CHAPTER

17

TAX STRUCTURE IN INDIA

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*Through taxes, government in reality decides how to draw the required resources from the nation's households and businesses for public purposes–the money raised so is the 'vehicle' by which real resources are transferred from private goods to public goods.**

** See Paul A. Samuelson and William D. Nordhaus, **Economics**, The McGraw-Hill Company, New York, 2005, pp. 327–340. Also see Joseph E. Stiglitz and Carl E. Walsh, **Economics,** W. W. Norton, New Yok, 4th Edition, 2006, pp. 380–86.*

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TAX

Modern economics ***defines*** tax as a mode of income redistribution.[1] There might be other ways also to look at it—the usual meaning of tax people think is that a tax is imposed by the government to fulfil its important obligations on the expenditure front.[2] We may take an example to see how taxes redistribute income:

Suppose an economy has a flat rate of income tax 30 per cent. Just see the impact of this tax on the income disparity of two people A and B earning Rs. 50,000 and Rs. 80,000, respectively.

Individual	*Nominal Income*	*Income Disparity before Tax*	*Income after Paying Tax*	*Income Disparity after Tax*
A	Rs. 50,000	Rs. 30,000	Rs. 35,000	Rs. 21,000
B	Rs. 80,000		Rs. 56,000	

We see here through the above-given Table as how the income disparity between two individuals A and B decreases from Rs. 30,000 to Rs. 21,000 after paying taxes—this is the *first level* when incomes of these individuals have got re-distributed.

Now the money the government has got by tax collection, i.e., Rs. 39,000 (Rs. 15,000 + Rs. 24,000) will be spent on different sectors—infrastructure, education, health etc.—which will provide services to each and everybody alike. Here income is re-distributed at the *secondary* level. Consider a person who pays income tax, but does not take services of government schools for his children's education, nor goes to the government hospitals for medical services and compare him with a person who has no option other than the government schools and the hospitals—the higher tax payer getting no government services and a lower tax payer getting all the services. Here income looks re-distributed from the consumption side.

INCIDENCE OF TAX

The point where tax looks as being imposed is known as the incidence of tax—the event of tax imposition.[3]

IMPACT OF TAX

The point where tax makes its effect felt is known as the impact of tax—the after effect of tax imposition.[4]

DIRECT TAX

The tax which has incidence and impact both at the same point is the direct tax—the person who is hit, the same person bleeds.[5] As for example income tax, interest tax, etc.

INDIRECT TAX

The tax which has incidence and impact at the different points is the indirect tax—the person who is hit does not bleed[6] someone else bleeds. As, for example, excise, sales tax, etc., which are imposed on either the producers or the traders, but it is the general consumers who bear the burden of tax.

METHODS OF TAXATION

There are three methods of taxation prevalent in economies with their individual merits and demerits—

1. Samuelson and Nordhaus, ***Economics,*** op. cit., p. 327.
2. For further references, Stiglitz and Walsh, ***Economics,*** op. cit., pp. 378–79 may be referred.
3. Samuelson and Nordhaus, ***Economics,*** op. cit., pp. 75–77.
4. Ibid., pp. 75–77.
5. Ibid., p. 329.
6. Ibid., p. 329.

Progressive Taxation

This method has increasing rates of tax for increasing value or volume on which the tax is being imposed.[7] Indian income tax is a typical example of it. The idea here is less tax on the people who earn less and higher tax on the people who earn more—classifying income earners into different slabs. This method is believed to discourage more earnings by the individual to support low growth and development unintentionally. Being poor is rewarded while richness is punished. Tax payers also start evading tax by showing lower unreal income. But from different angles this tax is pro-poor and taxes people according to their affordability/sustainability. This is the most popular taxation method in the world and a populist one, too.

Regressive Taxation

This is just opposite to the progressive method having decreasing rates of tax for increasing value or volume on which the tax is being imposed.[8] There are not any permanent or specific sectors for such taxes. As a provision of promotion, some sectors might be imposed with regressive taxes. As for example, to promote the growth and development of small scale industries, India at one time had regressive excise duty on their productions—with increasing slabs of volume they produced, the burden of tax used to go on decreasing.

This method while appreciated for rewarding the higher producers or income-earners, is criticised for being more taxing on the poor and low-producers. This is not a popular mode of taxation and not as per the spirit of modern democracies.

Proportional Taxation

In such a taxation method, there is neither progression nor regression from the point of view rate of taxes point of view. Such taxes have fixed rates for every level of income or production, they are neutral from the poor or rich point view or from the point of view of the levels of production.[9] Usually, this is not used by the economies as an independent method of taxation. Generally, this mode is used as a complementary method with either progressive or regressive taxation. If not converted into proportional taxes, every progressive tax will go on increasing and similarly every regressive tax will decrease to zero, becoming completely a futile tax methods. That is why every tax, be it progressive or regressive in nature, must be converted into proportional taxes after a certain level.

A GOOD TAX SYSTEM

What are the characteristics of a good tax system? There has always been a debate among economists and policymakers on the issue of design of the tax system. Taxation in developing economies has been even more debated as the trade-off assessment generates enough controversy. Main debatable issues in the design of a tax system are whether progressive or regressive taxation, direct tax or indirect tax collections should be higher, whether revenue deficit is better, etc. The controversies set apart, there is a broad consensus on five ***principles***[10] of a good tax system, among economists and the policymakers:

7. Samuelson and Nordhaus ***Economics,*** op. cit., p. 329; Stiglitz and Walsh, ***Economics,*** op. cit., p. 380.
8. Ibid.
9. Samuelson and Nordhaus, ***Economics,*** op. cit., p. 329.
10. Stiglitz and Walsh, ***Economics,*** op. cit., 382. A comprehensive analysis of good tax structure is also given in ***Meade Committe Report,*** Institute for Fiscal Studies (IFS), Washington DC, 1978.

(i) Fairness

Though fairness (i.e., the first criteria of a good tax system) is not always easy to define, economists suggest inclusion of two elements in the tax system to make it fair namely, ***horizontal equity*** and ***vertical equity.*** Individuals in identical or similar situations paying identical or similar taxes is known as ***horizontal equity.*** When 'better off' people pay more taxes it is known as ***vertical equity***.

(ii) Efficiency

Efficiency of a tax system is its potential to affect or interfere the efficiency of the economy. A good tax system raises revenue with the least cost on the taxpayers and least interference on the allocation of resources in the economy. The tax system affects the economic decisions of individuals and groups by either encouraging or discouraging them to save, spend, invest, etc. Taxes can improve efficiency of the economy—taxes on pollution or on smoking give revenue to the government and serves broader social purposes, too. This is known as the ***double dividend*** of a tax.

(iii) Administrative Simplicity

This is the third criterion which includes factors like computation, filing, collection, etc. of the taxes that all should be as simple as possible. Simplicity checks tax evasion too. Tax reform in India has simplification of tax as its major plank—also recommended by the Chelliah Committee.

(iv) Flexibility

A good tax system has the scope of desirable modifications in it if there is any such need.

(v) Transparency

How much tax taxpayers are actually paying and what are they getting against it in the form of the public services should be ascertainable, i.e., the transparency factor.

METHODS OF EXPENDITURE

Similar to the methods of taxation the modes of government expenditure are also of three types—Progressive, Regressive and Proportional.[11]

At first instance it seems that as a country achieves better levels of development, sectoral and the item-wise expenditure of the economy must have decreasing trends. But practical experience shows that the level of expenditure needs enhancement everyday and economy always needs more and more revenues to fulfil the rising expenditures. That is why for economies the best form of government expenditure is the progressive expenditure.

The best way of taxation is progressive and the best way of government expenditure is also progressive and they suit each other beautifully. Most of the economies around the world are having progressive taxation with progressive expenditure.

VALUE ADDED TAX

The value added tax (VAT) is a method of tax collection as well as name of a state level tax (***at present***) in India. A tax collected at every stage of value addition, i.e., either by production or distribution is known as value added tax.[12] The name itself suggests that this tax is collected on the value addition (i.e., production).

11. Based on the discussion on Government Expenditure in Samuelson and Nordhaus, ***Economics,*** op. cit.
12. Ibid., p. 333

Production of goods or services is nothing but stages of value additions where production of goods is done by the industrialists or manufacturers. But these goods require value addition by different service providers/ producers (the agents, the wholesalers and the retailers) before they reach the consumers. From production to the level of sale, there are many points where value is added in all goods. VAT method of tax collection is different from the non-VAT method in the sense that it is imposed and collected at different points of value addition chain, i.e., ***multi-point tax collection***. That is why there is no chance of imposing tax upon tax which takes place in the non-VAT method—***single point tax*** collection. This is why VAT does not have a 'cascading effect' on the prices of goods it does not increase inflation—and is therefore highly suitable for an economy like India where due to high level of poverty large number of people lack the market level purchasing capacity. It is a pro-poor tax system without being anti-rich because rich people do not suffer either.

NEED OF VAT IN INDIA

Over 150 nations in the world have implemented the VAT system of taxation regarding collecting their indirect taxes. There have been valid reasons why India should move towards the VAT method of tax collection. We may see some of the major reasons:[13]

(i) Due to single point tax collection, Indian indirect tax collection system was price-increasing (having *cascading effect* on the price) which was highly detrimental to the poor masses. Implementation of VAT will improve the purchasing capacity and so living standard of the poor people.[14]

(ii) India is having a federal political system where side by side the central government, states have also been given power to impose taxes and collect them. At the central level, there had been uniformity of taxes for the economy. But there was no 'uniformity' at the state level taxes (i.e., state excise, sales tax, entertainment tax, etc.). This was detrimental to the development of a single market for Indian economy as a whole. India basically had many markets, but no Indian market as such. To bring in uniformity at the state-level taxes, VAT was a necessary step in India.

(iii) With the process of economic reforms, India moved towards the market economy. And for this, firstly India needed to have a single market. Without uniformity at the state level taxes (***uniform VAT***) this was not possible.

(iv) Indian federal design has resulted in economically weaker states and stronger centre. As VAT increases the total tax collection (experience of the world suggests so) it was fit to be implemented at the state level.

(v) India has been a country of high level tax evasion. By implementing VAT method of indirect tax collection, it becomes almost impossible to go for large scale tax evasion. To prove one's level of value addition, the purchase invoice/receipt is a must which ultimately makes it cross-check the level of production and sale in the economy.[15]

13. Derived from the points forwarded by the ***GoI*** and the ***Empowered Group of State Ministers.***
14. Raja C. Chelliah, Pawan K. Aggarwal, Mahesh C. Purohit and R. Kavita Rao, ***Introduction to Value Added Tax*** , in Amaresh Bagchi edited ***Readings in Public Finance,*** Oxford University Press, N. Delhi, 2005, pp. 277–78.
15. Ibid.

(vi) If some of the state level taxes (which are many) are converted into state VAT the complexity of taxation will also be minimised. And at the end, it is possible to merge some of the centre's indirect taxes with it, i.e., arrival of the ***single VAT***.

Keeping all such things in mind, India started tax reform (Chelliah Committee and Kelkar Committee) and a certain level of sucess has been achieved in this area which can boost our motivation.

In the year 1996, the central government started collecting its excise duty on the VAT method and the tax was given a new name—the CENVAT.

The next proposal was to merge the states excise duty (imposed on intoxicants only) and their sales taxes into one tax—the state VAT or VAT. This could not take place due to states' lack of political will. Ultimately only sales taxes of the states were changed to be named VAT and was started to be collected on the basis of the VAT method (some states did not join it and some joined later). The experience has been encouraging.

IMPLEMENTATION EXPERIENCE OF VAT

The implementation experience of VAT in India has been very encouraging—the new tax system has been received well by all the stakeholders, the transition being quite smooth.[16] The revenue performance of VAT—implementing states/ UTs (25) has been encouraging the tax revenue registered, an increase of 13.8 per cent over the annual growth rate of the last five years.[17] Only 8 states claimed for VAT compensation from the Centre in 2005–06 which came down to only 5 in the fiscal 2006–07.

GOODS AND SERVICES TAX

The Goods and Services Tax (GST) is a tax proposal[18] in India which will emerge after merging many of the state and central level indirect taxes. Important points of the proposed GST are as follows:

(i) It will be a tax collected on the VAT method—having all the benefits of a VAT kind of tax.

(ii) It will be imposed all over the country with the uniformity of rate and will replace multiple central and state taxes (a *single VAT* it will be known). The taxes to be withdrawn or merged into the GST are:

Central Taxes: CENVAT, service tax, sales tax and stamp duty.

State Taxes: State excise, sales tax, entry tax, lease tax, works contract tax, luxury tax, octroi, turnover tax and cess.

(iii) The proposed tax has a single rate of 20 per cent of which Centre and state will have a share of 12 per cent and 8 per cent, respectively.

The Union Budget 2015–16 repeated its commitment towards implementation of GST. The major challenges in the path of its implementation as per the experts are as follows:

(i) States are collecting VAT with five rates—0 per cent, 1 per cent, 4 per cent and 20 per cent. The fifth rate is 12.5 per cent known as the RNR (revenue neutral rate). Now the challenge is to convince the states to be satisfied with their share of only 8 per cent in the GST at one hand and making it politically happen from the consumers point of view.

16. ***Economic Survey 2006–07***, MoF, GoI, N. Delhi, pp. 46–47.
17. Ibid.
18. Recommended by the Vijay Kelkar *Task Force on FRBM, 2003,* GoI, N. Delhi.

(ii) The next challenge is to decide the things like how and where to integrate central taxes and the state taxes as VAT or as the GST.

(iii) What to do with the custom duty is also a matter of concern as there is a move to integrate it with the GST at present.

Recent Attempts to Implement GST

To operationalise the GST, the Constitution (115th Amendment) Bill[19] has been introduced in the Lok Sabha in March 2011 to enable the Parliament and state legislatures to make laws for levying GST on every transaction of supply of goods or services or both. Some goods, namely crude petroleum, diesel, petrol, aviation turbine fuel, natural gas and alcohol are not to come under the purview of the GST.

The constitutional amendment bill also seeks to empower the President to set up within 60 days of the passage of the legislation, a GST Council with the Union Finance Minister as chairperson and Union Minister of State for Revenue and finance ministers of all the states as members. The GST Council is to work on the basis of consensus and make recommendations on issues like GST rates, exemption lists and threshold limits.

Further, the bill provides for setting up of a GST dispute settlement authority, comprising a chairperson and two members to resolve disputes arising out of deviations from the recommendations of the GST Council either by the central or state governments. The draft bill has since been referred to the Parliamentary Committee on Finance for examination.

Among the other steps that are being taken for the introduction of the GST is the establishment of a strong information technology (IT) infrastructure. For this purpose the government has set up an ***Empowered Group*** headed by Nandan Nilekani, Chairman, Unique Identification Authority of India (UIDAI).

Significant progress has been made in the conceptualisation and design of the GST Network (GSTN), which is a common portal for the Centre and states that will enable electronic processing of key business processes of registration, returns and payments. For this purpose, the structure of these processes is in advanced stages of finalisation. The National Securities Depository Limited (NSDL) has been selected as technology partner for incubating the National Information Utility that will establish and operate the IT backbone for the GST. In this regard the NSDL has set up a pilot project in collaboration with states prior to its roll-out across the country.

Launching a single VAT for the country (proposed as the GST) has been postponed sveral times by now. The postponements were due to lack of concensus between the Centre and the States related to several aspects of the GST. Though, a broad concensus is believed to be emerging in 2014–15 after which the GoI moved the *122nd Constitution Amendment Bill* in the Lok Sabha by mid-December 2014. The *Union Budget 2015–16* proposes to implement the GST from the financial year 2016–17.

ADDITIONAL EXCISE DUTY

There is a tax in India known as the Additional Excise Duty (AED) imposed and collected by the Centre. Basically, this is not a form of excise duty. At the same time, though the Centre collects it the total corpus of collected tax is handed over to the states.

On the request of the states, the central government passed the Goods of Special Importance Act, 1957 which empowered the

19. ***Economic Survey 2011–12,*** op. cit., p. 57

Centre to collect the AED on tobacco, textile and sugar in lieu of the states' sales tax on them so that these regionally produced goods (which are consumed nationally) have uniform and affordable prices across the country.

Once VAT is fully operational in the economy this responsibility will be handed over to the states (as proposed) to be integrated with their VAT with the condition that none of these commodities will be charged VAT exceeding 4 per cent.

CST REFORMS

The Central Sale Tax (CST), being an origin—based non-rebatable tax, it is generally agreed, is inconsistent with the concept of VAT. That is why it needs to be phased out; the CST reforms is a part of the tax reforms in India. The critical issue involved in phasing out of CST is that of compensating the states for revenue losses on account of such a phase out. Since phasing out of CST will entail a revenue loss, states have been insisting on a mechanism to compensate them on a permanent basis. The 4 per cent rate of the CST has to be phased out in stages with 1 per cent phase out in one financial year and the states duly compensated through tax devolution. Because of phasing out, it is now at 2 per cent.

SERVICE TAX

The share of the services sector in the GDP of India has been going upward for the last decade. The introduction of service tax in 1994–95 by the Government of India has started paying the government on its tax revenue front. Introduced to redress the asymmentric and distortionary treatment of goods and services in the tax regime, the service tax has seen gradual expansion in the country.

Introduced on only three serviecs, by now, the applies on more than 100 services. The rate of service tax has been increased by the *Union Budget 2015–16* to 14 per cent inclusive of education cesses (it was 12.36 per cent inclusive of education cesses). The change has been done to facilitate a smooth transition to levy tax on services by both Centre and states, once India switches over to the GST by the next year. Other than imposing a 2 per cent Swachh Bharat Cess, the *Budget* has also put all services provided by the government entities under the service tax net (both to be notified in coming times).

The service tax collection was estimated to increase to Rs. 2,16,000 crore (BE) in 2014–15 (from Rs. 71,000 crore of 2010–11) with a growth rate of 33 per cent over the previous year.[20]

VOLUNTARY COMPLIANCE ENCOURAGEMENT SCHEME

Announced in the *Union Budget 2013–14*, the Service Tax *Voluntary Compliance Encouragement Scheme (VCES)* is a one-time amnesty for those who have collected service tax but not deposited the same with the government. Those service tax providers that have not filed service tax return since October 2007 can disclose true liability and get an interest or penalty waive off.

COMMODITIES TRANSACTION TAX

The *Union Budget 2013–14* has introduced (basically, *reintroduced*) the Commodities Transaction Tax (CTT), however, only for ***non-agricultural*** commodity futures at the rate of **0.01** per cent (which is equivalent to the rate of equity futures on which a *Securities Transaction Tax* is imposed in India). Alongwith this, transactions in commodity derivatives have been declared to be

20. ***Economic Survey 2014–15***, MoF, GoI, N. Delhi, Vol. 2, p. 26.

made *non-speculative*; and hence for traders in the commodity derivative segment, any losses arising from such transactions can be set off against income from any other source (similar provisions are also applicable for the securities market transactions).

Like all financial transaction taxes, CTT ***aims*** at discouraging excessive speculation, which is detrimental to the market and to bring parity between securities market and commodities market such that there is no tax/regulatory arbitrage. *Futures contracts* are financial instruments and provide for price risk management and price discovery of the underlying asset commodity / currency / stocks / interest. It is, therefore, essential that the policy framework governing them is uniform across all the contracts irrespective of the underlying assets to minimise the chances of regulatory arbitrage. The proposal of CTT also appears to have stemmed from the general policy of the government to widen the tax base.

Commodities Transaction Tax (CTT) is a tax similar to Securities Transaction Tax (STT), proposed to be levied in India, on transactions done on the domestic commodity derivatives exchanges. Globally, commodity derivatives are also considered as financial contracts. Hence CTT can also be considered as a type of 'financial transaction tax'.

The concept of CTT was ***first*** introduced in the *Union Budget 2008–09*. The government had then proposed to impose a commodities transaction tax (CTT) of 0.017 per cent (equivalent to the rate of equity futures at that point of time). However, it was withdrawn subsequently as the market was *nascent* then and any imposition of transaction tax might have adversely affected the growth of organised commodities derivatives markets in India. This has helped Indian commodity exchanges to grow to global standards [MCX is the world's ***No. 3*** commodity exchange; globally, MCX is ***No. 1*** in gold and silver, ***No. 2*** in natural gas and ***No. 3*** in crude oil].

SECURITIES TRANSACTION TAX

The Securities Transaction Tax (STT) is a type of 'financial transaction tax' levied in India on transactions done on the domestic stock exchanges. The rates of STT are prescribed by the central government through its budget from time to time. In tax parlance, this is categorised as a ***direct tax***. The tax came into effect from *October 1, 2004*. In India, STT is collected for the Government of India by the stock exchanges. With charging of STT, long-term capital gains tax was made ***zero*** and short-term capital gains tax was reduced to 10 per cent (subsequently, changed to 15 per cent since 2008).

The STT framework was subsequently reviewed by the central government in the year 2005, 2006, 2008, 2012 and ***2013***. The STT rates were revised upwards in the year 2005 and 2006 while it was reduced for certain segments in 2012 and 2013. The STT provisions were altered in the year 2008 such that for professional traders (brokers), STT came to be treated as an *expense* which can be deducted from the income instead of treating the same as an advance tax paid. [The 2004 STT provisions provided that the STT payments of professional traders, whose 'business income' arising from purchase and sale of securities could be set off against their total tax liability.]

As on date, STT is not applicable in case of *preference shares, government securities, bonds, debentures, currency derivatives, units of mutual fund other than equity oriented mutual fund,* and *gold exchange traded funds* and in **such cases**, tax treatment of short-term and long-term gains shall be as per normal provisions of law.

Transactions of the shares of listed companies on the floor of the stock exchange or otherwise, mandated under the regulatory framework of SEBI, such as *takeover, buyback, delisting offers,* etc., also does not come under STT framework. The *off-market* transactions of securities (which entails changes in ownership records at depositories) also does not attract STT.

CAPITAL GAINS TAX

This is a direct tax and applies on the sales of all 'assets' if a profit (gain) has been made by the owner of the asset—a tax on the 'gains' one gets by selling assets. The tax has been classified into two—

(i) *Short Term Capital Gain* (STCG): It applies 'if the Asset has been sold within 36 months of owning it'. In this case the 'rate' of this tax is similar to the normal income tax slab. But the period becomes '12 months' in cases of shares, mutual funds, units of the UTI and 'zero coupon bond'—in this case the 'rate' of this tax is **15** per cent.

(ii) *Long Term Capital Gain* (LTCG): It applies 'if the asset has been sold after 36 months of owning it'. In this case the 'rate' of this tax is **20** per cent. In cases of shares, mutual funds, units of the UTI and 'zero coupon bond' there is 'exemption' (zero tax) from this tax (provided that such transaction is subject to 'Securities Transaction Tax').

MINIMUM ALTERANATE TAX

The Minimum Alternate Tax (MAT) is a direct tax imposed on the 'zero tax' companies at the rate of 18.5 per cent on their book profit. This was first imposed in 1997–98.

Basically, income tax is paid as per the provisions of the Income Tax Act (IT Act), but companies calculate their profit (through profit and loss account) as per the provisions of the Companies Act. The IT Act allows several kinds of exemptions and other incentives from total income together with deductions on the gross income. Again, the rates of 'depreciation' under the Companies Act is higher than the IT Act. As a result of these exemptions, deductions and other incentives under IT Act together with higher depreciation under the Companies Act, companies show their taxable income either 'nil' or 'negative', and this way, the 'zero tax' companies emerge.

Practically, 'zero tax' companies, might be having high 'book profit' and distributing huge dividends (under the Companies Act) to their shareholders, too, but showing 'nil' or 'negative' taxable income (under the IT Act) they might not pay any income tax! To bring such companies under the income tax, *Section 115JB* was introduced in the IT Act in 1997–98 and MAT was imposed accordingly.

MAT is a way of making companies pay minimum amount of tax. It is applicable on all companies except those engaged in infrastructure and power sectors, free trade zones, charitable activities, venture and angel funds. Foreign companies with income sources in India also come under it. The *Union Budget 2015–16* has rationalised the MAT provisions for the FIIs (Foreign Financial Institutions)—now they do not need to pay MAT on their profits from capital gains on transactions in securities (which are liable lower tax rate).

We may take an example – suppose a company has 'book profit' of Rs. 10 lakh. And, after claiming the deductuions, exemptions and depreciation its 'gross taxable income' comes down to Rs. 6 lakh, its taxable income becoming Rs. 4 lakh. In this case, the applicable income tax would be Rs. 1.2 lakh (if rate of income tax is 30 per cent flat). But the comapny will pay a MAT of Rs. 1.85 lakh (at the rate of 18.5 per cent on its 'book profit' of Rs. 10 lakh). The concerned comapny needs to pay the tax which is higher—here, the tax to be paid will be Rs. 1.85 lakh.

The MAT paid can be carried forward and set-off (adjustment) against regular tax payable during the subsequent five-year period subject to certain conditions. This is known as MAT credit.

INVESTMENT ALLOWANCE

Announced in the *Union Budget 2013–14*, a tax break given to companies for high value investment in plant and machineries, over and above depreciation benefits enjoyed by them. A company investing Rs. 100 crore or more in plant and machinery during the April 2013 to March 2015 will be entitled to deduct an investment allowance of **15** per cent of the investment. This is expected to see enormous spill-over benefits to small and medium enterprises.

The proposed investment allowance scheme should be seen a drain on the government's tax collections. It may be seen as a kind of *tax exemption*.

COLLECTION RATES

Given the large number of exemptions to rate of customs, the increase in value of imports does not necessarily imply similar magnitude in customs revenue. Collection rates are an indicator of overall incidence of customs tariffs including countervailing and special additional duties of imports. These are computed as the ratio of revenue collected from these duties to the aggregate value of imports in a year (or period) and thus represent trade-weighted tariffs. A major reason for the fall in rates has been the lower levels of duties on many items including on petroleum, oil, and lubricants (POL), which has significant import value and of course the impact of the various exemptions. At the overall level, the effective rate of taxes at around 6.1 per cent in 2013–14 as against the level of simple average tariff rates of basic customs duties and the CVD indicates the impact of exemptions.[21]

TAX EXPENDITURE

As per the current *Economic Survey 2014–15*, there is significant divergence in India between the official rates of taxes and the actual or *effective rate of taxation* (which is a simple 'ratio of tax revenue collected to the tax base'). This arises on account of the *exemptions* to the tax rate. As indicated earlier in the section on *collection rates*, the magnitude of **revenue foregone** *(i.e., tax expenditure)* is indeed high.

In case of the ***direct taxes***, the situation prevails as given below:

(i) Tax foregone on account of exemptions under *corporate income tax* for 2013–14 was estimated at Rs. 76,116 crore. In this case, ***deduction*** on account of accelerated depreciation, deduction for export profits of export-oriented units located in special economic zones (SEZs) and profits of businesses in the power and telecom sectors were some of the major incentives. Though, the absolute amount of deductions has decreased as a result of phasing out of profit-linked deductions.

(ii) Tax forgone on account of exemptions under *personal income tax* for individual taxpayers was estimated at Rs. 40,414 crore in 2013–14. In this case, the bulk of the revenue foregone was on account of the exemptions given for certain investments and payments under Section 80 C of the Income Tax Act.

In so far as ***indirect taxes*** are concerned, revenue forgone is defined as the difference between duty that would have been payable but for the issue of exemption notification and actual duty paid in terms of the relevant notification. The situation stands as given below:

21. ***Economic Survey 2014–15***, op. cit.

(i) The revenue forgone for the financial year 2013–14 in respect of *excise duties* is estimated at Rs. 1,95,679 crore including Rs. 12,880 crore on account of area-based exemptions.

(ii) Duty forgone for the year 2013–14 on account of all the exemption notifications on *customs* was estimated at Rs. 2,60,714 crore.

There is merit in limiting the exemptions or their *grandfathering*[22] on a case-by-case basis so as to realise fuller tax potential through a wider tax base. The *Direct Tax Code 2010* has enough scope to cut such exemptions. Similarly, the on-going indirect tax reforms such as the GST has such provisions.

14TH FINANCE COMMISSION

The 14th Finance Commission (FFC) was constituted on *January 2, 2013* under the Chairmanship of Dr. Y. V. Reddy, former RBI Governor with Prof. Abhijit Sen, Ms. Sushma Nath, Dr. M. Govinda Rao and Dr. Sudipto Mundle as the other *four* members. The recommendations of the commission will apply on the period ***2015–20*** and its report has to be submitted by October 31, 2014.

The broad *Terms of Reference* and the *matters* to be taken into consideration by the commission are:

(i) *Tax Devolution* & *Grant* related references

(a) the distribution between the union and states of the net *proceeds of taxes* which are to be, or may be, divided between them under *Chapter I, Part XII* of the Constitution and the allocation between the states of the respective shares of such proceeds;

(b) the principles which should govern the *grants-in-aid* of the revenues of the states out of the Consolidated Fund of India and the sums to be paid to the states which are in need of assistance by way of grants-in-aid of their revenues under *Article 275* of the Constitution for the purposes other than those specified in the provisos to *Clause (1)* of that article; and

(c) measures needed to augment the Consolidated Fund of a state to supplement the resources of the *panchayats* and *municipalities* in the state on the basis of the recommendations made by the finance commission of the state.

(ii) To review the state of finances, *deficit*, and *debt* levels of the union and states, and suggest measures for maintaining a stable and sustainable fiscal environment consistent with equitable growth including suggestions to amend the FRBMAs currently in force. The commission has been asked to consider and recommend incentives and disincentives for states for observing the obligations laid down in the FRBMAs.

(iii) In commission is required to consider—

(a) the *resources* of the Central government and the *demands* on the resources of the central government;

(b) the *resources* of the state governments and *demands* on such resources under

22. **Grandfather Clause** – a clause in a new law that exempts certain persons or businesses from abiding by it. For example, suppose a country passes a law stating that it is illegal to own a cat. A grandfather clause would allow persons who already own cats to continue to keep them, but would prevent people who do not own cats from buying them. Grandfather clauses are controversial, but they are common around the world. [*Source:* **Farlex Financial Dictionary**, Farlex Inc., N. York, USA, 2012; **Collins English Dictionary- Complete & Unabridged**, HaperCollins, N. York, USA, 2003.]

different heads, including the impact of debt levels on resource availability in debt-stressed states;

(c) the objective of not only balancing the receipts and expenditure on revenue account of all the states and the union but also generating surpluses for capital investment;

(d) the *taxation efforts* of the central government and each state government and the potential for additional resource mobilisation;

(e) the level of *subsidies* required for sustainable and inclusive growth and equitable sharing of subsidies between the central and state governments;

(f) the *expenditure* on the non-salary component of maintenance and upkeep of capital assets and the non-wage-related maintenance expenditure on Plan schemes to be completed by March 31, 2015 and the norms on the basis of which specific amounts are recommended for the maintenance of capital assets and the manner of monitoring such expenditure;

(g) the need for *insulating the pricing* of public utility services like drinking water, irrigation, power, and public transport from policy fluctuations through statutory provisions;

(h) the need for making public-sector enterprises competitive and market oriented; listing and disinvestment; relinquishing of non-priority enterprises;

(i) the need to balance *management of ecology, environment, and climate change* consistent with sustainable economic development; and

(j) the impact of the proposed *goods and services tax* on the finances of the Centre and states and the mechanism for compensation in case of any revenue loss.

(iv) To review the present *public expenditure management* systems and recommend, including—

(a) budgeting and accounting standards and practices;

(b) the existing system of classification of receipts and expenditure;

(c) linking outlays to outputs and outcomes; and

(d) best practices within the country and internationally.

6. To review the present arrangements of financing of *Disaster Management* with reference to the funds constituted under the Disaster Management Act 2005 and make recommendations.

7. To indicate the basis on which it has arrived at its findings and make available the *state-wise estimates of receipts and expenditure*.

The commission is required to generally take the base of population figures as of 1971 in all cases where population is a factor for determination of devolution of taxes and duties and grants-in-aid. However, the commission may also take into account the demographic changes that have taken place subsequent up to 1971.

FFC RECOMMENDATIONS

The 14th Finance Commission (FFC) submitted its report by early 2015. It has advised for far-reaching changes for sharing of revenues between the Center and the States, on the one hand, and between the States, on the other. The advices apply on the period 2015–20 and are likely to have major implications for Center-State relations, for budgeting by, and the fiscal situation of, the Center and the states. 'Successful implementation of the advices will advance the cause of cooperative federalism that the new government has enthusiastically embraced', the *Economic Survey 2014–15* concluded. Some of the ***major recommendations*** are as follows:

(i) It has radically enhanced the share of the states in the central 'divisible pool' of taxes from the current **32** per cent to **42** per cent which is the biggest ever increase in vertical tax devolution. The last two Finance Commissions, viz., Twelfth (2005–10) and Thirteenth (2010–15) had recommended a state share of 30.5 per cent (increase of 1 per cent) and 32 per cent (increase of 1.5 per cent), respectively in the central divisible pool.

(ii) It has also proposed a new horizontal formula for the distribution of the divisible pool among the states. There are changes both in the variables included/excluded as well as the weights assigned to them. Relative to the Thirteenth Finance Commission, the FFC has incorporated two new variables—

(a) 2011 population and forest cover; and

(b) Excluded the variable relating to fiscal discipline.

(iii) Implementing these recommendations will move the country toward greater *fiscal federalism*, conferring more fiscal autonomy on the states. For example, based on assumptions about nominal GDP growth and tax buoyancy and the policy measures that are contemplated for 2015–16, it is estimated that the additional revenue for the states could be as much as Rs. 2 lakh crores relative to 2014–15. Of this, a substantial portion represents the difference that is purely due to the change in the States' share in the divisible pool.

(iv) Preliminary estimates suggest that *all States stand to gain* from FFC transfers in absolute terms. However, to assess the distributional effects, the increases should be scaled by population, Net State Domestic Product (NSDP) at current market price, or by States' own tax revenue receipts. This will make the following effects on the ststes' revenue—

(a) The biggest gainers when scaled by any of these indicators tend to be the Special Category States (SCS, mostly those in the North-East) and by orders of magnitude.

(b) The major gainers in per capita terms turn out to be Arunachal Pradesh, Mizoram and Sikkim for the SCS states and Kerala, Chhattisgarh and Madhya Pradesh for other states (GCS or General Category States). Clearly, this increase in taxes to the States is sustainable for the center, only if there is a reduction in the central (Plan) assistance to the states (CAS).

In other words, States will now have greater autonomy both on the revenue and expenditure fronts.

(v) It is also possible to tentatively estimate what the FFC recommendations would do to net spending capacity of the States, where net refers to the difference between the extra FFC transfers and the reduced CAS that will be required by the FFC recommendations. Broadly, the Special Category States will be the biggest gainers. In addition, there are nine States among the GCS which are expected to get more than 25 per cent of their own tax revenue.

(vi) A collateral benefit of moving from CAS to FFC transfers is that overall progressivity will improve; that is, on average, States with lower per capita NSDP will receive more than those with a higher per capita NSDP. This results from the fact that CAS transfers, which tended to be discretionary, were less progressive than Finance Commission transfers.

To be sure, there will be transitional costs entailed by the reduction in CAS transfers. But the scope for dislocation has been minimised because the extra FFC resources will flow broadly to the states that have the largest CAS-financed schemes.

The far-reaching recommendations of the FFC, along with the creation of the *NITI Aayog*, will further the government's vision of *cooperative* and *competitive* federalism. The necessary, indeed vital, encompassing of cities and other local bodies within the embrace of cooperative and competitive federalism is the next policy challenge, which is believed to be strengthened by the body NITI Aayog.

CONCEPTS RELATED TO FC

Tax Devolution: Advising a formula to distribute the Union tax proceeds between Union and the States is the most important task of a FC, as the share of states in the net proceeds of Union taxes is the *predominant channel* of resource transfer from the Centre to states.

Divisible Pool: It is that portion of gross tax revenue which is distributed between the Centre and the States. The divisible pool consists of all taxes, except surcharges and cess levied for specific purpose, net of collection charges.

Before the 80th Constitution Amendment (2000), the sharing of the Union tax revenues with the states was in accordance with the provisions of articles 270 and 272, as they stood then. This amendment altered the pattern of sharing of Union taxes in a fundamental way—dropping the Article 272 and substantially changing the Article 270. The new Article 270 provides for sharing of all the taxes and duties referred to in the Union List putting all in a 'divisible pool'. There are some exceptions to it. The taxes and duties referred in the Articles 268 and 269 of the Constitution, together with surcharges and cesses on taxes and duties (referred in the Article 271) and any cess levied for specific purposes—do not fall under this 'pool'.

The new arrangement of tax devolution came as a follow-up to the recommendations of the 10th FC (1995–2000) which the FC termed as the 'Alternative Method of Tax Devolution' (AMD). A concensus between Union and States was a advised by the FC for such an arragnement to be effected. States were going to get extra 5 per cent share in the Union taxes in the AMD, thus, a serious demand came from them—ultimately, the AMD was accepted by the Centre. To make the AMD irreversible, the GoI went for the 80th Amendment in the Constituion.

Grants-in-aid: Though, tax devolution (from the *Divisible Pool*) is the primary instrument to attend the issue of 'horizontal imbalances' of revenue accruing to the states, the grants-in-aid is a complimentary/secondary instrument regarding the same. As per the Article 275, the FC recommends the *principles* as well as the *quantum* of grants to those states which are in need of assistance – different sums may be fixed for different states (one of the pre-requisites for such grants is the assessment of the needs of the states). The 1st FC had laid down *five broad principles* for determining the eligibility of a state for grants:

(i) The Budget of a state as the starting point for examination of a need.

(ii) The efforts made by states to realize the potential.

(iii) The grants should help in equalizing the standards of basic services across states.

(iv) Any special burden or obligations of national concern, though within the state's sphere, should also be taken into account.

(v) Grants might be given to further any beneficent service of national interest to less advanced states.

The grants recommended by FC are predominantly in the nature of general purpose grants meeting the difference between the assessed expenditure on the *non-plan revenue* account of each state and the *projected revenue* including the share of a state in Central taxes. These are often referred to as 'gap filling grants'.

The scope of grants to states, over the yaer, was extended further to cover special problems. Following the 73rd and 74th Amendments to the Constitution, FCs were charged with the additional responsibility of recommending measures to augment the *Consolidated Fund of a State* to supplement the resources of local bodies. This has resulted in further expansion in the scope of FC grants. The 10th FC was the first Commission to recommend grants for *rural* and *urban local bodies*. This way, the scope of grants-in-aid has gone for considerable extension, over the time.

Fiscal capacity: The *fiscal capacity* (also called 'income distance') criterion was first used by the 12th FC, measured by per capita GSDP as a proxy for the distance between states in *tax capacity*. When so proxied, the procedure implicitly applies a single average tax-to-GSDP ratio to determine fiscal capacity distance between states. The 13th FC changed the formula slightly and recommended the use of 'separate averages' for measuring tax capacity, one for general category states (GCS) and another for special category states (SCS).

Fiscal discipline: This as a criterion for tax devolution was used by the 11th and 12th FCs to provide an *incentive* to states managing their finances prudently. The criterion was continued in the 13th FC also. The index of fiscal discipline is arrived at by comparing improvements in the ratio of own revenue receipts of a state to its total revenue expenditure relative to the corresponding average across all states in the country.

PC as Collaborator: While the 12th FC (2005–10) was being set up, the GoI decided to make the Planning Commission (PC) function as a 'collaborator' to the FC—one member of the PC was added as an 'additional member' on the panel of the FC (the FC includes four members including the Chairman)—as a link between the bodies. This arrangement was continued with in the 13th and 14 FCs. It is believed that this arrangement was greatly helpful in bringing in a better idea about the revenue imbalances of the states. While the government did set up the NITI Aayog, no announcement came in this regard – there might be some developments in this regard once the 15th FC (2020–25) is set up in future.

DIRECT TAX CODE - 2013

On the recommendations of the *Kelkar Committe* on direct taxes the government started a major reform process in the area, trying to replace the existing direct tax laws, which is more than five decades old, in a sense, archaic. But passing a new direct tax Act has remained a difficult task for the governments (like the proposed GST). The **Union Budget 2014–15** (Interim) appealed to all political parties to resolve to pass the DTC in 2014–15—naturally, leaving the responsibility on the next Parliament and the new government in the Centre.

The first draft of the direct taxes code (DTC) was released in August 2009. Subsequently, the DTC-2010 Bill was tabled in Parliament in August 2010 and then referred to the Standing Committee on Finance (SFC) that submitted its report in March 2012. Due to the large number of changes that had to be incorporated, the government decided to bring a fresh Bill. Meanwhile, the government has accepted 153 of the 190 recommendations made by the SFC. The revised **Direct Taxes Code-2013** that will serve the country for the next 20 years has been put by the Ministry of Finance on its website for public discussion. The DTC aims at overhauling the existing direct tax regime with an effective and equitable direct tax system that facilitates voluntary compliance and reduces disputes. In the revised draft, the government has been guided by the overarching principle of progressively taxing higher income, bringing greater clarity on applicability of tax provisions and improving the tax administration.

The key changes in the revised Direct Taxes Code-2013 are as given below:

(i) An indirect share transaction will be liable to be taxed in India on foreign companies, if 20 per cent of the assets are based in India.

(ii) New tax slab introduced—individuals earning more than Rs. 10 crore a year to be taxed at 35 per cent.

(iii) No changes in other tax slabs for individuals.

(iv) Age for senior citizens relaxed to 60 years from 65 years.

(v) Levy of an additional 10 per cent if the dividend income exceeds Rs. 1 crore.

(vi) Financial assets included under the ambit of wealth tax as compared to only physical assets at present – to be taxed at the rate of 0.25 per cent. Net wealth not subject to tax proposed to be increased to Rs. 50 crores (up from Rs. 30 lakh).

(vii) Rationalisation of provisions related to non-profit organisations.

(viii) Ring-fencing of losses from business availing investment linked incentives.

(ix) Provision of Settlement Commission removed.

The enactment of most of the provisions of the DTC have already been included in the Income Tax Act by early 2015. Some of the provisions, left out, were included in the *Union Budegt 2015–16*. The Budget adds that the jurisprudence under the IT Act is well evolved and considering all these aspects there is no great merit in going ahead with the DTC as it exists today.