INCOME TAX CONCESSIONS FOR SAVINGS, HOUSI 'G AND FOREIGN EXCHANGE INFLOWS

P K AGGARWAL
A BAGCHI
A DAS-GUPTA
RITA PANDEY
M S PRASAD

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NATIONAL INSTITUTE OF PUBLIC FINANCE AND POLICY
18/2 SATSANG VIHAR MARG
SPECIAL INSTITUTIONAL AREA
NEW DELHI 110 067

Executive Summary of Major Recommendations for Reform of Income Tax Concessions

A. Concessions for Saving

Our income tax laws currently contain several provisions intended to encourage saving in specified forms. Despite efforts to rationalise them, these provisions do not constitute a well designed package which could help generate more savings or induce their flow into desired channels in a cost effective manner. A careful analysis of the scheme would show that they have the effect of:

i. Causing wide divergence in the rates of return on different categories of assets for which it is difficult to find any rationale but which can cause misallocation of resources;

ii. Raising rates of return on several incentives beyond levels which would normally be available even in the open market;

iii. Causing undue drain on the exchequer.

iv. Creating complications in the law, and thereby problems for administration and compliance, because of the multiplicity of the incentives and opportunities of abuse they open up. Several of the provisions are practically inoperative.

A thorough overhaul of the savings schemes which have evolved over the years as a result of ad hoc changes made from time to time is needed. It would not, however, be realistic to expect that the schemes could be rationalised all at one stroke. However a move could be made towards a more rational structure of savings incentives in the Income Tax Act. Possible alternatives are considered below:

I. Best Alternative

In order to curtail loss of tax revenue, enlarge the tax base and improve horizontal and vertical equity of the income tax without any sacrifice in tax revenue, the ideal course would be to remove all provisions which lead to concessional taxation of saving and, instead, raise the rate of interest on government bonds or government financial instruments used for borrowing from the public. Such a course of action would, however, have to be phased in over a number of years. For immediate implementation two alternative courses of action are proposed below.

II. Second best but less drastic reform

II.1 All financial saving may be brought within the purview of a single "netting" scheme on the lines of the National Saving Scheme (NSS) under Section 80CCA. The current schemes under Sections 80CCA and 80CCB may be modified as follows:

i. To make the "netting" scheme more attractive, the lock-in period should be reduced from 3 years to 1 year but not less than one year in order to guard against misuse.

ii. There should be a minimum withholding tax on withdrawal of funds at the rate of 20%.

iii. There should be no ceiling on the total investment permitted under this scheme in a year. However ceilings may be recommended for specified assets such as for mutual funds, personal equity plans and investment to finance house construction. This would require amalgamation of Sections 80CCA and 80CCB with necessary redrafting.

iv. The list of specified assets may be increased to include, besides the NSS and LIC schemes, schemes currently covered by Sections 10(15)(i) (except post office savings bank accounts); 10(15)(iib); 10(15)(iic); 10(15)(iv)(h); 10(15)(iv)(i); 80L (public sector or government assets only); 88 and 88A. Reinvestment in housing should also be included. To prevent tax favour to luxury housing only housing as approved by the National Housing Bank should be permitted reinvestment benefits.

II.2 In the case of Post Office Savings Bank accounts, exemption may continue as at present given its importance to small saving.

II.3 The current tax concession under section 80L may be replaced by a tax rebate at the minimum tax rate (20 per cent) subject to a ceiling of Rs 6000. This will be available only for return on assets not eligible for "netting" (such as bank deposits and company shares). In the case of dividend income an additional rebate equal to 20 per cent of the gross amount of dividend earned may be allowed to relieve double taxation. Deductibility as at present should continue only if the need for such a measure to encourage capital markets is felt.

II.4 Provisions governing reinvestment of capital gain will now become unnecessary. Thus, Sections 53, 54, 54B, 54D, 54E, 54F may be removed.

II.5 Concessional treatment of long term capital gain may be removed provided NHB approved housing is treated as a specified asset in the netting scheme.

II.6 Certain types of cash inflows currently exempt (e.g. monies received on maturity of life insurance policies and payments from provident funds) should be brought within the ambit of income or capital gains taxation. The "cost of acquisition" of LIC policies should be the sum of premia paid <u>less</u> premia that would have been payable on a "whole life policy without profits" for an equivalent insured sum and age of purchase of the policy. Alternatively, the cost of acquisition could be computed at a flat rate equal to 60% of the premium paid. Provident funds will receive appropriate treatment provided assets now covered by Section 88 start receiving netting treatment.

III. An Alternative Package with Marginal Reform

If none of the schemes recommended above seem to be workable in the short run, a third alternative may be considered which would involve marginal reform.

III.1 Revision of the netting scheme u/s 80CCA in line with recommendations II.1(i) to II.1(iii) and extension of the list of assets as in II.1(iv) except for sections 88,88A and 80L.

III.2 Continuation of exemption of interest on Post Office Savings Bank accounts.

III.3 Merger of provisions relating to reinvestment of long term capital gains in Sections 54, 54B, 54D, 54E and 54F. Deduction should be allowed on the basis of reinvested net consideration as currently in 54E or 54F and not on the basis of reinvested capital gain. The restriction on channels of reinvestment should be removed.

III.4 As in recommendation II.6. Only interest and the employers contribution to provident fund should be taxed as income of the previous year when it is withdrawn.

III.5 Redrafting of Section 45(6) may be required to bring about consistency in the use of the word "repurchase" (of units at the time of termination of the plan being dealt with) vis-a-vis Section 80CCB(2).

III.6 Section 80L should continue in its present form or be replaced by a tax credit equal to 20% of interest or dividend earned. The rebate on dividend income could be higher at 60% in view of the corporation tax currently at 40%. This benefit should be available only for return on assets not coming within the qualifying portfolio under the netting scheme outlined above or within the purview of Sections 88 and 88A.

B. Concessions for Housing

B.1 Interest deductibility under Section 24(2) may be withdrawn. Withdrawal of Section 24(2) would help in reducing the bias against rental housing and would also reduce the bias in favour of financing out of borrowed funds. If complete withdrawal is felt to be too abrupt, deductibility should be replaced by a tax rebate provision to remove the regressive bias of this provision.

B.2 The extension of tax credits under Section 88 to all approved housing linked saving schemes and not just the Home Loan Account (HLA) is recommended. This should promote greater savings to finance home ownership. Alternatively, if recommendations in A.I are accepted interest rates may be lowered.

B.3 Tax benefits to the HLA scheme of the NHB are unduly liberal and may be reduced without any adverse impact.

a. Rebate under Section 88 may be limited only to contributions to HLA rather than to both contributions and interest earned on contributions.

OR

b. Interest on loans from housing linked saving schemes should be based on the initial quantum of loan disbursed rather than on the current slab basis.

B.4 The restriction on investment of long term capital gains in more than one house in Section 54F(2) should be removed. This recommendation should apply, mutatis mutandis, if reinvestment provisions are clubbed as recommended earlier.

C. Recommendations for Rationalising the Tax Concessions to Encourage Inflow of Foreign Exchange

C.1 In the case of Sections 80R, 80RR and 80RRA there is no rationale for keeping them separate. They may, consequently, be amalgamated into one. Furthermore, only income in foreign currency brought into India should be taxed at a concessional rate and not income earned. The concessional rate should be given in the form of a tax rebate equal to 30 per cent of the income brought in (or nil if the rebate exceeds the tax due) and 40% in the case of authors, playrights, etc. as listed in Section 80RRA.

C.2 For foreign exchange investment in shares the provisions for tax exemption on reinvestment in capital gain in specified assets under Section 115F need amendment to continue tax concessions if sales proceeds from a foreign exchange asset are reinvested in similar assets within a period of thirty six months of the purchase of the foreign exchange asset.

C.3 To encourage export of services, an area of strength in India, income in foreign exchange earned under the head "income from business or profession" should be given concessional treatment as recommended above for Sections 80R, 80RR and 80RRA. This may entail consequent modification to Section 80HHC. However Section 80HHC needs examination separately.

PREFACE

The fiscal situation in India has deteriorated markedly in recent times due to the growing gap between government outlays and revenue receipts and the rising import bill. Careful yet speedy reform of the fiscal system is called for to reduce fiscal pressures on the government budget on a sustained basis. The need for hard decisions has been further underscored by the recent events in the Persian Gulf which will continue to have an adverse impact on the resource position in India for some time to come.

After exhibiting a spurt in the first few years of the Seventh Plan, growth of collection from personal income tax seem to have levelled off. While the factors underlying this trend call for investigation on several fronts, a feeling persists that the income tax base continues to be eroded by a plethora of concessions and incentive provisions. The Direct Taxes Cell at the NIPFP, set up less than two years ago with funding from the Central Board of Direct Taxes, has carried out several studies designed to help improve the revenue performance and economic influence of direct taxes in India.

The analysis of income tax concessions contained in this report was carried out by the Direct Taxes Cell of the NIPFP at the instance of the Central Board of Direct Taxes. The focus of the study, on savings concessions, housing concessions and concessions to encourage the inflow of foreign exchange, was chosen keeping in view the pressing budgetary problems of the government, the need to rationalise the structure of incentives to financial markets, the priority currently being accorded to housing and the precarious foreign currency reserves of the country. The study was completed in time for the budgetary exercises preceding the announcement of the Union budget for 1991-92.

The study team consisted of Pawan Aggarwal, Arindam Das-Gupta, Vijaya Devi, P.N. Jhingon, K. Kannan, Rita Pandey, M.S. Prasad and Naveen K. Singh. The Director of the NIPFP, Amaresh Bagchi, provided overall supervision. Authorship and research assistance details are as follows:

Pawan Aggarwal carried out the analysis in Chapters 3 and 4 and also wrote these chapters.

Arindam Das-Gupta prepared Chapter 1 (the overview) and, along with K. Kannan, the Appendix. He also helped prepare the executive summary and compiled the entire report to bring about a measure of stylistic unity and remove repetition.

Vijaya Devi provided computational assistance to Rita Pandey for Chapter 5 of the Report.

P.N. Jhingon helped to compile information on housing concession.

K. Kannan collected the material for the Appendix and helped to prepare it.

Rita Pandey authored Chapter 5.

M.S. Prasad assembled the material in Chapter 2, authored this chapter and provided necessary guidance to K. Kannan.

Naveen K. Singh of the computer centre provided competent programming and data processing support for Chapters 3, 4 and 5.

The Director, Amaresh Bagchi, carried out the final revision of the report including the Executive Summary.

While primary responsibility for the various chapters is as just stated, the report is a team-effort in the best sense of the term.

The Authors

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CONTENTS

CHAPTER 1

Overview of the Study and Recommendations for the Reform of Concessions Under the Income Tax Act

1.1 Introduction

In most countries the personal income tax system contains complex provisions designed to serve a wide variety of objectives. While their efficacy in achieving these objectives is often open to doubt, they lead to much variation in the tax base across assessees, open up loopholes and create complications in enforcement. A common method of introducing variation in the tax base across assessees is through exemptions, deductions and tax credits or rebates. The Indian income tax has many such provisions. It is now widely felt that if the tax system is to be improved to make it fair, simple and productive of revenue, these provisions should either be removed or reduced to a minimum and also redesigned to serve these objectives better.

Tax reliefs have been inserted from time to time to achieve specific objectives or under special circumstances. However, in some cases, these reliefs continue despite having outlived the initial purpose for which they were introduced. In other cases they come into conflict with goals which newly inserted provisions are meant to serve. Consequently there is need, from time to time, to undertake a comprehensive examination of existing relief provisions in order to rationalise them. New knowledge and experience may also be taken advantage of in doing so.

Here, some recommendations are made for the reform of three sets of incentives: those applying to savings, those meant for encouraging investment in housing and those designed to encourage the inflow of foreign exchange into the country. Evaluation and recommendations for saving concessions are taken up first. Thereafter, incentives for housing and then foreign exchange are considered.

1.2 Tax Concessions for Saving

Under the Income Tax Act, 1961 there are 11 major provisions which provide for taxation of saving at a less than normal rate. Relief is provided through exemption of certain types of income, deductibility of investment in some assets, tax credits linked to investment in certain other assets, deductibility upto a limit for another group of assets and postponement of tax liability in the case of yet other assets. Some assets even receive multiple relief from taxation. In addition, there are indirect incentives through concessional taxation of capital gains and relief on reinvestment of proceeds from asset sales. These provisions are described further in chapter 2 of this report.[1]

With the exception of some equity share issues and certain interest bearing instruments, most savings instruments receiving concessional treatment are government assets. Has concessional treatment encouraged saving? Has saving in government assets led to an enhancement in the resources available to the government? Are most concessions equitable? These are some of the questions that need to be taken up to arrive at appropriate recommendations. The summary below is based largely on the analysis in Chapters 2 to 4 of this study.

a. Summary of Findings on Tax Concessions for Saving

(i) Has concessional treatment encouraged saving?

A firm answer to this question is not possible due to two reasons. First, many assets enjoy saving incentives through exemption of income. For example, under Section 10(15)(i), fourteen schemes (some now discontinued) qualify for interest exemption either fully or upto a specified limit (see Chapter 2). Information on exempt income is not required to be reported in the return on income. Thus, no ready information is available on them. Secondly, schemes enjoying tax concessions may attract funds away from assets not enjoying concessions without any real increase in the overall savings rate by taxpayers. For both these reasons it is difficult to assess the savings impact of concessional treatment of saving. Nevertheless, figures given for some schemes in Chapter 2 show that, on a schemewise basis, several schemes have been successful in attracting saving.

(ii) Has saving in government bonds led to enhancement in government resources?

As mentioned, most financial instruments receiving concessional treatment are such that savings in these schemes become available to the government. However, this does not

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1. Concessions relating to housing and those designed to encourage foreign exchange inflows are also treated along similar lines in Chapter 2. The Appendix presents comparative international information mainly on saving and housing concessions.

necessarily imply that this augments government resources. First, savings mobilisation is at the expense of taxes. Lost taxes should therefore be netted out of savings which become available to the government. Secondly, the government must pay interest on saving in government assets. Such interest, besides being an additional drain on government resources, is very often coupled to additional tax concessions. Thus, after the initial years of a savings scheme it is likely that there will be a net drain in revenue. In Chapter 3, computations as to the cost of deductions in terms of tax revenue forgone are given. These computations are based on returned income data relating to about 50,000 individual Income Tax assessees and relate to the assessment year (AY) 1987-88.

On the basis of this sample it is estimated that deductions for saving under Sections 80C, 80CC and 80L amounted to Rs 2978 crore and gave rise to tax saving (and so revenue loss) of Rs 953 crore. This is equal to about 33per cent of total non-corporate income tax collection in that year. It should be emphasised that only one set of tax concessions is being examined here. Taking into account other deductions and also exemptions, it is possible for taxes forgone to exceed total tax collection.

What about total government cash inflows from funds invested in government securities? Take the example of a government bond which allows, a 20 per cent income tax rebate (or deduction with identical tax saving to investors) and pays tax-free interest at 8 per cent per annum over a period of 6 years. Imagine that the number of taxpayers increase at 3 per cent per year in a uniform manner so that purchases of this bond also increase by 3 per cent per annum. Table 1.1 gives the overall budgetary implications of this scheme. The figures reflect net budgetary inflows or outflows over the years (on account of the scheme) assuming Rs 100 of the bond is purchased by assessees in the year in which the scheme is introduced. From the table it can be seen that the government has a net budgetary gain of Rs 393 during the initial years of the scheme. Thereafter, there is a net drain on the budget between the 6th and 34th year after the inception of the scheme totalling Rs 920. The scheme gives rise to net budgetary inflows on a sustained basis only from the 35th year. A 4 per cent growth rate of the number of taxpayers improves the situation - but not by much.

Taking into account the various points made, it is hard not to be pessimistic about the effect of savings schemes on government revenues in the medium term. The available data, however, are inadequate to permit a firm conclusions as to the impact on government revenue. One relevant inference can, however, be drawn from the scheme by scheme analysis in Chapter 4. In several cases, especially for assessees in high tax brackets, effective interest rates paid by the government are higher on schemes enjoying concessions than on, for example, debentures of

Indian companies.[2] It is likely that overall revenue losses could be curbed, if tax concessions were watered down, without significant loss of savings flowing into government schemes. This would result in a net increase in budgetary resources as compared to their present level.

(iii) Are savings concessions equitable?

An attempt to improve equity features of savings concessions was made through the Finance Act of 1990. This was done by replacing deductions for investment in certain assets by tax credits (rebates). However, concessions to saving still act to reduce the progressivity of income taxation. In Chapter 4, the following inferences are drawn.

a. Given that most individuals are below the taxable limit in India any dilution of effective tax rates lowers progressivity.

b. Exemptions, deductions and netting based saving incentives enable assessees at higher marginal tax rates to obtain better effective interest rates on their saving.

c. Rebates or tax credits result in higher bracket taxpayers receiving higher effective interest rates than taxpayers in lower marginal tax brackets. However, interest rates received by some taxpayers remain higher than interest rates received by non-taxpayers. Even among taxpayers, if rebate is allowed on accrued interest in addition to the rebate on investment (as with the NSC VIII issue) upper bracket bracket taxpayers get higher subsidies (as opposed to effective interest rates) through the tax system.

d. Indirect concessions to saving through capital gains concessions are also regressive.

That savings incentives are, in principle, inequitable may not have much practical relevance if they are not extensively used by the rich. However, as shown in Chapter 3, tax saving in AY 1987-88 as a percentage of gross income was least for taxpayers whose income was below Rs 25,000. Savings incentives were regressive in practice and not just in principle. Among the most regressive concessions are the indirect concessions applicable to capital gains via Section 80T (since replaced by Section 48(2)).

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2. For example, the effective interest rate on HUDCO capital gains debentures is 23% for an assessee in the 50% marginal tax bracket. See Chapter 4, Table 4.3.

The points above all relate to vertical equity. It is clear that different effective tax rates applied to savers and non savers and indeed, different categories of savers, reduce horizontal equity of the income tax.

As a final point it may be pointed out that savings concessions as they currently stand distort the structure of interest rates and impair the efficiency of capital markets (Chapter 4).

b. Recommendations for concessional treatment of saving

i. <u>The first alternative</u>

i.1 In order to curtail loss of tax revenue, enlarge the tax base and improve horizontal and vertical equity of the income tax without any sacrifice in tax revenue, the "first best" solution is the removal of all provisions which lead to concessional taxation of financial or non-financial saving. This would mean removal of at least the following sections of the Act: 10(15)(i); 10(15)(iib); 10(15)(iic); 10(15)(iv)(h); 10(15)(iv)(i); 80CCA; 80CCB; 80L; 88 and 88A. Section 48(2) applicable to capital gains especially long term gains should also be removed. Thirdly certain types of cash inflows currently exempt (e.g. monies received on maturity of life insurance policies and payments from provident funds) should be brought within the ambit of income taxation.[3]

i.2 Instead of concessions, higher interest rates should be offered on government saving schemes. In fact the number of saving schemes may itself be reduced. If interest rates are pegged at about half or one percentage point higher than the debentures rate (that is, about 16 per cent) there should be no loss of government revenue.

One possible objection to this recommendation is that this will lead to a greatly increased interest burden on government saving schemes especially since existing saving currently in other forms will flow into government schemes. This fear is unfounded. If government saving schemes are currently being subscribed to by the public, it must be the case[4] that the

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3. The recommended basis for taxation of these inflows is described in recommendation ii.6 below.

4. Except where lack of information or difficulty of access to post offices or government agencies dealing with these schemes act as a barrier. Since these features may be expected to continue, the argument is not vitiated.

effective rate paid by the government, inclusive of tax concessions, exceeds the effective interest rate on alternatives. Furthermore, substitution to government assets from other schemes can occur even now. The only difference will be that poor persons will, with high interest rates, receive better returns to their saving than the rich.

A second objection relates to capital gain. Concessions to long term capital gain are often justified on the grounds that inflation erodes the real value of capital gain realised on an asset sale. Secondly, for large value assets, taxation at a high rate when the gains are realised in a lump is considered draconian. The first argument is not correct. The relevant criterion is that assets with the same effective return in the absence of taxes should continue to have the same return after taxes. In fact, even with no concession to capital gain, postponement of tax liability till realisation of proceeds on the asset results in tax favour to assets which have their return in the form of capital gain rather than interest, given the same effective pre-tax yield. The second argument is correct. However, this relates to all lumpy receipts and not just capital gains. The correct treatment is, therefore, an averaging provision applicable to all lumpy receipts and not just to long term capital gains.

A third possible objection is that such sweeping reform would greatly disturb existing plans of assessees and interfere with current arrangements in capital markets. This argument has some merit. Therefore an alternative, second best, proposal can be given.

(ii). Second best but less drastic reform

ii.1 All financial saving may be brought within the purview of a single "netting" scheme on the lines of the National Saving Scheme (NSS) under Section 80CCA. The current schemes under Sections 80CCA and 80CCB may be modified as follows:

a. To make the "netting" scheme more attractive, the lock-in period should be reduced from 3 years to 1 year but not less than one year in order to guard against misuse.

b. There should be a withholding tax at the minimum marginal tax rate (currently 20 per cent) on withdrawal of funds. A careful re-examination of the refund procedure in case of excess withholding may be required to minimise inconvenience to individuals below the taxable limit .

c. There should be no ceiling on the total investment permitted under this scheme in a year. However ceilings may be recommended for specified assets such as for mutual funds, personal equity plans and investment to finance house construction. However, additional restrictions on housing investment may be placed along the lines described below.[5] This would require amalgamation of Sections 80CCA and 80CCB with necessary redrafting.

d. The list of specified assets may be increased to include, besides the NSS and LIC schemes, schemes currently covered by Sections 10(15)(i) (except post office savings bank accounts); 10(15)(iib); 10(15)(iic); 10(15)(iv)(h); 10(15)(iv)(i); 80L (public sector or government assets only); 88 and 88A. Investment and reinvestment in housing should also be included. To prevent tax favour to luxury housing only housing approved by the National Housing Bank should be permitted reinvestment benefits.

ii.2 In the case of Post Office Savings Bank accounts, exemption may continue as at present given its importance to small saving.

ii.3 The current tax concession under Section 80L may be replaced by a tax rebate at the minimum tax rate (20 per cent) subject to a ceiling of Rs. 6000 or Rs. 7000. This will be available only for return on assets not eligible for "netting" (such as bank deposits and company shares). In the case of dividend income an additional rebate equal to 20 per cent of the gross amount of dividend earned may be allowed to relieve double taxation. Deductibility as at present should continue only if the need for such a measure to encourage capital markets is felt.

ii.4 Provisions governing reinvestment of capital gain will now become unnecessary. Thus, Sections 53, 54, 54B, 54D, 54E, 54F may be removed.

ii.5 Concessional treatment of long term capital gain may be removed provided NHB approved housing is treated as a specified asset in the netting scheme.

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5. Investment to finance house construction could include housing linked saving schemes, actual outlays on house construction and proceeds from asset sales set aside for reinvestment in housing as under the existing Capital Gains Account Scheme.

ii.6 Certain types of cash inflows currently exempt (e.g. monies received on maturity of life insurance policies and payments from provident funds) should be brought within the ambit of income or capital gains taxation. The "cost of acquisition" of LIC policies should be the sum of premia paid less premia that would have been payable on a "whole life policy without profits" for an equivalent insured sum and age of purchase of the policy. Alternatively, the cost of acquisition could be computed at a flat rate equal to 60 per cent of the premium paid. Provident funds will receive appropriate treatment provided assets now covered by Section 88 start receiving netting treatment.

This set of recommendations, even if not taken up immediately, should be phased in over the next few years if the first set of recommendations cannot easily be taken up. Even though a netting scheme continues to give tax favour to upper income groups from the point of view of annual income comparisons, such concessions will be limited given a minimum tax on withdrawal. Furthermore, concessions are less regressive than they first appear to be if viewed from the perspective of total lifetime income.

iii. An alternative package with marginal reform

As a third best set of policies which are even less sweeping, the following package can be considered.

iii.1 Revision of the netting scheme under Section 80CCA in line with recommendations ii.1(a) to ii.1(c) and extension of the list of assets as in ii.1(d) except for Sections 88,88A and 80L.

iii.2 Continuation of exemption of interest on Post Office Savings Bank accounts.

iii.3 Merger of provisions relating to reinvestment of long term capital gains in Sections 54, 54B, 54D, 54E and 54F. Deduction should be allowed on the basis of reinvested net consideration as currently in 54E or 54F and not on the basis of reinvested capital gain. The restriction on channels of reinvestment should be removed.

iii.4 As in recommendation ii.6 for life insurance. Interest and the employers contribution to provident funds should be taxed as income of the previous year on withdrawal and these sums should be deemed to be withdrawn prior to own contributions.

iii.5 Section 80L should continue in its present form or be replaced by a tax credit equal to 20 per cent of interest or dividend earned. The rebate on dividend income could be higher at 60 per cent in view of the corporation tax currently at 40 per cent. The tax credit should not be allowed to result in a negative income tax and, if desired, limited to Rs. 6000 or Rs. 7000.

This benefit should be available only for return on assets not coming within the qualifying portfolio under the netting scheme outlined above or within the purview of Sections 88 and 88A.

1.3 Tax Concessions for Housing

a. Summary of findings

Housing construction, especially for low income households is currently a priority activity. Various concessions are given to housing under the Income Tax Act for this and other reasons. Concessions are of three main types (See Chapter 2 for a more complete description): Concessional treatment of income from house property; concessional treatment of long term capital gains from a housing or other asset sales reinvested in housing; and tax concessions for housing investment. These concessions are available either directly to homeowners in self occupation, owners of rental dwellings or as concessions for equity or loan investment in housing construction or finance companies.

It is difficult to determine whether or not these concessions have had an impact on housing construction activity or home ownership in the absence of reliable data. Likewise, the overall cost to the government in terms of revenue foregone is difficult to assess.[6]

Nevertheless, on the basis of the analysis in Chapter 5, the following major conclusions can be reached about housing concessions under the income tax.

a. Given exemption of the imputed rental on owner occupied housing and deductibility of mortgage interest, a home owner can end up with a negative income tax liability. Consequently, tax treatment of owner occupied housing is more favourable than treatment accorded to tenant occupied housing. In fact, since rental housing is not allowed depreciation (unless these are industrial or commercial assets), it may be taxed more heavily than other assets.[7] For housing with the

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6. Some figures are provided, however, in Chapter 3 for deductions under Section 23(1), 24(2) and the discontinued Section 80T. Also, revenue loss calculations on the basis of simulation exercises are in Chapter 5.

7. Lack of depreciation has to be set against the tax credit allowed to mortgage repayment and, in some cases, "new construction allowance".

characteristics given in Table 1.2 below (see, Chapter 5) the value of owner occupied housing is 164 per cent of the initial cost of the house while, for the same house, tenant occupation leads to losses.

b. Mortgage interest deductibility under Section 24(2) and long term capital gains concessions applicable on sale of the house under Section 48(2) favour taxpayers in upper income brackets more than non-taxpayers or taxpayers in low income brackets.

c. Concessions via Section 24(2) and Section 88 are biased in favour of debt finance rather than finance out of own funds.

d. Of concessions available to housing, Section 48(2) concessions to long term capital gains lead to the greatest revenue loss to the exchequer. The estimates in Chapter 3 show that revenue loss under Section 80T (replaced subsequently by Section 48(2)) was Rs 99.44 crore. Under the assumptions of Chapter 5, concessions under Section 48(2) decrease financial returns to housing by 18.33 per cent. Section 88 lowers the financial returns by a further 6.45 per cent while the concession under Section 24(2) lowers the effective price by a further 5.8 per cent.

e. In the case analysed in Chapter 5 the effective interest rate on housing mortgage loans falls, in real terms, from about 7.3 per cent to about (-)8.8 per cent on account of tax concessions. This implies subsidies to housing through concessional mortgage interest. For the more liberal HLA scheme, however, the impact of tax concessions is to lower the real effective loan interest rate to about (-)40 per cent.

f. If a house is purchased and subsequently sold with 40 per cent of the price being paid and received in unaccounted funds, the return from the house, assuming the illegal transactions do not come to light, is about 71 per cent higher than in the case of a white transaction. If, indeed, the house is bought from a public housing authority but sold against part (40 per cent) black payment, the value is about 88 per cent higher than in the all white case. It is also possible that tax concessions accord greater favour to those who buy or sell housing against partially black funds.

b. Recommendations for housing concessions

On the basis of the analysis of housing concessions in this study, the following recommendations can be made:

b.1 Interest deductibility under Section 24(2) may be withdrawn. Withdrawal of Section 24(2) would help in reducing the bias against tenant-occupied housing and would also reduce the bias in favour of financing out of borrowed funds. If complete withdrawal is felt to be too abrupt, deductibility should be replaced by a tax rebate provision to remove the regressive bias of this provision.

b.2 The extension of tax credits under Section 88 to all approved housing linked saving schemes and not just the Home Loan Account (HLA) is recommended. This should promote greater savings to finance home ownership. Alternatively, if recommendations in A.I are accepted interest rates may be lowered.

b.3 Tax benefits to the HLA scheme of the NHB are unduly liberal and may be reduced without any adverse impact.

a. Rebate under Section 88 may be limited only to contributions to HLA rather than to both contributions and interest earned on contributions.

OR

b. Interest on loans from housing linked saving schemes should be based on the initial quantum of loan disbursed rather than on the current slab basis[8].

b.4 The restriction on investment of the net consideration in more than one house in Section 54F(2) should be removed. This recommendation should apply, mutatis mutandis, if reinvestment provisions are clubbed as recommended earlier.

b.5 To further redress the bias against tenant-occupied housing, it is recommended for further consideration that owners of rental housing be allowed to claim depreciation even in the case of individual owners. This should be at the rate allowed to residential houses owned by industrial undertakings (5 per cent). A more generous depreciation allowance may be considered on Low

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8. See Chapter 5, footnote 14.

Income Group (LIC) housing parallel to higher rate of depreciation (20 per cent) allowed to industrial undertakings on buildings having dwelling units with plinth area upto 80 square meters.

1.4 Tax Concessions to Encourage Inflow of Foreign Exchange

Currently, the following sections and sub-sections provide reliefs likely to encourage foreign exchange inflows.

i. Section 10(4)(i): Exemption of interest and premium on redemption of notified securities.

ii. Section 10(4)(ii): Exemption of Non-Resident (External) Accounts.

iii. Section 10(4B): Exemption of interest in notified savings instruments in case of investments made in convertible foreign exchange.

iv. Chapter XII-A: Special concessions for income of non-residents.

v. Sections 80R, 80RR and 80RRA: Deductions available to income of residents earned abroad.

In view of the precarious foreign exchange position, inflows of foreign exchange need to be encouraged. At the same time, the cost to the exchequer needs to be weighed. The following recommendations can be made.

c.1 In the case of Sections 80R, 80RR and 80RRA there is no rationale for keeping them separate. They may, consequently, be amalgamated into one. Furthermore, only income in foreign currency brought into India should be taxed at a concessional rate and not income earned. The concessional rate should be given in the form of a tax rebate equal to 30 per cent of the income brought in (or nil if the rebate exceeds the tax due) and 40 per cent in the case of authors, playrights, etc. as listed in Section 80RRA. It may be added that this recommendation will require efficient functioning of the machinery to enforce the Foreign Exchange Regulations Act. If this is not considered a practical possibility, then the only viable alternative is not to tax foreign exchange earnings at all.

c.2 For foreign exchange investment in shares, the provisions for tax exemption on reinvestment of capital gain in specified assets under Section 115F need amendment to continue tax concessions if sales proceeds from a foreign exchange asset are reinvested in similar assets within the minimum period allowed for long term capital gain treatment from the purchase of the foreign exchange asset. A grace period for this purpose may be allowed on the lines of existing reinvestment provisions. Consequent amendment of Section 115E may also be necessary.

c.3 To encourage export of services, an area of strength in India, income in foreign exchange earned under the head "income from business or profession" should be given concessional treatment as recommended above for Sections 80R, 80RR and 80RRA. This may entail consequent modification to Section 80HHC. However Section 80HHC needs examination separately.

c.4 A Non-Resident Indian should continue to receive concessions under Section 115E in the event of renewal during his lifetime of deposits with an Indian public company.

c.5 Inclusion of shares of Indian companies for continuation of concessional treatment under Section 115H needs consideration (see Chapter 2, part 2.5).

c.6 Granting of permission under Section 115G to authorised dealers to remit income from debentures and certain other securities (in addition to dividend income as is currently allowed) should be considered.

1.5 Additional Recommendations for Reform to Remove Problems with Implementation of Existing Provisions

d.1 Redrafting of Section 45(6) may be required to bring about consistency in the use of the word "repurchase" (of units at the time of termination of the plan being dealt with) vis-a-vis Section 80CCB(2).

d.2 As discussed in Chapter 2, necessary verbal amendments to the notified scheme under Section 10(15)(iv)(i) do not appear to have been carried out after the concession was extended to public sector employees in 1991. Necessary amendments should be carried out if the section is retained.

d.3 Extension of permission to contributors to use their credit balances in the Jeevan Dhara Plan of the Life Insurance Corporation of India as collateral for loans in case of urgent need may be considered.

d.4 In Section 87, the phrase `sections 88 or 88A´ should be replaced by the phrase `sections 88 and 88A´ if these sections are retained.

d.5 The bias in favour of borrowed funds for investment in a residential house under Section 88(2)(xv) needs review.[9]

d.6 National Savings Certificates of Series VIII should be notified under Section 10(4B) if the section is not withdrawn or replaced.

d.7 The status of banks with respect to Section 2(26)(4) should be clarified.

1.6 Outline of the Report

In Chapter 2, income tax concessions studied in this report are described along with a discussion of their genesis and motivation. Relevant statistics that help to appreciate the impact of these concessions are also presented. In Chapter 3, empirical estimates of the impact of selected savings and housing concessions are presented. These estimates use return based data on a large sample of assessees during AY 1987-88. In Chapter 4, the impact of tax concessions on the effective return to investors, on government revenues and on the progressivity of the tax system for 26 financial saving schemes, is analysed. These calculations are in terms of the per rupee investment in these schemes by investors in each marginal income tax bracket. In Chapter 5, the impact of housing concessions on the price of housing, housing demand, the cost of housing loans, government revenues and the progressivity of the tax system are examined. Numerical estimates in the chapter are based on simulations under alternative sets of assumptions. In the Appendix a review of tax concessions to saving and housing in selected countries is given.

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9. See Chapter 2 for details.

TABLE 1.1

Implications of a Hypothetical Government Saving Scheme

	Assumptions	(a)	(b)
a.	Rate of increase per annum of number of assessees	3%	4%
b.	Annual interest rate on scheme (per annum)	8%	8%
c.	Rate of initial tax rebate on investment	20%	20%
d.	Lock-in period of scheme	6 years	6 years
	Findings		
e.	Inflow during first six years of scheme if Rs. 100 is invested in the first year	392.56	404.04
f.	Years between which there is cash outflow from the scheme	Year 6 & year 34	Year 6 & year 24
g.	Total cash outflow between the years indicated at item (f)	Rs 920.01	Rs 567.30

TABLE 1.2

Assumptions used in Analysis of the Impact of Tax Concessions on Housing

	Item	Cases		
		White money only		40% black money
		Self occupied	Tenant occupied	self occupied
1.	Initial cost of house (Rs lakh)	2.5	2.5	6.0
2.	Of which % of cost due to land	40	40	24
3.	Ratio of actual/imputed rent to initial cost (%)	10	12	3.6
4.	Number of years after which house is sold	25	25	25
5.	Percentage of borrowed funds used to finance house purchase	40	40	24
6.	Loan terms			
	a. Interest rate (% per annum)	14[2]	14[2]	14
	b. Loan Payment period (years)	15	15	15
7.	Maintenance cost as a percentage of value of house	1.5	1.5	1.5
8.	Annual percentage rate of increase/ decrease (-) in			
	a. Imputed/actual rent	8	8	8
	b. Land value	16	16	16
	c. Value of structure	-2	-2	-2
	d. Maintenance cost	8	8	8
9.	Purchaser's real after tax rate of return on alternative investment (% per annum)	4 or 6	4 or 6	4
10.	General inflation rate (% per annum)	8	8	8
11.	Owner's marginal income tax rate (%)	30	30	30

Notes: 1. The basis of assumptions at serial numbers 2,3,6,7,8 (except 8(c)) is given in Chapter 5.

2. The case of a house financed by a loan under the Home Loan Account Scheme of the National Housing Bank is also considered. In this case deposits at 10% per annum are made over a 5 year term prior to receipt of the loan. Loan repayment term as per the HLA and not the explicit interest rate are taken.

CHAPTER 2

Concessions for Saving, Foreign Exchange Earning and Housing under the Income Tax Act

2.1 Introduction

In this chapter concessions under the Income Tax Act to specified activities are reviewed. Besides a description of various provisions, the genesis of the provisions and their underlying motivation are discussed if these are thought to be relevant. Relevant statistics, mainly pertaining to qualifying income and tax relief, are given if available. Finally, problems that appear to exist with the provisions are pointed out. Part 2.2 describes savings incentives. Part 2.3 covers concessional treatment of capital gains since this affects both savings and investment in such sectors as housing. Part 2.4 surveys housing incentives. Finally, Part 2.5 discusses concessions designed to encourage the inflow of foreign exchange.

2.2 Major Concessions for Saving

(a) Section 10(15)(i)

Under this sub-clause interest, premium on redemption, or other payment on notified securities, bonds, annuity certificates, savings certificates, other certificates issued by the Central government, and deposits, subject to the conditions and limits set in the notification are to be excluded from the total income.

This sub-clause has replaced sub-clauses (i), (ia), (ib), (ii) and (iia) by the Direct Tax Laws (Amendment) Act, 1987 with effect from (WEF) 1.4.89. These sub-clauses (other than sub-clause (i)) were inserted or amended by various acts between 1965 and 1987. Though the concession applies to all categories of assessees, it may substantially be availed of by individuals & Hindu Undivided Families (HUFs).

Under notification GSR 607(E) dated 9.6.89, the government has specified the eligible finance instruments and the maximum limit for interest, premium on redemption and other payment exempted for Assessment Year (AY) 1989-90 and onwards. These are given in Table 2.1.

Some instruments have been discontinued (e.g., serial No's. 4 to 7) but interest earned on them will continue to be exempt. Circular No. 218 dated 30.4.77 issued by the Central Board of Direct Taxes (CBDT) clarifies that if investment is made in the names of the spouse or minor child, exemption will be applicable upto the maximum amount that may be invested in the single or joint names, as prescribed in the savings certificates. Table 2.2 provides details of savings mobilised in selected schemes covered by this sub-clause. The falling off of investment in these assets in 1988-89, shown in the table, is probably due to Rs. 1940 crore mobilised by the Kisan Vikas Patra. Figures in the table give no indication as to how much of this investment is made by income taxpayers. As the income from these notified instruments is excluded from total income, there are no data regarding the tax revenue lost on account of this sub-clause. For this reason it is difficult to comment on whether the benefits accruing from this concession are commensurate with the tax revenue lost.

(b) Section 10(15)(iib)

Under this sub-clause interest from investment by individuals and HUFs in notified capital investment bonds is excluded from total income.

Capital Investment Bonds can be held by an individual in his or her name, or on behalf of a minor, or jointly with another individual and also by HUFs. The rate of interest is 7 per cent per annum and the Bonds are repayable at par 10 years from the date of issue. The bonds are exempt from wealth tax provided they are held for a minimum period of 6 months on the valuation date (Section 5(1)(xvid) of the Wealth Tax Act). Gifts made by an initial subscriber will be exempt subject to a maximum of Rs. 10 lakh in aggregate in one or more years (Section 5(1)(iiic) of the Gift Tax Act).

The objective of this clause is to stimulate savings by individuals and HUFs. Statistics on investment in capital investment bonds not being readily available, it is not possible to say whether this objective has been achieved.

(c) Section 10(15)(iic)

Interest on investment made by individuals and HUFs in notified relief bonds is exempt under this sub-clause.

This clause was inserted by the Finance Act 1988 WEF 1.4.89. 9 per cent Relief Bonds, 1987, were notified under GSR 919E dated 17.11.87 WEF 1.12.87. There is no maximum limit for investment in this scheme. Interest on such investment made by an individual in his or her name, or on behalf of a minor, or jointly with another individual or an HUF is eligible for exemption under this sub-clause. The bond has a maturity period of 5 years and carries simple interest of 9 per cent per annum. The asset is exempt from wealth tax provided it is held for at least 6 months on the valuation date. Gift of bonds made by the initial subscriber are exempt from gift tax subject to a maximum of Rs. 5 lakhs in one or more years. The bond is transferable by endorsement and delivery and can be held by banks as security for loans.

The bonds were issued for the purpose of raising additional resources to provide relief to drought affected farmers and persons in rural areas. It was initially issued for 3 months, but has subsequently been extended beyond 29.2.88.[1] Investment statistics are not available.

(d) Section 10(15)(iv)(h)

This sub-clause exempts interest on notified bonds or debentures issued by a public sector company, subject to the conditions laid down, including the condition that the holder of the bonds or debentures registers his name, and holding with a company.

This sub-clause was inserted by the Finance Act 1987 WEF 1.4.87. 15 bonds were notified under this clause between 1.4.87 and August 1988[2]. The tax-free rates of return are either 9 per cent or 10 per cent. These bonds are also notified for exemption from wealth tax under Section 5(1)(xvic) of the Wealth Tax Act.

This clause was inserted pursuant to the statement of the Finance Minister in the budget speech for 1986-87 that the government would introduce another series of public sector bonds with tax-free return. Earlier, between 1.4.1986 and 27.5.1988[3] several issues of bonds had been made by public sector companies, the taxed rate of interest being 14 per cent upto 1987 and 13 per cent in 1988. Deduction was admissible under Section 80L(1)(ii). These bonds were also exempt from wealth tax under Section 5(1)(xvie) of the Wealth Tax Act. No data on investment in tax-free bonds qualifying for exemption under this sub-clause are available.

(e) Section 10(15)(iv)(i)

Interest payable by the government on deposits made by an employee of the Central or State governments or of a public sector company in a notified scheme out of moneys due to him on

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1. Government of India, Ministry of Finance (1989).

2. Taxmann (1988).

3. Taxmann (1988).

retirement, whether on superannuation or otherwise, is exempt under this sub-clause.

This sub-clause was inserted by the Finance Act 1989 WEF 1.4.90 and the concession was extended to public sector employees by the Finance Act 1990 WEF 1.4.91. The scheme was notified by notification No. GSR 598(E), dated 7.6.89 WEF 1.7.89. Monies due to an employee on retirement, called 'retirement benefits' in the scheme, consist of the credit balance of the employee in any government provident fund, retirement/superannuation fund, gratuity, commuted value of pension, cash equivalent of leave salary and the savings element of a government insurance scheme payable to the employee on retirement. A depositor may open an account with any accounts office by depositing a sum not exceeding the total retirement benefits within 6 months of receiving them. Normally, the deposit has to be kept for a period of 3 years and earns interest at 9 per cent per annum. Premature withdrawal is allowed after one year from the date of deposit. If such a withdrawal is made, interest will be reckoned on the withdrawal at 4 per cent per annum till the date of withdrawal. The depositor may continue the account after 3 years elapse, at the same rate of interest. The deposit is not includible in net wealth under Section 5(1)(xxviic) of the Wealth Tax Act and the Rs. 5 lakh limit in Section 5(1A) is not applicable to it. **After public sector employees became eligible for the concession, corresponding verbal amendments do not appear to have been carried out, for example, in the definition of retirement benefits in para 1(d).**

The object of the clause is stated to be to obviate the need for retiring government employees to seek alternative sources in which to invest their retirement benefits and also to maintain the level of funds in various employee welfare schemes. Thus the government has access to the retiree's funds for the lock-in period of 3 years.

(f) Section 80CCA

The original Section 80CCA inserted by the Finance Act 1987 WEF 1.4.88 was substituted by the Finance Act 1988 from the same date. Sub-section (1) says that if an individual, HUF, or specified Association of Persons (AOP)/ Body of Individuals (BOI) deposits any amount in the notified National Savings Scheme (NSS), or pays any amount to effect or keep in force notified annuity plans of the Life Insurance Corporation of India (LIC) (to be notified under Section 80CCA (1)(ii)) out of income chargeable to tax, the sum deposited (excluding interest or bonus accrued or credited to the account, if any) will be eligible for a 100 per cent deduction, subject to a ceiling of Rs. 40,000 per annum from AY 1991-92. Sub-section (2) states that if any sum standing to the credit of the taxpayer under the NSS, which had been allowed as a deduction under Sub-section (1), together with accrued interest is withdrawn wholly or partly in any year or is received on surrender of the annuity policy or as annuity or bonus in any previous year, such a sum will be deemed to be the income of the previous year in which the withdrawal is made or the amount is received. Explanation I makes it clear that the accrued interest in the NSS will be chargeable only on withdrawal. Sub-section (3) inserted WEF 1.4.91 says that if there is a partition of the HUF or dissolution of the AOP after a deduction has been allowed, the provisions of Sub-section (2) will apply as if the person in receipt of the income referred to in the sub-section is the assessee.

Under the NSS Rules, 1987 only one withdrawal is permitted in an year, provided the amount of the withdrawal does not exceed the balance at the end of the fourth preceding financial year less withdrawals already made. There is thus a lock in period of 3 years. The notified rate of interest is 11 per cent per annum at present.

Under the notified Jeevan Dhara Plan of the LIC premia can normally be paid for upto 35 years. At the end of the contract period (deferment period) the LIC starts payment of the monthly annuity. The pension starts at a vesting age of not below 50 and not above 65. If death takes place within 3 years of the policy, only the total amount of the premia are returned. After 3 years but before the deferment period, the premia are returned with interest (6.5 per cent per annum). After the deferment period and vesting age, heirs are paid a lumpsum called Gross Insurance Value Element (GIVE) plus a final bonus. The policy can be surrendered after three years, but before the annuity vests, for an amount equal to 90 per cent of premiums paid excluding the first year premium. It cannot be surrendered after it vests. There is no provision for commutation, for assignment or for using the balance as collateral for raising a loan. **That is, a person contributing to this scheme cannot withdraw any sum for urgent needs, even as a loan, after the lock-in period.**

The notified Jeevan Akshay Plan of the LIC is meant for employees and self-employed persons aged over 50. The pension is payable for life commencing a month after the date of deposit of the premium. On death, a Guaranteed Insurance Sum (GIS) equal to the premium will be paid along with the Final Jeevan Akshay Bonus (FJAB) to heirs. No paid-up value or surrender value is permissible nor can a loan be raised against the policy.

The NSS, introduced by the Finance Act 1987, is based on the scheme suggested in the Long Term Fiscal Policy (LTFP) (Government of India, 1985). It was expected that the scheme would substantially strengthen savings, induce greater voluntary disclosure of incomes and be the first step towards the expenditure tax concept giving taxpayers an opportunity to moderate their liability to tax according to consumption over the lifetime.

The National Deposit Scheme (New Series) proposed in paragraph 5-9 of the LTFP permitted investment without any overall ceiling and without any lock-in period or limit for deposits or withdrawals. This proposal would have permitted averaging of fluctuating incomes which results in a heavier tax burden than income evenly distributed over the years. As implemented, however, there are limits for deposits and withdrawals in the NSS.

Statistics of savings in these schemes are not readily available.

(g) <u>Section 80CCB</u>

Under Section 80CCB, operation from AY 1991-92, a deduction will be allowed to an individual, HUF or specified AOP/BOI on investment made out of his chargeable income in units of mutual funds specified in Section 10(23D) or in units of the Unit Trust of India (UTI), under a notified equity linked saving scheme (ELSS), upto a ceiling of Rs. 10,000 in the previous year (Sub-section(1)). Any deducted amount returned to the assessee, either through repurchase of the units by the fund or Trust, or on the termination of the plan, will be deemed to be the income of the previous year in which the amount is returned (Sub-section 2). On partition of an HUF or on dissolution of an AOP after a deduction has been allowed to it, the amount on its return is deemed to be the income of the recipient (Sub-section(3)).

Section 45(1), amended by insertion of Sub-section (6), provides that the difference between the repurchase price of the units and the amount invested by the assessee will be deemed to be capital gains and taxed in the year in which the repurchase takes place or the plan is terminated.

Under Section 194F tax is deducted at source at 20 per cent at the time of payments referred to in Section 80CCB(2).

This concession has been stated in the Finance Minister's budget speech in 1990[4] to be based on the "netting" principle. The annual return on investment in the ELSS will be eligible for tax concession under Section 80L. On the return of any amount on which a deduction has been allowed to the taxpayer, either by way of repurchase or termination of the plan, it will be taxed as income and the excess over the cost of the units will be taxed as capital gains in the year of receipt. This provision will eventually replace the existing deduction under Section 80CC. Section 80CC has been substituted by Section 88A which allows a tax rebate instead of a deduction for AY 1990-91 only.

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4. Part B, Para 85.

(h) Section 80L

Section 80L provides for a deduction from gross total income of an individual, HUF or specified AOP/BOI of (a) interest, (b) dividends and (c) income from a mutual fund. The basic deduction is Rs. 7000, which is increased by a maximum of Rs. 3000 if the conditions in the first proviso below sec 80L(1) are satisfied. If the conditions laid down in the second proviso are also satisfied, the deduction gets enhanced by upto another Rs. 3000. Incomes eligible for deduction are:

Interest income from :

i. Instruments issued by Central or State Governments [Sub clauses (i) & (ia)];
ii. Deposits in schemes framed by the Central Government [sub clauses (iia) & (iii)];
iii. Deposits with the Post Office, Public Sector or Cooperative Banks [sub clauses (iiia) & (vi)];
iv. Deposits with approved banks or industrial finance corporations [sub clauses via) & (vii)];
v. Deposits with approved public companies registered in India giving housing finance [sub clause (x)];
vi. Deposits with Statutory Housing Boards [sub clause (viia)];
vii. Notified bonds issued by an institution or public sector company or cooperative society [sub clause (ii)];
viii. Deposits with a non-banking cooperative society by a member [sub clause (viii)].

Dividend Income from :

ix. An Indian Company [sub clause (iv)];
xi. Units of the Unit Trust of India [sub clause (v)];
xii. A cooperative society [sub clause (ix)];
xiii. An approved company registered in India providing housing finance [sub clause (x)].

Income from :

xiv. Units of a mutual fund approved under Section 10(23D); [sub clause (va)].

Under the first proviso, income not deductible under Sub-section (1), will be allowed subject to a ceiling of Rs. 3000 out of interest or deposits in the National Deposit Scheme (sub clause (iia)) or income from Units (sub clause (v) or (va)) or interest on dividends from an approved public company registered in India giving housing finance (sub clause (x)).

Under the second proviso, income not deducted under Sub-section (1) and the first proviso, will be allowed subject to a maximum of Rs. 3000 out of interest on deposits in the National Deposit Scheme (sub clause (iia)) or on dividends (sub clause (iv)).

Sub-section (3) makes it clear that if the assets are held by or on behalf of a firm, AOP/BOI, no deduction will be allowed in computing the total income of any partner of the firm or member of the AOP/BOI.

Table 2.3 presents figures on deductions claimed and tax relief under this section.

(i) Section 88

The subject matter of this section had been dealt with earlier by Section 87 as originally enacted, the original Section 80A as introduced by the Finance Act 1965 WEF 1.4.65 and Section 80C introduced by the Finance (No.2) Act 1967, WEF 1.4.68, operative till AY 1990-91.

Under Section 80C, the tax incentive to promote savings takes the form of a deduction of the whole or part of the funds invested or deposited in life insurance policies, deferred annuity policies, provident funds, superannuation funds, and so on. The deduction permissible is at 100 per cent of the first Rs. 6000 invested, at 50 per cent of the next Rs. 6000, and at 40 per cent on the balance. The maximum amount of savings eligible for deduction is Rs. 40,000 but in the case of authors, playwrights, musicians, actors and sportsmen (including athletes), the eligible amount is Rs. 60,000.

Under Section 88 which takes effect from AY 1991-92, an assessee will be entitled to a rebate of 20 per cent of the amount invested or deposited in specified channels from the income tax payable on his total income. The maximum rebate is Rs. 10,000 (on investment or deposit of Rs. 50,000), except in the case of authors, playwrights, musicians, actors and sportsmen (including athletes), where it is Rs. 14,000. The new section is a redraft of Section 80C, except for two minor modifications, with a more logical arrangement of subject matter.

Section 87 lays down the manner of computing rebate admissible under Sections 88 & 88A. Sub section (2) lays down that the aggregate amount of deduction under Sections 88 or 88A (**this should obviously read 88 and 88A**) shall not exceed income tax chargeable on total income prior to such deduction.

Statistics of deductions claimed under Section 80C for assessment years 85-86 to 87-88 are in Table 2.4.

(j) Possible Problems with Section 88

i. Certain abuses by some employers in the maintenance of provident and superannuation funds noticed earlier with respect to Section 80C have been set right by Sections 43B and 36(1)(va).

ii. Under Section 88(2)(xv) (corresponding to Section 80C(2)(h)(ii)), upto a maximum of Rs. 10000 is admissible for tax rebate if it is paid for the construction or purchase of a residential house property, the income from which is chargeable (unless self-occupied) to tax under the head "Income from house property". Eligible payments are, inter-alia:

a. Instalment or part payment of an amount due under a self- financing scheme of any development authority, housing board, etc; [88(2)(xv)(a)];

b. instalment or part payment of an amount due to any company or co-operative society of which he is a shareholder or member towards the house property allotted to him, [88(2) (xv)(b)];

c. repayment of amounts borrowed from banks, etc, excluding expenditure admissible under Section 24 (88(2)(xv)(c)).

Circular No. 498 issued on 4.11.87 by the CBDT specifies that this deduction (tax rebate now) can only be claimed in the year in which property income is assessable. As a result, a person who finances the house purchase himself may, at best, get only one deduction in the year of completion (because all payments have to be made before possession). However, a person who borrows funds for the investment gets tax rebate not only for the principal under Section 88 but also deduction for interest under Section 24(i)(vi).

(c) Contributions by employees to provident funds have a triple benefit - two direct and one indirect: Firstly, contributions by the employee are eligible for tax rebate under Section 88(2) and the contributions by the employer and accrued interest are also exempt (Provident Fund Act 1925) or exempt upto specified limits (Rule 6 Part A of Fourth Schedule) in a recognised provident fund. Secondly, payments made from these funds are again exempt under Sections 10(11) and 10(12). Thirdly, interest on securities and capital gains of a provident fund to which the Provident Fund Act, 1925 applies and any income of a recognised provident fund are also exempt under Sections 10(25)(i) and 10 (25)(ii).

(k) <u>Section 88A</u>

The provisions of Section 80CC operative till AY 1990-91 (inserted by the Finance Act 1978, from AY 1979-80) provided for a deduction at 50 per cent on investment in shares forming part of an eligible issue of equity capital, or units issued under any scheme of a mutual fund or the UTI, if the amount mobilised under the scheme is invested only in eligible issues of capital. There was a ceiling of Rs. 20,000 on the total amount qualifying for deduction under this section. Thus, the maximum deduction permissible was Rs. 10,000. In order to retain the benefit of this deduction, the taxpayer had to hold shares for a minimum period of three years. The scheme of Section 80CC has been incorporated in the new Section 88A, which will be applicable for AY 1991-92 only.

Under this section an individual, HUF or specified AOP/BOI is entitled to tax rebate at 20 per cent of the amount invested out of his income chargeable to tax in equity shares of an eligible issue of share capital (the offer for subscription for which is made before 1.4.91) or units of either a mutual fund notified under Section 10(23D) or of the UTI, provided the mutual fund or the UTI invests sums mobilised under the scheme in an eligible issue of capital within six months from the close of subscription to the scheme. Pending investment in the eligible issue of share capital, the funds can be invested in approved government securities. The tax concession will not be admissible to a scheme if the subscription closes after 30th September 1990 (Sub-section(1)). Investment upto a maximum of Rs 25,000 by a taxpayer in a previous year qualifies for rebate [Sub-section(2)][5] The other sub-sections are the same as in the existing Section 80CC, except for the insertion of the word "unit" where needed.

Table 2.5 sets out statistics of claims under Section 80CC. Data on equity capital issued by the companies to which Section 80CC applies are not readily available.

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5. Investment is to be made through a mutual fund or the UTI. The newly inserted section 271BB provides that if the fund fails to invest any amount of subscription received under the scheme in an eligible issue of capital within a period of six months, penalty of 20 per cent on the amount not so invested can be levied.

2.3 Tax Concessions for Income From Capital Gains Exclusively for Individuals & HUFs

(a) Section 53

Under the provisions existing before amendment by the Taxation Laws (Amendment) Act 1984 WEF 1.4.85, capital gains arising from the transfer of buildings or land appurtenant whose income was chargeable under the head 'Income from house property' were exempt from tax provided the consideration for the transfer did not exceed Rs. 25,000 and the aggregate fair market value of all such capital assets owned by the assessee immediately before the transfer did not exceed Rs. 50,000.

The section now provides that long-term capital gain arising from the transfer of a residential house will be exempt from tax in cases where the consideration does not exceed Rs. 2 lakh. If the consideration exceeds Rs. 2 lakh, the resulting long-term capital gains will be exempted proportionately. This exemption is available only if the assessee does not own any other residential house on the date of transfer.

The Economic Administration Reforms Committee (EARC) noted in its Report No. 7 (1982) that it has been recognised in the fiscal legislation of most countries that an assessee should be entitled to exemption from direct taxes in respect of one residential house property. In India, Section 54 provides for exemption of capital gains arising from the sale of a residential property subject to certain conditions. These conditions are not applicable if the property is sold for a consideration of Rs. 25,000 or less and the value of all residential properties sold is less than Rs. 50,000 (in accordance with Section 53 before amendment). **The EARC observed that considering the current values of house properties, Section 53 serves no purpose and should be deleted (para 8).**

(b) Section 54

Under the section as amended by the Finance Act, 1987, long-term capital gains from the transfer of a residential property (the original asset), are eligible for a deduction if the assessee has purchased within one year before or two years after the date of the transfer, or constructed within a period of three years after the date of the transfer, a residential house. The deduction permissible out of capital gain is to the extent of the cost of the residential house purchased or constructed (the new asset). If the new asset is transferred within a period of 3 years of its purchase or construction the exempted capital gain on the old asset is subjected to tax in the year of transfer of the new asset as laid down in the section (Sub-section (1)).

Prior to amendment by the Finance Act, 1987 long-term capital gains arising from the transfer of a residential house (Section 54), land used for agricultural purposes (Section 54B), and other capital assets (Section 54F) were exempt if such gains were reinvested in new assets within the time allowed for the purpose. Whenever the taxpayer failed to acquire the corresponding new asset, the original assessment required rectification.

To dispense with the need for such rectification, amendments made to Sections 54, 54B & 54F provided a new scheme for deposit of the amounts meant for reinvestment in the new asset. Consequently where the amount of the capital gain or the net consideration (Section 54F) is not appropriated or utilised by the taxpayer for the acquisition of the new asset before the date of filing the return of income, it has to be deposited by him on or before the date for furnishing the return under Section 139(1) in an account with a bank or institution and utilised in accordance with a scheme framed by the Central government.[6] The amount already utilised, together with the amount deposited, will be deemed to be the amount utilised for the acquisition of the new asset. If the amount deposited is not fully utilised for acquiring the new asset within the stipulated period, the capital gain relatable to the unutilised amount will be treated as capital gains of the previous year in which the 3 year period expires. In such a case, the basic deduction of Rs. 10,000 as well as the deduction under Section 53 will not be admissible. [Sub-section (2), proviso and Explanation].

Prior to its amendment by the Finance Act 1987 WEF 1.4.88 the definition of the word 'transfer' in Section 2(47) did not include transfer of certain rights accruing to a purchaser by becoming, <u>inter alia</u>, a member of (or acquiring shares in) a cooperative society, company, or association of persons. Such transactions do not require registration under the Registration Act, 1908. These arrangements, which confer the privileges of ownership without the transfer of title in the flat or building are a common mode of acquiring flats particularly in multi-storeyed constructions in big cities. The earlier definition also did not cover cases where possession is allowed to be taken or retained in part performance of a contract, under Section 53A of the Transfer of Property Act. Sub-Clauses (v) & (vi) inserted in Section 2(47) cover such transfers of rights. Section 2(47)(vi) covers what are commonly called 'Power of Attorney' arrangements, which are adopted where transfers of ownerships are not legally permitted, like transfers or purchases of Delhi Development Authority (DDA) flats. Such a transaction could be either a purchase or construction as the case may be.

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6. Capital Gains Accounts Scheme 1988 notified on 22.6.88.

The CBDT had occasion to consider whether the acquisition of a flat by an allottee under the Self-Financing Scheme (SFS) of the DDA amounts to purchase or is construction by the DDA on behalf of the allottee. Under this scheme, an allotment letter is issued on payment of the first instalment of the cost of construction. The allotment is final unless it is cancelled or the allottee withdraws from the scheme. The allottee gets title to the property on the issuance of the allotment letter. Payment of instalments is a follow up action and taking possession a formality. If there is failure on the part of the DDA to deliver possession of the flat after completing construction, the remedy for the allottee is to file a suit for recovery of possession. The CBDT stated in circular No. 471 dated 15.10.86 that, in these circumstances, the DDA takes up the construction work on behalf of the allottee and that the transaction is not a sale. For the purposes of capital gains tax the cost of the new asset is the tentative cost of construction. This principle can also be extended to companies and cooperative societies if the conditions are similar.

A three years period is normally a reasonable period for constructing a residential house. However, cases may arise where the taxpayer intends to acquire the flat from a company or cooperative society and makes payments for this but does not get possession if the construction of the multi-storeyed building is not complete in 3 years. It would be inequitable to the taxpayer if an attempt is made to withdraw the deduction already given under Section 54 on the ground that the construction is not completed within the period of 3 years specified. **Appropriate amendment of this provision and the similar provision in Section 54F may, therefore, be considered.** Table 2.6 provides some statistics on long term capital gains declared by income tax assessees.

(c) <u>Section 54B</u>

Under this section where capital gains arise from the transfer of land which was being used for agricultural purposes by the assessee or the assessee's parent for 2 years immediately preceding the date of transfer (the old asset) and the assessee has purchased within a period of 2 years after that any other land to be used for agricultural purposes (the new asset) , a deduction to the extent of the cost of the new asset is allowed from capital gain on the original asset. The new asset must be held for at least 3 years to retain this concession. The Capital Gains Account Scheme also applies to this section as in Section 54.

Prior to the amendment made by the Finance Act, 1970, the definition of "capital asset" in Section 2(14) excluded from its scope agricultural land in India. It was felt then that agricultural land situated in municipal and other urban areas was essentially similar to non-agricultural land, in its potentialities for use, due to rapid urbanisation and industrialisation. The Finance Act, 1970, therefore, amended Section 2(14) to exclude from its scope only agricultural land which is not situated in the jurisdiction of a municipality or Cantonment Board with a population of not less than 1,00,000. The government was authorised to notify any area outside the limits of such a municipality or Cantonment Board upto a maximum of 8 kilometers from such limits for the purposes of this provision. As a result of this amendment, capital gains arising from the transfer of agricultural lands situated in municipal and other urban areas would have been liable to taxation even if the land was used for bonafide agricultural purposes. Section 54B was inserted to provide relief from the burden of taxation in such cases.

Ninety three municipalities and Cantonment Boards were notified by Notification No. S077(E) dated 6 2.73.

(d) Section 54F

Section 54F provides for exemption of capital gain arising from the transfer by an individual or a HUF of any long-term capital asset other than a residential house to the extent that the net consideration is used to buy a residential house within one year before or two years after the date of transfer or construct one within three years after the date of transfer. Exemption of long-term capital gains is granted pro-rata, based on the ratio of the cost of the residential house to the net consideration of the asset transferred, subject to a maximum of 100 per cent.

This concession is not available to an assessee who owns any other residential house on the date of transfer, or who within two (three) years thereafter purchases (constructs) another residential house (Sub-section (1)). Furthermore, the house must be held for at least 3 years. The Capital Gains Account Scheme, 1988, is also applicable to reinvestment under this section as in Section 54.

The objective of this provision is stated to be "encouraging house construction". If that were so, why is it necessary to withdraw the concession if another house is purchased within 2 years, or constructed within 3 years of the date of transfer particularly as there is no bar to acquiring a house thereafter?

Two reasons had been given by the EARC in favour of investment of the net consideration on sale rather than capital gains. The first is that a mere change in the nature of assets, when there is no increase in the disposable income in the hands of the assessee, should not be subjected to tax: capital gains should be taxed when realised. The second is that when investment is made in a like asset, the chances are that a good proportion of the nominal gain on the original asset gets absorbed in the acquisition of the new asset whose real value may be no higher than the value, at the time they were originally acquired, of the asset sold[7].

2.4. Concessions to Housing Under the Income Tax Act

The sections of the Income Tax Act under which tax concessions are given to housing are Section 23, 24, 48, 53, 54, 54E, 54F, 88, 88A and 80L. Briefly, tax concessions to housing fall into three categories: Tax concessions on incomes from house property (Sections 23 and 24), tax concessions to long-term capital gains (Sections 53, 54, 54E, 54F and 48) and tax concessions on investment in housing or the housing sector (Sections 88, 88A and 80L). A description of these sections as they apply to housing, is given below to supplement the general discussion for some sections made in connection with saving incentives and capital gains.

(a) <u>Section 23(2) and Section 24</u>

Sub-section (2) of Section 23 was substituted by the Finance Act, 1986 WEF 1.4.87. According to this amendment, the Annual Value of a house occupied for his residence by the taxpayer (and which has not been let out nor any benefit derived from there) is to be taken as nil. If a property is partially let out or let out for a part of the year and the rest is used for residential purposes, a pro rata deduction is given for self-occupation. If the taxpayer utilises more than one house as his residence, the concession will be applicable to one house specified by him. Income from the other properties will be determined as if they had been let. The new construction allowance is not admissible if the house is used for residential purposes. Subsection (2) of Section 24, substituted by the same Act with effect from 1.4.87 provides that deductions under Section 24(1) (for repairs, insurance premia against risk, ground rent, land revenue, collection charges, etc.) will not be admissible to a self-occupied property. However, an exception was made in the case of interest on funds borrowed for constructing, repairing, renewing or reconstructing the property. Such interest is deductible subject to a ceiling of Rs. 5,000 (Section 24(i)(vi) and proviso below Section 24(2)). It may be mentioned that till AY 1986-87, deductions under Section 24 were permissible in the computation of income from a self-occupied property. In particular, interest on borrowed funds was fully admissible under Section 24(1)(vi). The sum of the deductions including interest

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7. See paragraph 10.3, EARC Report No. 7.

could have led to a negative income in some self-occupied properties in those years.

There are no public circulars of the CBDT on whether claims for self-occupation of a house property can be made by persons other than individuals and HUFs. However, as statistics published by the All India Income Tax Statistics (AIITS) show, such claims have been preferred and accepted by the Income tax Department. It had been held that occupation of the owner for the purposes of "his own residence" shows that the owner must be a natural person, that is an individual[8].

The accompanying Tables 2.7 to 2.9 contain statistical particulars of income from self-occupied and other properties, status-wise for AY 1985-86 to AY 1987-88, based on returned figures. Even though in an year returns are filed for that year as well as for earlier years, the statistics relate to the returns filed for that particular assessment year, for example, for AY 1987-88 in the financial year 1987-88. Definition of some expressions used are as follows:

Gross income: Returned income plus previous year's loss set off plus deductions claimed under Chapter VIA.

Average rate of tax: The ratio of tax payable to returned income

Gross tax: The product of gross income and the average rate of tax.

Average tax rate: The ratio of gross tax to gross income.

For AY 1986-87 and 1985-86, where the gross income per return exceeds Rs 36,000 the deduction under section 23(2) for self-occupation is taken at Rs 3,600 per return or taxpayer. Where the gross income is less than Rs 3,600, the deduction is taken at that figure because the deduction permissible was half the annual value or Rs 3,600 whichever is less. In the latter case the deductions permissible under section 24 are ignored. The deduction in column 6 of Table 2.7 is computed in this manner. It may be seen that for AY 1985-86, the (estimated) income from self-occupied property before the deduction under Section 23(2) is Rs. 161.8 crore and (estimated) tax on this is Rs. 38.1 crore. The income figures for AY 1986-87 are Rs. 357.8 crore and Rs. 121.7 crore respectively.

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8. CIT V. Mohd. Amin Tyamboo (1980), 125 ITR 375 (J&K).

(b) <u>Capital gains</u>

Some concessions for reinvested capital gains have already been discussed. A brief recapitulation of the relevant provision that apply to housing would be useful:

i. Section 53 provides for exemption of capital gains if the sale consideration of a residential house is Rs 2,00,000 or less. Pro-rata exemption is allowed where the sale consideration is more than Rs 2,00,000;

ii. Section 54 exempts capital gains arising from the transfer of a residential house to the extent that they are reinvested in another residential house;

iii. Section 54E provides for exemption of capital gains from the transfer of a long-term capital asset if the net sale consideration is invested in specified financial assets (including debentures of the National Housing Bank).

iv. Section 54F exempts capital gains to the extent that the net sale proceeds from long term capital assets other than housing are invested in housing; and

v. Section 48(2) provides that only 50 per cent of the long-term capital gain exceeding Rs. 10,000 from the sale of a house property (and certain other assets) is taxable.

(c) <u>Section 88</u>

Under this section payment of instalments due under a self-financing scheme of a housing development authority, or due to a company or cooperative society of which the assessee is a member or a shareholder towards the cost of the house allotted to him, or repayments of amounts borrowed for purchase of construction of a house is eligible for tax rebate. The limit on qualifying instalments is Rs 10,000 per year. Income from the property should be chargeable to tax unless self-occupied.

(d) <u>Section 88A</u>

Among eligible share issues under this section are also the shares issued by companies formed and registered in India for carrying on the business of, or providing long-term finance for, construction of residential housing.

(e) Section 80L

Interest on deposits with Statutory Housing Boards and interest on deposits or dividends from a company registered in India with the main objective of carrying on the business of providing long-term finance for construction or purchase of residential houses in India are eligible for a deduction, subject to a limit of Rs. 10,000, under this section.

2.5. Incentives to encourage flow of foreign exchange remittances into India

Incentives to encourage foreign exchange inflows are of two main types. Firstly, there are provisions granting exemption from taxation to interest on investments made in foreign currency. Secondly, there are provisions which allow concessional taxation of income earned abroad by Indian residents.

(a) Section 10(4)(i)

Under this sub-clause as substituted by the Direct Tax Laws (Amendment) Act, 1987 WEF 1.4.89, interest and premium on redemption of notified securities or bonds are exempt from taxation. By Notification SO 3331 dated 19.1065, the 4.25 per cent National Defence Loan 1968 and the 4.75 per cent National Defence Loan 1972 have been notified under this sub-clause. No other security or bond appears to have been notified thereafter.[9]

There are no data regarding either the investment or the revenue sacrifice on account of this concession.

(b) Section 10(4)(ii)

Under this sub-clause as amended by the Direct Tax Laws (Amendment) Act 1987 WEF 1.4.89, interest income of an individual, who is a person resident outside India as defined in Section 2(q) of the Foreign Exchange Regulation Act, 1973 (FERA), on balances of a Non-Resident (External) Account in any bank in India is exempt. This sub-clause is a re-draft of the earlier clause 4A. Section 10(4A) was inserted by the Finance Act 1965 WEF 1.4.65. The EARC observed in its interim report[10] that the version of Section 10(4A) existing at that time caused problems for Indians going abroad. A person treated as a non-resident under FERA and allowed to have a Non-Resident (External) Account could be treated as resident under the Income Tax Act and therefore lose the

9. Taxmann (1988).

10. EARC Report No. 6 dated 5.1.82, para 3.8.

exemption. It recommended exemption of interest in a Non-Resident (External) Account to any person permitted to have such an account under the FERA. Following the EARC recommendation Section 10(4A) was substituted by the Finance Act 1982 WEF 1.4.82. The balance in the Non Resident (External) Account is exempt under section 6 of the Wealth Tax Act. A gift made by a person resident outside India (as defined in Section 2(q) of the FERA) from his Non Resident (External) Account is exempt under Section 5(1)(iib) of the Gift Tax Act.

The purpose of this sub-clause is to encourage investments in India by non-residents. The provision has been in operation since AY 1965-66. Data on foreign exchange inflows under this section are given in Table 2.10.

Funds in Non-Resident accounts can be invested in securities of Central or State Governments, units of the UTI and National Savings Certificates without the permission of the RBI if purchases are made through the bank maintaining the account.

(c) Section 10(4B)

Under this clause interest on notified savings certificates issued by the Central government is exempt in the hands of a citizen of India or a person of Indian origin, who is a non-resident, if the subscription to the certificates is made in convertible foreign exchange remitted into India under the FERA.

This clause was introduced by the Finance Act 1982 WEF 1.4.83. Under Notification No. SO 653(E) dated 8.9.82, National Savings Certificates VI & VII Series have been notified under this clause.[11] These 6 year certificates carried interest at 12 per cent per annum (compounded or payable half yearly). From 1.4.87 the interest rate has been reduced to 11 per cent per annum. The exemption is only admissible to the original subscriber of the savings certificates. The value of these certificates is exempt under Section 5(1)(xvic) of the Wealth Tax Act. The value of gifted certificates is exempt under Section 5(1)(iid) of the Gift Tax Act. By the Finance Act, 1983, these sub-clauses in the Wealth Tax and Gift Tax Acts have been expanded to include foreign exchange assets as defined in Section 115(2)(b) of the Income Tax Act.

The object of this clause is to encourage the flow of foreign exchange remittances into India from non-resident Indian citizens and foreign nationals of Indian origin.

The fall in investment in 1988-89 apparent in Table 2.11 appears to be due to the introduction of a new instrument, the

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11. Taxmann (1988).

Kisan Vikas Patra, with 13.5 per cent compound interest per annum. Figures in Table 2.11 are total receipts giving no indication of investment made in foreign exchange. They include, inter alia, investment by taxpayers and non-taxpayers. Among taxpayers, individuals, government companies, corporations and cooperative societies are included.

National Savings Certificates (NSC) of Series VI and VII have been withdrawn and a new series, NSC VIII, has been introduced WEF 1.4.89. As this series does not appear to have been notified under Section 10(4B), tax concession under that clause will not be available from AY 1990-91 onwards. Interest on certificates of this series is not eligible for deduction under Section 80L.

(d) Section 115C/ Chapter XII-A

Section 115C consists of definitions for the purpose of Chapter XII-A. Besides the definition of a foreign exchange asset the main definition concerns the scope of 'specified assets':

> Specified asset means (i) shares in an Indian company; (ii) debentures in an Indian public company; (iii) deposits with an Indian public company; (iv) any security as defined in the Public Debt Act; (v) any other notified asset (Section 115C(f)).

Chapter XII-A was introduced by the Finance Act, 1983 WEF 1.6.83, following the recommendations of the EARC.[12] The object of the chapter is to encourage the inflow of foreign exchange remittances and investment in India by non-resident Indians (NRIs).

Circular No. 4AD (MA Series) dated 11.12.87 of the Reserve Bank of India (RBI), Exchange Control Depart- ment, clarifies that bonus shares will be treated as foreign exchange assets if the shares on the basis of which the bonus shares have been issued are "foreign exchange assets". Rights shares will be treated as foreign exchange assets only if they are purchased or subscribed to in foreign exchange. Sale of rights is not covered by Chapter XII-A. No other assets appear to have been notified under Section 115C(f)(v) so far.[13]

An irregularity noticed by the RBI is as follows. RBI approval is required under the FERA for purchase of shares or debentures by NRIs in any stock exchange under the portfolio

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12. EARC Report No. 18 dated 18.1.83.

13. Taxmann (1988).

investment scheme. One important condition imposed for granting approval is that purchases on a stock exchange be limited to 1 per cent per investor with an overall ceiling of 5 per cent for all investors. The RBI has come across cases where, after obtaining approval, purchases are effected by NRIs from stock exchanges without the knowledge of the bank through which such transactions should be routed. Monitoring the ceiling limits, as well as considering requests for permission to remit sale proceeds, is thus made difficult. The RBI has requested broker members of stock exchanges not to purchase shares or debentures on behalf of NRIs without involving designated branches.[14]

(e) Section 115D and 115E

Under Section 115D no expenditure or allowance is allowed under any provision of the Income Tax Act in computing investment income of a NRI (Sub-section (1)). If a NRI has only investment income or income from capital gains (or both) no deduction will be allowed under Section 48(2) or under Chapter VIA (Sub-section (2)(a)). If, on the other hand, his gross total income includes investment or capital gains income, it will be reduced by such income, and deduction will be allowed under Chapter VIA on the balance as if this was his gross total income (Sub-section (2)(b)).

Under Section 115E if the total income of a NRI consists of only investment or capital gains income or both, tax will be payable at a flat 20 per cent rate (Sub-section (1)). On the other hand, if the total income of a NRI includes investment or capital gains income, the aggregate tax payable is 20 per cent on his investment or capital gains income and income tax on the balance as if it were his total income (Sub-section (2)).

It may be mentioned that under Section 32(1)(aa) of the Unit Trust of India Act, a non-resident's income from units purchased out of their external funds is exempt from tax and is also free from tax deduction at source.

Under Section 5(1)(xvic) of the Wealth Tax Act, an NRI is entitled to exclude any foreign exchange asset as defined in Section 115(b) of the Income Tax Act from his net wealth.

A person resident outside India (as defined in Section 2(q) of the FERA) can make a gift from a Non Resident (External) Account in accordance with the FERA, without attracting gift tax (Section 5(1)(iib)). Also, a gift of convertible foreign exchange remitted from outside India in accordance with the FERA, by a NRI to a relative (as defined in Section 2(41)) in India attracts no gift tax (Section 5(1)(iic)).

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14. Business Standard 18.7.1989.

Foreign exchange assets gifted (as defined in Section 115C) to a relative as defined are also exempt from gift tax (Section 5(1)(iid)).

Under Chapter XVII-B, tax is deductible at source from the income of a NRI for AY 1991-92, inter alia, at 20 per cent on investment income and long-term capital gains, at 15 per cent on income from a tax-free security and at 30 per cent on other incomes.

(f) Selected Incentives for NRI Investment: Provisions and Problems

A brief discussion of various incentives to NRI investment is in order here.

The EARC had recommended in its 18th Report (1983) that a reasonable rate of taxation of a NRI on income and capital gains from shares and securities acquired out of external funds would be 10-15 per cent (paras 20 and 29). It further recommended that tax should be fully deducted at source, and that such deduction should be treated as a final assessment on such income. Remittance of such income to the NRIs should be allowed thereafter without the requirement of a tax clearance certificate (para 21). It has also recommended that the flat rate system should be confined to transactions of investment income and capital gains which are effected through designated branches of a bank, who should be responsible for the deduction of tax at source (paras 33 & 34).

From 31.7.86, to facilitate prompt remittance of dividends, authorised dealers have been granted permission by the RBI to remit dividends to a non-resident shareholder irrespective of the face value of equity shares or the percentage of issued capital held by such a non-resident, without prior approval for non-FERA companies. Remittance of dividends from FERA companies still requires approval from the RBI. Since 1987-88, authorised dealers are also allowed to repatriate sale proceeds of shares (effected under Section 19(3) of the FERA) abroad, or give credit to the Non Resident (External) Rupees Account of sellers after payment of taxes in India.

According to a Press Information Bureau release on 31.7.89, the Minister of State for Industrial Development informed the Rajya Sabha that: (a) NRIs have been given the benefit of repatriation of capital and income upto 40 per cent of the total paid up capital for non-priority projects and upto 74 per cent for priority industries. (b) NRIs are also eligible for incentives for the import of capital goods, components and raw materials for setting up industrial units in accordance with the Import and Export policy, 1989-91. (c) NRIs investments are allowed for all activities except for real estate business or for agricultural and plantation activities.

In 1986-87 the facility of direct investment under the 40 per cent scheme of NRIs was extended to companies engaged in development of software and oil exploration. Besides, the Rs. 40 lakh ceiling under the 40 per cent scheme for investments in India in private limited companies was removed. From 1987-88 applications for loans against fixed deposits of NRIs held in Non Resident (External) Accounts, or Foreign Currency (Non-Resident) Accounts can be considered as investment in India, subject to the condition that investment cannot be made in commercial activities, agricultural/real estate business or portfolio investment.

According to a policy paper dated 31.5.90 announcing a new industrial and foreign investment policy, upto 40 per cent equity investment will be allowed automatically keeping in view the need to attract effective inflow of foreign technology. In such proposals also, the landed value of imported capital goods should not exceed 30 per cent of the value of plant and machinery (para 16).

NRIs with shares and debentures made a representation to the government that, due to the fall in the value of the rupee in relation to other currencies in which investments were made by them, they were adversely affected on sale of shares or debentures. Section 48(1) was therefore amended by the Direct Tax Laws (Second Amendment) Act, 1989 WEF 1.4.90. Capital gains on investment by NRIs will now be computed as follows: The cost of acquisition, consideration for transfer and expenditure in connection with the transfer will be converted into the foreign currency in which the investment was made. Capital gains computed in foreign currency will be reconverted into Indian currency. The conversion and reconversion will be at the telegraphic transfer buying rate, on the dates specified in Rule 115.

Data on inflows into the Non Resident (External) Rupee Accounts and Foreign Currency (Non-Resident) Accounts have been given in Table 2.10. Data on NRI Investments is given in Table 2.12.

Some problems relating to treatment of NRI investments are as follows:

(a) The CBDT, in a reply to a chartered accountant[15] stated that deposits made in a nationalised bank will be treated as a specified asset under Section 115C(f)(iii), "if the said bank fulfills the conditions of an Indian company under Section

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15. In its letter dated 29.9.1989, F.No. 478/15/89/FTD.

2(26) of the Income Tax Act". Both the Banking Companies (Acquisition and Transfer of Undertakings) Act 1970 and Banking Companies (Acquisition and Transfer of Undertakings) Act 1980, say (in Section 11) that a bank would be deemed to be an Indian company and a company in which the public are substantially interested for the purposes of the Income Tax Act. It is **not, however, clear whether the banks will fall under the definition of an Indian company under Section 2(26)(iia) which speaks of a corporation established under a Central Act; this is because, after their nationalisation, they may no longer continue to be registered as Indian companies under the Companies Act. A clarification appears to be necessary on this point.**

(b) Deposits with an Indian public company are specified assets under Section 115(f)(iii). When the deposit is renewed, in theory it involves a return of the amount to the depositor and a redeposit of this amount by him. As the latter is not made in foreign currency, it could be argued that the benefit of section 115E is not available on renewal. **A clarification appears to be necessary since such a move does not appear to be justified.**

(g) <u>Section 115F</u>

Under this section long-term capital gains will not be charged to tax if the entire net consideration[16] received or accruing is invested or deposited by the NRI within 6 months from the date of transfer in any specified asset or notified saving scheme under Section 10(4B): (Section 115F(1)(a)).

If the invested amount is less than the net consideration, exemption from tax on capital gains will be allowed in the same proportion as the aggregate invested amount bears to the net consideration (Section 115F(1)(b)). The new asset so acquired should be held by the NRI for 3 years. Otherwise, the capital gains not charged earlier will be deemed to be long-term capital gains and taxed in the year in which the asset is transferred or converted into money (Section 115F(2)). Sections 2(29B) and 2(42A) define long term capital gains and long term capital assets.

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16. Full value of the consideration received on transfer <u>minus</u> expenditure incurred wholly and exclusively in connection with the transfer.

If a NRI invests in a specified asset following the prescription in Section 115F(1), the long-term capital gains becomes exempt as laid down therein. However, the income from the specified asset will be taxable, in the normal manner, since it has not been acquired in convertible foreign exchange and is therefore not a foreign exchange asset. The other option is investment in notified savings certificates under Section 10(4B). After the withdrawal of the VI and VII series of NSCs, NSCs of the VIII series do not appear to have been notified under Section 10(4B). So if investment is made in this series, income from the investment is not exempt. **If the intention is that in the circumstances mentioned in Section 115F(1), specified assets are to be deemed to be foreign exchange assets, Section 115F may require amendment.**

The EARC observed in its 18th Report that to obviate the possibility of funds being brought in by NRIs purely for the purpose of making short-term capital gains and withdrawing them immediately thereafter (which could mean considerable cost to the country in foreign exchange), it may be necessary to consider whether investments by NRIs should be subject to a condition that the shares and securities should be held for, say, 2 to 3 years time (para 31). Sections 115E and 115F met this point by according concessional treatment to long-term capital gains. **After the amendment of the definition of short-term capital asset as shares held for not more than 12 months WEF 1.4.88, the theoretical possibility pointed out by EARC could become reality.** If the view that the NRI gets relief only on taxation of capital gains in Section 115F(1), while income from specified assets continues to be taxable at normal rates is correct, remittance of sale proceeds becomes relatively attractive. Remittance of sale proceeds and re-remittance to India for acquisition of a foreign exchange asset, (income from which would be taxable at a concessional rate) becomes a distinct possibility.

(h) Sections 115G & 115I

Section 115G provides that NRIs with only investment income or long-term capital gains, from whose income tax has been deducted at source will not be required to file a return under Section 139(1). A NRI may, however, elect not to be governed by the provisions of Chapter XII-A for any assessment year. For this purpose he will have to furnish to the Assessing Officer his income tax return for that assessment year under Section 139, declaring there that the provisions of this chapter shall not apply to him for that assessment year. If such a declaration is filed by a NRI, tax will be charged in the normal manner (Section 115I).

Section 115G is based on the EARC's recommendations in para 27(b) of its 18th Report. EARC also recommended the remittance of investment income to parties abroad on deduction of tax at source without the requirement of a tax clearance certificate (para 27(d)). From 31.7.86, to facilitate prompt remittance of dividends, authorised dealers have been granted permission to remit dividends to non-resident shareholders, irrespective of the face value of the equity shares or the percentage of issued equity capital held, without prior approval of the RBI in respect of non-FERA companies. Similar provision does not appear to have been made for income from debentures, deposits with Indian companies (including banks), and securities. Section 115I is also based on the EARC's recommendation (para 27(e)).

The objective of Section 115G is to remove irritants like having to file a return and dealing with the bureaucracy. Section 115I is designed to help a NRI whose Indian income is so low that his tax liability is negligible so that he can file a return and obtain a refund of tax deducted at source.

(i) <u>Section 115H</u>

Where a NRI becomes assessable as a resident special provisions of Chapter XII-A will continue to apply in relation to the investment income from certain foreign exchange assets (debentures of an Indian company, deposits with an Indian company, any specified security of the Central government and any other notified assets) if he furnishes a declaration in writing to this effect along with his return for the assessment year for which he is so assessable. Once a declaration is furnished, the provisions of Chapter XII-A continue to apply to the investment income from such assets for that and subsequent years until the transfer or encashment of such assets.

The EARC recommended that a NRI's foreign income should not be subjected to tax in India on his return to India, but should continue to be exempt for a period equal to that for which he has been non-resident immediately prior to his arrival, subject to a maximum period of 8 years.[17] Furthermore, tax exemption on income from FCNR/NR(E) accounts, Units of the UTI and concessional and simplified taxation of income from shares and securities should continue for a period for which there is a tax exemption on his foreign income (para 26). Investment in shares and securities should also be exempt from wealth tax as long as he is non-resident (para 36) and exemption on shares, securities, units acquired out of external funds and on the balance in FCNR/NR(E) accounts should continue for a period equal to the period for which they were non-residents before their return, subject to a maximum of 7 years (para 37). In implementing this recommendation, dividends from shares of Indian companies have been omitted. This restriction require re-examination.

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17. Paragraph 11, 18th Report of the EARC.

(j) Section 80R

Under this section, professors, teachers or research workers of Indian citizenship working in a foreign university, educational institution or other association or body were entitled to a deduction of 50 per cent of their remuneration in the computation of their taxable income till AY 1990-91. The concession was limited to a period of 36 months till AY 1990-91 if the individual rendered continuous service abroad for a period exceeding 36 months. The concession applies to residents. From AY 1991-92 the deduction admissible is 50 per cent of the remuneration or 75 per cent of such remuneration brought into India under the FERA, whichever is higher; the provision limiting the deduction to a period of 36 months has been deleted.

The EARC noted in its interim report on income tax,[18] that, as assessment of foreign income of an individual depends upon the length of his stay in India, it tends to encourage taxpayers to artificially manipulate the date of departure or to stay abroad for longer periods than necessary. It recommended full exemption of foreign income earned by employment or by rendering professional service even for residents (para 3.6). No special restrictions were felt to be necessary for employees in the private sector, as, in all such cases, the opening of offices or posting of personnel abroad is controlled by the RBI. To give relief to Indian citizens who are employed or render professional service abroad, the Finance Act 1982 deleted clause (b) in Section 6(1), and added an Explanation WEF 1.4.83. This was further liberalised by the Direct Tax Laws (Second Amendment) Act, 1989 WEF 1.4.89. Clause (a) of the Explanation, inserted by the Finance Act 1982, provides that an individual will be resident in India if he had been in India for 365 days in the four preceding years and is in India for 182 days or more in the year in which he leaves India to take up employment outside India (it is otherwise 60 days or more). Clause (b) of the Explanation as amended by the Direct Tax Laws (Second Amendment) Act, 1989[19] provides that an Indian citizen or NRI who visits India in any previous year, will be treated as resident if he was in India for 365 days or more in the four preceding years and is in India for 150 days or more. Thus the EARC's recommendation was partially met by extending the period of stay in the year of departure or visit for reckoning residence.

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18. Report No. 6, dated 5.1.82, para 3.5.

19. Specially amended for the convenience of NRIs, who represented that the existing periods of 60 or 90 days were too short.

The change in the deduction permissible from AY 1991-92 is stated to be to induce the bringing in of foreign exchange into India. The rationale for the deletion of the 36 months period is that with the deletion of the test for determining residential status on the basis of maintenance of a dwelling house in India (clause (b) of Section 6(1)) a person leaving India for employment abroad and serving there continuously for more than 36 months becomes a non-resident, and is therefore not subject to tax on his foreign income.

The objective of the predecessor Section 80F introduced by the Finance Act (No. 2), 1967 (which was substituted by Section 80R WEF 1.4.68) was to relieve hardship in meeting higher living costs and other essential expenditure in foreign countries. Table 2.13 gives data on deductions claimed under Section 80R. Foreign remuneration earned in AY 1987-88, according to these statistics, is a meagre Rs. 1.84 crore (twice the deduction claimed) against income from salary declared in India of Rs. 3006 crore.

(k) <u>Section 80RRA</u>

Under this section, an Indian citizen who derives any remuneration from a foreign employer or Indian concern in foreign currency for services rendered outside India is eligible, from AY 1975-76, for a deduction of 50 per cent of the remuneration, or 75 per cent of such remuneration brought into India under the FERA, whichever is higher. Till AY 1990-91, this deduction was admissible only for a continuous aggregate period of 36 months (Sub-section (1)). For government servants, services outside India should be sponsored by the Central government. Otherwise the individual should be a technician (as defined in the Explanation) and the terms and conditions of his services outside India should be approved by the the Central government or the prescribed authority (Sub-section (2)). The prescribed authority is the Foreign Tax Division, Department of Revenue. Under a clause which permitted the CBDT to prescribe, in addition, any other field, it prescribed the fields of actuaries, banking, insurance and journalism. From AY 1991-92, the maximum period of 36 months laid down permitting the deduction was deleted by the Finance Act, 1990.

The EARC noted in its 16th Report (1983) that Sections 80R and 80RRA provide the same type of relief to two different categories of assessees. It recommended that Sections 80R and 80RRA be combined into a single section, allowing exemption of all salaries earned outside India, as well as fees and royalties received from approved and notified institutions, etc. (para 25).

Table 2.14 gives data on deductions claimed under this section. Foreign remuneration earned in AY 1987-88 is approximately Rs. 7.4 crore (roughly double the deduction claimed) against income from salary of Rs. 3006 crore in that year. This is, once again, surprisingly low.

(1) Section 80RR

Under this section a resident individual being an author, playwright, artist, musician, actor or sportsman (including an athlete) who derives income by the exercise of his profession from the Government of a foreign State or a non-resident was entitled to a deduction of 25 per cent of such income received in or brought into India under the FERA in the computation of his total income. From AY 1991-92, he is entitled to a deduction of 50 per cent of such income or 75 per cent of the income brought into India under the FERA, whichever is higher. Professional activities include activities like publication of books, giving music performances, exhibiting paintings, etc. The CBDT has extended the definition of artist to include photographers and television cameramen.

TABLE 2.1

Financial Instruments Eligible for Interest Exemption Under Section 10(15)(i) of the Income Tax Act from AY 1989-90

	Instrument	Maximum amount of exempt earning
1.	12 Year National Savings Annuity Certificates	No limit
2.	National Defence Gold Bonds, 1980	-do-
3.	Special Bearer Bonds, 1991	-do-
4.	10 Year Treasury Savings Deposit Certificates	-do-
5.	5 Year Post Office Cash Certificates	-do-
6.	10 Year National Plan Certificates	-do-
7.	12 Year National Plan Savings Certificates	-do-
8.	7 & 12 Years Post Office National Savings Certificates	-do-
9.	Post Office Savings Bank Accounts	-do-
10.	Public Account referred to in item 6 of the Table below rule 4 of the Post Office Savings Account Rules, 1981	Rs. 5,000
11.	Post Office Cumulative Time Deposits 1981.	Whole of the amount
12.	Schemes of Fixed Deposits governed by the Government Savings Certificates (Fixed Deposit) Rules, 1968	-do-
13.	Schemes of Fixed Deposits governed by the Post Office (Fixed Deposit) Rules 1968	-do-
14.	Special Deposit Scheme, 1981	-do-

TABLE 2.2

Savings Mobilised by Selected Schemes Eligible for Exemption under Section 10(15)(i) of Income the Tax Act

(Rupees Crore)

	1986-87	1987-88	1988-89
P.O. Savings bank deposits, cumulative 10 year time deposits, recurring deposits and time deposits (1 to 5 years)	4,127	4,730	5,434
6 Year and 7 Year National Savings Certificates	3,176	3,430	2,445
TOTAL	7,303	8,160	7,879

Source : Reserve Bank of India: Report on Currency and Finance, Various Issues.

TABLE 2.3

Deductions and Tax Relief Claimed Under Section 80L

(Rs crore)

	Assessment Years					
	1985-86		1986-87		1987-88	
Section 80L	Deduction claimed	Tax relief	Deduction claimed	Tax relief	Deduction claimed	Tax relief
Deductions from dividends	110	23	113	21	181	34
Deductions from Interest	79	14	138	22	264	44
Deductions from unclassified income	0.24	0.03	1.2	0.3	1	0.2
TOTAL	189	37	252	43	446	78

Source: All India Income Tax Statistics.

TABLE 2.4

Deductions Claimed Under Section 80C

(Rs crore)

Section 80C	85-86	86-87	87-88
	Assessment Year		
On Life insurance premia	485	571	792
On Provident Funds	131	142	261
On Investment in NSCs	69	78	117
On Investment in Units of UTI	8	5	102
Unclassified	168	230	214
TOTAL	861	1026	1486

Source: All India Income tax Statistics.

TABLE 2.5

Deduction Under Section 80CC

(Rs crore)

Assessment Year	No.of Companies which issued 80CC Shares	No.of I.T returns in which 80CC deduction claimed	Amount of deduction claimed	Tax relief
(1)	(2)	(3)	(4)	(5)
1984-85	56	38495	11.1	1.8
1985-86	52	27430	9.5	1.4
1986-87	96	58918	24.7	3.0
1987-88	73	73386	28.4	4.5

Source: Except column 2, All India Income Tax Statistics.
Column 2: Income Tax Ready Reckoner by K.G. Mehta.

TABLE 2.6

Long term capital gains declared in the returns filed by Individuals and HUFs

(Rs.crore)

Asst.Year	1985 - 86			1986 - 87			1987 - 88		
	No. of returns filed	Gross income returned	Gross tax thereon	No. of returns filed	Gross income returned	Gross tax thereon	No. of returns filed	Gross income returned	Gross tax thereon
Individuals	15103	21.1	4.5	25635	63.1	12.1	35274	97.8	22.7
HUFs	1762	4.1	0.8	2367	9.7	2.2	4315	11.2	2.9
TOTAL	16865	25.2	5.3	28002	72.8	14.3	39589	109.0	25.6

Notes: Gross Income = Returned income plus previous year's loss set off plus deductions under chapter VIA.
Average tax Rate = Ratio of tax payable to returned income.
Gross tax = Product of gross income and Average tax rate.

Source: All India Income Tax Statistics.

TABLE 2.7

Statistical Particulars of Returned Income from Self-occupied Properties

Status	No. of returns filed	Gross Income returned Rs.	Gross tax thereon Rs.	Average income per tax-payer Rs.	Average tax rate ((3)/(4)) %	Deduction under section 23(2)	Tax effect thereon at average rate	Gross income before giving effect to sec. 23(2)	Gross tax thereon
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)
				ASSESSMENT YEAR 1987-88					
Individuals	1,59,565	105.5	20.5	6,611	19.4	--	--	--	--
HUFs	11,153	17.0	4.6	15,243	27.1	--	--	--	--
RFs	928	2.4	0.2	25,862	8.3	--	--	--	--
Others	701	1.3	0.4	18,545	30.8	--	--	--	--
Companies	3,331	169.6	69.6	5,09,156	41.0	--	--	--	--
TOTAL	1,75,678	295.8	95.3						
				ASSESSMENT YEAR 1986-87					
Individuals	2,66,512	110.1	19.3	4,131	17.5	95.9	16.8	206.0	36.1
HUFs	22,962	14.6	2.7	6358	18.5	8.3	1.5	22.9	4.2
RFs	929	3.2	0.3	34,446	9.4	0.3	0.03	3.5	0.3
Others	1,909	2.5	0.9	13,096	36.0	0.7	0.3	3.2	1.2
Companies	1,391	121.7	79.6	8,74,910	65.5	0.5	0.3	122.2	79.9
TOTAL	2,93,703	252.1	102.8			105.7	18.9	357.8	121.73
				ASSESSMENT YEAR 1985-86					
Individuals	2,36,829	69.0	15.7	2,913	22.8	69.0	15.7	13.8	31.4
HUFs	16,363	11.4	3.3	6,967	28.9	5.9	1.7	17.3	5.0
RFs	1,297	1.8	0.2	13,878	11.1	0.5	0.1	2.3	0.3
Others	4,935	2.4	0.8	4,863	33.3	1.8	0.6	4.2	1.4
Companies	--	--	--	--	--	--	--	--	--
TOTAL	2,59,424	84.6	20.0			77.2	18.1	161.8	38.1

Note: Cols. 2,3,6,7,8 & 9: Rupees crore.
Source (of Cols. 1,2 & 3): All India Income Tax Statistics.

TABLE 2.8

Statistical Particulars of Returned Income from Properties Other than Self-occupied Property

Status	No. of returns filed	Gross income retured	Gross tax thereon	Average income per return (Rs)	Average tax rate
	(1)	(2)	(3)	(4)	(5)
		ASSESSMENT YEAR 1987-88			
Individuals	2,27,719	268.6	50.3	11,795	18.7
HUFs	33,620	51.2	10.2	15,229	19.9
RFs	2,260	5.3	0.6	23,451	11.3
Others	1,306	2.8	0.9	21,440	32.1
Company	--	--	--	--	-
TOTAL	2,64,905	327.9	62.0		
		ASSESSMENT YEAR 1986-87			
Indivudals	1,98,667	198.4	34.4	9,987	17.3
HUFs	24,052	23.6	4.1	9,812	17.4
RFs	2,724	8.3	0.9	30,470	10.8
Others	836	1.3	0.4	15,550	30.8
Companies	--	--	--	--	--
TOTAL	2,26,279	231.6	39.8		
		ASSESSMENT YEAR 1985-86			
Individuals	1,46,341	119.7	24.6	8,180	20.6
HUFs	15,774	16.0	3.2	10,143	20.0
RFs	1,927	4.0	0.6	20,757	15.0
Others	5,933	4.5	1.2	7,585	26.7
Companies	1,543	27.4	16.6	1,77,576	60.6
TOTAL	1,71,518	171.6	46.2		

Note: Cols. 2 & 3 : Rupees crore

Source (Cols. 1,2 & 3): All India Income Tax Statistics.

TABLE 2.9

Statistical Particulars of Income Returned from Property

Status	No. of returns filed	Gross income returned	Gross tax thereon	Average income per return Rs.	Average tax rate thereon %
	(1)	(2)	(3)	(4)	(5)
			ASSESSMENT YEAR 1987-88		
Self-occupied	1,75,678	295.8	95.3	16,838	32.2
Others	2,64,905	327.9	62.0	12,378	18.9
TOTAL	4,40,583	623.7	157.3		
			ASSESSMENT YEAR 1986-87		
Self-occupied	2,93,703	252.1	102.8	8,584	40.8
Others	2,26,279	231.6	39.8	10,235	17.2
TOTAL	5,19,982	483.7	142.6		
			ASSESSMENT YEAR 1985-86		
Self-occupied	2,59,424	84.6	20.0	3,261	23.6
Others	1,71,518	171.6	46.2	10,004	26.9
TOTAL	4,30,942	256.2	66.2		

Note: Cols. 2 & 3 : Rupees crore.
Source (Cols. 1,2& 3): All India Income Tax Statistics.

TABLE 2.10

Foreign Exchange Inflow to Non-Resident Accounts Specified in Section 10(4)(ii)

(Rupees crore)

	1984-85	1985-86	1986-87	1987-88	1988-89
Non-Resident(External) Rupee Account	358	287	483	300	245
Foreign Currency (Non Resident) Account	275	1151	1169	1398	2075
Total	633	1438	1652	1698	2320

Source: RBI: Report on Currency and Finance, Various Issues

TABLE 2.11

Receipts and Payments in Securities Specified in Section 10(4B)

(Rupees crore)

Financial Year	N.S.C. VI Series Receipts	N.S.C. VI Series Payments	N.S.C. VII Series Receipts	N.S.C. VII Series Payments
1982-83	844	nil	118	nil
1983-84	1345	nil	205	4
1984-85	2338	31	260	9
1985-86	2883	94	274	24
1986-87	2903	135	244	38
1987-88	3214	691	186	119
1988-89	2310	1055	114	138

Source: RBI Report on Currency and Finance, Various Issues

TABLE 2.12

Value of Approvals for Investment by Non-Residents of Indian Nationality/Origin

(Rs Crore)

Calendar Year ended	Direct Investment: On repatriation basis: 40% Scheme	Direct Investment: On repatriation basis: 60% Scheme	Total 2+3	On non-repatriation basis	Total 4+5	Portfolio Investment: On Repatriation basis	On non-repatriation basis	Total 7+8	Grand total 6+9
1985	201.5	16.7	218.1	34.2	252.3	6.2	0.2	6.4	258.7
1986	255.0	8.6	263.6	64.0	327.5	4.9	0.4	5.3	332.8
1987	211.9	9.3	220.2	56.9	277.1	6.0	0.5	6.5	283.6
1988	174.7	18.1	192.8	42.8	235.6	7.5	0.4	7.9	243.5

Note: Figures rounded off to the first decimal place.
Source: RBI Report on Currency and Finance, 1988-89.

TABLE 2.13

Deduction Under Section 80R

(Rupees Crore)

Assessment Year	No. of returns filed claiming relief under Section 80R	Aggregate Amount of deduction claimed	Tax Relief
1985-86	1336	0.40	0.05
1986-87	889	0.50	0.06
1987-88	2965	0.92	0.14

Source: All India Income Tax Statistics.

TABLE 2.14

Deduction Under Section 80RRA

(Rupees crore)

Assessment year	No. of returns filed claiming relief under section 80 RRA	Aggregate Amount of deduction claimed	Tax Relief
1985-86	1504	0.72	0.16
1986-87	697	1.00	0.32
1987-88	3177	3.70	0.83

Source: All India Income Tax Statistics.

CHAPTER 3

REVENUE LOSS TO THE EXCHEQUER FROM SOME SAVINGS SCHEMES

3.1. Introduction

Some provisions in the Indian Income Tax Act allow tax concessions for savings and investment in specified assets or schemes. The objective of this chapter is to estimate revenue loss to the exchequer due to schemes designed to promote savings.

3.2. Scope of the Study

Estimation of tax savings of taxpayers in any year requires information on the income class-wise distribution of exemptions and deductions taken advantage of by taxpayers. Information on exemptions not being available no attempt is made to estimate tax savings due to exemptions in the personal income tax. Tax savings of taxpayers due to deduction provisions covered by Chapter VIA, Section 23(1) and Section 24(2) of the Income Tax Act 1961 are estimated.

The latest year for which the required data are available is AY 1987-88. We have therefore estimated tax saving of individual taxpayers for this year. An attempt is also made to obtain an estimate of tax saving for the year 1990-91 (AY 1991-92) by projecting findings for AY 1987-88 under some assumptions.

3.3. Estimation of Tax Saving

Our sample of individual taxpayers for AY 1987-88 consists of 50,074 assessees from computer tapes supplied by the Income Tax Department. These tapes contain data on selected items from income tax returns. The All India Income Tax Statistics (AIITS) gives the distribution of taxpayers for a significant number of taxpayers by 10 income classes. The Report of the Comptroller and Auditor General of India (RCAG), gives the distribution of the total population of income taxpayers by three income classes.

Sample taxpayers are classified into different income classes with different marginal tax rates. The income class-wise distribution of their income and deductions is given in Table 3.1. A Multiplier for each income class is calculated using the AIITS and the RCAG to obtain aggregate estimates from sample data. The distribution of all taxpayers as in the RCAG and also those covered in the AIITS are given along with the implied

AIITS-to-all-taxpayers multipliers in Table 3.2. Multipliers derived to obtain aggregate estimates from sample estimates using the RCAG multipliers derived in Table 3.2 and also sample-to-AIITS multipliers are presented in Table 3.3. Estimates of income and deductions of all taxpayers are obtained from sample estimates by multiplying sample data for different income classes by the respective multipliers (column 6 of Table 3.3). Figures relating to deductions are further multiplied by the respective marginal tax rates (column 31 of Table 3.1) to obtain tax savings of the taxpayers. This process of estimating tax saving assumes that the marginal tax rate of a taxpayer would remain unchanged even if the deduction was not taken. It is, however, possible that marginal tax rates of some taxpayers may have been higher without deductions claimed. Estimates of tax saving are, consequently conservative, having a downward bias.

3.4. Estimates

Deduction and tax saving estimates for taxpayers by broad deduction categories are in Table 3.4 and the corresponding income class-wise distributions are in Table 3.5. Deduction and tax saving classified by different sections of Chapter VIA are reported in Table 3.6. The Income class-wise distribution of deductions and tax saving under selected sections in Chapter VIA is in Table 3.7.

For AY 1987-88, Table 3.4 shows that deductions claimed by individual taxpayers under Chapter VIA, Section 23(1) and Section 24(2) work out to Rs. 3565 crore, resulting in tax saving of Rs. 1165 crore (Columns 3 and 4). This equals about 40 per cent of income taxes (other than the corporation tax) collected during the financial year 1986-87. It bears repetition that tax saving due to exemptions and other tax concessions is not included in this estimate. Tax saving due to tax concessions for newly constructed houses and for self-occupied houses does not exceed 1 per cent of the figure given (Column 6). The distribution of deductions with respect to each of the three categories is found to be progressive. Deductions claimed by the rich form a lower percentage of total deductions as compared to their income share (Table 3.5, Columns 2,3,5 and 7). Distribution of tax saving, however, is found to be progressive only in the case of the deduction for self-occupied property (Table 3.5, columns 2 and 8). Tax saving in the case of newly constructed property is distributed in favour of middle income taxpayers in the income range Rs 25,000 to 50,000 (Table 3.5, columns 2 and 6). Distribution of tax saving due to chapter VIA deductions is found to be regressive (Table 3.5, columns 2 and 4). This is so because the rich save tax at a higher marginal rate.

Deductions under incentive provisions introduced to promote savings and investment in specified assets (Sections 80C, 80CC and 80L) amount to Rs. 2978 crore which account for more than 84 per cent of deductions claimed under Chapter VIA (Table 3.6, Columns 2 and 4). This results in tax saving of Rs. 953 crore accounting for about 83 per cent of tax saving under Chapter VIA (Table 3.6, Columns 3 and 5). From Table 3.7, it may be noted that the distribution of deductions under Chapter VIA which is dominated by the deductions due to Section 80C is progressive (Columns 2 & 3). Under sections 80CC, and 80L deductions favour taxpayers in the income range Rs. 25,000 to Rs. 1 lakh (Columns 2,5,and 7). The distribution of deductions under Section 80T[1] is highly regressive (Columns 2 and 9) implying that the rich avail of a higher percentage of deductions on account of long term capital gains in relation to their income. Distribution of deductions under other sections is regressive. The distribution of tax saving is not progressive even under Section 80C (Columns 2 and 4). It is clearly regressive under section 80T (Columns 2 and 10), and favours taxpayers in the income range of Rs. 25,000 to Rs. 1 lakh, under sections 80CC, and 80L (Columns 2,6, and 8)

3.5 Projections for Assessment Year 1991-92

It is possible to obtain a rough estimate of tax saving from tax concessions prevalent in 1990-91 (AY 1991-92) under some assumptions. We do this in two steps. First, we obtain tax savings that would have been made, in AY 1987-88, if tax incentive provisions of the year 1990-91 had prevailed in AY 1987-88. Second, from the resulting estimate of tax savings for AY 1987-88, a forecast is made for AY 1991-92.

To obtain estimates of tax saving in AY 1987-88, given 1990-91 tax incentives, sample data for AY 1987-88 are adjusted as follows. Returned income of each individual in the sample is adjusted by adding back deductions under Sections 80C and 80CC. A tax credit on investments which had qualified for deductions under Sections 80C and 80CC in AY 1987-88 is then calculated at the rate allowed in AY 1991-92. Investment eligible for deduction under section 80CC is double the amount of deduction under that section. Computation of investment corresponding to the deduction under Section 80C is more complex[2].

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1. Since replaced by Section 48(2).

2. See chapter 2, Section 2 for details.

To obtain total tax relief, sample taxpayers are classified on the basis of adjusted returned income into 11 income classes as given in Table 3.8 (column 1). Individuals with adjusted returned income not exceeding Rs 22,000 are not taken into account since the exemption limit for 1990-91 is Rs 22,000. Deductions and investments of sample taxpayers in different income classes are multiplied by the weights given in Table 3.8 (column 2). Combined figures for all income classes are presented in Table 3.9 (column 39, serial Nos. 1 to 3). Tax relief due to deductions is then computed by multiplying the deductions by the marginal tax rates of taxpayers in different income brackets given in Table 3.8 (column 3). Aggregated figures are, once more, in Table 3.9 (column 4, serial Nos. 1 and 3). The tax rebate on investments eligible for rebate under sections 88 and 88A is at 20 per cent of the investment (Table 3.9, column 4, serial No. 2).

Interest deduction for self occupied property is computed only with respect to taxpayers reporting negative income from self occupied property. This class of taxpayers consists mostly of taxpayers who have only one self occupied property financed, at least partly, through borrowed funds. The estimate of tax relief due to interest deduction allowed to self-occupants is given in Table 3.9 (column 4, serial No. 4).

The total amount of tax relief in AY 1987-88 given AY 1991-92 tax concessions (in Chapter VI-A and in Sections 88, 88A, 23(1) and 24(2)) is estimated to be Rs 1117 crore. If a growth rate of 10 per cent is assumed, tax saving in the year 1990-91 will work out to be Rs 1487 crore which is about 27 per cent of the budget estimate of non-corporate income tax for 1990-91.

TABLE 3.1

Distribution of Sample Individuals and their Incomes and Deductions for Assessment Year 1987-88

(Rupees)

Returned income class (Rs. thousand)	Number of indivi-duals	Gross income	Gross total income	Chapter VIA deductions	Returned income	Deductions under Section 80C with respect to investment in LIC	PF/PPF	NSC	ULIP	Others
(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(8)	(10)	(11)
18-22	15147	357256600	356355400	63542080	292811300	23517570	8565773	2651766	4542151	8522293
22-25	4849	150997700	150227900	36310740	113917200	13097260	5461784	1393189	3121262	5064547
25-30	5638	202873500	202261500	48254080	154007200	18264660	5751862	1549481	3507293	6881388
30-50	10692	524953900	523264500	114921300	408343000	39051810	13302170	6842669	6447743	14664840
50-100	7215	594309900	591566700	101245100	490322000	29848500	10631620	4751172	4000940	9666970
100-200	4724	711992300	709168100	83992200	625177700	20032640	6934938	2847309	1572085	9841571
200-300	918	248970900	248489600	25960880	222528800	4014447	1609411	434702	190222	2166515
300-500	496	198989100	198384800	14011760	184373100	2150322	727743	382304	6960	950206
500-1000	236	174055400	173993800	9806066	164187700	1249725	396299	78974	2500	433826
above 1000	159	410680100	410616500	51297890	359318600	1119351	364543	42189	0	159376
	50074	3575079400	3564328800	549342096	3014986600	152346285	53746143	20973755	23391156	58351532

TABLE 3.1 (Contd)

Returned income class (Rs. thousand)	Total Deductions u/s 80C	Deductions u/s 80CC	Deduction u/s 80L for Dividend	Deduction u/s 80L for Interest	Deduction u/s 80L for Unclassified	Deduction u/s 80T for long term capital gains	Deduction u/s 80G for donations	Deduction u/s 80HH for units in backward	Deduction u/s 80HHA for units in rural	Deduction u/s 80HHB for foreign projects	Deduction u/s 80HHC for exports
	(12)	(13)	(14)	(15)	(16)	(17)	(18)	(19)	(20)	(21)	(22)
18-22	47799553	705559	2938323	5613884	25978	1022382	183610	0	0	0	0
22-25	28138042	356104	1501911	3053799	10992	489802	101680	11962	0	0	23009
25-30	35954684	499055	2348017	4512943	37426	909467	204931	1000	0	0	2370
30-50	80309232	1362133	7338216	11813300	72950	2983312	567734	45929	13006	0	162247
50-100	58899202	1355120	9119269	11995480	38000	3775662	736303	60780	24654	0	110217
100-200	41228543	1000770	8261657	8386952	35932	4561346	1006816	47816	24959	0	175879
200-300	8415297	262233	2002758	1452286	1642	4541067	185395	41449	1773	0	1701199
300-500	4217535	138061	956430	763677	7000	3279234	172414	34686	0	0	423191
500-1000	2161324	48750	469358	338674	0	1653044	176881	0	0	0	561830
above 1000	1685459	22000	414588	339830	14000	18112180	882352	12870390	7000	0	2039440
	308808871	5749785	35350527	48270825	243920	41327496	4218116	13114012	71392	0	5199382

TABLE 3.1 (Contd)

Returned income class (Rs.thousand)	Deduction u/s 80I for new units	Deduction u/s 80J for new units	Deduction for foreign income/ remuneration u/s 80R	80RR	80RRA	Deduction u/s 23(1) for new construction	Deduction u/s 24(2) for self occupied house	Dividend income	Interest Income	Marginal tax rate in years 1987-88	1990-91*
	(23)	(24)	(25)	(26)	(27)	(28)	(29)	(30)	(31)	(32)	(33)
18-22	133193	24564	15380	0	28987	160214	5297566	11507240	34983780	0.25	0.00
22-25	33254	0	23786	0	4824	130810	2356114	3251534	10115950	0.25	0.20
25-30	58375	3062	21816	12622	72637	222559	2295155	5518822	16120710	0.3	0.20
30-50	194827	0	94878	0	183959	499890	4878512	17000420	48970400	0.3	0.30
50-100	645850	22759	74482	15803	212661	297341	3685647	30700780	66024760	0.4	0.40
100-200	229864	16165	15950	442	423865	417175	3151035	40405340	70672270	0.5	0.50
200-300	112023	0	5988	0	185324	234286	719971	27380220	21624050	0.5	0.50
300-500	52574	0	0	12000	0	4284	527654	19583100	16719820	0.5	0.50
500-1000	224668	2500	0	3790	95900	0	102418	13688590	10156500	0.5	0.50
Above 1000	12701510	2500	0	0	0	0	0	22467000	14736460	0.5	0.50
	14386238	71550	252280	44657	1208157	1966559	23014072	191503046	310124700		

Note: A surcharge of 12 per cent on tax compiled is applicable if returned income exceeds Rs 75,000.

Source: Returns based data from Computer tapes supplied by the Income Tax Department.

TABLE 3.2

Distribution of Total Number of Individuals for Assessment Year 1987-88

Returne income range (Rs.thousand)	Number of individuals: Covered in AIITS	Total	AIITS to total multiplier (3)/(2)
(1)	(2)	(3)	(4)
18-100	2596019	3935698	1.52
100-500	62078	72102	1.16
Above 500	1579	3461	2.19
	2659676	4011261	-

Sources : Columns (2) and (3) are taken respectively from All India Income Tax Statistics (AIITS, 1987-88) and Report of the Comptroller and Auditor General of India (RCAG, 1988).

TABLE 3.3

Distribution of Sample and AIITS Individuals for Assessment Year 1987-88

Returned income range (Rs.thousand)	Number of individuals covered in		Sample to AIITS multiplier (3)/(2)	AIITS to total multiplier	Sample to total multiplier (4).(5)
	Sample	AIITS			
(1)	(2)	(3)	(4)	(5)	(6)
18-50	36326	2127635	58.57	1.52	88.80
50-100	7215	468384	64.92	1.52	98.42
100-200	4724	47799	10.12	1.16	11.75
200-300	918	9324	10.16	1.16	11.80
300-500	496	4955	9.99	1.16	11.60
500-1000	236	957	4.06	2.19	8.89
Above 1000	159	622	3.91	2.19	8.57
	50074	2659676	-	-	-

Note: Column 5 is based on Table 3.2 (Column 4).

TABLE 3.4

Selected Deductions and Tax Relief of Individual Taxpayers for Assessment Year 1987-88

S.No	Particulars of deduction	Amount of deduction Rs.lakh)	Tax relief (Rs.lakh)	Deduction as percentage of total	Tax relief as percentage of total
(1)	(2)	(3)	(4)	(5)	(6)
1.	Chapter VIA	353033	115405	99.03	99.10
2.	Newly constructed property [u/s 23(1)]	1270	413	0.36	0.35
3.	Self Occupied property [u/s 24(2)]	2163	640	0.61	0.55
	TOTAL	356466	116458	100.00	100.00

TABLE 3.5

Income Class-wise Deductions and Tax Relief as Percentages of Deductions and Tax-Relief of All Individual Taxpayers for Assessment Year 1987-88

Returned Gross income class (Rs. '000)	income	Chapter VIA		Newly Constructed Property		Self Occupied Property	
		Deductions	Tax relief	Deductions	Tax relief	Deductions	Tax relief
(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
18-25	24.14	25.12	19.21	20.35	15.65	43.65	36.90
25-50	34.57	41.04	37.66	50.52	46.63	41.46	42.07
50-100	31.29	28.23	35.54	23.05	28.36	12.26	16.59
Above 100	9.99	5.62	8.59	6.08	9.35	2.63	4.44
ALL	100.00	100.00	100.00		100.00	100.00	100.00
100.00							

TABLE 3.6

Estimates of Chapter VIA Deductions and Tax Relief of Individual Taxpayers for Assessment Year 1987-88

S.No.	Section	Amount of deductions (Rs lakh)	Tax relief (Rs. lakh)	Deductions as percentage of total	Tax relief as percentage of total
	(1)	(2)	(3)	(4)	(5)
1.	80C	235299	74348	66.65	64.42
2.	80CC	4100	1350	1.16	1.17
3.	80L	58393	19558	16.54	16.95
4.	Sub-Total	297792	95256	84.35	82.54
5.	80T	11668	4435	3.30	3.84
6.	80G	1916	685	0.54	0.59
7.	80HH	1230	598	0.35	0.52
8.	80HHA	40	15	0.02	0.01
9.	80HHB	0	0	0.00	0.00
10.	80HHC	770	340	0.22	0.29
11.	80I	2164	936	0.61	0.81
12.	80J	49	16	0.02	0.01
13.	80R	214	70	0.06	0.06
14.	80RR	29	10	0.01	0.01
15.	80RRA	547	200	0.15	0.17
16.	Others	36614	12844	10.37	11.13
17.	TOTAL	353033	115405	100.00	100.00

Note: The category others consists of Chapter VIA of the Income Tax Act, 1961 except the sections listed in this Table.

TABLE 3.7

Income Class-wise Deductions and Tax-Relief as Percentage of Deductions and Tax-Relief of all Individual Taxpayers for the Assessment Year 1987-88

(Per cent)

Returned income class (Rs. thousand)	Gross Income	Under Section 80C		Under Section 80CC		Under Section 80L		Under Section 80T		Others	
		Deductions	Tax Relief	Deductions	Tax Relief	Deductions	Tax Relief	Deductions	Tax Relief	Deductions	Tax Relief
(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	(11)	(12)
18-25	24.14	28.86	22.67	22.99	14.47	20.02	12.48	11.51	6.15	16.70	11.58
25-50	34.57	43.88	41.67	40.31	38.04	39.79	37.21	29.63	23.74	30.64	25.48
50-100	31.29	24.64	31.19	32.53	40.94	39.58	49.36	31.85	34.03	36.28	40.24
Above 100	9.99	2.83	4.48	4.17	6.55	0.61	0.95	27.02	36.08	16.38	22.70
All	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00

Note: The category 'others' consists of Chapter VIA of the Income Tax Act except sections 80C, 80CC, 80L and 80T.

TABLE 3.8

Income Classes, Marginal Tax Rates and Weights Used in Simulation Excercise for the year 1990-91

Adjusted returned income (Rs thousand)	Weights	Marginal tax rate
(1)	(2)	(3)
18-22	-	-
22-25	88.80	0.200
25-30	88.80	0.200
30-50	88.80	0.300
50-75	98.42	0.400
75-100	98.42	0.448
100-200	11.75	0.560
200-300	11.80	0.560
300-500	11.60	0.560
500-1000	8.89	0.560
Above 1000	8.57	0.560

Note: Weights given in column 2 are based on Table 3.2 (column 4).

TABLE 3.9

Estimated Tax Relief of Individual Taxpayers for Assessment Year 1987-88 under Tax Provisions of Assessment Year 1991-92

S. No.	Particulars	Section	Amount of Deduction/ investment(*) (Rs lakh)	Amount of Tax relief (Rs lakh)
(1)	(2)	(3)	(4)	(5)
1.	Chapter VI A deductions	80	105962	39807
		80L	53724	19401
		80T	10686	4344
		80G	1799	696
		80HH	1211	662
		80HHA	40	17
		80HHB	0	0
		80HHC	775	389
		80I	2065	1001
		80J	49	19
		80R	213	76
		80RR	29	11
		80RRA	523	204
		Others	34848	12987
2.	Tax Rebate on Savings		354637*	70927
		88	346860*	69372
		88A	7777*	1555
3.	Deduction for Newly Constructed Property	23(1)	1105	380
4.	Interest deduction for self occupied property	24(2)	2048	618
				111732

Figures marked with an asterisk represent investments rather than deductions.

CHAPTER 4

Evaluation of Concessions Under the Personal Income Tax[1]

4.1. Introduction

Tax concessions are provided through the income tax to promote savings in desired channels[2]. Tax concessions may take different forms, and accrual of tax relief may be immediate or spread over the holding period of an asset. Immediate tax relief is generally given in the form of an income deduction or a tax credit. Tax relief over the holding period of an asset is usually in the form of yield exemption or deduction or concessional taxation of yield. An income deduction or a tax credit under investment schemes which provide for accumulation of yearly returns may also be treated as reinvestment eligible for tax relief. Based on these forms of tax concessions, various schemes of different durations have been designed from time to time to attract savings by taxpayers.

Under most schemes, the extent of tax relief that different investors can avail of is not readily apparent. Substantial and unintended tax relief to investors is, therefore, a possibility. For schemes which were available during 1985-86 and 1986-87, it has been shown that post-tax rates of return from these schemes are distortionary, unduly high and could have

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1. The author of this chapter is grateful to Amaresh Bagchi for stimulating discussion on the subject under consideration. Disucssions with Arindam Das-Gupta, B.N. Goldar, M.C. Purohit, Tapas Kumar Sen and Rita Pandey were also useful. Praveen Kumar provided adept secretarial assistance.

2. Satisfactory evidence on the effectiveness of tax concessions in promoting savings and investment is lacking. For an attempt at analysing the role of interest rates in promoting household savings in India, see, for example, Bhattacharya (1985). There, however, is some evidence available about the positive effects of some income tax concessions given to the Indian corporate sector. See Aggarwal (1989 and 1991.)

adverse budgetary implications[3]. These rates differ widely across schemes and categories of taxpayers.

The Finance Bill 1990 has initiated the process of rationalising schemes of tax concession for savings and investment. The major step in this respect has been the shift from income deductibility to tax credits based on savings in specified forms. This has changed the extent of tax relief to different categories of taxpayers on their savings in specified channels. Some new incentive schemes have also been introduced.

This chapter aims at estimating rates of return to different categories of taxpayers under selected savings schemes available in 1990-91. From the rate of return structure that emerges, we have attempted to draw some inferences about the following:

(i) Extent of tax concession and subsidy built in into the savings schemes eligible for tax concessions,

(ii) Effect of the savings schemes on the pre-tax distribution of income,

(iii) Adequacy of the structure of savings schemes, and

(iv) Budgetary impact.

The plan of the chapter is as follows. Section 4.2 describes the tax rate schedule for individuals for 1990-91 and tax provisions governing saving schemes. Rate of return and tax concession concepts are discussed in Section 4.3. The methodology employed is presented in Section 4.4. The interest rate structure that emerges from savings schemes is presented and discussed in Section 4.5. Inferences with respect to the effect of the savings schemes on the distribution of pre-tax income are drawn in Section 4.6. Estimates of the extent of tax subsidy built in into savings schemes are presented and relevant budgetary implications are discussed in Section 4.7. Policy imperatives are discussed in Section 4.8.

3: See, for example, Bandoupadhyay and Das-Gupta (1988) and Das-Gupta (1988 & 1990). For a lucid discussion on savings, tax concessions and effective rates of return, see Hills (1984a, 1984b, 1984c).

4.2. Rate Schedule, Tax Concessions and Savings Schemes

The Income tax rate schedule for individuals in force during AY 1990-91 is given in Table 4.1. The marginal tax rate varies between 20 per cent at Rs.22,000 and 50 per cent at income exceeding Rs.1,00,000. A surcharge at the rate of 12 per cent is levied on the tax computed if taxable income exceeds Rs.75,000.

Salient features of 32 selected schemes eligible for deduction, tax credit, exemption or long term capital gains treatment once are given in Table 4.2.[4].

From Table 4.2 it is apparent that the 32 selected savings schemes have minimum holding periods varying from 0 to 15 years. Given this feature and also the varied tax treatment these schemes are eligible for, they broadly represent the gamut of savings schemes.

4.3. Rate of Return Concepts

Three concepts of the interest rate (or rate of return) are used: Administered, effective, and benchmark rates. In general, interest rates in India are adminisitered[5]. When administered rates are accompanied by tax concessions, the rate of return to the investor differs from the administered interest rate. The rate of return to an investor is called the effective rate of interest. The effective rate of return is the result of tax concessions and the administered interest rate. The difference between the effective and administered rates of interest measures the extent of tax concession in the effective rate of interest. Whether the effective interest rate is high or low cannot be judged in relation to the extent of tax concession or administered interest rate since a scheme with high tax concessions may be accompanied by a low administered interest rate and vice versa. For this purpose, the effective interest rate has

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4. See Chapter 2 for a comprehensive discussion of savings concessions

5. The interest rate or rate of return on investments in some assets, however, is not administered such as on investment in equity or mutual funds.

to be compared with a benchmark rate of interest.[6]. The benchmark rate of interest may be taken as the administered rate of return on an asset not eligible to tax concessions such as non-convertible debentures or fixed deposits of public limited companies. The difference between the effective rate of interest and benchmark rate of interest is a subsidy to the investor. Further, the administered, effective and benchmark rates of interest are defined as pre-tax and post-tax, where a post-tax rate of interest is taken as the pre-tax rate multiplied by the factor 'one minus the marginal tax rate of the investor'. The tax concession and subsidy based on pre-tax rates of interest can be termed the pre-tax tax concession and pre-tax subsidy respectively. Similarly, the tax concession and subsidy based on post-tax rates of interest can be called the post-tax tax concession and post-tax subsidy[7] . For the concepts discussed here, the following notation is used:

$R_{ap}(R_{apo})$: Administered pre-tax (post-tax) rate of interest.

$R_{ep}(R_{epo})$: Effective pre-tax (post-tax) rate of interest.

$R_{bp}(R_{bpo})$: Benchmark pre-tax (post-tax) rate of interest.

$TC_p(TC_{po})$: Pre-tax (post-tax) tax concession.

$S_p(S_{po})$: Pre-tax (post-tax) subsidy.

$CO_p(CO_{po})$: Pre-tax (post-tax) compensation for low/high administered tax rate.

t : Marginal tax rate of an investor.

$R_{apo} = (1-t)R_{ap}$

$R_{epo} = (1-t)R_{ep}$

$R_{bpo} = (1-t)R_{bp}$

The administered interest rate, with or without tax concessions, results in a stream of post-tax returns to the investor during the holding period of an asset. This gives rise to an internal post-tax rate of return. This internal post-tax rate

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6. This would normally be "the market rate of interest". However, with administered rates of interest, capital market imperfections and imperfect international mobility of capital flows, a single market rate structure is hard to identify if at all it exists

7. To understand the concepts of pre-tax and post tax subsidy/tax concession it should be recognised that a subsidy/tax concession can be taxable. For example, Central investment subsidy to the companies in the backward areas can be taxable or non-taxable.

of return depends on tax concessions associated with the investment and may also depend on the marginal tax rate of the investor. This rate of return is referred to as the effective post-tax rate of return (R_{epo}). For an investor, the effective post-tax rate of return is equivalent to some pre-tax rate of return with no tax concessions. This pre-tax rate of return is denoted by R_{ep}. Clearly, these effective pre- and post-tax rates of return are related as $R_{epo} = (1-t)\ R_{ep}$. A rational investor would be indifferent between an effective pre-tax rate of return 'R_{ep}' and an effective post-tax rate of return 'R_{epo}' holding constant other features of the asset.

The difference between the effective and administered pre-tax rates of return (R_{ep}-R_{ap}) gives the tax effect implicit in the effective pre-tax interest rate. A positive value of this difference would imply a tax concession and a negative value would mean a tax penalty in the rate of return. The tax effect can be decomposed into two parts as follows:

$$R_{ep} - R_{ap} = (R_{ep} - R_{bp}) + (R_{bp} - R_{ap}) \qquad (1)$$

The second component on the right of this equation can be interpreted as the adjustment or compensation for a low or high administered interest rate in comparison with the benchmark rate of return. A positive value of this component implies a compensation for a low administered rate and negative value means an interest penalty for a high administered interest rate. This component does not depend on the marginal tax rate of the investor. The first component on the right side of equation (1) is the interest subsidy to the investor. This subsidy may vary with the marginal tax rate of the investor. Variation in this term is attributable to variation in effective pre-tax rates of return 'R_{ep}' of investors.

4.4. Methodology

Effective post-tax rates of return on investment in various savings schemes can be computed as post-tax internal rates of return on investments in these schemes[8]. These rates of return can be translated into effective pre-tax rates of return by using the relation $R_{ep} = R_{epo}/(1-t)$ where t is the marginal tax rate of an investor.

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8. A justification for using the internal rate of return criterion as opposed to a present value criterion is in Auerbach (1982).

The relative distortion in the interest rate or rate of return structure can be analysed in terms of variation in the effective pre-tax rates of return across different categories of investors and across different savings schemes.

Inferences about the influence of the interest rate structure on the distribution of pre-tax income can also be drawn from the effective pre-tax rates of return. If this rises with the marginal tax rate of investors this would mean higher interest rate subsidy to the rich. Such a subsidy can be said to be inconsistent with income redistribution policies which the developing countries generally advocate. This would have an adverse effect on the distribution of pre-tax income. A constant R_{ep} for all the investors irrespective of their marginal tax rates can be said to be distributionally neutral. A subsidy that results in R_{ep} falling as the marginal tax rate of investors increases can be said to have potential to redistribute income in favour of the relatively poor.

The tax concession per rupee of investment in an asset with a holding period of n years can be computed as $(1+R_{ep})^n-(1+R_{ap})^n$, the benefit available to an investor after n years. Its present value to the investor, using R_{ep} as the discount rate, is $[(1+R_{ep})^n-(1+R_{ap})^n]/(1+R_{ep})^n$. This can also be decomposed into tax subsidy and compensation for low or high administered interest rate as follows:

$$\frac{(1+R_{ep})^n-(1+R_{ap})^n}{(1+R_{ep})^n} = \frac{(1+R_{ep})^n-(1+R_{bp})^n}{(1+R_{ep})^n} + \frac{(1+R_{bp})^n-(1+R_{ap})^n}{(1+R_{ep})^n} \qquad (2)$$

As in equation (1), the first term on the right side of equation (2) is subsidy to the investor for investing one rupee for n years in a specified asset. This may vary with the marginal tax rate of the investor. A positive (negative) value of this component means a subsidy (penality) to the investor for investing in the specified asset. The second term is, as before, the adjustment or compensation for the administered interest rate in comparison with the benchmark rate of return which is independent of the marginal tax rate of the investor.

Alternatively, the subsidy per rupee of savings in an asset with a holding period of n years can be computed as follows:

$$1.(1+R_{b,pre})^n = X.(1+R_{e,pre})^n \qquad (3)$$

Here, X is the required investment in an asset subjected to concessional tax treatment leading to the same amount after n years as from a one rupee investment at the benchmark rate of interest. (1-X) then measures the amount of subsidy given per rupee of savings invested for n years in the specified asset. Note that the subsidy, (1-X) is the same as the subsidy component in equation (2).

It is clear that the subsidy in equations (2) and (3) depends on the holding period of the asset. It is, therefore, comparable across assets only with same holding period. It would also be useful to estimate yearly subsidy in order to permit comparison across assets having different holding periods. The yearly tax concession or subsidy can be obtained by putting n = 1 in equation (2). This gives:

$$\frac{Rep-Rap}{1+Rep} = \frac{Rep-Rbp}{1+Rep} + \frac{Rbp-Rap}{1+Rep} \qquad (4)$$

Equation (4) translates tax benefits available at the end of the year into the present value of the benefits to the investor.

An interest rate structure or interest rate subsidy that is neutral or inequality reducing will have adverse budgetary implications as compared to an interest rate structure that raises inequality. This is because the same (positive) interest subsidy to the rich means less net cost to the government given that the rich pays tax at a higher marginal tax rate. This net cost criterion is directly applicable in analysing budgetary implications of the subsidy. To analyse budgetary implications, equations (2), (3) and (4) can be rewritten in terms of post-tax rates of return as follows:

$$\frac{(1+Repo)^n-(1+Rapo)^n}{(1+Repo)^n} = \frac{(1+Repo)^n-(1+Rbpo)^n}{(1+Repo)^n} + \frac{(1+Rbpo)^n-(1+Rapo)^n}{(1+Repo)^n}, \qquad (5)$$

$$(1+Rbpo)^n = X^* (1+Repo)^n, \text{ and} \qquad (6)$$

$$\frac{Repo-Rapo}{1+Repo} = \frac{Repo-Rbpo}{1+Repo} + \frac{Rbpo-Rapo}{1+Repo} \qquad (7)$$

where $(1-X^*)$ is the post-tax (or net) subsidy.

In equations (5) and (7) the terms on the left side are the post-tax (or net) tax concession, the first component on the right side can be interpreted as post-tax (or net) interest subsidy and the second component on the right side is the net adjustment for administered interest rates. The net interest subsidy is the policy variable so far as budgetary implications are concerned. This may vary across assets and hence different portfolios, depending on tax concessions available on different assets and across investors depending on their marginal tax rates.

Regarding the benchmark rate of return 'R_{bp}' it may be noted that investment in non-convertible debentures of companies is not subject to any tax concessions and is approximately as safe an investment as assets receiving concessional tax treatment studied in this chapter. The maximum rate of interest payable on non-convertible debentures is therefore taken to be the benchmark rate of return. The maximum interest rate allowable on these debentures is 14 per cent cumulated monthly. This amounts to a 14.93 per cent per annum annual compound rate of interest. For brevity, the benchmark rate of return payable yearly can be taken to be 15 per cent.

4.5. Interest Rate Structure of Savings Schemes

Effective pre-tax and post-tax rates of return are computed for 26 selected financial assets, including 21 assets entitled to tax concessions. These financial assets cover a variety of schemes based on different forms of tax concessions and with different holding periods. Effective post-tax and pre-tax rates of return are computed[9] for investors with different marginal tax rates, and these are presented respectively in Tables 4.3 and 4.4.

Table 4.4 shows that effective pre-tax rates of return differ widely across different assets irrespective of the holding period. Also, with respect to a given asset, these rates differ across investors in different marginal income tax brackets[10]. The range of variation for different holding periods is, furthermore, fluctuating. The rates of return vary from 8.24 to 45.98 per cent. This clearly shows that the interest structure is highly distortionary. The prevalence of such an interest structure can be attributed to hidden and almost surely unintended subsidies. To some extent, distortion in the interest structure is apparent from the interest rates (Column 4) applicable to non-taxpayers (i.e., investors with zero marginal tax rate) but this gets ignored as the tax concession schemes are not really geared to this class of investors.

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9. To compute the internal rate of return of a savings scheme, it is assumed, wherever necessary, that the marginal tax rate of the investor remains unchanged during the period of the scheme. For specific assumptions and the formulae for computation of internal rates of return (post-tax), see the Annexure to this chapter.

10. There are some exceptions such as non-convertible debentures, fixed deposits of companies and post office 10-year social security certificates.

From Table 4.3, it can be seen that effective post-tax rates of return, like effective pre-tax rates of return, vary widely across different assets. This reaffirms the finding that the interst stucturre is highly distortionary. Note, however, that for a given asset, the effective post-tax rate of return, unlike the pre-tax rate of return, generally remains unchanged or declines with the marginal tax rate of the investor. This simply reaffirms the fact that Indian personal income tax is progressive.

4.6. Distribution of Income

From Table 4.4 it can also be observed that, for a given asset, rich investors have higher effective pre-tax rate of return than others[11]. The rate of return rises with the marginal tax rate of the investor (columns 4 to 8). This suggests that the interest structure of savings schemes has an adverse effect on the distribution of income. This is contrary to the goal of mitigating economic inequality that is generally advocated by developing countries.

It may also be noted in the succeeding section that the interest structure of savings schemes results in a system of subsidy that rises with the marginal tax rate of investors. This reaffirms our finding that the interest structure is distortionary and adversely affects distribution of income.

Though, apparently, the pre-tax interest rate structure and its effect on distribution of pre-tax income appear notional, this is not the case. Assume that the government borrows Rs. Z through savings schemes receiving tax concessions. Let the average pre-tax interest rate on these borrowings be denoted by R. Now let us have an alternate scenario of borrowing by the government wherein it pays pre-tax interest rate at R per cent but with no tax concessions. The alternative scenario of borrowing would, in fact, result in a distribution of pre-tax income that is more equal as compared to that associated with the system of borrowing through the savings schemes eligible for tax concessions[12].

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11. See footnote 10.

12. The alternate scenario may, however, give rise to other policy issues such as whether or not the government would be able to borrow Rs Z by paying the pre-tax interest rate R or, if R or any lower rate necessary to borrow Z is higher than the interest rate fixed for borrowing by the private sector, which in fact would be true, then the interest rate allowable on borrowings of the private sector, has to be simultaneously raised. This however does not reduce the importance of the fact that the alternative scenario of bor

4.7. Tax Subsidy in Savings Schemes

Subsidy with reference to the benchmark pre-tax rate of return (15 per cent) is computed for all 26 assets and investors with different marginal tax rates. The subsidy (in present value terms) for the full period of holding of different assets is computed by using equations (2) and (5), and the yearly subsidy is computed by using equations (4) and (7). Estimates of effective pre-tax subsidy for the full holding period obtained by using equation (2) are given in Table 4.5 and those of the yearly pre-tax subsidy computed by using equation (4) are presented in Table 4.6. The estimates of effective post-tax subsidy for the full holding period of different assets obtained by using equation (5) are reported in Table 4.7 and those of the yearly post-tax subsidy obtained by using equation (7) are given in Table 4.8.

a. Analysis of pre-tax Subsidy

Table 4.5 shows that there is substantial variation in pre-tax subsidy across investors with different marginal tax rates as well as across assets having the same holding period. Distortions in the system of subsidy are vivid. In general, the subsidy rises with the maginal tax rate of the investor. In fact, low income persons (particularly non-taxpayers) get negative subsidy so that they are penalised if they happen to invest in tax incentive schemes designed to lure the taxpayer.

The level of subsidy is of serious concern. For example, under the 15 year provident fund scheme, an investor with a marginal tax rate of 20 per cent is required to invest only Rs. 64 to get (after 15 years) an amount that he would have received by investing Rs. 100 at the benchmark rate of return. An investor with a marginal tax rate of 50 per cent however has to invest only Rs. 17 to get the same amount after 15 years. It may, however, be noted that level of subsidy is a function of the holding period. Consequently, the yearly subsidy estimates in Table 4.6 are more informative.

From Table 4.6, it would be noted that there is substantial variation even in yearly pre-tax subsidy across different assets as well as across investors with different marginal tax rates. The pattern of variation is similar to that observed in the case of effective pre-tax rates of return (Table 4.4). This again confirms the finding that the interest structure is highly distortionary and has an adverse effect on the distribution of income.

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rowing would result in a more equal distribution of pre-tax income.

Among assets considered, the element of subsidy is highest for HUDCO capital gain debentures (1990), followed, in descending order, by the National Savings Scheme (for a person due to retire after three years), 10-year Unit Linked Insurance Plan (1971), Dhan Varsha II (1990), 15-year Public Provident Fund, 7-year interest deductible public sector bonds, 7-year Monthly (or Cumulative) Income Unit Scheme of the UTI (1990-II).

b. <u>Analysis of post-tax subsidy</u>

Table 4.7 shows that there is substantial variation in post-tax subsidy across investors with different marginal tax rates. The variation in post-tax subsidy is, however, lower than the variation in pre-tax subsidy (Table 4.5). The variation in post-tax subsidy, like that in pre-tax subsidy, is associated with higher subsidy to the investors with higher marginal tax rates. Investors with higher marginal tax rates enjoy higher subsidy inspite of constant or lower post-tax rate of return of investors with higher marginal tax rates (Table 4.3) because the post-tax benchmark rate of return is lower for investors with higher marginal tax rates. Post-tax subsidy, like pre-tax subsidy, varies across assets even among assets with the same holding period. Yearly post-tax subsidy is also found to vary substantially across different assets and across investors with different marginal tax rates (Table 4.8). Across investors it moves from negative to positive as the marginal tax rate increases. Across assets, the subsidy for an investor with a marginal tax rate of 50 per cent varies from -1.60 to 23.13 per cent.

The level of effective yearly post-tax subsidy to taxpayers is unduly high under some savings schemes eligible for tax concessions. Note that the subsidy is in addition to what taxpayers would have normally received at the benchmark rate of interest. From Table 4.8, the yearly post-tax subsidy for investors with a marginal tax rate of 50 per cent is 12.59 per cent of the amount invested in HUDCO capital gain debentures - 1990 (serial No. 15, column 8). Several other schemes are also found to be highly subsidised. High levels of post-tax subsidy built-in into savings schemes eligible for tax concessions will obviously have an adverse effect on budgetary resources.

From the discussion above, it is clear that the level of post-tax subsidy is high and the structure of interest rate subsidies is highly distortionary and in favour the relatively rich. A reduction in the level of subsidy as well as in the extent of variation in subsidy across specified assets and investors with different marginal tax rates appears to be desirable. This should be achieved through reduction in tax concessions particularly for schemes which result in relatively high pre-tax rates of return.

4.8 Policy Imperatives

To correct the prevalent interest structure and make it less distortionary and more egalitarian, the following rules of thumb are proposed.

i) As far as possible, different incentive schemes should be so designed that there is no variation in rates of return, under these schemes;

ii) Dependence on tax concessions should be reduced, and wherever necessary, administered interest rates may be raised.

iii) To the extent reliance on tax concessions is considered desirable, concession should be given in the form of a tax credit (such as under Sections 88 and 88A) instead of in the form of a deduction or exemption (such as under Sections 10 and 80L).

TABLE 4.1

Marginal Tax Rates of Income

Taxable Income (Rs. thousand)	Marginal tax Rate (Per cent)
(1)	(2)
0 - 22	0
22 - 30	20
30 - 50	30
50 - 100	40
Above 100	50

Note: A surcharge at the rate of 12 per cent on the tax computed is levied if taxable income exceeds Rs. 75,000.

Table 4.2

Characteristics and Tax Treatment of Selected Assets for Assessment Year 1991-92

S.No.	Asset	Holding period (years)	Income tax benefit u/s	Actual pre-tax interest rate (%)	REMARKS
(1)	(2)	(3)	(4)	(5)	(6)
	Post Office Savings Scheme				
1.	Savings account	0	10(15)	5.5	Payable half yearly.
2.	Time deposits	1-5	10(15)	9.5-11.0	Interest rate for 1,2,3 and 5 year deposits are respectively 9.5, 10.0, 10.5, and 11.0 per cent. Half yearly compounding; premature encashment permitted with 2 percentage point penalty on the rate applicable for the period lapsed.
3.	5-Year recurring deposit	5	10(15)	11.0	Quarterly compounding; a monthly deposit of Rs. 10/- for 5 years fetches Rs. 800/30.
4.	National Savings Scheme	3 or more	80CCA	11.0	Yearly compounding. Deposits in the account are deducted from and withdrawals added to taxable income.
5.	Indra Vikas Patra	5	None	-	Money doubles in 5 years, bearer bonds.
6.	Kisan Vikas Patra	5.5	48		Money doubles in 5½ years. Premature encashment permitted after 2.5 years.
7.	National Savings Certificates (Series VIII)	6	88	12.0	Half yearly compounding.
8.	10-Year social security certificates	10	None		Money triples in 10 years. Tax is payable on yearly tax credits. On death of the holder before maturity, the target amount (i.e., triple) is paid to the nominee etc.
9.	15-Year public provident fund	15	80,10(11)	12.0	Yearly compounding. Loans are permitted after 3 years and partial withdrawals are permitted after 7 years.
10.	Monthly income scheme	6	80L	12.0	Monthly compounding or payable monthly, plus 10 per cent bonus on maturity.
	Commercial Bank Deposits				
11.	Savings account	0	80L	5.0	Half yearly compounding.
12.	Time deposits	1 or more	80L	8-10	Quarterly compounding. Interest rates for 1 and 2 years deposits are 8 and 9 per cent respectively and that for 3 or more years deposits is 10 per cent. Premature encashment permitted with 2 percentage point penality on the rate applicable for the period lapsed.

(1) (2)	(3)	(4)	(5)	(6)
13. Recurrent deposits	1 or more	80L	8-10	Same as for time deposits of commercial banks except the clause of compounding.
14. 7-Year mutual funds	0-7	80CC,80L	-	
Unit Trust of India				
15. Units scheme, 1964	0	80L	-	
16. Master Shares, 1986	0	80L	-	
17. 7-Year monthly/cumulative income unit scheme 1990 (II)	0-7	80L	13+	Monthly compounding, two bonuses in 3rd & 5th Year and capital appreciation. Transfer under cumulative scheme permitted.
18. 10 Year unit linked insurance plan, 1971	10	88,80L	-	
19. 15-Year unit linked insurance plan, 1971	15	88,80L	-	
Public Sector Bonds				
20. 7 Year interest deductible bonds	0-7	80L	14	Half yearly compounding. Buyback at par after 3 years. Transferable and quoted.
21. 10-Year interest exempt bonds	0-10	10	10	Half yearly compounding. Buyback at par after 3 years. Transferable and quoted.
Private Sector Schemes				
22. Convertible debentures	0-3	None	12.5-14.0	Half yearly compounding. Interest rate and terms of conversion vary between companies. Transferable and quoted.
23. Non-convertible debentures	0-9	None	14	Half yearly compounding. Transferable, quoted and secured.
24. 1-Year fixed deposit	1	None	13	Half yearly compounding.
25. 2(3) Year fixed deposit	2(3)	None	14	Half yearly compounding.
Life Insurance Corporation				
26. Dhan Varsha II (1990)	5.5	80L	14+	Quarterly compounding plus appreciation.

(1)	(2)	(3)	(4)	(5)	(6)
	Equity				
27.	Short term	0	80L	-	
28.	Long term	1	48,80L	-	
29.	Eligible issue of new companies	3	48,80CC,80L	-	
	Other Assets				
30.	General provident fund		88,80L,10(12)		
31.	Contributory provident fund		88,80L,10(12)		
32.	HUDCO Capital gains debentures	3	54E,80L	9	Half yearly compounding or payable half yearly. Under cumulative scheme Rs. 1,000 grows to Rs 1,302 on maturity.

TABLE 4.3

Effective Posttax Rates of Return on Selected Financial Assets Entitled to Tax Concessions

S.No.	Asset	Holding period (year)	Marginal income tax rate (per cent) 0	20	30	40	50
(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
1.	7 Year Interest Deductible Public Sector Bonds	0-7	14.49	14.49	14.49	14.49	14.49
2.	7 Year Cumulative Income Unit Scheme of UTI (1990 II)	0-7	14.37	14.37	14.37	14.37	14.37
3.	10 Year Interest Exempt Public Sector Bonds	0-10	10.25	10.25	10.25	10.25	10.25
4.	5 Year Non-Convertible Debentures of Companies	0-5	14.49	11.59	10.14	8.69	7.24
5.	Post Office Time Deposit	1	9.73	9.73	9.73	9.73	9.73
6.	Commercial Bank Fixed Deposit	1	8.24	8.24	8.24	8.24	8.24
7.	Fixed Deposit of Companies	1	13.42	10.74	9.40	8.05	6.71
8.	Post Office Time Deposit	2	10.25	10.25	10.25	10.25	10.25
9.	Commercial Bank Fixed Deposit	2	9.31	9.31	9.31	9.31	9.31
10.	Fixed Deposit of Companies	2	14.49	11.59	10.14	8.69	7.24
11.	Post Office Time Deposit	3	10.78	10.78	10.78	10.78	10.78
12.	Commercial Bank Fixed Deposit	3	10.38	10.38	10.38	10.38	10.38
13.	Fixed Deposit of Companies	3	14.49	11.59	10.14	8.69	7.24
14.	National Savings Scheme	3	11.00	19.57	25.01	31.60	39.85
15.	HUDCO Capital Gain Debentures (1990)	3	9.20	13.96	16.67	19.66	22.99
16.	Post Office Time Deposit	5	11.30	11.30	11.30	11.30	11.30
17.	Commercial Bank Fixed Deposit	5	11.46	11.46	11.46	11.46	11.46
18.	Indra Vikas Patra	5	14.87	11.82	10.35	3.87	7.43
19.	National Savings Scheme	5	11.00	15.21	17.80	20.86	24.59
20.	Kisan Vikas Patra	5.5	13.43	12.59	12.16	11.72	11.28
21.	Dhan Varsha II (1990)	5.5	14.74	14.74	14.74	14.74	14.74
22.	Post Office Monthly Income Scheme	6	13.58	13.58	13.58	13.58	13.58
23.	National Savings Certificates (Series VIII)	6	12.39	16.21	14.79	13.37	11.96
24.	Post Office 10-Year Social Security Certificates	10	11.61	9.29	8.13	6.97	5.81
25.	10 Year Unit Linked Insurance Plan-1971	10	14.25	18.80	18.80	18.80	18.80
26.	15 Year Public Provident Fund	15	12.00	14.74	14.74	14.74	14.74

Note: The marginal tax rate of the investor is taken to remain unchanged during the period of a savings scheme except in the case of National Savings Scheme wherein it is assumed that the marginal tax rate of the investor falls to nil on maturity of the scheme.

TABLE 4.4

Effective Pretax Rates of Return on Selected Financial Assets Entitled to Tax Concessions

S.No.	Asset	Holding period (year)	Marginal income tax rate (per cent)				
			0	20	30	40	50
(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
1.	7 Year Interest Deductible Public Sector Bonds	0-7	14.49	18.11	20.70	24.15	28.98
2.	7 Year Cumulative Income Unit Scheme of UTI (1990 II)	0-7	14.37	17.96	20.53	23.95	28.74
3.	10 Year Interest Exempt Public Sector Bonds	0-10	10.25	12.81	14.64	17.08	20.50
4.	5 Year Non-Convertible Debentures of Companies	0-5	14.49	14.49	14.49	14.49	14.49
5.	Post Office Time Deposit	1	9.73	12.16	13.90	16.22	19.46
6.	Commercial Bank Fixed Deposit	1	8.24	10.30	11.77	13.73	16.48
7.	Fixed Deposit of Companies	1	13.42	13.42	13.42	13.42	13.42
8.	Post Office Time Deposit	2	10.25	12.81	14.64	17.08	20.50
9.	Commercial Bank Fixed Deposit	2	9.31	11.64	13.30	15.52	18.62
10.	Fixed Deposit of Companies	2	14.49	14.49	14.49	14.49	14.49
11.	Post Office Time Deposit	3	10.78	13.47	15.40	17.97	21.56
12.	Commercial Bank Fixed Deposit	3	10.38	12.97	14.83	17.30	20.76
13.	Fixed Deposit of Companies	3	14.49	14.49	14.49	14.49	14.49
14.	National Savings Scheme	3	11.00	19.57	25.01	31.60	39.85
15.	HUDCO Capital Gain Debentures (1990)	3	9.20	17.45	23.81	32.77	45.98
16.	Post Office Time Deposit	5	11.30	14.12	16.14	18.83	22.60
17.	Commercial Bank Fixed Deposit	5	11.46	14.32	16.37	19.10	22.92
18.	Indra Vikas Patra	5	14.87	14.87	14.87	14.87	14.87
19.	National Savings Scheme	5	11.00	15.21	17.80	20.86	24.59
20.	Kisan Vikas Patra	5.5	13.43	15.74	17.37	19.54	22.56
21.	Dhan Varsha II (1990)	5.5	14.74	18.42	21.06	24.57	29.48
22.	Post Office Monthly Income Scheme	6	13.58	16.98	19.40	22.64	27.16
23.	National Savings Certificates (Series VIII)	6	12.39	20.26	21.13	22.28	23.92
24.	Post Office 10-Year Social Security Certificates	10	11.61	11.61	11.61	11.61	11.61
25.	10 Year Unit Linked Insurance Plan-1971	10	14.25	23.50	26.86	31.33	37.60
26.	15 Year Public Provident Fund	15	12.00	18.42	21.06	24.57	29.48

Note: Corresponding effective posttax rates of return are given in Table 4.3.

TABLE 4.5

Percentage of Effective Pretax Subsidy on Selected Financial Assets Entitled to Tax Concessions

S.No.	Asset	Holding period (year)	Marginal income tax rate (per cent) 0	20	30	40	50
(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
1.	7 Year Interest Deductible Public Sector Bonds	0-7	-03.16	17.04	28.72	41.49	55.20
2.	7 Year Cumulative Income Unit Scheme of UTI (1990 II)	0-7	-03.92	16.30	28.02	40.82	54.62
3.	10 Year Interest Exempt Public Sector Bonds	0-10	-52.47	-21.20	-3.18	16.41	37.32
4.	5 Year Non-Convertible Debentures of Companies	0-5	-2.25	-2.25	-2.25	-2.25	-2.25
5.	Post Office Time Deposit	1	-4.80	-2.53	-0.97	1.05	3.73
6.	Commercial Bank Fixed Deposit	1	-6.25	-4.26	-2.89	-1.12	1.28
7.	Fixed Deposit of Companies	1	-1.39	-1.39	-1.39	-1.39	-1.39
8.	Post Office Time Deposit	2	-8.80	-3.92	-0.63	3.52	8.92
9.	Commercial Bank Fixed Deposit	2	-10.68	-6.11	-3.02	0.90	6.01
10.	Fixed Deposit of Companies	2	-0.89	-0.89	-0.89	-0.89	-0.89
11.	Post Office Time Deposit	3	-11.87	-4.10	1.04	7.36	15.33
12.	Commercial Bank Fixed Deposit	3	-13.09	-5.49	-0.44	5.77	13.64
13.	Fixed Deposit of Companies	3	-1.34	-1.34	-1.34	-1.34	-1.34
14.	National Savings Scheme	3	-11.20	11.03	22.15	33.27	45.40
15.	HUDCO Capital Gain Debentures (1990)	3	-16.80	6.13	19.86	35.02	51.11
16.	Post Office Time Deposit	5	-17.76	-3.92	4.81	15.11	27.38
17.	Commercial Bank Fixed Deposit	5	-16.92	-3.01	5.75	16.07	28.32
18.	Indra Vikas Patra	5	-0.57	-0.57	-0.57	-0.57	-0.57
19.	National Savings Scheme	5	-11.36	0.91	11.33	22.00	33.00
20.	Kisan Vikas Patra	5.5	-7.85	3.47	10.61	19.18	29.54
21.	Dhan Varsha II (1990)	5.5	-1.25	14.89	24.61	35.57	47.91
22.	Post Office Monthly Income Scheme	6	-7.74	9.74	20.17	32.02	45.29
23.	National Savings Certificates (Series VIII)	6	-14.77	23.54	26.77	30.81	36.12
24.	Post Office 10-Year Social Security Certificates	10	-34.88	-34.88	-34.88	-34.88	-34.88
25.	10 Year Unit Linked Insurance Plan-1971	10	-6.76	50.99	62.52	73.49	83.37
26.	15 Year Public Provident Fund	15	-48.66	35.57	53.71	69.85	83.12

Notes:

1. The benchmark annual pretax rate of return is taken to be 15 per cent for all the persons, and actual effective pretax rates of return are as given in Table 4.4.

2. Subsidy is computed for the maximum holding period.

3. Subsidy figures are expressed as a percentage of present value of investment in the scheme.

TABLE 4.6

Percentage of Effective Yearly Pretax Subsidy on Selected Assets Entitled to Tax Concessions

S.No.	Asset	Holding period (year)	Marginal income tax rate (per cent) 0	20	30	40	50
(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
1.	7 Year Interest Deductible Public Sector Bonds	0-7	-0.45	2.63	4.72	7.37	10.84
2.	7 Year Cumulative Income Unit Scheme of UTI (1990 II)	0-7	-0.55	2.51	4.59	7.22	10.67
3.	10 Year Interest Exempt Public Sector Bonds	0-10	-4.31	-1.94	-0.31	1.78	4.56
4.	5 Year Non-Convertible Debentures of Companies	0-5	0.45	-0.45	-0.45	-0.45	-0.45
5.	Post Office Time Deposit	1	-4.80	-2.53	-0.97	1.05	3.73
6.	Commercial Bank Fixed Deposit	1	-6.25	-4.26	-2.89	-1.12	1.27
7.	Fixed Deposit of Companies	1	-1.39	-1.39	-1.39	-1.39	-1.39
8.	Post Office Time Deposit	2	-4.31	-1.94	-0.31	1.78	4.56
9.	Commercial Bank Fixed Deposit	2	-5.21	-3.01	-1.50	0.45	3.05
10.	Fixed Deposit of Companies	2	-0.45	-0.45	-0.45	-0.45	-0.45
11	Post Office Time Deposit	3	-3.81	-1.35	0.35	2.52	5.40
12.	Commercial Bank Fixed Deposit	3	-4.19	-1.80	-0.15	1.96	4.77
13.	Fixed Deposit of Companies	3	-0.45	-0.45	0.45	-0.45	0.45
14.	National Savings Scheme	3	-3.60	3.82	8.01	12.61	17.77
15.	HUDCO Capital Gain Debentures (1990)	3	-5.31	2.09	7.12	13.38	21.22
16.	Post Office Time Deposit	5	-3.32	-0.77	0.99	3.22	6.20
17.	Commercial Bank Fixed Deposit	5	-3.18	0.59	1.18	3.44	6.44
18.	Indra Vikas Patra	5	-0.11	-0.11	-0.11	-0.11	-0.11
19.	National Savings Scheme	5	3.60	0.18	2.38	4.85	7.70
20.	Kisan Vikas Patra	5.5	-1.38	0.64	2.02	3.80	6.17
21.	Dhan Varsha II (1990)	5.5	-0.23	2.89	5.01	7.68	11.18
22.	Post Office Monthly Income Scheme	6	-1.25	1.69	3.68	6.23	9.56
23.	National Savings Certificates (Series VIII)	6	-2.32	4.37	5.06	5.95	7.20
24.	Post Office 10-Year Social Security Certificates	10	-3.04	-3.04	-3.04	-3.04	-3.04
25.	10 Year Unit Linked Insurance Plan-1971	10	-0.66	6.88	9.35	12.43	16.42
26.	15 Year Public Provident Fund	15	-2.68	2.89	5.01	7.68	11.18

Notes:

1. The benchmark annual pretax rate of return is taken to be 15 per cent for all the persons, and actual effective pretax rates of return are as given in Table 4.4.

2. Subsidy figures are expressed as a percentage of the present value of investment in the scheme.

TABLE 4.7

Percentage of Effective Posttax Subsidy on Selected Assets Entitled to Tax Concessions

S.No.	Asset	Holding period (year)	Marginal income tax rate (per cent)				
			0	20	30	40	50
(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
1.	7 Year Interest Deductible Public Sector Bonds	0-7	-3.16	14.27	21.99	29.11	35.66
2.	7 Year Cumulative Income Unit Scheme of UTI (1990 II)	0-7	-3.92	13.63	21.42	28.58	35.18
3.	10 Year Interest Exempt Public Sector Bonds	0-10	-52.47	-17.06	-2.29	10.78	22.32
4.	5 Year Non-Convertible Debentures of Companies	0-5	-2.25	-3.74	-1.65	-1.43	-1.22
5.	Post Office Time Deposit	1	-4.80	-2.07	-0.70	0.66	2.03
6.	Commercial Bank Fixed Deposit	1	-6.25	-3.47	-2.09	-0.70	0.68
7.	Fixed Deposit of Companies	1	-1.39	-1.14	-1.01	-0.88	-0.74
8.	Post Office Time Deposit	2	-8.80	-3.20	-0.45	2.25	4.93
9.	Commercial Bank Fixed Deposit	2	-10.68	-4.98	-2.19	0.57	3.28
10.	Fixed Deposit of Companies	2	-0.89	-0.74	-0.65	-0.57	-0.48
11.	Post Office Time Deposit	3	-11.87	-3.34	0.76	4.74	8.62
12.	Commercial Bank Fixed Deposit	3	-13.09	-4.47	-0.33	3.70	7.62
13.	Fixed Deposit of Companies	3	-1.34	-1.11	-0.98	-0.86	-0.73
14.	National Savings Scheme	3	-11.20	17.82	30.94	43.18	54.58
15.	HUDCO Capital Gain Debentures (1990)	3	-16.80	5.07	15.04	24.42	33.22
16.	Post Office Time Deposit	5	-17.76	-3.18	3.54	9.91	15.94
17.	Commercial Bank Fixed Deposit	5	-16.92	-2.45	4.23	10.56	16.55
18.	Indra Vikas Patra	5	-0.57	-0.61	-0.68	-0.60	-0.33
19.	National Savings Scheme	5	-11.36	13.18	27.38	40.34	52.18
20.	Kisan Vikas Patra	5.5	-7.85	2.85	7.87	12.68	17.31
21.	Dhan Varsha II (1990)	5.5	-1.25	12.45	18.71	24.59	30.13
22.	Post Office Monthly Income Scheme	6	-7.74	8.06	15.21	21.88	28.11
23.	National Savings Certificates (Series VIII)	6	-14.77	19.86	20.22	21.01	21.64
24.	Post Office 10-Year Social Security Certificates	10	-34.88	-27.75	-24.21	-20.68	-17.17
25.	10 Year Unit Linked Insurance Plan-1971	10	-6.76	44.54	51.53	57.72	63.19
26.	15 Year Public Provident Fund	15	-48.66	69.59	43.15	53.69	62.38

Notes:

1. Subsidy is computed for the maximum holding period.
2. Benchmark posttax rates of return are taken to be 15, 12, 10.5, 9 and 7.5 per cent respectively for persons with marginal tax rates of 0, 20, 30, 40, and 50 per cent. The corresonding actual posttax rates of return are as given in Table 4.3.
3. Subsidy figures are expressed as percentages of the present value of investment in the scheme.

TABLE 4.8

Percentage of Effective Yearly Posttax Subsidy on Selected Assets Entitled to Tax Concessions

S.No.	Asset	Holding period (year)	Marginal income tax rate (per cent)				
			0	20	30	40	50
(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
1.	7 Year Interest Deductible Public Sector Bonds	0-7	-0.45	2.17	3.48	4.80	6.11
2.	7 Year Cumulative Income Unit Scheme of UTI (1990 II)	0-7	-0.55	2.07	3.38	4.70	6.01
3.	10 Year Interest Exempt Public Sector Bonds	0-10	-4.31	-1.59	-0.23	1.13	2.49
4.	5 Year Non-Convertible Debentures of Companies	0-5	-0.45	-0.37	0.33	-0.28	-0.24
5.	Post Office Time Deposit	1	-4.80	-2.07	-0.70	0.66	2.03
6.	Commercial Bank Fixed Deposit	1	-6.25	-3.47	-2.09	-0.70	0.6
7.	Fixed Deposit of Companies	1	-1.39	-1.14	-1.01	-0.88	-0.74
8.	Post Office Time Deposit	2	-4.31	-1.59	-0.23	1.13	2.49
9.	Commercial Bank Fixed Deposit	2	-5.21	-2.46	-1.09	0.28	1.66
10.	Fixed Deposit of Companies	2	-0.45	-0.37	0.33	-0.28	-0.24
11.	Post Office Time Deposit	3	-3.81	-1.10	0.25	1.61	2.96
12.	Commercial Bank Fixed Deposit	3	-4.19	-1.47	-0.11	1.25	2.61
13.	Fixed Deposit of Companies	3	-0.45	-0.37	-0.33	-0.28	-0.24
14.	National Savings Scheme	3	-3.60	6.33	11.61	17.17	23.13
15.	HUDCO Capital Gain Debentures (1990)	3	-5.31	1.72	5.29	8.91	12.59
16.	Post Office Time Deposit	5	-3.32	-0.63	0.72	2.07	3.41
17.	Commercial Bank Fixed Deposit	5	-3.18	-0.48	0.86	2.21	3.55
18.	Indra Vikas Patra	5	-0.11	-0.16	-0.14	-0.12	-0.06
19.	National Savings Scheme	5	-3.60	2.79	6.20	9.81	13.72
20.	Kisan Vikas Patra	5.5	-1.38	0.52	1.48	2.43	3.40
21.	Dhan Varsha II (1990)	5.5	-0.23	2.39	3.70	5.00	6.31
22.	Post Office Monthly Income Scheme	6	-1.25	1.39	2.71	4.03	5.35
23.	National Savings Certificates (Series VIII)	6	-2.32	3.62	3.70	3.85	3.98
24.	Post Office 10-Year Social Security Certificates	10	-3.04	-2.48	-2.19	-1.90	-1.60
25.	10 Year Unit Linked Insurance Plan-1971	10	-0.66	5.72	6.99	8.25	9.51
26.	15 Year Public Provident Fund	15	-2.68	2.39	3.70	5.00	6.31

Notes:

1. Benchmark posttax rates of return are taken to be 15, 12, 10.5, 9 and 7.5 per cent respectively for persons with marginal tax rates of 0, 20, 30, 40, and 50 per cent. The corresponding actual post-tax rates of return are as given in Table 4.3.

2. Subsidy figures are expressed as percentages of the present value of investment in the scheme.

CHAPTER 5

5.1. Introduction

Housing In India is subject to two categories of direct taxes: Taxes which enter into the cost of construction such as registration fee and stamp duty, and taxes on income derived from housing including the income tax and municipal tax or property tax.

To promote ownership housing, the personal income tax in India provides certain concessions. Tax concessions reduce the after tax price of housing services to taxpayers or increase the net financial return from housing which tends to induce people to invest more in housing. These tax incentives, however, also have implications for the government budget, private saving behaviour apart from housing investment, the progressivity of the tax system and demand for housing.

The objective of this study is to analyse the implications of current tax treatment of investment in housing for the price of housing services to homeowners and to analyse the consequences for:

i. The quantity of housing services demanded;
ii. tenure choice;
iii. revenue implications for the exchequer; and
iv. the progressivity of the personal income tax.

5.2. Subsidies to Investment in Housing Through the Tax Code

Income tax treatment of housing has already been discussed in Chapter 2. Property taxes are generally levied on the basis of the rateable value of a house as assessed by local bodies. For rental housing, actual rental realised is assessed.

Briefly, owner-occupied housing in India is deductible from taxable income in respect of payments of mortgage interest and mortgage repayments upto a specified limit in any financial year. Inputed rent from a single house is excluded from taxable income and the capital gain from a house sale is taxed lightly. If comprehensive income were the tax base, net inputed rent would be included in taxable income. In effect, the personal income tax system seems to encourage taxpayers to hold larger stocks of assets which yield imputed rather than cash income.

If income from investment in housing was taxed like income from other investments, say investment in plant and machinery, homeowners would have to report as income the gross imputed rent on their house. Like other investors, they would be allowed deductions for maintenance, depreciation, interest and property taxes as expenses incurred in earning this income.[1] The difference between gross imputed rent and these expenses, that is the net rent, would be included in taxable income.

It is useful to express the difference between 'normal' and existing tax treatment algebraically. Let NI be the net imputed rent, GI be the gross imputed rent, M be maintenance costs, D be depreciation for tax purposes, T equal the property tax and MI be the mortgage interest. Then

$$NI = GI - M - D - T - MI \qquad (1)$$

If the houseowner's income tax rate is t, then, with a comprehensive tax base, the tax payment on net imputed rent is t(NI). Under the current tax regime the individual has a tax payment of

$$(T) - (t\, MI' + u'MR). \qquad (2)$$

In (2), u' is the rate of tax credit on mortgage repayment (MR) and MI' is the amount of mortgage interest which is deductible. It may be noted, further, that the income tax component in (2) is negative. The limits on MI' and MR are respectively Rs 5,000 and Rs. 10,000 in a financial year under current tax provisions.

Subtracting (2) from t(NI) the element of subsidy is seen to be

$$t(NI) - [\, T - (tMI' + u'MR)] \qquad (3)$$

Owners of let out houses are allowed to deduct local property or house taxes and the Rs. 3600 new construction allowance (NCA) from the annual rent received. The latter is available for at most 5 years (See Chapter 2). The balance so obtained would be the annual letting value of house. From the annual letting value the houseowner is allowed to deduct expenses incurred on maintenance and repair, payments of mortgage interest, rent collection charges, insurance premium paid, etc. In addition

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1. Investment in plant and machinery is also allowed certain tax concessions. This is only for illustration.

to this houseowners are allowed the deduction for mortgage repayments as with self-occupied property. Thus, the owner of a tenant occupied house pays in tax

$$T + t\,(NI') - (u'MR), \quad \text{where} \tag{4}$$

$$NI' = GI - T - M - MI - NCA. \tag{5}$$

Subtracting (2) from (4), the element of subsidy for owner-occupied housing vis-a-vis tenant-occupied housing is:

$$(T) - (t.MI' + u'MR) - [\ T + t(NI') - u'MR\ ].$$

On rearrangement of the expression above we get

$$t\,(MI' + NI'). \tag{6}$$

In such a situation there will be an incentive for households to invest more in self occupied housing rather than rental housing.

While algebraic expressions are useful to form an idea of the structure of tax favour to owner-occupied housing vis-a-vis tenant occupied housing and other assets, empirically relevant numerical estimates of tax saving are necessary to quantify the impact of tax concessions on the cost of and demand for housing. Following Leeuw and Ozanne (1981), net present value calculations are used to assess the impact of tax provisions on the price of owner occupied and tenant-occupied housing. The procedure for calculating the net present value is discussed in section 5.4.

5.3. Owning Vs Renting - The Question of Choice of Tenure[2]

In the previous section it has been argued that exclusion of imputed rent from taxable income makes income tax treatment of owner-occupied housing more favourable than treatment of rental housing and, possibly, other assets. This is likely to adversely affect the supply of rental housing and the level of rent in the rental housing market. Further, this will also have a bearing on the choice of tenure. This section attempts to analyse the effect of tax concessions on the choice between owning and not owning a house.

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2. For a detailed and lucid discussion of this question see NIUA (1989).

Factors influencing the choice between owning and renting can be divided into two groups: economic and non-economic variables (Gupta and Pandey, 1990 and NIUA, 1989). Important economic variables are:

i. Income and wealth of the household;
ii. availability of credit and credit terms;
iii. the relative price of owning versus renting;
iv. tax concessions available to ownership and rental housing and other government policies relating to the two types of housing;
v. the expected rate of inflation of house prices;
vi. uncertainty relating to future levels of rents and to frequency of relocation; and
vii. the prevalence of practices such as `key' money.

The likely influence of each of these factors on the owning versus renting decision is obvious and does not require elaboration.

Besides economic factors there are non-economic considerations due to which a premium exists for homeownership in most societies including India. Among, these the more important ones are social status attached to ownership and the security that ownership of a house confers.

All factors mentioned above, except for those relating to affordability, tilt the household's decision in favour of owning a house to renting.

If non-economic considerations which favour ownership housing are ignored, households would make the decision to own or rent on the basis of financial considerations alone comparing the cost of owning to that of renting. Why should differences in costs of the two types of tenures exist? Theoretically, in the event of differences between the cost of owning and renting, households and prospective rentiers would have the incentive to arbitrage between market segments by changing tenure. But this is very unlikely to occur rapidly in developing countries due to long lags in housing markets, which are faced with severe supply side constraints such as lack of infrastructure, and a poor financial system. Even otherwise arbitrage is not costless. Thus, differences in costs are likely to persist.

Financial considerations apart, a premium exists for the ownership right of housing. Hence, individuals are generally likely to prefer owning to renting if they can manage the financial aspects of ownership. In our view, tax concessions would have a limited role in the decision making process about the choice of tenure.[3] For this reason and also because of the limited scope of this study, comparison of costs of renting and owning is not attempted here. However, two considerations which may tilt household decisions in favour of rental housing are now briefly discussed.

Unlike ownership, relatively low initial cost is involved in renting. In the absence of "pugree", the initial cost is near zero.

Expectations of rising inflation would generally boost the demand for ownership. However, empirical evidence suggests the opposite (Follain, 1982). As inflation and a fixed payment mortgage combine to reduce the size of funds that can be borrowed for the purpose of buying a house, given the importance of mortgage finance the quantity of ownership housing demanded decreases. However, inflation also has the effect of increasing the operating cost of housing. Although increases in anticipated inflation also increase anticipated capital gains that houseowners receive at the time of sale of the house, if demand is more sensitive to operating costs than it is to capital gains the balance will tilt in favour of rental housing. Due to the paucity of similar studies for developing countries the empirical validity of alternative hypotheses cannot be verified. However, for many households in India, who view housing as one of the basic necessities of life and normally do not indulge in it for speculation, the decision to own a house should be more sensitive to the operating cost than to the accrued capital gains of owning a house.

Since a large percentage of population in urban India lives in rental housing[4] and since the demand for rental housing will not decrease in the forseeable future, supply side problems in the rental housing market should receive attention in policy making

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3. This, however, should not be taken to mean that taxation has no impact on demand for ownership housing. More important to the individual is the change in the absolute price of ownership rather than the relative prices of owning and renting. Another way of looking at it is this: If tax concessions result in declining prices, demand would increase to the extent that the earlier prices inhibited effective demand for ownership housing. This relationship is, however, expected to be more evident in the case of low or middle income group housing and less important for high income group and luxury housing. Furthermore, other factors like locational advantages are likely to intervene to modify the relationship described.

4. See NIUA (1989).

for urban housing. Schemes that focus on increasing the rental stock should be given due weightage. One way of increasing the rental stock would be through fiscal concessions. We now study income tax concessions available to owners of rental housing.

5.4 The Present Value of Housing Investment

Benefits and costs in each time period of an investment are discounted using appropriate discount factors for each item of cash inflow and outflow. These year-by-year net financial flows are used to arrive at present values. The major advantage which the net present value method has over the rental cost of capital method (Jorgenson, 1983) is that it allows a distinction between short-run and long-run price effects to be made.

Consider the case of investment in a new owner-occupied house. The benefits and costs of investment in an owner-occupied house accrue in three stages. In the first stage there is full payment of the price of the house and certain transaction costs; in the second phase imputed rental income accrues while operating costs, property taxes, mortgage interest, mortgage repayment and certain taxes less tax saving allowed under current tax law have to be borne. In the final phase when the house is sold, sale proceeds net of transaction costs and certain taxes less tax savings are received. To compute present values the following assumptions have been made.

<u>Assumptions</u>

	Item	Value
1.	Initial cost of the house or price received by the seller (Rs.)	2,50,000
	1.1 Break up of the cost into	
	a. Land	40 per cent
	b. Construction	60 per cent
2.	Ratio of imputed rent to initial cost	10 per cent
3.	Ratio of operating costs to initial cost	1.5 per cent
4.	Holding period (years)	25
5.	Ratio of loan to initial cost	0.40
6.	Terms of loan	
	a. interest rate	14 per cent
	b. Term (years)	15 years

7. Expected annual rate of increase in

a.	imputed rent	8 per cent
b.	Land	16 per cent
c.	Structure	Depreciates at 2 per cent[5]
d.	Operating cost	8 per cent

8. Individuals' marginal income tax rate — 30 per cent

9. Owner's real after tax rate of return or opportunity cost. — 4 per cent

10. General inflation rate — 8 per cent

The contribution of outflows in the first period to the present value of the house may be represented as

$$- [1 - m + (1-u')c] V_o \tag{7}$$

where V_o is the purchase price of the property, m is the ratio of mortgage to purchase price, c is the ratio of transaction costs to purchase price and u' represents the rate of tax credit allowed under Section 88. Clearly, (7) represents investor's equity.

During the holding period the contribution of total cash inflows and outlays both actual and imputed to present value can be represented as the sum of the following terms:

$$\frac{R_i}{(1+r)^i} - \frac{Q_i}{(1+r)^i} - \frac{PT_i}{(1+r)^i(1+p)^i} \quad \text{for } i=1,..25, \text{ and}$$

$$\frac{-MI_i}{(1+r)^i(1+p)^i} + \frac{-MR^i}{(1+r)^i(1+p)^i} + \frac{tq}{(1+r)^i\ (1+p)^i} + \frac{u'B}{(1+r)^i\ (1+p)^i}$$

for i=1,..,15, where:

R	= Imputed rent
O	= Operating cost
PT	= Property tax
MI	= Mortgage interest
MR	= Mortgage repayment
t	= Marginal income tax rate of the houseowner
q	= Amount of Mortgage interest on which deduction is allowed
u'	= Rate of tax credit

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5. The useful life of the structure is assumed to be 50 years.

B = Amount of mortgage repayment on which tax credit is allowed
r = houseowner's real discount rate
p = general inflation rate.

The subscript i denotes the year and runs from 1 to n, the holding period for investment. In the example above, a 15 year repayment and 25 years holding period is assumed.

The contribution of the year in which the house is sold is given by

$$\frac{(1-s)V_n - at}{(1+r)^n(1+p)^n}$$

where

s = ratio of selling costs to sale price
V_n = sale price
a = taxable fraction of capital gains

Present value calculations are also carried out for tenant-occupied housing. The division of cash inflows and outflows into three periods is much the same for tenant-occupied housing as for owner-occupied housing. The tax calculations for tenant-occupied housing, however, are more complex as rentals flowing from rental housing are subjected to tax under the current laws. The net present value (npv) expression for such housing is found by summing the following terms:

$$-[1-m+(1-u')c]v_o + \frac{R_i}{(1+r)^i} - \frac{O_i}{(1+r)^i} - \frac{PT_i}{(1+r)^i(1+p)^i}$$

$$-\frac{t(NI)}{(1+r)^i(1+p)^i} \quad \text{for } i=1,\ldots,25;$$

$$\frac{-MIi}{(1+r)^i(1+p)^i} + \frac{-MRi}{(1+r)^i(1+p)^i} + \frac{u'B}{(1+r)^i(1+p)^i} \quad \text{for } i=1,\ldots,15; \text{ and}$$

$$\frac{(1-s)V_n-at}{(1+r)^{25}(1+p)^{25}},$$

where NI is net taxable income from house property.

Assumptions for tenant-occupied or rental housing, except numbers 2 and 7(a), are the same as for owner-occupied housing. For rental housing the ratio of rent to initial cost and the annual increase in rent are assumed to be 12 per cent and 10 per cent respectively, 2 percentage point higher than that for owner-occupied housing.

5.5. Uses and Limitations of Net Present Value Calculations

Net present value is calculated for each income tax bracket separately. Major assumptions to which results could be sensitive such as for the interest rate, discount factor, rate of land appreciation, land/structure ratio and the proportion of loan in the total cost of the house have been varied for NPV calculations of both owner-occupied and tenant-occupied housing. Investment of black income is also analysed.

For a given opportunity cost (or discount rate) a zero NPV would imply that the value of the house to the owner equals the initial cost or price of the house. The sum of the price of the house and the NPV (whether positive or negative) would be the price which the investor would be willing to pay for the house. We call this price his `demand price'. For a positive (negative) NPV the `demand price' would be higher (lower) than the price of the house by an amount equivalent to the present value of the net benefits (costs). The `demand price' measures the short-run asset price effects of tax concessions.

To a positive NPV, the market would respond in the following way if it functioned with reasonable efficiency. Market forces would lead to growth in investment in housing resulting in growth of the stock of housing. This may either be in the form of more new construction or better maintenance of the existing old stock. In either case there would be addition to the existing stock of housing. The increase in the stock of housing will have the effect of lowering the price of housing services. As a result, the return on housing will also decline. Similarly, a negative NPV implies the value of the house to the owner/investor falling below the cost/price. This would effectively mean a disincentive to investment in housing and eventually lead to an increase in the price of housing services.

The analysis of present value employed in this study is limited in that it does not offer any clue about the form of changes in the stock of housing or the point upto which the rate of return from housing investment would tend to move as a consequence of a change in tax provisions or other economic conditions.

NPV calculations can also be used to find out the required change in rent for a given discount rate and also the rent at which the present value equals zero under varied tax regimes. The long-run rent/cost ratio so obtained is used to estimate the effect of a change in the price of housing services on quantities of housing demanded. To do this estimates of price elasticities of demand for housing are required. These estimates have been taken from Dholakia (1980).

Price and quantity demanded estimates can be used to estimate the revenue consequences of housing tax incentives.

5.6. Interpretation of Variables used in Net Present Value Computations

a) The initial cost, Vo, is taken to be the price received by the seller - being development authority, housing board, etc. Clearly, this is not the price prevailing in the market for similar housing. We now bring the question of black wealth into NPV calculations. In housing, black wealth is interpreted in terms of underreporting of the value of the property or house. Black wealth is associated with both undervaluation of new private construction and with underreporting of the sale proceeds of the old or new house. Such wealth is introduced into the model in the following way.

For new private construction, valuation is problematic and the value reported by the owner cannot be taken to be its true value since, in most cases, black resources which cannot be put on record are invested in housing. A lower value is normally declared[6] to evade several taxes - wealth tax, income tax on incomes corresponding to housing, property tax and registration expenses - since the chance of detection of black income is low. At the same time investment in housing is expected to earn a relatively high return compared to safe financial assets. Identifying black income generated through sale of houses is relatively less problematic.

Assume that there are individuals who are willing to sell new houses recently allotted to them by some housing authority. Let us also consider that there are buyers in the market for these houses and that these houses command a premium in the market. If both sellers and buyers are dishonest, which implies that some fraction of sale proceeds must go unrecorded, both buyers and

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6. See Acharya and Associates (1986).

sellers would have the incentive to underreport the true sale proceeds. Buyers' incentives to declare a lower price on the sale deed have been discussed above.

Sellers' incentives include - 1) evasion of capital gains taxation and 2) access to black money which may be used for investment in assets where such funds are necessary or where chances of detection are minimal. Information on the true sale price of a sample of houses in one colony in Delhi was obtained by interviewing brokers and households.[7] For the black component of these prices we have relied on available estimates of white and black wealth in real estate. According to one estimate,[8] the proportion of white and black wealth in real estate is 60:40. Using these estimates the component of white wealth in the true sale price of property is calculated. This is then used to split owner's equity (Vo) into black and white components.

b) Land and construction components of the initial cost are taken as 40 per cent and 60 per cent respectively.[9]

c) Annual imputed rent is taken to be 10 per cent of the value of property.[10] The rental stream during the holding years begins at 10 per cent of the initial cost and is reduced in subsequent years by depreciation of the structure.[11] In terms of the model described earlier, the increase in the value of house (the capital appreciation) is notional till the house is sold and the gain is actually realised.

Thus, in effect, increases in rent keep pace with the increase in value of the house to the extent that the increase in

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7. This may not necessarily be a representative sample. Market price of similar houses may be lower or higher elsewhere - even in the same city.

8. Acharya and Associates (1986).

9. See NCAER (1967) and Gupta (1985).

10. Rent to value ratio may be higher for luxurious houses or those at prime locations. Given the cost of houses assumed here 10 percent imputed rent is justified.

11. The value of structure declines over time in the absence of any replacement of the depreciated value of structure. As a result, rentals also decline over time. It may be recalled that the useful life of the house is assumed to be 50 years.

value is due to general price inflation.[12] This implies that the major gain then comes from capital appreciation rather than from rentals.[13]

d) The annual operating cost is taken to be 1.5 per cent of the initial cost. This includes expenditure on repair and maintenance and house insurance premium.

e) The house is expected to be held for 25 years. That is, the legal transfer of the property will take place at the end of the twenty fifth year from the date of possession.

f) Quite apart from the problem of assessing the potential profile of rental income from a given house, there are knotty questions regarding land appreciation. Because of variation in individual preferences for various housing attributes - important among them being location and size - determination of appreciation in land value becomes very difficult. Data on land prices in Delhi is available from two sources; one of them is the New Delhi Municipal Corporation (NDMC) and the other source is a study by the Town and Country Planning Organisation (TCPO) for the period 1980 to 1982. The average land price for the period 1970-71 to 1988-89 as reported by the NDMC hase shown about a 22 per cent growth per annum. The latter source puts the minimum increase in land prices at 16 per cent per annum. Given the long data series used by the NDMC we would have preferred to rely on this data. It

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12. In the case of let out housing the rent is taken to be 12 percent of the initial cost. Further, the rent increases annually by 10 percent. Growth in rent is taken to be a little less than the average growth in rent, 12.5 percent per annum for MCD area of Delhi, to make it representative for Class one cities where the level of and growth in rent is lower than that of in Delhi.

13. Alternatively, an increase in rent roughly proportionate to the increase in the value of the house can be hypothesised if the houseowner calculates the rate of return, not on his equity or the initial price paid, but on the new higher market value of the house. Most recurring costs such as the property tax, cost of maintenance and repair will also have to increase with increasing value of the house, which may also be added to the rent. However, available data on average rent for the MCD area in Delhi does not support the latter view of rent determination. For instance, while the average rate of growth in rent per square foot has been 12.50 percent per annum, growth in land prices and construction cost per unit were reported to be about 22 percent and 10 percent respectively for the period 1970-71 to 1988-89.

may, however, be mentioned that none of these data reflect the true market prices of land. While the TCPO estimates, which are based on data obtained mostly from government agencies (and therefore reflect either pre-determined or controlled prices, or prices reported on sale deeds), would be lower than market prices and, at best, represent the price paid in white money, the NDMC prices would be quite close to the market value of land. Given the white component of land value (taken to appreciate at 16, 18 or 20 per cent in alternative simulations) the NIPFP study is used to compute the market price of land. This is then used to calculate the market rate of land appreciation. The former rate of appreciation is likely to be observed when both buyer and seller are honest whereas the latter would prevail when both parties are dishonest.

g) Mortgage terms of the HDFC and employers (other than government and public sector) are used here. Accordingly, the range of interest rates is taken to be 10 per cent to 14 per cent and the repayment period is set at 15 years. The Home Loan Account scheme of the NHB is also discussed and incorporated in NPV calculations.

h) It is assumed that all investors are able to raise a mortgage loan equivalent to at least 40 per cent of the initial cost.

i) The registration fee, stamp duty and so on at the time of buying and selling the house are taken to be 2 per cent of initial cost and 6 per cent of the sale proceeds respectively.

j) The property tax and income tax are taken as statutory tax rates. As is well known, at the individual level, taxation of capital gains significantly increases the effective tax rate. Additional increase in the marginal tax rate occurs if inflation pushes taxpayers into higher brackets. The effect of inflation as well as capital gains on individuals' marginal income tax rates is, however, ignored though, in principle, it can be incorporated into the model.

k) The inflation rate, p, is taken to be the change in the wholesale price index.

l) The discount factor, or investor's opportunity cost, r, is proxied by the after tax real rate of return on investment with the same risk as investment in housing. This is taken to be 4 per cent. The opportunity cost could vary across income tax brackets and is likely to be higher for low income bracket households. Therefore simulations are also carried out with a 6 per cent discount rate.

m) Some parameters to which results are sensitive expected rate of land appreciation, mortgage interest rate, cost of house to loan ratio, structure to land ratio, discount factor and the investors' marginal tax rate are varied for NPV computations. Computations are carried out with:

i. Land appreciation at 16 per cent, 18 per cent and 20 per cent,
ii. mortgage interest rate of 10 per cent to 14 per cent,
iii. a loan to total cost ratio of 40 and 60 per cent,
iv. land to structure ratios of 60:40 and 40:60,
v. discount factors at 4 per cent and 6 per cent and
vi. the owners' marginal income tax rates from 0 to 50 per cent.

Simulations are also done with alternative tax treatment of housing.

5.7 Results

We first discuss the results for owner-occupied housing. Results for tenant-occupied housing are discussed later.

(a) Tax concessions and owner-occupied housing

Computed results for owner-occupied housing are displayed in tables 5.1 to 5.3. Estimates of the effects of changes in the price of housing services on the quantity of housing demanded are in Tables 5.4 and 5.5. The following important features of the results are apparent.

i. Tax concessions currently available to investment in housing have significantly increased the net return from this form of investment.

ii. The tax favour to upper income brackets is higher than that to lower bracket tax payers: The difference between the NPV with no tax concessions and the actual post tax NPV increases with the tax bracket.

iii. As is obvious *a priori* interest deductibility and concessional capital gains taxation reduce the progressivity of the tax system by giving more generous concessions to house-owners in higher tax brackets.

iv. Both mortgage interest deductibility and concessions for housing under Section 88 are biased in favour of debt financing.

v. Tax concessions to capital gains are found to be relatively more generous than other tax concessions for housing in terms of loss in revenue.

vi. A relatively low interest rate, long repayment period and high rate of land appreciation result in making investment in housing more attractive.

vii. Investment in land is found to be more profitable than investment in construction of structure (housing).

As is apparent from Table 5.4, the demand price and consequently the value of the house to the investor is more than the cost of the house under the current tax laws as well as in the absence of tax concessions. On comparing the demand price with the cost of the house, the former is found to be higher by 64.70 per cent and 45.11 per cent under the current tax laws and in the absence of tax concessions respectively. The long-run rent/cost ratio for the given opportunity cost of the investor is computed to be 5.29 per cent which is nearly 47 per cent lower than the initial rent/cost ratio. This implies the existence of downward pressure in the price per unit of housing services (rent) upto a point where the demand price equals the cost of the house and the investors' real after tax return of 4 per cent is also restored. Such rent would be 5.29 per cent of the cost. As expected, the long-run rent/cost ratio increases in the absence of tax concessions. The 8th row of Table 5.4 presents percentage changes in the amount of housing per household as a result of changes in long-run rent/cost ratios. Estimates underlying row 8, column 1 imply that a 47 per cent decrease in the rent would be accompanied by about a 35 per cent increase in the quantity of housing demanded. Estimates in row 10 imply that in the long-run while disallowance of mortgage interest would cause a 5.8 per cent decrease in the amount of housing per household, withdrawal of Section 88 and concessions to capital gains would be accompanied by a 6.2 per cent and 18.3 per cent decrease respectively in the quantity of housing demanded per household.

Table 5.5 presents estimates of the long-run rent/cost ratio and short- run demand price when the investor's opportunity cost increased from 4 per cent to 6 per cent. As expected, this results in a lower demand price implying a much higher increase in the long-run rent/cost ratio in the absece of tax concessions than with a 4 per cent discount rate.

The main conclusions to be drawn from this analysis are: First, tax concessions are favourable to owner-occupied housing as they increase their NPV. The tax advantages, however, vary under alternative conditions such as the investors' discount rate, rate of land appreciation, loan/cost ratio, interest rate and the investor's marginal income tax rate. Second, under current tax laws, the owner-occupant needs to earn a rental of 5.29 per cent of the initial cost of the house for the investment to be viable at a discount rate of 4 per cent. However, with no tax concessions, he will be required to earn a rent of 6.7 per cent of the initial cost of the house which is lower than the assumed rent/cost ratio of 10 per cent.

(b). Revenue Impact of Tax Concessions to Owner Occupied Housing

The annual tax sacrifice, in rupees, per rupee of investment in housing or the annual tax saving to the house-owner is given in Table 5.6. The most important finding is that, in this model, 30 per cent income tax bracket investors recover an amount equivalent to nearly 40 per cent of the mortgage loan while a 50 per cent income tax bracket investor recovers about 52 per cent of the mortgage loan through tax saving due to interest deductibility and Section 88. Further, an investment of Rs. 100 in self-occupied housing results in a total nominal tax saving of Rs. 232.67 over 25 years. 93 per cent of this, comes through liberal taxation of capital gains realised by the owner in the final year. Tax saving due to interest deductibility and Section 88 are respectively Rs. 19.20 and Rs. 20.00 per rupees 100 of mortgage loan or Rs. 7.68 and Rs. 8.00 per Rs. 100 of investment in housing. Clearly, this would increase with a higher loan/cost ratio. Tax saving due to interest deductibility rises with the marginal tax rate of the investor. For instance, for the 50 per cent tax bracket and a 40 per cent loan/cost ratio it is about Rs. 32 per Rs. 100 of mortgage loan. This suggests that the structure of these tax concessions has an adverse impact on income distribution as well as on tax revenue to the exchequer.

One interesting observation is about the effective cost of mortgage loan. On comparing the present value of mortgage interest and repayment with the present value of the maximum tax saving associated with the loan plus the loan amount, the latter is found to exceed the former. For instance, on a loan of Rs. 1.5 lakh the present value of total tax gain is Rs. 24,564.41, the present value of mortgage interest is Rs. 94,362.68 and the present value of mortgage repayment is Rs. 66,960.83. Thus, in real terms, a borrower receives Rs. 1.5 lakhs and pays back little more than Rs. 1.61 lakhs so, that the effective cost of loan funds is about 7.3 per cent in the absence of tax concessions. The actual post tax effective cost of the loan is however -8.83 per cent. Distortion in the cost of funds is to a large extent caused by, besides tax concessions, the fixed payment mortgage. These distortions have implications for the size of the mortgage loan market.

(c) The Effect of the Home Loan Account Scheme (HLA) of the National Housing Bank on the Price of Owner Occupied Housing

With an HLA the NPV of self-occupied housing is found to be 15 per cent higher than the NPV in the absence of the above scheme.

In brief, the HLA requires a member to save regularly (monthly or quarterly or annually) for a minimum period of five years. Deposits earn interest at 10 per cent per annum. After the subscription period the member is entitled to a loan equal to a multiple of accumulated savings at concessional interest. (See the annexure to this chapter).

In this exercise we have assumed that the individual saves a constant amount annually. As the cost of house is taken to be Rs. 2.5 lakhs, the person plans his savings in such way that he gets Rs. 2.5 lakh after 5 years. The NHB advises an individual to save one twelfth of the cost of the house per year as a thumb rule (see the annexure). Accordingly, he saves Rs. 20,833.33 per annum for 5 years. His contributions and interest thereon are eligible for tax concession under Section 88 under the scheme. Therefore, his gross return on deposits would be interest plus tax saving under Section 88.

Now assume that his after tax nominal rate of discount is 12 per cent. The difference between gross return at 12 per cent and the gross return on HLA deposits is taken to be the subsidy to HLA deposits. This may be subtracted from the present value of interest paid on the loan. Adding repayments and deducting tax saving under Section 88 and tax saving due to interest deductibility, gives the effective cost of the HLA loan. The effective cost of funds works out to -5.4 per cent in the absence of tax concessions, lower than the effective cost of 7.3 per cent in the general situation examined earlier because the effective rate of interest to be paid on loans is lower in the HLA scheme. The actual post tax effective cost is around -40 per cent with the HLA scheme against -8.83 per cent in the absence of this scheme.

(d) Effect of Black Wealth on the Net Present Value of owner occupied housing and its Implications for Revenue Loss to the Government.

We now discuss two cases of investment in housing where black wealth is involved both in buying and selling the house and where black wealth is generated when the house is sold. Other assumptions of section 5.4 continue to be applicable. In line with the discussion is section 5.6, Rs. 6 lakh is taken to be the actual (market determined) sale price. Of this Rs. 3.6 lakh, is assumed to be white. This is, roughly the situation for houses sold at Rs. 2.5 lakh by housing authorities according to real estate brokers. The property tax and also the income tax (if the house is let) are based on the reported price of house. It may be mentioned that, since the rate of appreciation of rents lags behind the rate of appreciation of property, this house will earn rent lower than of 10 per cent of the market value. We assume that this house can earn only as much rent as other similar houses. In such a scenario the rental earned would be 6.9 per cent (3.6 per cent) of the reported value of the house (the true purchase price). This, implies a reduction in inflows during the operating years. However, the net gain will increase in the terminal year when the house is sold, given that the true sale price of the house is underreported. If 16 per cent is the white appreciation in land value, untaxed black appreciation would be 40 per cent of the total sale price. The present value of housing investment in this case is Rs. 2.8 lakh for a 30 per cent bracket taxpayer compared to Rs. 1.6 lakh for an all white sale.

Underreporting of the sale price by 40 per cent is found in this case to result in evasion of tax of a little more than Rs. 4.5 lakhs which is about Rs. 75 per Rs. 100 of investment.

Consider, next, the case where a dishonest person gets a house from a public housing authority. He sells it after holding it for 25 years as in the earlier case. Since he is dishonest he does not declare the full capital gains earned from the sale of the house. The net present value of his investment in housing is computed to be about Rs. 3.05 lakh. In this case evasion of tax is even higher than the in previous case at Rs. 160 per Rs. 100 of investment.

(e) <u>The Effect of Tax Concessions on Tenant-occupied or Rental Housing</u>

Tables 5.7 to 5.9 present the computed results for short run price effects of tax concessions on rental housing. The main conclusions drawn are:

i. Taxation is less favourable to investment in rental housing than to investment in owner-occupied housing.

ii. Under similar economic conditions while investment in self- occupied housing is profitable, investment in rental housing is found to be making losses. (see Tables 5.10 and 5.11)

iii. As in the case of self-occupied housing, tax concessions favour high income groups more than than low income bracket taxpayers and, obviously, do not favour non-taxpayers at all.

iv. Capital gains concessions are, once again, more liberal than other tax concessions. This concession dilutes the progressivity of the tax system.

v. Taxation is biased in favour of debt financing. Furthermore, debt financing is more favourable to higher income bracket investors.

We now analyse the computed results of a specific case of investment in tenant-occupied housing as described in section 5.4. On comparing Tables 5.1 and 5.7, it can be seen that under similar economic conditions the rate of return from investment in self-occupied housing is more than from investment in rental housing. Further, Tables 5.4 and 5.10 show that for 30 per cent income tax bracket investors, other things being the same, investment in self-occupied housing is profitable while investment in rental housing makes a loss of Rs. 4,434. On comparing the difference between actual post tax NPV with pre-tax NPV for both types of housing, the difference is seen to be lower for rental housing which indicates that the tax system accords greater favour to investment in owner-occupied housing.

When the concession to capital gains is disallowed, the tax saving resulting from it becomes zero and the value of the house to the taxpayer goes down further by Rs. 29,659. When Section 88 is also withdrawn the value of the house to the investor fall by more than Rs. 44,000. Given the likely fall in housing supply, the long run equilibrium rent/cost ratio worked out to 12.3 per cent (Table 5.10) which is 2.46 per cent more that the initial rent/ cost ratio. Table 5.10 indicates that, in the short-run, if tax concessions are withdrawn the NPV will go down further by over Rs. 39,500. This would lower investment in rental housing which would, in turn, result in increasing rent (row 6, column 5). However, the increase in rent would eventually lead to a reduction in the quantity of housing demanded per household (row 8, columns 3 and 4). Withdrawal of both concessions mentioned above would cause an increase in the rent/cost ratio by 24.45 per cent which would consequently be accompanied by an 18.26 per cent reduction in the quantity of housing demanded per household. However, if concessions are withdrawn, the long-run reduction in quantity of housing demanded would be 16.03 per cent.

Table 5.11 presents computed results for a discount factor of 6 per cent instead of 4 per cent. As expected, the NPV falls to Rs. (-)64,493.44 and the long run rent/cost ratio goes up to 16.9 per cent which is 40.8 per cent more that the initial rent/cost ratio assumed in this study.

5.6 Revenue Impact of Tax Concessions to Rental Housing

On examination of the estimates in Table 5.12, it is apparent that the major tax gain to the investor is due, once again, to liberal taxation of capital gains on housing. Estimates in the final column of Tables 5.12 and 5.13 show that an investment of Rs. 100 results in a tax saving equivalent to Rs. 224.94 or Rs. 15.84 in present value terms over 25 years. As has been mentioned earlier, most tax saving comes in the 25th year. Annual saving during the holding period is about 53 paise per Rs. 100 of investment.

5.7 Recommendations

To encourage home ownership, the income tax system provides various tax concessions. In this context the following observations have been made.

i. There is a case for limiting tax benefits enjoyed by owner-occupants under existing income tax law.

ii. Tax concessions which accord greater favour to upper income groups are unjustified. This particular feature of the present tax system needs rectification.

iii. There is no apparent reason for relatively heavy taxation of rental housing vis-a-vis self-occupied housing especially where the supply of rental stock needs to be enhanced in view of the considerable financial barriers to entry for most potential home owners.

iv. There is need to remove the bias in favour of debt financing vis-a-vis equity financing in the tax system.

On the basis of these observations the following recommendations can be made.

i. Section 24(2) (interest deductibility) which has created a situation of negative income tax for owner occupiers may be withdrawn. Its withdrawal would affect high brackets taxpayers - in terms of tax loss

- with little effect on low income groups. Withdrawal of Section 24(2) would help to achieve equal treatment of self occupied and rental housing and would also reduce the bias in favour of borrowed funds.

ii. Insofar as tax concessions increase with the marginal tax rate, they necessarily provide larger subsidies to high bracket households. In order to correct this it is suggested that concessions in the form of tax credits rather than tax deductions be given under Sections 48(b) and 24(2) even if immediate withdrawal of Section 24(2) is considered too abrupt. As pointed out elsewhere in the report (Chapter 1) concessional treatment of long term capital gain has no particular merit.

iii. Our results show that rental housing yields relatively low returns vis-a-vis self occupied housing. Further, there are situations where rental housing is unprofitable even though similar self-occupied housing is profitable. This calls for measures which would improve the return from this form of investment. In the majority of OECD countries, rental housing is provided depreciation which can be set against gross rental income. However, rules of depreciation differ across countries.

iv. India and the UK are unusual in treating housing (offered by households in the rental market) as an asset with an infinite life for tax purposes and allowing no deductions for depreciation, though depreciation is allowed for both residential and non-residential buildings in India, if these happen to be industrial and commercial assets. A 10 per cent depreciation rate is applied for non-residential buildings and a 5 per cent rate for residential buildings. A 20 per cent rate is admissible on buildings with dwelling units each with plinth area not exceeding 80 square meters. In order to correct this inconsistency, it is suggested that depreciation at the rate of 5 per cent to individual owners of rental housing be permitted. A more generous depreciation allowance may be considered for Low Income Group (LIG) housing.

v. Relatively favourable tax treatment to debt financing vis a vis financing through own funds is expected to discourage housing oriented savings. To mobilise household savings for the housing sector, housing loan linked saving schemes need to be encouraged. One such scheme is the Home Loan Account (HLA) of the National

Housing Bank. Contributions to HLA are allowed a tax credit under Section 88 of the Income Tax Act. Extension of this benefit to all recognised housing linked saving schemes other than the HLA of the NHB is recommended. This is expected to induce people to save more and thus reduce dependence on borrowing for house purchase or construction.

vi. However, as our results show, the HLA scheme of the NHB is unduly generous. Concessions to the scheme should be reduced in either of the following ways:

1. by limiting the benefit of Section 88 only to contributions to the HLA as opposed to both contributions and the interest earned on contributions.

OR

2. by charging the same rate of interest on the loan taken through out the repayment period rather than on a slab basis as at present[14].

v. Section 54F provides for exemption from capital gains tax if sale proceeds of any long-term asset, not being a residential house, are invested in the purchase or construction, within a stipulated period, of a residential house. However, this concession is withdrawn if another house is purchased within the prohibited period prescribed for investment of capital gains under this section. As recommended in Chapter 2, this condition appears to be needless and may be withdrawn.

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14. We have been unable to obtain clarification from bank officials as to the exact method of reckoning interest for different slabs. It is clear however, that different interest rates are charged on different slabs. In the calculations reported earlier, it has been assumed that lower interest rates apply after early slabs of the loan have been repaid.

TABLE 5.1

Net Present Value of Self Occupied Housing Under Actual Tax Legilsation

Loan and Interest Terms	Land Appreciation (percent per annum)	Land Component 40 Percent of the total cost: Rs. lakh	Land Component 40 Percent of the total cost: As percentage of Col-1				Land Component 60 Percent of the total cost: Rs. lakh	Land Component 60 Percent of the total cost: As percentage of Col-6				Col6 as % of Col. 1
		Marginal Tax Rates (percent)					Marginal Tax Rates (percent)					
		0	20	30	40	50	0	20	30	40	50	
		1	2	3	4	5	6	7	8	9	10	11
I Loan 40 percent of the cost												
1. Interest 14 percnet	16	1.73	97.59	93.51	89.44	85.36	2.90	94.98	90.75	86.53	82.31	167.44
2. Interest 14 percnet	18	2.85	94.61	90.18	85.74	81.31	4.58	93.15	88.64	84.14	79.63	160.58
3. Interest 14 percnet	20	4.54	92.90	88.26	83.62	78.97	7.11	92.03	87.35	82.67	77.99	156.65
II Loan 50 percent of the cost												
1. Interest 14 percnet	16	1.71	98.94	94.85	90.77	86.68	2.88	95.76	91.53	87.30	83.07	168.18
2. Interest 12 percnet	18	2.95	95.56	91.27	86.98	82.70	4.67	93.78	89.36	84.95	80.54	158.65
3. Interest 10 percnet	18	3.06	95.68	91.53	87.38	83.23	4.79	93.90	89.58	85.26	80.93	156.50
III Loan 60 percent of the cost												
1. Interest 14 percnet	16	1.69	100.29	96.18	92.07	87.96	2.86	96.54	92.30	88.05	83.80	168.94
2. Interest 12 percnet	18	2.95	96.35	92.08	87.82	81.86	4.68	94.28	89.88	85.48	81.08	158.58
3. Interest 10 percnet	18	3.08	96.48	92.39	88.29	84.20	4.81	94.42	90.13	85.85	81.56	156.02
IV Loan 70 percent of the cost												
1. Interest 14 percnet	16	1.67	100.33	96.19	92.05	87.91	2.84	96.54	92.28	88.01	83.75	169.72
2. Interest 12 percnet	18	2.95	96.37	92.12	87.87	83.62	4.68	94.30	89.91	85.52	81.13	158.51
3. Interest 10 percnet	18	3.11	96.53	92.49	88.44	84.39	4.84	94.47	90.21	85.96	81.70	155.55

TABLE 5.2

Net Present Value of Self Occupied Housing Under Actual Tax Legislation and Alternative Tax Terms
(Land Component 40 Per cent of the cost)

Loan as a Percentage of cost and interest rate (p.a)	Land Appre-ciation (% p.a)	Actual Tax Legislation: Block 1 (Rs. lakh)					Interest Deductibility disallowed: As a percentage of Block 1				In the absence of Tax Credit: As a percentage of Block 1				Concessions for capital gains taxation disallowed: As a percentage of Block 1			
		Marginal Tax Rates (%)					Marginal Tax Rates (%)				Marginal Tax Rates (%)				Marginal Tax Rates (%)			
		0	20	30	40	50	20	30	40	50	20	30	40	50	20	30	40	50
		1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16	17
Loan: 40 %																		
Interest 14 %	16	1.73	1.69	1.62	1.55	1.48	96.30	94.20	91.92	89.41	94.12	93.86	93.58	93.28	88.29	81.66	74.44	66.52
Interest 14 %	18	2.85	2.70	2.57	2.45	2.32	97.68	96.30	94.89	93.26	96.32	96.14	95.94	95.72	88.50	81.91	74.63	66.56
Interest 14 %	20	4.54	4.21	4.00	3.79	3.58	98.52	97.66	96.70	95.64	97.64	97.52	97.36	97.23	88.64	82.06	74.75	66.59
Loan: 50 %																		
Interest 14 %	20	4.52	4.22	4.00	3.80	3.59	98.49	97.74	96.64	95.56	97.12	97.10	96.80	96.61	88.65	82.19	74.79	66.65
Interest 10 %	20	4.74	4.44	4.23	4.02	3.81	98.61	97.81	96.93	95.94	97.26	97.13	96.98	96.81	89.22	83.02	76.18	68.57
Loan: 60 %																		
Interest 14 %	20	4.50	4.22	4.01	3.80	3.59	98.47	97.59	96.61	95.52	96.59	96.41	96.22	96.00	88.66	82.11	74.83	66.70

Notes: 1. All Computation assume a 4 per cent discount rate.
2. NPV for zero marginal tax rate is not repeated since it is same for each block.

TABLE 5.3

Net Present Value of Self Occupied Housing under Actual Tax Legislation and with No Tax Concessions
(Land Component 40 percent of the cost)

	Loan and Interest Terms	Land Appreciation (Per cent)	Actual Tax Legislation					No Concessions			
			Block 1 (Rs. lakh)					As a percentage of Block 1			
			Marginal Tax Rates (Per cent)					Marginal Tax Rates (Per cent)			
			0	20	30	40	50	20	30	40	50
			1	2	3	4	5	6	7	8	9
I	Loan 40 Per cent of the cost										
	1. Interest 14 Per cent	16	1.73	1.69	1.62	1.55	1.48	78.70	69.73	59.94	49.21
	2. Interest 14 Per cent	18	2.85	2.70	2.57	2.45	2.32	82.51	74.40	65.46	55.53
II	Loan 50 Per cent of the cost										
	1. Interest 10 Per cent	18	1.94	1.92	1.84	1.77	1.70	80.10	72.30	63.88	54.76
	2. Interest 14 Per cent	18	3.06	2.93	2.80	2.67	2.55	83.13	75.72	67.60	58.68
III	Loan 40 Percent * of the cost										
	1. Interest 14 Per cent	16	0.64	0.66	0.63	0.59	0.56	59.19	42.56	23.97	3.03
	2. Interest 14 Per cent	18	1.34	1.29	1.22	1.15	1.08	73.65	61.91	48.75	33.88
IV	Loan 50 Percent * of the cost										
	1. Interest 10 Per cent	16	0.85	0.89	0.86	0.82	0.79	67.61	55.84	43.07	29.14
	2. Interest 14 Per cent	18	1.55	1.52	1.45	1.38	1.31	76.39	66.67	55.97	44.12

Note: Computed results are for 4 percent discount rate except those marked *.

TABLE 5.4

Effects of the current tax law and of changes in the tax terms on owner-occupied housing

(Rupees)

Item		Tax Terms				
		Actual Tax treatment	Mortgage deductibility not allowed	Concessions under Section 88 withdrawn	In the absence of concessions in respect of Taxation of capital gains	No Concession
		(1)	(2)	(3)	(4)	(5)
1.	NPV	161748.65	152370.00	151320.54	132089.48	112783
2.	Demand Price	411748.65	402370.00	401320.54	382089.48	352783
3.	Percent difference from initial cost	64.69	60.54	60.53	52.84	45.11
	<u>Long Run</u>					
4.	Demand Price	0	0	0	0	
5.	Percent difference from initial cost	0	0	0	0	
6.	Rent/cost ratio(%)	5.2941	5.5670	5.58305	6.15707	6.7
7.	Percent difference from 0.10 (initial rent/cost ratio)	-47.0	44.3	44.2	-38.0	35.0
8.	Effect of long-run change in rent the amount of housing per household	+35.0	+33.09	+33.02	+28.39	+24.65
9.	Percent difference from 5.2941%	0	+5.2	+5.45	+16.30	26.56
10.	Affect of longrun change in rent on the amount of housing per household	0	-3.88	4.07	12.176	-19.84

Note: Computations assume a 4 per cent discount rate

TABLE 5.5

Effects of the current tax law and of changes in the tax terms on owner-occupied housing

(Rupees)

Item		Tax Terms				
		Actual Tax treatment	Mortgage deductibility not allowed	Concessions under Section 88 withdrawn	In the absence of Concessional Taxation of capital gains	No Concessions
		(1)	(2)	(3)	(4)	(5)
1.	NPV	62508	54025.378	53511.59	44086.081	26606
2.	Demand Price	312508	304025.378	303511.593	294086.081	276606
3.	Percent difference from initial cost	25.00	21.61	21.40	17.83	10.64
	<u>Long Run</u>					
4.	Demand Price	0	0	0	0	0
5.	Rent/Cost ratio (%)	7.80512	8.103	8.12103	8.45199	9.06577
6.	Percent difference from 0.10 (Initial rent/cost ratio)	-22.0	-19.0	-18.79	-15.5	-9.34
7.	Effect of long run change in rent on the amount of housing per household	+16.43	+14.19	+14.79	+11.58	+6.98
8.	Percent difference from 7.80512%	0	3.8	4.0	8.3	16.15
9.	Effect of long run change in rent on the amount of housing per household	0	-2.84	-2.98	-6.20	-12.06

Note: Estimates are for a 6 per cent discount rate.

TABLE 5.6

Annual Tax saving from self-occupied Housing

(Figures are in Rupees)

Year	Section 88	Due to Interest deductibility	Section 88	Sum of columns	Concessions in respect of capital gains taxation	Annual total tax gain per Rs.100
1	2	3	4	3 and 4	5	6
0	1500					0.4
1		1500	1333.33	2833.33		1.13
2		1500	1333.33	2833.33		1.13
3		1500	1333.33	2833.33		1.13
4		1500	1333.33	2833.33		1.13
5		1500	1333.33	2833.33		1.13
6		1500	1333.33	2833.33		1.13
7		1500	1333.33	2833.33		1.13
8		1500	1333.33	2833.33		1.13
9		1500	1333.33	2833.33		1.13
10		1500	1333.33	2833.33		1.13
11		1400	1333.33	2733.33		1.1
12		1120	1333.33	2453.33		0.98
13		840	1333.33	2173.33		0.86
14		560	1333.33	1893.33		0.75
15		280	1333.33	1613.33		0.64
25					541484.32	216.59
Total	1500	19200	20000.00	39200.00	541484.32	232.67

Note: To simplify computations, constant repayment of principle is assumed. The main results of the study remain unaffected if interest is calculated on a declining balance basis.

TABLE 5.7

Net Present Value of Tenant Occupied Housing under Actual Tax Legislation

(Rs lakh)

Loan and Interest terms	Land appreciation (percent per annum)	Land Component 40 percent of the cost: Rs lakh	As percentage of Col-1				Land Component 60 percent of the cost: Rs lakh	As percentage of Col-6				Col.6 as a % of Col.1
		Marginal Tax Rates (%)					Marginal Tax Rates (%)					
		0	20	30	40	50	0	20	30	40	50	
		1	2	3	4	5	6	7	8	9	10	11
I Loan 40 Percent of the cost												
1. Interest 14 percent	16	0.35	34.33	-12.54	-59.41	-106.28	1.42	75.77	60.16	44.54	28.93	401.35
2. Interest 14 percent	18	1.48	76.68	61.65	46.63	31.60	3.10	83.49	73.64	63.79	53.94	210.23
3. Interest 14 percent	20	3.16	83.78	74.11	64.43	54.75	5.63	86.42	78.74	71.07	63.40	178.12
II Loan 60 Percent of the cost												
1. Interest 14 percent	16	0.32	54.95	9.65	-35.65	-80.95	1.38	81.66	67.29	52.91	38.53	437.35
2. Interest 14 percent	18	1.44	82.32	68.47	54.63	40.78	3.06	86.25	77.02	67.80	58.57	213.12
3. Interest 14 percent	20	3.12	86.47	77.40	68.33	59.26	5.59	87.94	80.63	73.32	66.00	179.07
4. Interest 10 percent	16	0.59	69.50	41.95	14.41	-13.13	1.65	82.42	69.27	56.12	42.97	282.02
5. Interest 10 percent	18	1.71	82.98	70.26	57.54	44.82	3.33	86.25	77.22	68.19	59.15	195.26
6. Interest 10 percent	20	3.39	86.47	77.59	68.70	59.82	5.86	87.87	80.58	73.28	65.99	172.78

TABLE 5.8

Net Present Value of Tenent Occupied Housing under Actual Tax Legislation and Alternative Tax Terms
(Land Component 40 percent of the Cost)

Loan and interest terms	Land appreciation (percent per annum)	Actual Tax Legislation					In the Absence of Tax Credit				Concession in respect of Capital gains taxation not allowed			
		Block 1 (Rs. lakh)					As a percentage of Block 1				As a percentage of Block 1			
		Marginal Tax Rates (percent)					Marginal Tax Rates (percent)				Marginal Tax Rates (percent)			
		0	20	30	40	50	20	30	40	50	20	30	40	50
		1	2	3	4	5	6	7	8	9	10	11	12	13
I Loan 40 percent of the cost														
1. Interest 14 percent	16	0.35	0.12	-0.04	-0.21	-0.38	18.23	-323.91	-147.25	-126.41	-62.86	-768.90	-288.22	-231.52
2. Interest 14 percent	18	1.48	1.13	0.91	0.69	0.47	91.23	89.09	85.57	78.71	72.59	48.86	9.84	-66.28
3. Interest 14 percent	20	3.16	2.65	2.34	2.04	1.73	96.25	95.76	95.12	94.26	81.92	69.34	52.97	30.52
II Loan 60 percent of the cost														
1. Interest 14 percent	16	0.32	0.17	0.03	-0.11	-0.26	17.10	-372.02	-227.79	-156.28	-13.90	-872.75	-451.15	-293.30
2. Interest 14 percent	18	1.44	1.18	0.98	0.79	0.59	87.84	85.38	81.68	75.46	73.80	52.75	21.03	-32.22
3. Interest 14 percent	20	3.12	2.70	2.42	2.13	1.85	94.67	94.04	93.26	92.22	82.27	70.28	55.12	35.31
4. Interest 10 percent	16	0.59	0.41	0.25	0.08	-0.08	64.63	41.41	-70.56	-287.21	51.41	-20.74	-368.67	-742.93
5. Interest 10 percent	18	1.71	1.42	1.20	0.98	0.77	89.84	88.00	85.35	81.19	78.11	61.22	36.86	-1.32
6. Interest 10 percent	20	3.39	2.93	2.63	2.33	2.03	95.09	94.53	93.83	92.91	83.68	72.71	58.91	41.01

Note: Estimate of net percent value for zero marginal tax rate is not repeated since it is same for each block.

TABLE 5.9

Net Present Value of Tenent Occupied Housing Under Actual Tax Legislation and with no Tax Concession
(Land component 40 percent of the cost)

(Rs lakh)

Loan and interest Terms	Land Appre-ciation (Percent per annum)	Actual Tax Legislation: Block 1: Marginal Tax Rates (percent) 0	20	30	40	50	No Concessions: As a percentage of Block 1: Marginal Tax Rates (percent) 20	30	40	50
		1	2	3	4	5	6	7	8	9
I. Loan 40 percent of the Cost										
1. Interest 14 percent	16	0.35	0.12	-0.04	-0.21	-0.38	-144.63	-992.83	-335.48	-257.94
2. Interest 14 percent	18	1.48	1.13	0.91	0.69	0.47	63.81	37.95	-4.59	-87.57
II. Loan 60 percent of the Cost										
1. Interest 14 percent	16	0.56	0.34	0.16	-0.01	-0.18	4.98	-155.69	-5890.26	-439.48
2. Interest 14 percent	18	1.68	1.35	1.12	0.89	0.66	67.93	47.49	16.56	-35.76
III. Loan 40 percent of the Cost *										
1. Interest 14 percent	16	-0.39	-0.53	-0.64	-0.76	-0.88	-140.20	-142.52	-144.12	-145.31
2. Interest 14 percent	18	0.31	0.10	-0.05	-0.20	-0.35	-187.84	-825.16	-334.47	-261.86
IV. Loan 60 percent of the Cost *										
1. Interest 14 percent	16	-0.18	-0.31	-0.43	-0.55	-0.68	-175.21	-168.20	-164.27	-161.76
2. Interest 14 percent	18	0.52	0.32	0.16	0.005	-0.15	4.82	-147.36	-10620.56	-489.10

Notes: Computed results are for 4% discount rate except those marked *.

TABLE 5.10

Effects of the Current Tax Law and of Changes in the Tax Terms on Tenant-occupied Housing

(Rupees)

Item	Current tax laws	In the absence of Section 88	Concessions in respect of capital gains tax not allowed	No concessions
(1)	(2)	(3)	(4)	(5)
1. NPV	- 4434.31	-14362.41	-34093.48	-44021.59
2. Demand Price	245565.69	235637.59	215906.52	158087.3
3. Percent difference from initial cost	-1.8	-5.7	-13.6	-17.6
<u>Long-Run</u>				
4. Demand Price	250000	250000	250000	250000
5. Percent difference from initial cost	0	0	0	0
6. Rent/cost ratio (%)	12.2956	12.957	14.273	14.93496
7. Percent difference from 0.12 (initial rent/cost ratio)	2.46	7.8	18.94	24.45
8. Effect of long-run change in rent on the amount of housing per household (Per cent)	-4.52	-5.83	-14.15	-18.26
9. Percent difference from 12.2956	0	5.4	16.08	21.46
10. Effect of change in rent/ cost ratio on housing per household when base rent/cost ratio is 12.2956 per cent rather than 12 per cent.		-4.03	-12.01	16.03

Note: Computed result are for a 4 per cent discount rate.

Table 5.11

Effects of the Current Tax Law and of Changes in the Tax Terms on Tenant-occupied Housing

(Rupees)

Item	Current tax laws	In the absence of Section 88	Capital gains tax concessions not allowed	No Concessions
(1)	(2)	(3)	(4)	(5)
1. NPV	-64493.44	-73490.31	-82915.82	-91912.70
2. Demand Price	185506.56	176509.69	167084.18	205978.406
3. Percent difference from initial cost	-25.79	-29.40	-33.17	-17.61
<u>Long-Run</u>				
4. Demand Price	250000	250000	250000	250000
5. Percent difference from initial cost	0	0	0	0
6. Rent/ Cost ratio (%)	16.9	17.6	18.3	18.988
7. Percent difference from 0.12 (initial rent/cost ratio)	40.8	46.7	52.5	57.5
8. Effect of long run change in rent on housing per household (Percent)	-30.48	-34.88	-39.22	-42.95
9. Percent difference from 16.9%		4.1	8.3	12.36
10. Effect of change in rent/ cost ratio on housing per household when base case rent/cost ratio is 16.9%		-3.06	-6.20	-9.23

Note: Computed results are for 6 per cent discount rate.

TABLE 5.12

Annual Tax saving to the houseowner and revenue loss to the exchequer

Year	Section 88	Concessions in respect of capital gains tax	Annual total tax gain per Rs. 100
0	1000		0.40
1	1333.333		0.53
2	1333.333		0.53
3	1333.333		0.53
4	1333.333		0.53
5	1333.333		0.53
6	1333.333		0.53
7	1333.333		0.53
8	1333.333		0.53
9	1333.333		0.53
10	1333.333		0.53
11	1333.333		0.53
12	1333.333		0.53
13	1333.333		0.53
14	1333.333		0.53
15	1333.333		0.53
25		541484.32	216.59
Total	21,000	541484.32	224.94

TABLE 5.13

Present value of total tax saving to the houseowner

Section 88	Concessions in respect of capital gains tax	Total	Tax gain per Rs. 100 invested
9928.11	29660.62	39588.73	15.84

A.1 Income Tax Concessions with Special Reference to Savings and Housing in Selected Countries: A Comparative Chart

Key to Abbreviations Used in the Chart

1. BITR : Basic income tax rate
2. CG : Capital gains
3. CGT : Capital gains tax
4. D : Deductions from taxable income
5. Di : Dividends
6. E : Exempt from income tax
7. H : Maximum holding period
8. I : Investment
9. In : Income
10. Int : Interest
11. IRA : Individual Retirement Account (USA)
12. L : Limit in local currency on concession or as a percentage of amount
13. LI : Lock in period
14. LO : Loss offset
15. M : Months
16. NR : Non-Residents
17. P : Pensions/Pension Funds
18. PEP : Personal Equity Plans (U.K)
19. PPS : Personal Pension Scheme (U.K)
20. PS : Pounds Sterling
20. PSS : Profit sharing schemes
21. SAYE : Save As You Earn
22. T : Taxable at
23. TC : Tax credit
24. TI : Taxable income
25. TESSA : Tax Exempt Special Savings Account (U.K)
26. WAH : Individuals aged 65 and over, widows with dependent children and handicapped individuals
27. Y : Years

Part A: Dividend/Interest /Earnings from or on

Country	Banks	Government Securities	Retirement/Social Security Contributions	Investment in Specified Sectors	Mutual Funds, etc.	Profit Sharing Plans/Others
(1)	(2)	(3)	(4)	(5)	(6)	(7)
1. Federal Republic of Germany	Fixed Interest Bonds : E					a. 100 DM of I In (200 DM couples) : E b. Di : 9/16 TC
2. France	E				Securities Savings Accounts: TC/L 25 per cent of I upto 1750 Ffr (single) and 3500 Ffr (married).	a. Postal Savings : E b. Savings Accounts for House Construction : E c. I In : 50 per cent TC d. Di:E/ L: 8000 Ffr (single), 16000 Ffr (couple)
3. Indonesia		a. National Development Savings (TABANAS): E (Individuals only) b. Time Insurance Saving (TASKA) : E (Individuals only)				
4. Japan[1,2]	a. Deposits by WAH: E/ L Yen 3 Million of capital b. Current deposits:E	National/Local government bonds by WAH/ L Yen 3 million of capital	Specified Employee Savings Plans: E/ L Yen 5 million capital			a. Debentures with WAH: E/ L Yen 3 million of capital b. Int/Profits of joint operation trusts by school students: E
5. Korea		National Saving Association Deposits:E				Di : TC/ L 12 per cent to 6 per cent
6. Malaysia	Specified Savings Deposits :E	Saving Certificates: E				a. Specified non-bank savings deposits: E b. Di of unit trust: E/ L M$5000
7. Pakistan[3]	a. Savings Accounts : E/ L Rs1000. b. Foreign Currency Bank Accounts[3]: E	a. Specified Securities: E/ L Rs5000. b. Special Savings Schemes:E			a. National Investment (Unit) Trust: E/ L Rs15,000[4] b. Mutual Funds: E/ L Rs15,000[4].	a. Approved debentures: E/ L Rs 5000 b. Participation Term Certificates: E/ L Rs5,000. c. Post Office Savings Bank: E d. Di from companies: E/ L Rs15,000 (Listed/specified) Rs5,000 (Unlisted)
8. Singapore						a. Di from profits of specified companies : E b. Post Office Savings Bank: E c. Asian Dollar Bonds of NR:E d. Asian Currency Units funds of NR:E
9. Taiwan (Republic of China)	E/ L NT$270,000[7]	Treasury Bonds: E/ L NT$270,000[7]	Savings Trust Funds: E/ L NT$ 270,000[7]			a. Di of listed companies: E/ L NT$270,000[7] b. Corporate Bonds: E/ L NT$270,000[7] c. Deposits with financial Institutions: E/ L NT$270,000[7]

Country	Banks	Government Securities	Retirement/Social Security Contributions	Investment in Specified Sectors	Mutual Funds, etc.	Profit Sharing Plans/Others
(1)	(2)	(3)	(4)	(5)	(6)	(7)
10. United Kingdom	a. National Savings Bank: E/ L 70PS. b. Deposits: E upto BITR c. TESSA: E/ L 9.000PS and 5Y/ L I 5Y on capital	a Stocks with NR:E b. Government Savings Certificates: E	SAYE: E PPS: E Trust Schemes: E	Building Societies: E upto BITR	a. PEP: E for CG/ L 4,800PS of I DI is E/ Int T BITR b. CG for pension schemes/ Unit Trusts: E	
11. United States of America	Tax Exempt Municipal Bodies : E	a. KEOGH Plans: E till withdrawal b IRA: E till distribution				a. Qualifying loans to Employee Stock Ownership Plans : E/ L 50 per cent b. DI from ESOP : E c. Concessional tax for PSS fund/employer's contribution

A.1, Part B: Contributions

Country	Retirement/Social Security Funds	Deferred Annuities	Mutual Funds	Other Securities
(1)	(2)	(3)	(4)	(5)
1. Federal Republic of Germany	Pensions Plans: D			
2. France	a. Employees Pension Plans: D/ specified conditions b. French Social Security: D c. Pension: D			
3. Indonesia	a. Approved Pension Funds: D b. Workers Social Insurance Programme (ASTEK): D			
4. Japan	a. Social Insurance Premium (self and dependents): D	Qualified Annuity Insurance: D/ L Yen 5,000		
5. Korea	Contribution by Employer to National Pension Fund :D			Swings through National Savings Association: TC 15 per cent.
6. Malaysia	a. Under Widows and Pension Ordinance: D b. Approved Provident Fund : D			
7. Pakistan	Approved Provident/Pension Fund: D/ L 20 per cent of salary[5]	a. For government employees D/ L : 20 per cent of salary[5]. b. Approved old age schemes : D/ L 5 per cent of In upto Rs 5000.		a. Special Government Savings Schemes : D/ L[5] b. Approved Shares and Debentures : D/ L[5] and LI 3Y . c. Company Participation Term Certificates: D/ L[5]
8. Singapore	a. Own/Parents' Provident Fund: D/ L 15 per cent of TI upto S$10,800. b. Employer Contributions to Provident Fund: D/ L S$5,000[6]. c. Widows/Orphans Pension Scheme : D/ L S$5,000[6].			
10. United Kingdom	a. Pension: D b. PPS: T at BITR upto 17.5 per cent of specified In Employer Contribution: E	D/ L 1/6th upto 1,500PS if assessee has no Employee Pension Fund.	PEP : D/ L 6000PS on qualifying I	Employer purchase of PSS: E/ L 6,000PS or 10 per cent of Salary/ Minimum L 2,000PS.
10. United States of America	a. Deferred Pay Plan: D/ L $ 7627 b. Section 457 Plans: D/ L 1/3rd In upto $ 7500 c. Keogh Plans: D d. IRA: D/ L $2,000 reducing to zero at In $35 000 (Individual) and In $50,000 (couple) e. Simplified Employee Pension Plan by Employers: D/ L 15 per cent of employee's In upto $30 000			

A.1, Part C: Expenses

Country	Mortgage Repayments	Mortgage Interest	Other Housing Expenses	Life Insurance Premia	Other Insurance Premia	Other
1. Federal Republic of Germany					a Health : D b. Unemployment : D	
2. France		D	Home Improvement : D	D	Unemployment : D	a Interest : D b. Alimony/Childcare : D
3. Indonesia						a. Approved occupational/ business expenses of employees: D/ L 5 per cent In upto Rp 360,000.
4. Japan				D/ L : 100 per cent upto Yen 25,000 premium reducing to Yen 50,000 on premium above Yen 100,000.	Casualty: D/ L Yen 3,000 (Short term); Yen 15,000 (10 years or more)	a. Major (specified floor) medical expenses : D/ L Yen 2,000,000. b. Specified farm In :D c. Unreimbursed casualty loss (specified floor) : D.
5. Korea					a. Medical : D b. Other : D/ L 240,000 Won	a. Some taxes : D b. Medical expenses educational expenses and insurance premia : D/ L
6. Malaysia				E/ L 70 per cent of capital sum assured upto M $3,500 of premium.		
7. Pakistan				D/ L[5]		
8. Singapore				D/ L S$5,000[6]		
9. Taiwan (Republic of China)		D/ L NT $ 80,000		D/ L NT$24,000.		
10. United Kingdom		P/ L 30,000PS		D/ L 1/6th of In upto 1,500PS on specified items.		
11. United States of America						a. Alimony/Maintenance : D b. Some taxes : D

A 1, Part D: Other Specified Incomes

Country	Gifts	Bequests/Inheritances	Life Insurance Proceeds on Death	Other Insurance Proceeds	Other Income
(1)	(2)	(3)	(4)	(5)	(6)
2. France					Materinity allowance : E
3. Indonesia	E if unrelated to profession of individual				
4. Japan					Employment Income : D/ L on sliding scale, 100 per cent at Yen 70,000 In to 5 per cent plus 2,095,000 on In over Yen 10 million.
5. Korea					Severence Indemnity: D/ L over 50 per cent depending on duration of employment.
6. Malaysia					Qualifying retirement gratuities : E
7. Pakistan					Income from House property (including rent) : E/ L.
8. Singapore					a. Pension income : E b Retirement/Death gratuities : E c. Sums from pension commutation : E
9. Taiwan (Republic of China)					a. Annual pension : E b. Maintenance allowance for specified categories : E c. Salaries of specified teachers, etc. : E d. Lumpsum pension: E/ L 50 per cent e. Sea fishing In : E/ L 50 per cent.
10. United Kingdom					Trading In from futures/ options with pension schemes/ unit trusts : E.
11. United States of America					

Notes: 1. In Japan certain kinds of interest and profits are taxed separately from other income through a final withholding tax.

2. The limit of Yèn 5 million of capital for pension plans and savings for house purchase is a joint limit.
3. The limit of Rs 5000 applicable to interest on government securities, approved debentures and profits of participation term certificates in Pakistan is a joint one.
4. The Rs 15,000 limit in Pakistan applicable to mutual funds, unit trust listed/specified companies and scheduled banks is a joint limit.
5. These items (Pakistan) have an aggregate investment limit of 1/3rd of total income upto Rs50,000.
6. These deductions (Singapore) have an aggregate investment limit of S$5,000.
7. These exemptions (Taiwan) have a common aggregate limit of NT$270,000.

A.2 Tax Concessions to Housing in Countries of the Organisation for Economic Cooperation and Development (OECD)

A.2.1. Owner Occupation

All countries of the OECD offer substantial subsidies to owner occupiers as part of a general subsidy to housing or as a special incentive. Subsidies are mainly through low interest loans for house purchase or tax concessions to home-owners. Tax expenditures (exemptions/deductions/tax credits or rate reliefs) are important for housing subsidy in practically all OECD countries. At present, the main housing tax expenditures are for mortgage interest payments and imputed income; wealth and capital gains; property taxes; sales taxes; and income from saving schemes.

The OECD countries can be grouped into three categories based on their income-tax treatment of owner occupier housing.

i. Countries which tax imputed rental income and allow tax deductions on loan interest payments (Denmark, Finland, Greece, Luxembourg, Netherlands, Norway, Spain, Sweden).

ii. Countries which do not tax imputed rental income and allow tax deductions on loan interest payments or housing costs (Federal Republic of Germany, France, Japan, Portugal, Turkey, United Kingdom, United States).

iii. Countries which do not tax imputed rental income and do not allow tax deductions on loan interest payments (Australia, Canada, New Zealand).

Two methods of allowing deduction of mortgage interest payments are prevalent if such deduction is allowed. Loan interest is either allowed to be set against gross income or, as in France, a tax credit is given. This tax credit may imply a negative tax liability resulting in a receipt to taxpayers in some countries.

In most countries tax concessions are confined to the owner's main residence. The following are the main exceptions:

i. In France, tax concessions are restricted to the early years of the loan (for 5 to 8 years) and are linked to family size.

ii. In Germany, reliefs are restricted to once in the borrower's lifetime and to early years of the loan. Reliefs are also related to family size.

iii. In Japan, tax relief is restricted to a proportion of loan interest.

iv. In the United Kingdom, tax reliefs may be restricted by stipulating a maximum loan size for interest deductability.

v. In the United States of America, concessions extend to a second house.

vi. A few countries restrict reliefs to only low income groups.

A.2.2 Wealth and Capital Gains

In practically all OECD countries, wealth held in the form of owner occupier housing and the capital gains realised through its sale are exempt from taxation. Usually, these exemptions are subject to specified conditions.

A.2.3. Rental Housing

Private rental housing receives subsidies in the form of low interest loans (for example, in Canada, Japan and the USA) or, in most countries, preferential tax treatment through various deductions and exemptions, in comparision with commercial or industrial investment. The main cost item on which preferential treatment is allowed is depreciation which can be set against gross rental income. The method of assessment varies. Examples of this are as follows:

i. France and the Netherlands: Gross rental income receives a 15 per cent flat rate deduction for depreciation throughout the life of the property.

ii. Germany: Housing completed after 27th July, 1981 is allowed depreciation at 5 per cent for the first 8 years, 2 to 5 per cent for the next 6 years and 1 to 5 per cent for a further 36 years.

iii. The United Kingdom: Housing is treated as an asset with an infinite life for tax purposes and no deductions are allowed for depreciation.

iv. The United States of America: The period of depreciation of housing investment is normally 20 years. For housing sold since 1st January, 1981, taxpayers may opt either for linear depreciation or for accelerated cost recovery.

Most countries also allow private landlords to deduct general operating costs such as maintenance and repair costs, insurance and management and loan charges, from gross income. In some countries (for example, Canada, Germany and the USA), operating costs in excess of gross property income can be set against other income of the taxpayer. Other countries limit the use of property deficits on the ground that they encourage tax evasion. In France, for example, property deficits may only be set against property income for the first 5 years following acquisition.

Some countries allow specific tax deductions to encouraging investment in rental housing, particularly low income housing. In France, for example, a deduction from gross income of 5 per cent of the investment sum up to a specified ceiling is allowed.

A number of countries offer tax exemptions on income from certain types of rental housing. In the USA, for example, Real Estate Investment Trusts are taxed only on non-distributed profits, provided that at least 95 per cent of gross income is earned from real estate and that at least 95 per cent of current income is distributed within one year of the years of accrual.

Sources of Information

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Annexure to Chapter 4

Computation of Post-Tax Rates of Return

The structure of various savings schemes considered for computing internal post-tax rate of return is given in Table 4.2. In computing these post-tax rates of return, the following additional assumptions are made:

1. Marginal tax rate (t) of the investor is assumed to remain unchanged during the period of a savings scheme except in the case of National Savings Scheme wherein it is assumed that marginal tax rate of the investor falls to nil on maturity of the scheme.

2. Wherever interest is deductible under section 80L, it is assumed that the amount of interest from savings schemes is within the limit of the amount deductible under section 80L.

3. For the 7-Year Cumulative Income Unit Scheme of the UTI (1990-II), it is assumed that there will be 10 per cent capital appreciation on maturity instead of two bonuses in the 3rd and 5th year plus capital appreciation on maturity.

4. For HUDCO Capital Gain Debentures - 1990, it is assumed that principal (p) in the net consideration from a long term capital asset is negligible, and that a proportion (d) of the capital gains,(taken to be 0.5) would have been deductible in any case under section 48. The fact that p is taken to be zero implies that the post-tax internal rate of tax is over estimated.

5. For Dhan Varsha (1990-II), capital appreciation on maturity is assumed to be nil.

6. For National Savings Certificate - Series VIII, a tax credit at the rate of 20 per cent is allowed on initial investment as well as on interest accrued (but unpaid) at the specified rates. Interest accrues at the rates 0.124, 0.139, 0.156, 0.175, 0.194, and 0.224 in the 1st, 2nd, 3rd, 4th, 5th and 6th year respectively. The tax credit is available for the interest accrued in all the years except the last. On maturity, an investment of Re. 1 fetches Rs. 2.015.

7. For the 10-Year Unit Linked Insurance Plan-1971, a target amount of Rs. 12,000 is assumed. An instalment of Rs. 1,200 is payable every year in say July. The UTI pays Rs. 25 every year towards the linked insurance plan and allots units for the balance Rs. 1,175 plus assumed dividend, if any. The price of units in the base year (July 1990) is taken to be Rs. 12 and is assumed to increase by 10 paise every year. The sale price of a unit on maturity of the plan is taken to be Rs. 12.60 (12.00+1.00-0.40). In July 1990, the dividend declared under ULIP-1971 was 13.75 per cent. The dividend rate is assumed to grow at the rate of 20 percentage points every year. With these assumptions, the number of units held in the beginning of ith year (X_i) can be expressed as:

$$
\begin{aligned}
X_1 &= 1175/12 \\
X_2 &= X_1 + (1.395X_1+1175)/12.1 \\
X_3 &= X_2 + (1.415X_2+1175)/12.2 \\
X_4 &= X_3 + (1.435X_3+1175)/12.3 \\
X_5 &= X_4 + (1.455X_4+1175)/12.4 \\
X_6 &= X_5 + (1.475X_5+1175)/12.5 \\
X_7 &= X_6 + (1.495X_6+1175)/12.6 \\
X_8 &= X_7 + (1.515X_7+1175)/12.7 \\
X_9 &= X_8 + (1.535X_8+1175)/12.8 \\
X_{10} &= X_9 + (1.555X_9+1175)/12.9 \\
X_{11} &= X_{10} + 1.575X_{10}/13
\end{aligned}
$$

The number of units held by the investor on maturity is given by X_{11} and the sale value of these units is taken as Rs. X ($=12.6X_{11}$).

8. In the 15-Year Public Provident Fund, it is assumed that an equal amount (say Re. 1) is contributed towards the scheme every year and that no loan or withdrawal facility is availed of before maturity of the scheme.

With these assumptions, the formulae or the cash flows used for computing effective post-tax rates of return (R_{epo}) under various savings schemes considered here can be expressed as given in Table A.1. The assets in Table A.1 are listed in the same order as in Tables 4.3 to 4.8. The administered pre-tax interest rate is denoted by R_{ap}.

Annexure Table 1

Formulae for Computing Effective Post tax Rates of Return

S.No.	Asset	Holding period (year)	R_{ap}	Formula for Computation of R_{epo}
(1)	(2)	(3)	(4)	(5)
1.	7 Year Interest Deductible Public Sector Bonds	0-7	0.14	$R_{epo} = (1+R_{ap}/2)^2-1$
2.	7-Year Cumulative Income Unit Scheme of UTI (1990 II)	0-7	0.13	$R_{epo} = [(1+R_{ap}/12)^{84}+0.1)]^{1/7}-1$
3.	10 Year Interest Exempt Public Sector Bonds	0-10	0.10	$R_{epo} = (1+R_{ap}/2)^2-1$
4.	5 Year Non-Convertible Debentures of Companies	0-5	0.14	$R_{epo} = [(1+R_{ap}/2)^2-1](1-t)$
5.	Post Office Time Deposit	1	0.095	$R_{epo} = (1+R_{ap}/2)^2-1$
6.	Commercial Bank Fixed Deposit	1	0.08	$R_{epo} = (1+R_{ap}/4)^4-1$
7.	Fixed Deposit of Companies	1	0.13	$R_{epo} = [(1+R_{ap}/2)^2-1](1-t)$
8.	Post Office Time Deposit	2	0.10	$R_{epo} = (1+R_{ap}/2)^2-1$
9.	Commercial Bank Fixed Deposit	2	0.09	$R_{epo} = (1+R_{ap}/4)^4-1$
10.	Fixed Deposit of Companies	2	0.14	$R_{epo} = [(1+R_{ap}/2)^2-1](1-t)$
11.	Post Office Time Deposit	3	0.105	$R_{epo} = (1+R_{ap}/2)^2-1$
12.	Commercial Bank Fixed Deposit	3	0.10	$R_{epo} = (1+R_{ap}/4)^4-1$
13.	Fixed Deposit of Companies	3	0.14	$R_{epo} = [(1+R_{ap}/2)^2-1](1-t)$
14.	National Savings Scheme	3	0.11	$R_{epo} = [(1+R_{ap})^3/(1-t)]^{1/3}-1$
15.	HUDCO Capital Gain Debentures (1990)	3	0.09	$R_{epo} = [1.302/(1-(1-p)d.t)]^{1/3}-1$
16.	Post Office Time Deposit	5	0.11	$R_{epo} = (1+R_{ap}/2)^2-1$
17.	Commercial Bank Fixed Deposit	5	0.10	$R_{epo} = (1+R_{ap}/4)^4-1$
18.	Indra Vikas Patra	5	-	$R_{epo} = [(2)^{1/5}-1](1-t)$
19.	National Savings Scheme	5	0.11	$R_{epo} = [(1+R_{ap})^5/(1-t)]^{1/5}-1$
20.	Kisan Vikas Patra	5.5	-	$R_{epo} = [2-(1-d)t]^{1/5.5}-1$
21.	Dhan Varsha II (1990)	5.5	0.14	$R_{epo} = (1+R_{ap}/4)^4-1$
22.	Post Office Monthly Income Scheme	6	0.12	$R_{epo} = [(1+R_{ap}/12)^{72}+0.10^{1/6}-1$
23.	National Savings Certificates (Series VIII)	6	0.12	See footnote 1.

(Contd..)

Annexure Table 1 (Contd.)

S.No.	Asset	Holding period (year)	R_{ap}	Formula for Computation of R_{epo}
(1)	(2)	(3)	(4)	(5)
24.	Post Office 10-Year Social Security Certificates	10	-	$R_{epo} = (3-2t)^{1/10}-1$
25.	10 Year Unit Linked Insurance Plan-1971	10	-	See footnote 2.
26.	15 Year Public Provident Fund	15	0.12	See footnote 3.

Notes:

1. Based on assumption 6, the following cash flow equation need be solved for computing $R_{epo}(=R)$:

$$-(1-.2)-\left(\frac{.124}{1+R}+\frac{.139}{(1+R)^2}+\frac{.156}{(1+R)^3}+\frac{.175}{(1+R)^4}+\frac{.194}{(1+R)^5}\right)(t-.2)+\frac{2.015-.224t}{(1+R)^6}=0$$

2. Based on assumption 7, the following cash flow equation need be solved for computing $R_{epo}(=R)$:

$$-1200(1-.2)[(1+R)^{10}+(1+R)^9+........+(1+r)]+X=0$$

or,

$$-1200(.8)\frac{(1+R_{epo})^{10}-1}{R_{epo}}+X=0$$

3. Based on assumption 8, the following cash flow equation need be solved for computing $R_{epo}(=R)$:

$$-(1-.2)[(1+R)^{15}+(1+R)^{14}+.......+(1+R)]+[(1+R_{ap})^{15}+(1+R_{ap})^{14}+......+(1+R_{ap})]=0$$

or

$$-(.8)\frac{(1+R_{epo})^{15}-1}{R_{epo}}+\frac{(1+R_{ap})^{15}-1}{R_{ap}}=0$$

Description of the Home Loan Account Scheme of the National Housing Bank

The HLA is a very special scheme to help individuals to save specifically for housing. The scheme will be operated by the scheduled banks throughout the country. After subscribing for a minimum period of five years, you will be eligible for a loan to acquire a new house/flat. It is a scheme to help those who want to help themselves. It is intended to help the middle class, the lower middle class and the poor. It will cater to the salaried employee, the daily wage worker, the professional, the trader and the farmer.

Why is it Necessary to Save for Housing?

Presently, banks, housing finance companies, cooperative housing finance societies and government/non-government employers give loans; but, their funds are limited. Please do not take chances. Joint the scheme and be assured of a loan.

Even if you are sure that you can get a loan from your employer or some other agency, you can't be sure that the amount of loan they give will be sufficient. This scheme enables you to get an additional loan upto Rs 3 lakhs.

Again, no agency gives you loan for the full cost of the house. You are required to provide a margin from your own funds - which will not be less than 20 per cent of the total cost and, sometimes, can be as much as 50 per cent. Make sure you have those funds by joining the scheme.

Finally, the rate of interest you pay now on loans from most of the housing finance agencies is higher by 1.5 to 2.0 per cent than the HLA rate. So, do not lose time; join the scheme now.

HLA Scheme at a Glance

1. The basic feature of the scheme is that if a member saves regularly for a minimum period of five years, she/he will be assured of a loan as a multiple of accumulated savings. A minor can get loan only on attaining majority. A member must continue to save so long as she/he does not own a house and needs a loan for the purpose.

2. A unique facility of the scheme is that, an account holder, irrespective of the place of opening the account, is eligible for a loan for acquisition of a house/flat anywhere in India.

3. Deposits will earn interest at 10 per cent per annum. Housing loans up to Rs 50,000 will carry interest at 10.5 per cent, i.e., only half percentage point higher than the deposit rate. Large loans (ceiling: Rs 3,00,000) will carry higher rates of interest; but there are substantial tax concessions for all housing loans which bring down the effective interest rates.

4. A loan under the scheme will not bar a loan from any other source including a loan from a bank on usual terms.

5. The amount saved under the scheme is tied to a housing facility and can be utilised only for building or buying a house/flat. However, part withdrawals are permitted for paying registration fees for specific schemes or for purchase of a plot allotted by a public agency or a cooperative housing society, subject to certain conditions.

Who can Open a HLA

Any Indian national, not owning a house/flat exclusively in her/his name, can open a HLA. A non-resident Indian can also open a HLA through either direct remittance or transfer from NRE/NRO account. The scheme is on **one-member-one account** basis. You can open account in your name and one account each in the names of your minor children. Next to sending her/him to a good school, the best you can do for your child is to inculcate the habit of saving - by saving on her/his behalf, to start with. After she/he starts earning, she/he can continue to save in the HLA till she/he decides to acquire a house or flat.

How much to Save

You can save as little as Rs 30 per month or Rs 90 per quarter or Rs 180 every half year or Rs 360 every year (just a rupee a day). There is no ceiling on the amount you can save. However, you must save as long as you do not own a house of your own and need a loan for the purpose. You can start saving every month and then switch over to quarterly, half yearly or annual payments or the other way about. You can vary the amount of savings as and when you like, but in multiples of Rs 10.

The savings scheme is flexible in every way. But, you should not be complacent. Please remember that your savings should one day entitle you to a sufficient amount of loan to enable you to acquire a house.

For a house costing Rs 30,000 you must save atleast Rs 80 per month for a period of five years (see footnotes).

If you want a house costing Rs 60,000 you must save not less than Rs 160 per month.

For acquiring a house worth Rs 1,20,000, you must save atleast Rs 400 per month.

If the house is going to cost Rs 2,00,000 you must save about Rs 700 per month

If you are planning a house costing Rs 3,00,000 it is desirable to save Rs 1,500 per month.

And, if the house is going to cost Rs 4,50,000, there is no point in saving less than Rs 2,000 per month.

----

a. You can save less per month; but, then, you will have to save for a longer period. The period of 5 years is the minimum period under the scheme. It is generally necessary to save over longer periods to accumulate sufficient amount of savings. Hence, join the scheme well in advance of the decision to acquire a house/flat.

b. If you are saving quarterly/half yearly/yearly, you can work out the corresponding amounts to be saved.

Do you get Preferential Allotment of a House or Plot

Right now, no agency that gives housing loan guarantees allotment of a house or plot. HLA scheme also does not guarantee a house or plot. However, the National Housing Bank will do its best to persuade the housing boards and other public agencies at the State level to give preferential allotment to those joining the HLA scheme on first-joined, first allotted basis. Funds will be made available to these agencies for acquisition and development of land only on that condition.

You can avail of Home Loan Account loan for acquiring a house/flat/plot from any source you like. You are not tied to any specific agency.

How much Loan can you Get?

The loan that can be availed under the scheme after a minimum subscription period of fivé years will be a multiple of the accumulated savings as follows:

For built-up accommodation	Eligible amount of loan
Upto 40 sq. mtrs. or 430 sq. ft.	Upto 4 times
Upto 80 sq. mtrs. or 860 sq. ft.	Upto 3 times
Above 80 sq. mtrs. or 860 sq. ft.	Upto 2 times

Sanction of the loan and the amount thereof will be at the discretion of the bank.

What would be the Interest Rate on loan under the HLA Scheme?

Existing Rate of Interest		Under the HLA Scheme	
Loan Amount (Rs)	Interest (%)	Loan Amount (Rs)	Interest (%)
Upto to 20,000	12.5	Upto Rs 50,000	10.5
20,001 to 50,000	13.5		
50,000 to 1,00,000	14.0	50,001 to 1,00,000	12.0
1,00,001 to 3,00,000	14.5 to 16.0	1.00.001 to 2,00,000	13.5
		2,00,001 to 3,00,000	14.5

What will Happen if the Amount of Loan Under the Scheme is not Sufficient?

You can taken an additional loan from the same bank on a priority basis at the existing rate of interest.

How about Getting a Loan Before Five Years?

By joining the scheme, you will become our valued client. We will give you preference for a housing loan, but on usual terms.

If you are Prudent, You will Plan to save more now

If you save more now, and take a smaller loan later, the amount you repay as loan (and interest) will not be a burden to you.

As a thumb rule, if you save every month one hundred and fiftieth of the cost of the house you want to acquire, the amount of instalment payment on you loan later will be about the same as your rate of savings now.

For a house costing Rs 45,000, if you save Rs 300 per month, the instalment payment on the loan later will also be about Rs 300 per month. For a house worth Rs 1,50,000, if you save at the rate of Rs 1,000 per month, you will find it easy to repay the loan later.

If you are saving annually, you are advised to save one twelth of the cost of the house, that is, Rs 5,000 per annum for a house of Rs 60,000 and Rs 30,000 per annum for a house of Rs 3,60,000.

Source: Brochure released by Canara Bank, 1991

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