers needs to be eventually abandoned as its positive impact on revenue yield remains questionable. An account-based audit should not only tighten the tax net but raise revenues through a wider acceptability of a tax administration in the public eye.

[iii] Improves international competitiveness

Since VAT has the potential for eliminating cascading, it is possible to design the VAT in a manner that will ensure that exports are free from any tax burden (zero-rating). Further, such adjustments under the VAT structure are also WTO consistent. As a result the competitiveness of exports in international markets is enhanced. Even though exports are generally exempt from sales tax and the burden of input tax embedded in the exports is sought to be eliminated through the duty drawback mechanism, nevertheless, the process is cumbersome and the effect is not fully realised. As export competitiveness can be adversely influenced by the tax factor, the capacity to zero rate easily and accurately is an important aspect of the VAT.

[iv] Imparts transparency

Another positive aspect of the VAT is its simplicity and transparency, which commodity taxes usually lack. The VAT tends to collect the quantum of tax payable at every stage of transaction. Both producers and consumers, who ultimately bear the tax burden, are fully aware of the tax liability, which is not as easily ascertainable in other forms of commodity taxation.

1 *Since VAT credit can be demanded by a taxpayer only on the basis of invoices he has collected from his sellers.*

[v] Buoyant source of revenue

When faced with chronic budget deficits and growing expenditures, governments have been turning to tax reform as a way to raise revenues. governments seek revenue sources that are income elastic and not sensitive to changes in prices of particular goods or income sources. Since the VAT permits a relatively larger coverage in as much as it is possible to extend it to value addition at all stages in the production-distribution chain, the potential for raising resources efficiently is generally higher.

[C] Single VAT versus Dual VAT

Devising a scheme of destination based VAT in a federal country with powers of taxing domestic production and trade divided between the Centre and the states is not simple. From an administrative viewpoint, the VAT is levied more easily at the national level because of the phenomenon of interstate trade that complicates matters at the state level. However, given that sales taxes constitute the most important source of the states' revenue, divesting them of the power of sales taxation would grievously erode their fiscal autonomy.

Alternatively, the Centre could vacate the domestic trade tax field and leave it to the states to operate a destination based VAT in a harmonised way. That option also does not seem to be feasible as it would have very serious negative repercussions of the Centre's revenue and its capacity to undertake regional redistribution, unless there is a major compensating shift in its powers and functions. Further, the Centre has already advanced in the use of the VAT principle in its excise taxation. In order to complete the process of changing the Union excises into a full-fledged manufacturers' VAT, several measures have been taken by the Centre which has already been discussed in Chapter 5. Most manufacturing items are now covered by CENVAT, the CENVAT rules having been relaxed over time to allow credit for duty paid on an increasing number of inputs which were not admissible earlier.

A third possibility is a dual or joint VAT system whereby the VAT is levied by the Centre and the states concurrently but independently, both going up to the final consumer. In combination, the Centre could levy VAT upto the manufacturer level while the states would operate it upto the final consumer (or sale to the last registered dealer), within the framework of a harmonised system.

The Group's terms of reference require us to recommend a comprehensive VAT whereby the central and state VAT stand integrated. To achieve this end, ***our proposal of a state level VAT would be to recommend one that could co-exist with the present arrangement of the central VAT (or CENVAT). Thus central jurisdiction would give setoff only for central duties and state jurisdiction for state duties***. An integrated central-state VAT arrangement can easily exist in parallel or dual format. However, respective tax jurisdictions (and administrations) would have to be careful about excluding the taxes paid to the other jurisdiction from the assessment of value bases.

[D] Reform of Existing Sales Tax

Regarding the states, a prior step to introducing a harmonised VAT would be to rationalise their sales taxes. Accordingly, it has been agreed upon by an Empowered Committee of Finance Ministers of the states to reform their sales taxes and prepare the ground for introducing a VAT in a phased way. Consequently they have introduced five floor rates. There is also a broad consensus on the need for doing away with concessions and incentives in sales taxation. Steps have been initiated in 1999-2000 to give effect to this broad consensus. Some other important steps towards reform of the state level sales tax relate to:

1 Commissioning of a study for harmonised classification and coding of commodities for the entire country.

2 Training of Commissioners of Commercial Tax and subordinate officials of states and Union Territories;

3 Giving impetus to scaling back concessions and incentives with the objective of eventually eliminating them.

The adoption of uniform floor rates has resulted in elevation of existing rates, in turn producing some revenue gains. Unfortunately, the consensus on floor rates has been managed on only around 200 items with around 100 items still eluding consensus. While comprehensive coverage is the immediate objective, it may still not equate the total number of operative rates with the number of floor rates. Thus, in many states, a specified category of commodities has more than one operative rate even though all rates may be above the assigned floor level. A single rate equal or above the floor rate is clearly called for if the total number of operative rates in each state is desired to be kept at a minimum size for the purpose of efficient VAT administration. As a result, against five floor rates, the maximum number of operative rates will also be five.

For the sole purpose of augmenting revenues, withdrawal of sales tax incentives with prospective effect is also clearly not adequate. As of now, many industries which have been recently exempted, are enjoying exemption for as long as twenty years. Clearly the beneficial impact of withdrawing exemption cannot be immediately felt unless exemptions are withdrawn with retrospective effect. Indeed, relatedly, the current sales tax revenue status, which is serving as the standard for measuring possible revenue losses and gains in structuring a VAT, is a distorted yardstick.

We therefore recommend that the next step on the agenda should be to move over to state Value Added Tax (state VAT). The Empowered Committee of state Finance Ministers must decide expeditiously on the design of the VAT so that appropriate VAT legislation can be enacted and rules and regulation framed well before April 1, 2002. Integral to the adoption of VAT is the withdrawal of central sales tax (CST), which hitherto was sending goods to importing states laden with tax. The imported tax was taxed again under first point general sales tax in the importing state resulting in "tax on tax", or cascading, a practice that should not be admissible under the VAT. Similarly,

the Committee of Commercial Tax Commissioners that has already been formed must decide on the various administrative issues relating to VAT like registration, establishing an efficient information system, collection, audit, taxpayer education, a system of penalties and appeal, training and computerisation.

[3] State Level VAT—Design Issues

VATs can take many forms. A state contemplating the introduction of a VAT has a number of choices to make. Some of the important structural choices or decisions to be made are:

1 The type of VAT, i.e. consumption, income or gross product.

2 The regime for VAT on trade: the origin principle (exports taxable, imports untaxed) versus the destination principle (exports zero rated, imports taxable).

3 The method by which a taxpaying firm may compute its liability: subtraction method, tax credit/ invoice method, or addition method.

4 The technique of freeing a firm from VAT: exemption (the firm need not file a VAT return but does not get a refund of tax paid on inputs) or zero-rating (the firm must file a return but pays a zero gross tax, and also gets a refund for VAT paid on inputs).

5 A single-rate VAT versus a VAT with two or more rates (in addition to the zero rate, if any).

[A] Type of VAT—Consumption, Income, or Production

There are three possible variants of VAT, depending upon what macro-aggregate the government wants to tax: gross income, net income or consumption. A **gross product type VAT** treats both consumption and capital formation as final uses of the good; hence capital goods purchased by the dealer would not be treated as inputs. Input tax credit will not be available on taxes paid on capital goods. A **income type VAT** would give credit for tax paid on current inputs and tax paid on capital goods to the extent attributable to depreciation of capital goods, in any given year. Credit for tax on capital goods will therefore be spread over the life of the capital good. A **consumption type VAT** goes a step further in that only final consumption is treated as the final use of a good; full credit, therefore, is given for taxes paid on capital goods as well, in the year of purchase.

The consumption base has been a much favoured tax base from both the perspective

of economic neutrality and ease of administration. It is also the only VAT that is equivalent to a retail sales tax, in that it restricts the burden of the tax to final consumption goods. In effect, the tax is only on the pure value added within the production stage in question. Consumption VATs are also the easiest to compute—all taxes previously paid on purchases from other firms to be simply subtracted from taxes due on sale. No distinction needs to be drawn between capital goods and other inputs, and no depreciation need be computed. Consumption, it is argued, is also a broad measure of the ability to pay taxes, much like income. Furthermore, it excludes savings from the base, hence does not discourage investment.

From an economic growth perspective, both the income and gross product VAT have an anti-investment bias. This is all the more significant in countries that impose substantial income taxes. An income tax taxes saved income and hence investment twice—one as the income is being earned and again as the rewards for saving appear as interest and profit, which are again taxed. Since income tax is fairly well established in India, ***we recommend that states should adopt a consumption type VAT, i.e. there should be no distinction between raw materials and capital goods in allowing VAT credit. Only this VAT variant is equivalent to a retail sales tax. The consumption base must be as wide as possible and must comprehensively include manufacturers and dealers of all goods indicated in sales tax schedules.***

[B] Exemption versus Zero Rating

Suppliers of goods and services are either taxable or tax exempt. By definition, exemption relieves the exempt trader's value added from the tax, but all his purchases including capital goods are taxed. Exemption will therefore increase the amount of tax finally paid on intermediate goods—the opposite effect that the exemption was supposed to provide. In the case of final goods, exemption eliminates the tax on value added in the final stage only. In other words, if a commodity is exempt only at the retail level, then only the retail level is freed of VAT. Although the retailer would not charge VAT on its sale, the retailer would not be entitled to a credit for tax paid on the purchase of an exempt item.

If a commodity or service is zero rated, the zero rated trader's value added is not taxed and the trader receives a credit for the tax paid on the purchase of materials and other inputs used. Zero rating, in theory, is the only way to ensure that a product is truly free of VAT, since any tax paid would be credited on the last sale.

The considerations influencing the choice between zero rating and exemption are: (1) The desirability of freeing users of specific goods or services completely from VAT (as with zero rating), or only partially (as with exemption); (2) the merits of excluding certain firms from the registration and filing of returns. Even from the perspective of firms themselves, there are conflicting considerations. If a firm's goods are completely exempt, it is not required to register or file a return, but the prices of the goods sold by the exempt firm will include the tax incurred by the exempt firm on its purchases. This may be particularly objectionable to the exempt firm's customers who cannot

receive credit for the embedded tax. In this case, exemption would place the exempt firm at a competitive disadvantage.

If the objective is to have a broader tax base, however, exempting certain goods may become preferable to zero rating them. In addition, the administrative burden of the zero rating procedure can be onerous. Zero-rating implies buildup or payout of refunds, which may entail huge administrative costs, requiring verification and disbursement of refund cheques. Furthermore, there is the issue of controlling evasion or fraud. Zero rating creates an incentive for sellers to exaggerate the values of their final sales and to correspondingly inflate the value of taxable inputs purchases, in order to avail themselves of the refund of a larger input tax element. The resources needed to cross-check such claims can impose additional and perhaps unsustainable demands on prevailing systems.

Keeping in view the above-mentioned economic and administrative implications of exemptions and zero rating, ***we recommend that:***

1 ***The states must draw up a common exemption list.***

2 ***Unprocessed food articles, life-saing drugs and commodities with negative externalities whose consumption needs to be checked should be exempted from state VAT.***

3 ***All concessions with regard to state VAT coverage should be eliminated and benefits if any should be given only in exceptional circumstances through budget based subsidies.***

4 ***Small dealers whose annual turnover does not exceed Rs.15 lakhs should be exempt from the liability of VAT but subjected to a retail sales tax not exceeding one percent.***

5 ***All international exports should be zero rated.***

6 ***Commodities with negative externalities whose consumption needs to be checked should, however, be subject to Special Additional Tax (SAT) against which no input tax credit should be granted. The states must draw up a common list for the purposes of SAT and the number should not, in any case, exceed ten. Further, SAT should not be imposed purely with the objective of protecting revenue from particular commodities, as this would defeat the very purpose of a non-cascading VAT.***

7 ***Luxuries should not be taxed under the SAT. Instead it would be better to have a common, high, third VAT rate for luxuries.***

8 ***States should refrain from designing SATs with the primary objective of maintaining revenue equivalance with selected commodities under the prevailing sales tax regime.***

[C] Single versus Multiple Rates

The choice of a single or multiple VAT rates is highly controversial. Politicians think that the public will acquiesce to a VAT more easily if products consumed by low-income households are taxed at lower rates than products consumed by those that are better off. Administrators who actually implement the tax know that every additional rate will significantly increase cost and complexity. In the end, neither administrators nor economists speak with a common voice—some support the economic elegance of a single rate, and others espouse the optimality of multiple rates.

Early European and Latin American VAT systems frequently attempted to make the rate structure a progressive one, taxing basic necessities at lower rates and luxuries at higher rates, compounded with numerous exemptions. A simple practical VAT (one positive rate, a zero rate, and some exemptions) requires several pieces of information from each taxpayer (the value of supplies at the two rates and the value of exempt supplies, the value of purchases at the two rates, two liabilities to VAT on output, and two liabilities to VAT on inputs). Commensurately, a VAT with three positive rates, a zero rate, and exemptions needs many more pieces of information. Further the greater the number of rates the greater is the problem of classification leading to protracted legal disputes and taxpayers' grievances. The cost of auditing the classification of exempt and taxable items and the applicable rates thereon at every stage of production, distribution and sale is also extremely high.

Reconciling the different opinions on this issue, ***we recommend a two floor VAT rate structure in addition to the zero rate: one for essential commodities and another for all other items. The local VAT rates should be close to uniform across states, reflecting the existing consensus on uniform floor rates. The two floor rates should be set with smaller states in mind that may need to have lower floor rates reflecting the particular characteristics of their production and distribution patterns, small size of consumption, geographical distance and lack of access to markets. To accommodate these states, the floor rates should be fixed at lower levels than what larger and economically more powerful states may want. That would enable the smaller states to operate at lower floor rates while the others would be obliged to operate at higher than floor rates, given their revenue needs. This would be better than enacting two sets of floor rates, one for smaller, and the other for larger states.***

[D] Origin versus Destination Principle

A VAT can be implemented under either the origin or the destination principle. Under the former, the VAT is imposed on the value added of all taxable products that are produced domestically; under the latter, the VAT is imposed on the value added of all taxable products that are consumed domestically. Obviously, the two principles are identical in a closed economy. In an open economy, the difference between them lies solely in their treatment of imports and exports: exports are taxed but imports are not under the origin principle, while just the converse holds under the destination principle. It is important to note that the distinction between the two principles is

based on the location of production and consumption. Given the fact that we have recommended a consumption type VAT and the need for increased international competitiveness, ***we recommend structuring the VAT on the destination principle.***

[E] Method of Computation

There are essentially three methods of computing VAT liability: addition method, subtraction method and the credit method (also known as the invoice method). The principal debate concerning choice of methods in computing VAT liability is normally restricted to the credit and subtraction methods. The credit method requires that the amount of VAT charged be explicitly stated on the invoice associated with any taxable transaction. The amount of tax a dealer submits to tax authorities is simply the difference between the tax he collected on his sales and the tax he paid on his purchases. Under the subtraction method, each dealer's tax liability is computed by applying the applicable VAT rate to the difference between his total sales (inclusive of the VAT element in his sales price) and his total purchases (inclusive of the VAT element in his purchase price). Hence, unlike the credit method, the amount of VAT connected with a taxable transaction is not required to be explicitly stated on the associated invoice.

The credit method therefore, is more transparent, whereby the effective tax rate on any commodity is easily identifiable as the rate applicable to the last transaction in that commodity. In the case of the subtraction method, the rate of VAT is not separately indicated and to this extent there is a loss of transparency. Further, since the effective rate under the subtraction method is a weighted average of the rates at the various stages, there could exist an incentive to shift value added to the stages with the lower tax rate. This kind of tax distortion needs to be avoided.

In view of the above, ***we recommend that the credit method should be adopted for computation of the VAT liability.***

[F] Treatment of Interstate Trade

The Indian Constitution as it originally stood envisaged taxation of interstate sales only in the state where it was consumed. Unfortunately, this led some states to issue notices to dealers not resident within their jurisdictions to file returns. To bring some order in the matter, a law was enacted by the Parliament in 1956 authorising the central government to levy a tax on interstate sales called the central sales tax (CST). But the power to administer the tax was delegated by the Centre to the states of origin of the sales who were also allowed to retain the revenue. Initially, the tax was levied at the rate of only 1 per cent but it was raised successively to 4 per cent. The salient features of the CST Act, for a commodity that is being sold inter-state, are:

1 The rate of CST is 4 per cent if the sale is between two registered dealers across states. Such a transaction is documented through the use of "C Forms". The latter

is issued by the importing state to the importing registered dealers within the state, and are submitted to the exporting dealer in order that the latter can avail himself of the concessional rate of tax.

2 If the good is sold to unregistered dealers outside the state and is not a declared good, the transaction, by law attracts a tax of 10 per cent or the rate applicable in the exporting state, whichever is higher.

3 In the case of sale of "declared goods" to unregistered agents outside the state, the tax is leviable at twice the rate applicable to such transactions within the state.

4 The states can charge a CST lower than 4 percent on some goods or classes of goods, or alternatively on inter-state transactions to some persons or classes of persons. In such a situation, the transaction is not required to be documented through the "C Form".

5 Since sales tax applies only when there is a sale, no tax is attracted when goods move from one state to another as transfer between branches of the same enterprise or on a 'consignment" basis.

The CST constitutes a distorting factor in the location of industries and the flow of internal trade, impeding the growth of a truly common market in the country. It also causes interjurisdictional inequity and reduces the international competitiveness of exports. Further the administration of and compliance with the CST is also beset with problems, like the need for the Department to monitor the exports to unregistered dealers on the one hand and the need to procure "C Forms" from the department by the importers and getting "C Forms" from the importers on time by the exporters.

Similarly, the treatment of branch transfers and consignment sale under the CST has opened up an easy avenue for evading and added to the unwarranted distribution cost, even though it saves enterprises operating in more than one state from paying any tax on movement of goods between branches located in different states. To plug this loophole, under pressure from the states, the Constitution has been amended to provide for the levy of tax on consignments as well. Legislation to authorise such a levy has not yet been passed by the Parliament but the pressure persists, regardless of the problems of valuation that are inherent in any scheme of export taxation.

Notwithstanding the adverse economic implications of the CST, the states have come to acquire a vested interest in maintaining the status quo since about 20 percent of the sales tax revenue of the states comes from CST and in some cases the proportion is as high as about 35 percent. states that are relatively advanced (net exporters) appropriate a disproportionately large share of the revenue from the CST.

In the prevailing circumstances, the decision to shift to a comprehensive VAT is caught up in the resolution of the intangible problem relating to the treatment of inter state sales/transfers. It must be realised that there are three elements to a VAT when it is at the level of states. The first two are common to a central level VAT: that the VAT should

fall on the consumption of commodities,[2] and that it should remove distortions caused by cascading, i.e. the phenomenon that results in tax already collected being included in subsequent tax bases. Both these aspects are addressed by the credit mechanism of the VAT.

The third element pertains specifically to a state VAT and arises from the expectation that VAT revenue from the entire product will accrue to that state where the final consumer is located. This is called the "destination principle". If the revenue accrues to the state where the product is manufactured, it is the "origin principle" of revenue accrual that prevails. VAT structures may also feature a mixture of origin and destination based revenue accruals. Indeed, the European Union has devised a temporary mechanism that is essentially origin based, with an intention to move towards the destination principle in due course. That is yet to materialise. Brazil too has an origin based state level VAT, but with a rate structure that allows for some variation.

A destination based VAT is recommended for the Indian state level VAT which must remain the ultimate goal. This is because the destination principle ensures that exports from one state to another are effectively zero-rated, so that the importing state, where consumption occurs, receives the revenue. In the destination based VAT, if an importer in state A bought his goods from an exporter in state B, he would pay the VAT in state B and claim credit for it in his home state A. B, through an appropriate mechanism, would have to compensate A for the revenue it had collected.

This could be achieved through an application of the "Versano method", named after the Brazilian expert who proposed it. In any VAT return, there would be two columns, one for intrastate transactions and one for interstate transactions, the latter to be taxed at a common rate by all states. The net VAT payable on interstate transactions would be remitted by every taxpayer to an overarching all-state administration, or to the central tax administration. The revenue would be distributed at the end of the period according to the consumption size of states. This is one example of the so-called "clearing house" mechanism that could be operated by the states themselves or by the Centre. However, the Group did not find any consensus among states regarding such a mechanism though it is not at all impossible to achieve.

To avoid the compensation route, the importer in state A could carry a document (such as the “C Forms” used in the prevailing sales tax regime for interstate trade) that would prove he was undertaking an interstate purchase. Then the seller in state B would not collect any tax from him. However, this method carries the usual administrative problems related to the issuance and use of “C Forms”. The Group was cautioned time and again that “C Forms” were subjected to non-availability or sale by administrators on the one hand, and misuse and fraud by the trader, on the other. ***Therefore, it is recommended that the use of "C Forms" should not be a feature of the VAT.***[3]

2 *As explained earlier, a production type or income type VAT is not considered attractive in general.*

A transitory alternative that eschews the difference between destination and origin states would be to require the granting of credit in a state whenever tax is collected. If an interstate sale took place from state B to state A, state B would collect the VAT on sale and also give the appropriate credit for input tax paid on it. If, however, the good was sent on consignment from B to A, state A would collect the VAT reflecting that no sale took place in B and that any sale subsequent to the interstate transfer would take place only in A. Thus any applicable credit for input tax paid in state B would have to be given in state A. This would meet the first two elements of the VAT i.e. it would be a tax on consumption and it would remove cascading. But the revenue would accrue to the state where value is added in the process of production and distribution.[4]

Reflecting discussions with various state authorities as well as transitory revenue considerations, it was felt that the transitory alternative should comprise the initial arrangement for the interstate segment of the VAT when introduced on April 1, 2002. However, the destination principle must remain the final objective. Such an arrangement would also reflect international practice as already explained. Consequently the central sales tax act must also be abolished simultaneously. Without this compromise, states would tend to delay the April 1, 2002 deadline for VAT introduction that they have set. Or they would ignore interstate trade from the VAT structure altogether.

It is important to note, however, that the compensation that the states are expecting from the Centre when they bring down the prevailing 4 percent CST on interstate sales would only help preserve the origin principle. This is because it is proposed to compensate states that loose revenue from the CST that is structured on the origin principle. Were the Centre to accommodate this demand in the first year when the CST rate is brought down from 4 percent to 3 percent, it may be envisaged that the states' expectations for continuing compensation would remain as they bring down the CST rate in subsequent years from 3 percent to 2 percent, from 2 percent to 1 percent, and from 1 percent to 0 percent. It might then look as though exports have been zero rated but, in essence, it would be superficial, if not erroneous, to think so, since the original revenue accrual on interstate trade according to the origin principle would have remained intact. ***The Group is of the opinion, therefore, that if the Centre were to compensate states, it should not do so according to the origin principle in any event. A lasting solution would be to allow states to tax services and assist building of institutional capacities through modernisation of tax administration.***

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3 *Instead of the "C Form", an importer could be asked to make an advance payment of his tax on interstate purchase in his home state, thus directly resulting in the destination objective being realized. Nevertheless, in practice, this could again result in administrative mismanagement and attract legitimate ire from the taxpayer, adding an avoidable distortion into the VAT system.*

4 *Thus in the case of CST when the sale has taken place in the exporting state, the same state would collect VAT and give input tax credit. In the case of consignment transfer in which the sale takes place only when the good reaches the importing state, it is the importing state that collects VAT and gives input tax credit.*

Finally, given the complexities of interstate sales issues, the introduction of VAT by a state in isolation is likely to lead to difficulties for the taxpayer to be fully compliant with the tax law. ***The Group, therefore, does not recommend VAT introduction by individual states. Rather, they should act in unison on the issue.***

[4] State VAT: Administrative Issues

In many developing countries efficient or equitable tax policies may fail because the tax administration is not able to implement these policies. Consideration of the tax administration dimension becomes even more complex when different levels of government are involved in collecting taxes. In any developing country, a simple system of tax policy and administration is needed to ensure adequate revenue collections. Any undue complications could result in serious administrative burdens and problems in securing taxpayer compliance, as well as potential revenue loss.

There are four basic conceptual models for tax administration among different levels of government: (1) central government tax administration only, with provision of revenue sharing and transfers; (2) central government tax administration only, with assignment of different taxes to different levels of governments; (3) multilevel administration, with revenue sharing and transfers; and (4) each level of government administering the taxes assigned to it. The first two options centralize tax administration by maintaining central government control over all tax offices at the regional and local level. The third and fourth options permit tax collection by sub national governments. Whether tax administration is centralised, allocated to one level other than the central level, or spread over various levels of government depends on political realities as on technical considerations, but there are technical implications associated with different tax administration structures.

In assessing how best to collect taxes, it is important to keep in mind two primary objectives of tax administration: (1) to apply the tax laws uniformly to achieve maximum collection at minimum costs, and (2) to promote voluntary compliance by taxpayers.

Uniform application of tax laws across taxpayers demonstrates that the tax administration is committed to the fair treatment of taxpayers. This emphasis on fairness has been identified as one factor that helps to enhance confidence in the tax system and to promote voluntary compliance. However, the promotion of voluntary compliance entails not only a fair treatment of those who comply but also rigorous enforcement and swift action against those who fail to comply with the tax laws, for example, by failing to file a tax return, or failing to file an accurate return. Taxpayers will be more inclined to comply voluntarily if they perceive a risk that noncompliance will be detected and punished. A tax administration that simply attempts to minimise its costs of collection, in relation to the potential revenue cannot be viewed as effective unless it fosters a high level of voluntary compliance.

When countries select multilevel or subnational tax administration, authority to collect specific taxes would be given to the level of government that is able to function with the lowest collection and enforcement costs. In this perspective, the central government should take full advantage of administrative economies of scale. Therefore, in the case of individual and corporate income taxes, tax administration costs will be lower if taxes are collected at the central level than at subnational levels. Similarly, collection and enforcement costs for the VAT (especially on a destination basis), customs duties, natural resource taxes, and social security taxes can also be minimised if the central government determines tax policy through legislation, sets uniform regulations, and operates the tax administration. Subnational governments, on the other hand, can collect taxes, such as property taxes, certain excise taxes, and user charges, the administration of which does not present cost advantages associated with the size of government.

Another consideration is the availability of resources, including information for each level of government. Tax administrations of subnational governments may be less able than the central government to afford the cost of skilled manpower, modern office facilities, and up-to-date technology. However, tax officials at the subnational level have more intimate knowledge of the developments in their geographical area.

Yet another consideration is the increased compliance burden on taxpayers arising out of differences in the legal framework of the tax laws at the subnational level. Taxpayers are also likely to bear higher compliance costs as each level of tax administration issues different forms, regulations, and procedures. These costs can be especially high for taxpayers that have several branches or subsidiaries operating in different jurisdictional areas. Tax autonomy for subnational governments can also open door to excessive tax competition among jurisdictions, which distorts companies' location decisions, and can involve substantial revenue losses to the competing jurisdictions.

When a country authorises one governmental level other that the Center, or various levels of government, to levy and collect taxes, administration becomes more complicated than in the case of centralised tax administration. In general, each level of tax administration can create its own organisational structure and processes, which may not be the most efficient from a countrywide perspective. Duplication of effort among levels can easily occur and effectiveness can suffer if the various tax administrations do not put in place requirements for adequate coordination.[5] While local government officials may have increased autonomy, freedom, and resources to pursue local policy objectives, the overall cost of collection could be relatively high.

Under the approach where multiple levels of government are responsible for collecting taxes, the choice between revenue sharing and tax assignment may affect certain functions of tax administration. In situations where one level surrenders a large net amount of tax revenue to another level, perverse incentives can be created to maintain revenue in the jurisdiction by favourable assessment of taxes due.[6]

Where countries collect taxes through subnational tax administration, it provides

more flexibility with respect to organisational structure and personnel practices than a centralised one. Local officials become more accountable, as a clearer link is established between local decisions to raise revenues and to make expenditures. However, one disadvantage of this system is that some subnational governments, owing to resource constraints, may not be able to staff the various tax administration functions adequately. If some of these governments allocate fewer resources to areas such as taxpayer services, audit, penalties, and appeals, then it is possible that taxpayers in different jurisdictions would not receive uniform treatment with respect to all tax administration functions. While inequity would be generated, this will also have the potential for affecting decisions relating to location of trade and industry.

Given the decision of both the central and the state governments to replace the existing distorted scheme of taxation of domestic goods by a comprehensive dual VAT on domestic goods, it is necessary to determine which branch of the tax administration should be responsible for administering the VAT, particularly in the context of its "spill-over" effects. There are four options: the existing sales tax authority, the customs and central excise authority, the income tax authority or a completely new authority for this purpose.

In a country where imports form a significantly large proportion of the total trade, there is a clear case for giving the duty of collecting VAT to the customs authority. The argument for combining the administration of VAT on internal supplies with the administration of the direct taxes is equally strong. In particular, many income tax payers with business income will also be taxable persons for VAT purposes. Many transactions will require review for both income tax and VAT purposes, although the

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5 *As part of the federal income tax law in the United States, tax returns and tax return information can generally be disclosed to state tax agencies. if a taxpayer in the United States is audited with respect to federal income taxes, any action taken that changes the taxpayer's liability is automatically transmitted to state tax authorities. States that find state income tax violations also share that information with the Internal Revenue Service (IRS). There is a formal information-sharing agreement between states and the IRS. Detailed guidelines have been published to ensure confidentiality of taxpayer information (United States, Internal Revenue Service, 1993).*

6 *In pre-1994 China, for example, the central government relied on the local (provincial) tax administration to collect most taxes. Revenue was then shared between the provinces and the center on the basis of an ad hoc revenue-sharing formula, negotiated separately for each province. The temptation was strong to lower the official assessment and then split the difference between the local government and the taxpayer. While the central government officials were aware of this problem, they were unable, with a staff of about 450, to police effectively the activities of more than 5,00,000 tax staff at the local (provincial level). Tax administration in China became rule by negotiation rather than rule by law. In order to more closer to rule by law, the Chinese tax structure was overhauled in 1994, with uniform tax laws, a central tax administration for central and shared taxes, as well as parallel provincial or local tax administrations, to remove the perverse incentives from the system.*

ways in which income tax and VAT liabilities are calculated from that common base are radically different. Despite the differences in result, many of the problems of administration of direct taxes and VAT invite similar solutions. For example, the powers of auditors carrying out field audits, or those of desk officers demanding information from taxpayers or from third parties may be aligned. There is an additional advantage in aligning these powers in that officers will be able to gather information for the two kinds of liability at the same time, thereby minimising the demand on taxpayers. This approach also enables a crosscheck on compliance with the requirements of one tax from information gathered in checking compliance with the other. One of the strengths of the invoice-based form of VAT is the resulting audit trail, which can be used to check other taxes. Where the VAT is origin based, it may be desirable to assign the responsibility for collecting VAT to the excise authority since bulk of the revenues would be collected at the manufacturing level. Similarly, since the VAT is perceived as a substitute for sales tax administered by the state-level tax administration, which has the benefit of local information relating to trade and industry and given the need for maintaining autonomy of the states in the federal polity, there may be a strong case for administration of VAT by the state-level sales tax authority. In view of the above, ***we recommend the following:***

1 ***The administration of VAT on imports should continue to vest in Customs Department under the central government.***

2 ***The central VAT should continue to be administered by the central excise department under the central government***

3 ***The state level commercial tax department should administer the VAT, which is proposed to replace the state level sales tax. The VAT administration should be restructured—from the current sales tax administrative structure—into functional classification reflected in the departmental structure. The objective should be to enhance administrative efficiency and to minimise the taxpayer—tax administrator nexus. The department composition should reflect return filing, selective audit/assessment, judicial interpretation, collection and investigation, anti-evasion and policy unit/VAT monitoring unit.***

4 ***Since the income tax administration has established a system of Permanent Account Number (PAN), is otherwise engaged in collecting information relating to sale and purchase by taxpayers, and has the largest computerised network amongst the various tax administrations, the state level tax administrations must co-ordinate and draw upon the same information to avoid duplication of effort and reduce compliance burden of taxpayers.***

In view of the above recommendation, the Advisory Group interacted with the state governments of Andhra Pradesh, Goa, Karnataka, Maharashtra, Sikkim, Tamil Nadu and West Bengal. The Group also met state Chambers of Commerce and Industry and visited sales tax offices for detailed interviews with Commercial Tax Commissioners. The responses generated through these meetings were educative in that they helped place in perspective the field realities and forged many of the recommendations of the Advisory Group.

By and large discussions were centred on sales tax and consequently on the state level VAT. The Chambers expressed their dissatisfaction with the procedure for securing tax compliance, which was often mired in securing and producing documents/forms relating to differential treatment of goods under local sales tax, entry tax, inter-state trade and intra-state surcharges, concessions and exemptions. What was however somewhat alarming was their optimism about a state level VAT, which was perceived to be a kind of a magic wand adequately equipped to cleanse the state level tax system of all its bottlenecks. In this regard, the Group was constrained to point out that a regime of state VAT would require of all manufactures and dealers a more stringent requirement and advanced system of book keeping if they were to avail of tax setoffs and if the regime of physical controls were to be minimised. The system of setoffs could also burden the tax administration with an increased load of work following from a sizeable expansion of the dealer base unless careful preparation was undertaken and completed. And if the tax administration is unable to meet the challenge, its deliverance in terms of inefficiencies could multiply manifold and aggravate the distress levels of taxpayers.

The apprehension, which the Group harbored about the ability of the sales tax administration to graduate to VAT did not go away after visiting sales tax offices. Given the understanding that states will adopt VAT from April 1, 2002, administrative preparedness would have to be speeded up. While appropriate software for cross verifying claims for tax setoffs was not yet installed, even the existing computerised processes were minimal. Computerisation efforts, when visible, were insufficient as yet to provide registration numbers to the increased number of dealers with the introduction of VAT. By and large, the sales tax departments had not initiated much interaction with the central tax authorities for building up a third party information bank. What perhaps was most telling was the modus operandi of assessment. The assessment, to start with, checked for arithmetical errors and verified claims for tax concessions and exemptions. Even in this process of detection of prima facie errors, the tax administration was required to interact with the taxpayers. Then, on the basis of gut feeling mainly deriving from the hunches of the sales tax inspectors, physical verification would follow. The latter has been opined to be the most significant event underlying the complaints of harassment and corruption. The VAT approach would call for a fundamentally different approach that would necessitate in-depth training.

Many representative departments are also not yet prepared to accept assessment through account based cross verification aided with intelligence reports under VAT. Physical verification, which also manifested in border check posts was considered most sacrosanct as a deterrent measure against evasion. In other words, tax administration under VAT tends to be conceived as an extension of prevailing practices. The idea of advocating a modern tax administration under which the taxpayer is de-linked from the assessing officer (auditor) remains to be addressed.

Similarly, little progress has been reported on computerisation with only initial steps undertaken in a few states. One state has prepared a vision document which could serve as a guideline for others. So far, computers have been used for little else than inputting of information, if at all, and that too on a pilot basis. If a state level VAT has

to be a reality in the near future, notwithstanding the delays in reaching a consensus on CST, states must invest in evolving a suitable administrative back-up under which comprehensive computerisation of VAT administration is imperative. While doing so, computerisation must be oriented towards enabling collating of information both within and across the states. Information, when collated would satisfy the intrinsic requirement of checking evasion.

The state level tax administration should include several basic tax administration functions. One unit should be established to provide taxpayer services (education, information, assistance). Simple collection procedures should be designed to minimise the burden on taxpayers. These procedures should be designed with a view to computerising taxpayer records as soon as possible. Depending on the type of tax administered, a unit of auditors should be established and staff should be trained. These auditors would also need to be supported by an efficient taxpayers information system. A straightforward system of penalties and appeals should be developed. A separate unit should be responsible for each of these functions. In addition to an organisational plan, other preparatory steps should be undertaken. For example, discussions should be held with the central tax administration to provide for some type of information sharing, so that crosschecking activities can be performed.

The Committee of Commissioners should speed up discussions on common problems and solutions. For instance, it should prepare a model tax declaration so that each administration does not have to design its own form. It could also disseminate information on various issues, such as how to strengthen enforcement.[7] The state tax administrations would have to recruit and train staff to perform various functions within an appropriate organisational structure. Further, given the volume of information that the tax administration is expected to process at all levels, it is necessary to put in place a similar comprehensive and computerised system as the backbone of the VAT regime particularly since the greatest benefit attributed to VAT is its ability to counteract evasion.

The creation of an efficient taxpayer information system for the purposes of administering a VAT necessarily entails the creation of a taxpayer's master file through a mechanism of registration of all dealers liable to VAT. Registration brings a person within the control of the tax authorities. Steps towards its compilation must be taken well in advance of the start of the tax. Our visits to the states reveal a need to hasten the preparations for registration. states have not yet completed the registration number scheme, or the forms for registration or embarked on any time bound program for VAT registration. Fortunately, there exists a unique taxpayers identification number at the central level in the Income Tax Department in the form of the Permanent Account Number (PAN). All persons who are liable to income tax or whose sales exceed Rs.5,00,000 are required to obtain a PAN. The Customs and the

7 *State tax administrations in the United States have formed the Federation of Tax Administrators, which performs a number of coordinating and information-disseminating activities.*

Central Excise Department has already adopted the PAN for registration of importers and exporters and manufacturers. Since the operation of a successful VAT entails co-ordination between the tax administrations at both the national and the state level through computerised information sharing ***we recommend the following:***

1 ***The PAN, with suitable modification, should be adopted as the VAT registration number. The ten digit alpha-numeric PAN should be extended by five more digits where the first two digits should indicate the state code and the other three digits would indicate the branch code within the state. Only the first ten digits are permanent and susceptible to computer check. This number scheme should be publicised widely.***

2 ***The registrant dealer should be required to furnish a form, only by way of information, indicating the registration number for each of his branch offices, which should be used to update the PAN database. There would not be any necessity to issue fresh registration number.***

3 ***All dealers, irrespective of their total sales, must be required to be registered. This will enable the tax administration to monitor even those dealers who claim to be exempt from VAT liability.***

4 ***The Income Tax Act should be suitably amended to permit issue of PAN even to cases where there is no liability to income tax or where the total sales are less than Rs.5,00,000.***

5 ***The states should refrain from issuing any separate registration numbers. If the states were to issue separate registration numbers, it would be impossible to cross verify the transactions across states in the absence of a unique permanent number thereby increasing the potential for tax evasion.***

These recommendations will enable the VAT administration to save on considerable time for registration and also enable computerisation of transactions by distinguishing one record from another. ***If VAT has to be introduced with effect from April 1, 2002, it is important that registration formalities are all completed by December 31, 2001.***

Another important element of the taxpayer information base is the VAT invoice, which forms the primary source of information and therefore a crucial control document of VAT. In an invoice based VAT system, the issue of invoices in the proper form is an essential part of the procedure for imposing and enforcing the VAT. Typically, under the VAT laws the allowance of a credit for input tax is conditional on the existence of a VAT invoice issued during the period for which the credit is claimed. An invoice is also required by the tax authorities to audit the collection of VAT. Further as indicated above, the VAT invoices form the primary source from which the return of VAT invoices will have to be prepared and furnished to tax authorities for third party information matching. Accordingly, ***we make the following recommendations relating to VAT invoices:***

1 *The law should require a supplier making a taxable supply to another taxable person to provide a VAT invoice with that supply or the payment for it. The requirement should be enforceable by some penalty.*

2 *The VAT invoice should be standardised across all states so as to contain a minimum of information about the supply being invoiced. That information should be:*

- *The name, address, and VAT number of the taxable person making the supply,*
- *The nature of the supply made (type of supply, type of goods or services, and quantity of goods or extent of services),*
- *The time the supply was made,*
- *The amount of payment for the supply*
- *The amount of VAT(indicate separately the central VAT and the state level VAT)*
- *The name, address, and VAT number of the taxable person supplied,*
- *The date on which the invoice is issued, and*
- *The serial number of the invoice (together with identification of the printer if the invoiced was purchased privately).*

3 *Based on the VAT invoices issued during a month, the dealer should be required to furnish a monthly statement known as the Return of VAT Invoices within seven days from the end of the month. The form of this return must be prescribed by the tax administration. This return should provide all the information contained in the VAT invoices issued during the month. Wherever possible the return should be collected in a pre-formatted magnetic diskette.*

4 *A mechanism should be set up to collect the return of VAT invoices with the full data stored in the computer system. The Central Information Branch of the Income Tax Department should assist in this process. Both the Income Tax Department and the sales (VAT) tax administrations should have accessibility for third party information matching. A system of third party information matching created at an all-India level along the above lines will serve as a deterrence to potential fraud in set-off claims.*

Since the amount of VAT collected by a dealer is related to his turnover, the dealer is likely to accumulate a huge VAT liability within a very short period. Hence, it is necessary to minimise the risk of payment defaults by dealers, in particular fly-by-night operators. Given that the collection under VAT will serve as the dominant source of revenue for state governments it is imperative to provide for a collection mechanism which would ensure a periodic flow of revenue to the exchequer subject to a minimum compliance burden on taxpayers and risk of revenue loss. Such a mechanism should comprise the following elements:

1 *All taxable persons must be required to self determine the net amount of VAT due for the VAT period (i.e. all VAT collected (output tax) less allowable VAT credit*

(deduction for input tax) and any allowable excess VAT credit carryover). The VAT period should be a calendar month.

2 *The amount so determined should be paid to the account of the tax authority in any designated bank along with a "challan" (more commonly referred to as the VAT return) within seven days from the end of the VAT period. The present archaic practice of some state tax administrations directly collecting cheques from taxpayers for depositing in the government account must be given up.*

3 *The "challan" should contain the following essential information:*

- *The total VAT collected on all taxable supplies made by the taxable person (output tax) in the VAT period.*
- *The total VAT paid by the taxable person on supplies made to the taxable person in the VAT period and for which a credit is allowed (the allowable VAT credit or input tax deduction), and*
- *The amount of any excess of allowable input tax over output tax in the previous VAT period that can be carried forward (allowable excess VAT credit or input tax deduction).*
- *The net amount of VAT payable to the tax authorities for that VAT period.*

4 *The challan should be required to be filed even if the taxable person has no taxable supplies for a VAT period. This rule allows efficient operation of systems to detect and chase after persons who are delinquent in filing.*

5 *The banks receiving payments should furnish the information contained in the VAT returns (challans) to the tax administration in a magnetic diskette.*

While in the earlier sections we have made recommendations for collecting information from third parties and banks, yet another important source of information is the annual tax return filed by the taxpayer himself wherein he self-assessees his annual liability, claims credit for taxes paid during the year and determines the net amount payable. This return also forms the basis for audit selection. Accordingly, ***we recommend that all taxpayers should be required to file an annual return furnishing such particulars as may be prescribed. This annual return should be filed within three months from the end of the financial year.***

No tax administration can be a policeman to all taxpayers and therefore it must foster voluntary compliance. If tax administration has to successfully promote voluntary compliance it must set the deterrence level sufficiently high so that evasion cannot be practiced with impunity. The audit function of the tax administration plays a crucial role in setting the level of deterrence. Audit can reveal non-compliance due to mistakes on the part of the taxpayer or intentional non-compliance. Typically, auditing means the examination of filed returns by tax authorities to determine the correctness of self-assessed taxes. The success of auditing and the feasibility of various auditing strategies depend on the quality of the information available to the auditor, which in turn depends on information gathered from the taxpayer and third parties and

through the tax administration's own efforts. A second factor affecting the feasibility of auditing strategies is the information processing capacity of auditors. Our recommendations on the establishment of an efficient information system should make available to auditors quality information and this would meet the first pre-requisite. The second condition depends on the training imparted to auditors. Further, the procedure for audit can also seriously undermine effectiveness and equity. To the extent the taxpayers can predict the selection process, they could devise strategy to evade scrutiny through self-selection. In view of the aforesaid considerations, ***we recommend that the audit process should be a two-step process, the first to check for mistakes and the second to deter non-compliance.*** All returns should be subjected to the first step while a selective few should be subjected to the second process. The latter category should be identified through a computerised selection process, which should take into consideration all relevant information.

Administrative mechanisms for the VAT in the states visited are yet to be initiated or are just beginning. Thus it is difficult to foresee at this point a smooth transition to an account-based audit system operating through third party information. The apprehension that, in the face of administrative hurdles, losses on account of fake and unverified setoffs could be large is, therefore, not irrelevant. On the contrary, if setoffs are challenged without a proper mechanism of cross verification in place, administrative bottlenecks would cause hardship for tax filers.

The need for computerisation of the tax administration for enhancing its effectiveness and improving the quality of taxpayers service is well recognised. In the context of the invoice based credit method for computation of VAT liability, computerisation acquires critical importance. Computerisation has to be pursued at a "war footing" to ensure installations of both hardware and software to facilitate essential aspects of VAT operations, in particular, selected cross-verification of invoices to obviate the possibilities of fraudulent claims for credit against input tax paid. Hence, the need for establishment of a computerised network across the nation which could be used by the central and the state level tax administration. However, this effort could be seriously jeopardised by the lack of adequate financial resources with the tax administration thereby delaying the process of introduction of VAT. ***Accordingly we recommend that:***

1 ***The process of computerisation of the tax administration both at the central and state levels should be treated as a separate project for augmenting the institutional capacity and not a mere exercise in office modernisation.***

2 ***The central government must provide financial assistance to the state level tax administrations, CBDT and the CBEC towards this institutional capacity building through computerisation and training (both domestic and foreign). For this purpose, an adequate budgetary provision under plan must be made.***

The road map to administrative preparedness for the introduction of VAT in April 2002 is presented in Table 6.1.

Table 6.1

VAT Time Table

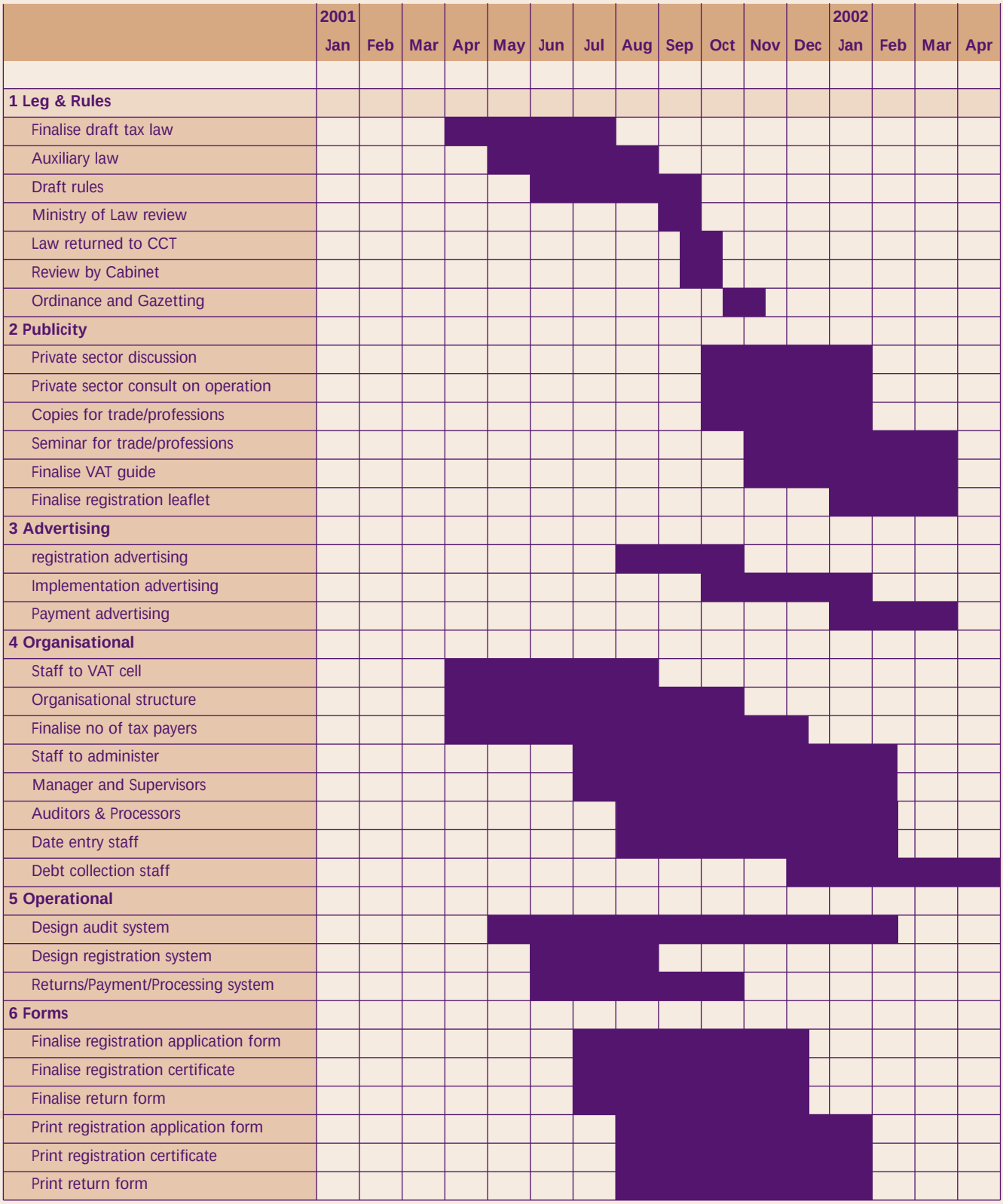

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Table 6.1

VAT Time Table

◄continued from previous page

	2001 Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	2002 Jan	Feb	Mar	Apr
7 Computer Development																
Decide computer allocation	■	■	■	■	■	■	■	■								
Complete user specs registration system					■	■	■	■	■	■						
Develop registration system					■	■	■	■	■	■	■					
Test registration system						■	■	■	■	■	■	■				
Load final registration data base early sup						■	■	■	■	■	■	■	■			
Complete user specs. On going system						■	■	■	■	■	■	■	■	■		
Develop ongoing system						■	■	■	■	■	■	■	■	■	■	
Test and develop ongoing system									■	■	■	■	■	■	■	
8 Manuals																
Prepare initial staff manual									■	■	■	■				
Prepare supplimentry manual						■	■	■	■	■	■	■	■			
Prepare audit and compliance manual									■	■	■	■	■	■		
9 Training Delivery																
Preliminary training				■	■	■	■	■	■	■	■					
General training				■	■	■	■	■	■	■	■	■	■	■		
Audit training delivery									■	■	■	■	■	■	■	
10 Registration and implementation																
Issue registration application forms														■	■	■
Issue registration certificates														■	■	■
Conduct advisory visits											■	■	■			
Issue first return forms														■	■	■
receive first payments																■
Identify defaulters																■
Pursue defaulters																■
11 Monitoring Cell																
Follow price movements														■	■	■
Inform traders															■	■
Action taken																■

[5] Taxation of Services

As pointed out in the earlier sections, reform of the indirect tax entails the introduction of a broad based VAT. If the general rate of VAT has to be reasonable and the buoyancy from this source is to be increased, it would be necessary to extend the scope of the VAT beyond taxation of goods. There are strong economic justifications for extending this scope to cover the services sector. At present levy of indirect taxes is restricted to commodity only, with very little effort to include the services sector even in the face of its ever-increasing share in the gross domestic product. As a result, it is not surprising that the combined ratio of central excises and state sales tax to GDP has shown a downward trend. This could further worsen as the services sector continues to expand relatively faster than the other sectors. Since we need to reverse the trend in the context of the growth targets for the Tenth Plan, it is necessary to expand the scope of the tax on domestic goods to include the services sector also. Second, failure to tax services distorts consumer choices, encouraging spending on services at the expense of goods and savings. Third, untaxed services mean traders are unable to claim VAT on their service inputs. This causes cascading, distorts choice and encourages businesses to develop in-house services, creating further distortions. Fourth, as most of the services that are likely to become taxable are positively correlated with expenditure of high-income households, subjecting them to taxation will improve equity.

The power to levy a tax on services in general is not mentioned either in the Union List or in the State List in the VII Schedule of the Constitution. However, by virtue of Entry 97 in the Union List which gives power to the Centre for levy and collection of "any tax not mentioned in either of those lists" (that is, state List or the Concurrent List), it is the Union Legislature alone which is competent to levy indirect tax on services. In exercise of this power the central government has already introduced a tax at 5 percent on selected services like telephone bills, premium on insurance other than life, commissions and brokerage charged by stockbrokers and road transport. The 2001-02 Union Budget expanded the scope of this levy to cover more services. These sporadic efforts of the central government remain far below the revenue potential of this sector. This is partly due to the administrative complexity and feasibility consideration of taxing the vast range of services, which are primarily local in nature.

A subnational government is better placed in terms of available information and taxpayer service to tax these services but are unable to do so on account of constitutional impediments. Consequently, the revenue mobilisation efforts of both the central and state governments are seriously undermined. The rationale for services being taxed by states comprises the following:

1 A comprehensive VAT at the state level should include both goods and services. Thus, if services are assigned to the states, a widely based VAT such as in Brazil or Canada comprising both goods and services, could be designed for India. It is worth noting that, in Brazil, services are assigned exclusively to states and local bodies.

2 The prevailing rate of the Centre's service tax at 5 percent is low because it is based on turnover without input tax credit. It is therefore distortionary, with input tax embedded in it. This can be corrected if services are included in the VAT base. That should also carry a greater revenue potential.

3 For widening the tax base with resource mobilisation in mind, the cooperation of states is essential.

4 If the financial position of states is to improve, they would need an expanded tax base.

5 Services as a part of the tax base of states would be preferable to compensating states by the Centre on the basis of revenue loss from eliminating the CST.

An interim method that should enable states to tax services with cooperation from the Centre and without the need for a Constitutional amendment could be as follows. The Centre and states should first arrive at a consensus to form a list of services that can be administered by the states. Such lists have already been prepared by states such as Karnataka and Maharashtra that could serve as the subject matter for discussion to begin with. Once the list is agreed upon, the Centre may levy the service tax on them and authorise the states to administer/collect them. There should be no difficulty in this in legal terms where levy and collection are considered as independent events.

Article 246 of the Constitution says that Parliament has the "exclusive power to make law with respect to any of the matters enumerated in the Union List". It therefore gives the Centre the exclusive right of levy. The Centre could, however, assign collection to the states. The collection would have to first go to the Consolidated Fund of India as per Article 266(2). After that, the Centre would disburse an equivalent amount to the states.[8] The matter was discussed by the Group with Chief Ministers and Finance Ministers of states who were all in favour of it. This route to service taxation should therefore be pursued as an initial solution. It would also help progress towards integrating goods and services in a comprehensive VAT base which must remain a medium term goal that could be achieved by the end of the Tenth Plan provided an appropriate Constitutional amendment is made.

Our main recommendations relating to taxation of services are the following:

1 The central government must allow states to levy tax on all services other than financial services (including all insurance services), telecommunication, postal communication and transportation of goods and passengers by air, sea and rail.

2 After the initial introduction, services could be incorporated into the VAT.

8 Note that there is already a precedent in the CST in which the levy is by the Centre and the collection is by the states.

3 The rate structure for the VAT on services should be identical to those for goods to obviate distortions in producer and consumer decisions.

4 The state taxes like luxury and entertainment tax on restaurants, hotels and other lodgings, professions tax, motor vehicles tax, goods and passenger tax and electricity duty should be integrated with the state level VAT.

5 Various public utility services that have scope for corporatisation should be brought within the state level VAT on services.

6 The VAT on services should be fully integrated with the VAT on goods, both in its design and administration, with an appropriate mechanism to setoff service input tax against goods output tax and vice versa. Therefore, a destination based, invoice credit method, dual VAT—one at the central level and another at the level of states—comprising both goods and services could be envisaged by the end of the Tenth Plan.

7 The assignment of the powers to tax services to states must be viewed as adequate compensation for revenue loss on account of abolition of central sales tax.

[6] Other Taxes

[A] State Excises on Liquor

The discussions on state excise, i.e. the production tax on liquor, indicated that although it is most desirable to introduce prohibition, the concerns for illegal manufacturing and trading entailing grave repercussions on liquor quality have compelled state governments to do otherwise. The pragmatic option therefore has been to permit manufacturing, trading and consumption at a prohibitive cost injected through a tough fiscal and quality control stance. Accordingly, in most states, excise duty has been pitched at a very high level along with various kinds of fees and fines. And with high rates of sales tax, the final price turns out to be high even by international standards.

While, through this approach, the idea has been to discourage consumption, quality concerns have been addressed by institutionalising checks and balances along the entire liquor manufacturing network and chain. To prevent leakages, a few states have even taken over the wholesale distribution of liquor and undertaken auctioning of vending rights to ensure that only that liquor is consumed, which is routed through the institutional network. Excise duty, mainly as a source for raising revenue, has not therefore been the priority of state governments.

Accordingly, the need for a well designed state excise on liquor comes through as a necessity. The base for state excise should be the distilling cost or the value at which it enters wholesaling trade. While the assessment of state VAT at the wholesaling stage of liquor must provide setoffs for taxes previously paid, the subsequent assessment at the retailing stage also calls for a similar treatment. Given the inelastic demand for liquor consumption, high tax rates existing as of now should continue to prevail. Naturally, convergence towards a comparable rate is called for by all state governments.

However, too high a VAT arte on liquor could become a major point of difference between the treatment of liquor and other commodities, given that other commodities would tend to converge towards uniform floor rates. ***Therefore we recommend a two-part levy for liquor. The first part should be the excise component, which would be levied at the manufacturing level. This should be advalorem and the base should be the maximum retail price and not the invoice price, which would be the MRP less trade discount. The second component should comprise regulation fee/charges, which could be based on an auction mechanism as has been done in some states.***

[B] Registration Fees

Registration fees are in the nature of a service charge levied by government for documentation and preservation of property documents. Such preservation is necessary to settle any dispute relating to ownership of property. Registration fee rates, which in a few major states are close to 10 percent, are very high and encourage under-valuation of property. Counter claims by registration authorities based on CPWD based value assessment often lead to litigation, with government losing out on many occasions. Prospects for litigation become the breeding ground for corruption resulting in large losses of potential revenue. Since property registration is not compulsory but a service merely chosen to be availed by registrants, higher fees make this option unattractive resulting in still higher revenue loss. The options for plugging such leakages through a building tax, infrastructure levy and even outright pre-emptive purchase of property as existing in some states have been generally inferior options.

Ordinarily, the nature of service rendered is uniform across the nature/value of property registered. Therefore, the registration fee should be uniform for all registrations. However, for reasons of equity and revenue the fee is related to the value of the property sought to be registered. The high rates of registration fee provide an incentive to evade through undervaluation of property. This has a "spillover" effect on compliance with other tax laws like stamp duty and capital gains tax. ***We therefore, recommend that the registration fee should not exceed one percent of the value of the property registered.*** The revenue loss on account of such reduction should be more than adequately compensated by the increase in the declared value of the property giving rise to additional stamp duty and capital gains tax.

[C] Stamp Duties

Stamp duty (non-judicial stamps) is the actual tax paid on the purchase of property. The main problems associated with this revenue source are the high rates of stamp duty and valuation of real estate resulting in large-scale evasion of stamp duty. Consequently, some states have lowered the tax rates in recent times resulting in significant revenue gains. Further, the stamp duty is in the nature of a transfer tax and exhibits the same cumulative effects as a cascading turnover tax. This 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 housing services of the immovable property that belongs in the VAT base. Theoretically, it would be better to abolish the transfer taxes and subject gains realised upon the sale of immovable property (including dwellings) to the VAT. However, the treatment of real estate under VAT is complex and therefore on feasibility considerations it would only be appropriate not to expose the infant VAT administration to such complexity. The VAT regime should be allowed to stabilise before VAT is extended to real estate. ***In the transition, we would recommend the continuation of the stamp duty.***[9] However, given the problem of cascading, valuation and the quantum of black money involved in any real estate transaction, ***we also recommend that the existing multiple rates of stamp duty be replaced by a single rate duty of five percent of the value of the property.*** As a result, the effective tax burden will remain reasonable inspite of the cascading effect.

[D] Motor Vehicles Tax

The motor vehicle tax (MVT) is levied under the Indian Motor Vehicles Act, 1940. It includes fees levied for registration, permit and driving license. The fees have been revised from time to time. In addition to the tax under the central legislation, motor vehicles tax is levied by the states under their respective motor vehicles taxation acts. The rates vary according to type of vehicles (such as motors, cabs, taxis, stage carriers) or laden weight. Generally, permits of private carriers are taxed at higher rates than those related to public carriers. While many states have graduated from a levy on unladen weight of the vehicle to cubic capacity, some others have even moved over to an ad valorem structure. The latter has been necessitated due to entry of vehicles, whose price differences are not commensurate with the differences in physical attributes. Therefore, charging the same specific tax amounts to a regressive structure. Further, in recent times the tenure of MVT has moved over to a lifetime tax. Some states have criticised life-time tax on the ground that although it is administratively convenient, it falls out of line with the recurring nature of maintenance cost for road use. Nevertheless, for practical reasons, the lifetime nature of MVT for personal use vehicles has to be continued. The switch to a lifetime tax from an annual motor vehicle tax by a few state governments is itself an indication of treating this as a final commodity tax levy.

9 *After three to five years, real property could be subjected to the Stock VAT.*

The passengers and goods tax (PGT) is levied on passengers and goods carried by road or by inland waterways. The PGT, however continues to be a periodic tax. While Goods tax is calculated on the maximum ceiling permissible on the laden weight of a commercial vehicle, passenger tax is directly obtained from tour operators based on the seating capacity. These taxes are required to be filed on a monthly return basis after the same have been paid at check posts. The latter has immense scope for corruption and thus evasion in the event of which tax filing merely reduces to eyewash. The high administrative cost incurred in manning the check-posts further increases the cost of tax collection.

Both these taxes are treated as user charges or a charge for construction and maintenance of roads. These taxes fall on the same base and are paid ultimately by the same group of people. Some of the states levy both these taxes but others have merged the two and levy a single tax. Some of the states in addition levy a surcharge on motor vehicles tax. However, the proceeds from MVT/PGT go into the general kitty from which earmarking of funds commensurate with expenses incurred in offering services becomes a matter of discretion with state governments. Hence, MVT/PGT have been established as general revenue raising tools of government.

Another element of recoveries under MVT/PGT is the whole array of fees and fines structure which, as rightly pointed out by a few states is supposed to have a deterrent effect on law breakers rather than merely qualify as a tool for raising revenues. It has been, therefore, opined that such fines may only be properly structured in line with traffic discipline, with revenue accrual treated as incidental to the main objective.

In view of the above, ***we recommend the following:***

1 ***The motor vehicles tax should be merged with the state VAT. The VAT rate for all categories of motor vehicles (both commercial and personal vehicles) should be higher by eight percentage points than the general commodity VAT rate.***

2 ***To the extent the motor vehicle is used for personal purposes the VAT so paid will be on final consumption and accordingly, no input credit would be available to the owner of the vehicle. If the vehicle is used for commercial purposes, the VAT treatment will be same as in the case of any other capital good, i.e. the owner would be eligible to claim input credit.***

3 ***Similarly, since the transport of goods and passenger results in consumption of services, the goods and passenger tax should be replaced by the service tax on carriage of goods and passengers and integrated into the state commodity VAT.***

4 ***The existing administration for goods and passenger tax should be abolished and merged with the state level VAT.***

[E] Profession Tax and Entertainment Duty

The last of the important state taxes, which was considered was Profession tax as it bears similarities with service taxation. The yield from Profession tax is, however, limited due to a restricted base covered by state governments and a monetary ceiling of Rs.2,500 defined by the Centre as annual charge on the professionals. The ceiling was last fixed in 1989 through a constitutional amendment. On account of the erosion in the real value of this ceiling over the last decade, we recommend that the ceiling should be increased to Rs.5,000 immediately. In any event, the Profession tax should be merged with the VAT in the same way as the MVT. The same argument holds also for Entertainment duty.

Government Order Setting up Advisory Group

Annexure 1

No.23/2/2000-FR
GOVERNMENT OF INDIA
PLANNING COMMISSION

Yojana Bhavan,
Sansad Marg,
New Delhi
Dated 10th July, 2000

ORDER

Subject: Setting up of an Advisory Group on Tax Policy and Tax Administration

1 Planning Commission has decided to set up an Advisory Group on "Tax Policy & Tax Administration".

2 An Advisory Group on "Tax Policy and Tax Administration" is, accordingly, constituted as under:

1	Dr. Parthasarthi Shome, RBI Professor, Indian Council for Research in International Economic Relations	Chairman
2	Dr. D.K Srivastava, Senior Fellow, National Institute of Public Finance and Policy	Member
3	Shri D.B. Lal, Ex-Member, Central Board of Direct Taxes	Member
4	Shri Sukumar Mukhopadhya, Ex-Member, Central Board of Excise and Customs	Member
5	Dr. N.J. Kurian, Adviser (FR), Planning Commission	Member
6	Dr. Pavan Agarwal, Senior Fellow, National Institute of Public Finance and Policy	Member

3 Shri Rajiv Mishra, Senior Research Officer in the Financial Resources Division of the Planning Commission will act as convener of the Advisory Group.

4 The Advisory Group will examine and recommend practical policy initiatives aimed at improving resource mobilization for the Tenth Five-Year Plan consistent with achieving 7.5 to 8% growth.

5 The Terms of Reference of the Group will be as follows:

i To analyze the performance of tax revenue and its major components in

Annexure 1

relation to GDP over the 1990s in the Centre and the states;

ii To examine the structure of personal income tax and recommend means of expanding its base, in particular, by streamlining tax incentives;

iii To examine the structure of the Corporate tax and recommend; (a) means of expanding its base and (b) simplification of the overall structure as specified in the current law;

iv To examine the present status of the Central Value Added Tax (CENTVAT) and make appropriate recommendations for its improvement in both structure and revenue generating capacity;

v To study the implications for resource mobilization of the declared objective of reducing tariffs to East Asian levels in a phased manner;

vi To study the scope for expanding the base of taxes on services keeping in mind experience in other countries;

vii To study the feasibility of a Value Added Tax (VAT) at the level of the states and the necessary components and steps needed to make it feasible;

viii To make other specific proposals for improving sales tax collection in the states pending the shift to a full state level VAT;

ix To study the scope for mobilizing resources through other tax revenues at the state level;

x To study the possibility of achieving the objective of a national VAT in which the CENTVAT and state taxes or state VAT can be integrated and also the scope for integration of service taxation within such a national VAT;

xi To suggest constructive tax administrative measures for the effective implementation of the recommended tax policy reform at both the Central and state levels.

6 The group may co-opt other members if necessary.

7 The Group will submit its report by the end of November, 2000.

8 Non-Official members of the Group will be paid TA/DA by the Planning Commission as per rules.

Sd/-

(K.K Chhabra)
Under Secretary (Administration)

Chairman and Members of the Group

Copy to:
P.S to Dy. Chairman
P.S to Member (MSA)
Senior P.P.S to Secretary
P.S. to Additional Adviser (Admn.)
Director (Finance)
US (Admn-II)
Protocol Unit

Sd/-
(K.K Chhabra)
Under Secretary (Administration)

Meetings and Visits of Advisory Group

Annexure 2

Meetings and Visits of the Advisory Group

Dates	Venue/ Places of Visit	Particiants from Advisory Group
14.7.2000	Planning Commission, New Delhi	P Shome, D K Srivastava, D B Lal, S Mukhopadhyay, N J Kurian, P Aggarwal, R Mishra
16.8.2000	Planning Commission, New Delhi	P Shome, D K Srivastava, D B Lal, S Mukhopadhyay, N J Kurian, P Aggarwal, A Modi, G Ray, R Mishra
31.8.2000	Planning Commission, New Delhi	P Shome, D B Lal, S Mukhopadhyay, N J Kurian, P Aggarwal, A Modi, R Mishra
9.9.2000	Planning Commission, New Delhi	P Shome, D B Lal, S Mukhopadhyay, N J Kurian, A Modi, G Ray, R Mishra
18.10.2000	Planning Commission, New Delhi	P Shome, D K Srivastava, D B Lal, S Mukhopadhyay, N J Kurian, A Modi, G Ray, R Mishra
19.10.2000	Planning Commission, New Delhi	P Shome, D K Srivastava, D B Lal, S Mukhopadhyay, N J Kurian, A Modi, R Mishra
10.11.2000	Planning Commission, New Delhi	P Shome, D K Srivastava, D B Lal, S Mukhopadhyay, N J Kurian, P Aggarwal, A Modi, G Ray, R Mishra
28.11.2000	Planning Commission, New Delhi	P Shome D K Srivastava, D B Lal, N J Kurian, P Aggarwal, A Modi, R Mishra
30.11–1.12.2000	Chennai, Tamil Nadu	P Shome, D K Srivastava, S Mukhopadhyay, N J Kurian, P Aggarwal, R Mishra
11–12.12.2000	Kolkata, West Bengal	P Shome, D K Srivastava, D B Lal, S Mukhopadhyay, N J Kurian, A Modi, R Mishra
28.12.2000	Planning Commission New Delhi	P Shome, D B Lal, S Mukhopadhyay, N J Kurian, A Modi, R Mishra
3.01.2001	Planning Commission New Delhi	Presentation of the Interim Report
1 –3 2 2001	Panjim, Goa	P Shome, S Mukhopadhyay, A Modi, R Mishra
5 –6.2.2001	Mumbai, Maharashtra	P Shome, S Mukhopadhyay, P Aggarwal, A Modi, R Mishra
14–15.2.2001	Bangalore, Karnataka	P Shome, S Mukhopadhyay, P Aggarwal, A Modi, R Mishra
20.3.2001	Planning Commission, New Delhi	P Shome, D K Srivastava, D B Lal, S Mukhopadhyay, N J Kurian, P Aggarwal, A Modi, R Mishra
20–21.4.2001	Hyderabad, Andhra Pradesh	P Shome, S Mukhopadhyay, P Aggarwal, A Modi, R Mishra
27–30.4.2001	Gangtok, Sikkim	P Shome, D K Srivastava, S Mukhopadhyay, N J Kurian, P Aggarwal, A Modi, R Mishra