103

Rational Ways of Increasing Tax Revenues in India*

Raja J. Chelliah
R. Kavita Rao

No. 4 January 2002

*Paper presented at the conference on *India: Fiscal Policies to Accelerate Economic Growth* organised by the NIPFP in collaboration with the DFID and the World Bank during May 21-22, 2001.

National Institute of Public Finance and Policy
New Delhi

RATIONAL WAYS OF INCREASING TAX REVENUES IN INDIA

Raja J. Chelliah and R. Kavita Rao

Madras School of Economics, Chennai
and
National Institute of Public Finance & Policy, New Delhi

RATIONAL WAYS OF INCREASING TAX REVENUES IN INDIA*

Raja J. Chelliah and R. Kavita Rao

I. INTRODUCTION

The objective of this paper is to trace the trends in the tax revenues (major taxes) at the level of the centre and the states and against that background to formulate recommendations on tax policy changes in order to increase tax revenues along with the growth of the economy. An increase in total tax revenues faster than that in GDP is now generally considered necessary in the medium term because of the distinct fall in the tax to GDP ratio (hereafter called tax ratio) since the year 1989-90.

In our analysis of past trends, we focus on tax revenue behaviour during the past decade although the broad trends since 1980-81 are also presented. Only the major taxes of the centre and the states are covered. In the analysis of trends an attempt is made to identify the causes that have led to the fall in the tax ratio in some cases and a rise in the others. Using the insights gained from the analysis of trends in the tax ratios and on the basis of an examination of the existing tax structure and administration, we outline the needed changes in tax policy and tax administration constituting a new framework of reform.

II. TRENDS IN TAX REVENUES

Tables 1 and 3 present the ratios of the yield of major taxes of the centre and the states to GDP and the combined tax ratio of the two levels of government in the period 1980-81 to 1999-2000. The combined tax ratio (CTR), which was only 13.75 per cent in 1980-81, increased in the latter half of the 1980s and stood at 15.93 in 1989-90. It then started declining and reached the low point of 14.20 in 1993-94. Since then there has been no declining trend, with the CTR remaining about 14.50 per cent and below 15 per cent (except for a temporary dip in 1998-

* Data collection and computational assistance by Mr. A.H. Halen and Ms. Geetha and word processing assistance by Ms. Thara Ganesan are acknowledged with thanks.

99). As of 1999-00, there has been a decline in the CTR of 1.4 percentage points from the highest level reached in 1989-90. Comparing the CTRs in the latter half of the 1990s with those in the latter half of 1980s, it can be said that there has been a decline of about 1.5 percentage point. It may be noted that the decline must be entirely attributed to the decline in the tax ratio of the centre: the combined tax ratio of the states (own tax revenues) remained more or less constant during 1989-90 – 1990-00, fluctuating between 5.3 per cent and 5.8 per cent.

At the central level, the decline in the tax ratio is due to a substantial dip in the ratio of the yield of customs, and Union excises to GDP: while the ratio of customs to GDP declined from 3.7 per cent in 1989–90 to 2.47 per cent in 1999-00, that of Union excises declined from 4.59 per cent to 3.16 per cent in the same period. Thus these two taxes served to bring down the central tax ratio by as much as 2.66 percentage points. This was counterbalanced only to the extent of 0.88 percentage point by an increase in the ratio of income taxes. The total tax ratio came down by 1.82 percentage points (other minor taxes fell by 0.4 percentage point).

As against the fall in the central tax ratio by 1.82 percentage points between 1989-90 and 1999-2000, the CTR fell only by 1.40 percentage points.

To summarize the findings:

a. From 1990-91, there was a decline in the CTR; by 1999-2000, it had declined by 1.40 percentage points from the level reached in 1989-90.
b. The decline in the CTR was brought about by the decline in the central tax ratio.
c. The central tax ratio fell because of the decline in ratios of customs and excises to GDP, which was higher than the increase in the ratios of the income taxes to GDP.
d. The tax ratio of the states remained more or less constant, with a slight increase towards the end.

There has been a significant change in the composition of central tax revenues: in 1989-90, the taxes on income (corporate and personal) brought in only 18.9

per cent of the total revenue of the centre; by 1999-2000 their share had risen to 32.8 per cent (Table 2). Correspondingly, the share of customs and Union excises came down from 78.3 per cent in 1989-90 to 64.2 per cent in 1999-2000. It is generally expected that with economic growth and the extension of the scope and range of the organized sector, the share of direct taxes in the total would go up. However, this should happen without a fall in the overall tax ratio. But in the period under review, the ratio of customs and excise to GDP fell by more than the increase in the ratio of the income taxes. As the tax reform programme is extended and stabilized, it should be possible. through the reform measures themselves, to raise the ratio to GDP of the income (or direct taxes), and also that of the major taxes on commodities and services (customs excises and sales taxes), with the greater emphasis on the former. The share in the total of the latter might continue to fall, but without a decline in the overall tax ratio.

In 1989-90, the centre was raising 66.5 per cent of the combined tax revenues of the centre and the states; by 1999-2000 this proportion had declined to 60.4 per cent. It is of course desirable that there is some decentralisation in the raising of revenues. But it should happen without a fall in the CTR.

III. FACTORS GOVERNING THE MOVEMENT IN THE RATIO OF TAX TO GDP

The trends in the tax to GDP ratios can be attributed to broadly three kinds of factors:

- The growth in the potential base for the tax being different from the growth in the total GDP. Since each of the taxes targets a part of the total GDP, differentials in growth rates of these component parts could contribute to changes in the tax ratio. For instance, in the case of Union excise duties, the potential base would be manufacturing sector output, which would be captured through GDP from manufacturing. Relatively faster growth of the non-manufacturing sector, would result in a decline the share of the manufacturing sector in total GDP and thereby leading to a decline in the tax collections when viewed as a proportion of GDP.

- Given the dimensions of the potential base, the tax system actually targets a part of this potential base. Exemptions and deductions of various kinds built into the tax law on the one hand and problems of efficiency of the tax administration and problems of compliance by the tax payers on the other hand contribute to the variation of the actual base brought under the tax from the potential base. Consider, for instance, income tax. Since agricultural income is outside the purview of the existing system of income tax, non-agricultural GDP would be the potential base for this tax. However, the variety of exemptions, deductions and concessions offered within the Act would reduce this base. Chapter VIA deductions alone reduce the gross taxable income by more than 10 per cent. This process is further accentuated by inefficiencies of tax administration and poor compliance by the tax payers.

- Finally, given the actual base subject to tax, the ratio of collections of the tax to the actual base would change if rates are changed, more or less incentives are given or the degree of tax compliance changes.

Thus, the tax ratio can be decomposed as follows:

Tax/GDP = (Tax yield/Actual base) x (Actual base/Potential base) x (Potential base /GDP)

The above decomposition of the tax to GDP ratio would provide a basis for understanding the factors affecting tax performance, segregated into general economic factors and problems with structure and administration of the taxes. The use of this methodology is however constrained by the nature of data available. Time series data for the "actual base" is not available for most of the taxes. In such an eventuality, the analysis has been restricted to the examination of the external versus the tax specific factors, i.e., the second and third factors outlined above need to be analysed together.

a. Income tax

As regards total income tax collections (the sum of corporation income tax and personal income tax), the ratio of collections to GDP displays a consistent upward trend supplemented with two discrete surges. Between 1990-91 and 1999-2000, the ratio increased from 1.99 per cent of GDP to 2.88 per cent. (Figure 1) In the decade of the nineties, there is one surge in 1991-92 and another stretched over two years in 1994-95 and 1995-96. 1997-98 witnesses a decline, after which an upward trend is resumed. A similar trend is also in evidence if one examines the ratio of non-agricultural GDP to total GDP. This suggests that part of the explanation for the trends in the income tax to GDP ratio is accounted for by the behaviour of the base, GDP from non-agriculture. This however, does not tell the whole story. The ratio of income tax collections to non-agricultural GDP increases from 3.2 per cent in 1990-91 to 4.41 per cent in 1999-2000. However, it does register a sharp fall in 1997-98, a recovery from the latter not completed till 1999-2000. This suggests that an analysis of the decomposed ratios would be useful.

The only source of information on the actual base for income tax is the *All India Income Tax Statistics,* which uses a sample (but not of uniform size) of the assesses for analysis. Since this source does not provide comprehensive information on all the taxpayers, it can be used only to arrive at a rough idea of the ratios of income tax collected to returned income. This source provides information for the period 1985-86 to 1997-98. From the limited data available from this source, it seems that the ratio of income tax collected to returned income was fairly stable from 1986-87 to 1990-91, after which it increased by about 2 percentage points in 1991-92. Thereafter, the ratio falls till 1995-96 to reach 21.71 per cent before recovering to 25.7 per cent by 1997-98. As argued earlier, the downward trend appears to capture the impact of changes in the rate structure, during the mid nineties.

b. Union excise

The potential base for Union excise collections is the GDP from manufacturing. Since the base of the tax is GDP manufacturing net of excise, we consider the ratio of GDP manufacturing to total GDP at factor cost. This ratio for the two decades being analysed, is fairly stable around 16 per cent, with some increase during the mid-nineties. The ratio of GDP from manufacturing to total GDP at market prices too shows a similar behaviour, with the level being pegged at around 14. In other words, the potential base for the tax has remained fairly stable when viewed as a proportion of GDP at market prices. However, Union excise duty collections as a proportion to GDP experienced a fairly secular decline from 1990-91 onwards right up to 1998-99. (Figure 2)

Assuming GDP from manufacturing to be the effective potential base for all these years, the ratio of GDP manufacturing to total GDP is the first ratio for consideration. 1989-90 and 1990-91 witnessed a surge in this ratio. From an average of 14.3 per cent in the earlier years, it increased to around 15.2 per cent. This is sustained for two years and then the ratio falls back to 14.3 per cent in 1991-92. From the next year onwards, there is a upward trend till 1995-96, when the ratio is 16.06 per cent. In the subsequent years, a decline is once again in evidence. This seems to support a part of the decline in the ratio of excise collections to GDP after 1995-96. For the earlier period, however, the explanation has to be completely in terms of the changes in the ratio of tax collected to actual base and in changes in the ratio of the actual base to the potential base.

The combined impact of the changes in the ratios of tax to actual base and actual base to potential base, i.e., the changes in the ratio of tax to potential base show a secular decline from 1991-92 to 1995-96 after which the ratio is stable at about 21 per cent for four years before it creeps upto 22 per cent in 1999-2000. This reflects the fact that the changes in the tax structure along with possible changes in the tax compliance account for a large part of the change in the tax ratio in the case of excise.

For a further segregation of the factors, information on the actual base in the case of excise, however, is not readily accessible. The department used to put together the statistics of collections by commodities, along with the "value of clearances". However, the corresponding aggregate across all sectors is not available. Further, since the introduction of MODVAT, as a part of the duty is paid through MODVAT credits, the decomposition of the total duty collected into MODVAT paid and cash duty paid is essential for any understanding of the relation between the actual base and the potential base. These numbers too are not compiled.

c. Customs duties

The collections under customs duties as a proportion of GDP exhibit a secular decline right from 1988-89 to 1993-94. A reversal in the trend is in evidence for three years, followed by a decline in 1997-98 and 1998-99.

Comparing the level for 1990-91 to 1999-2000, it has declined from 3.63 per cent to 2.47 per cent. (Figure 3)

Interestingly, during most of this period, the ratio of imports to GDP actually registers an increase, barring a dip in 1991-92. The ratio stabilises at a little over 10 per cent from 1996-97 onwards. This seems to suggest that the cause of the observed trend lies not in the relatively slower growth of the potential base, but rather in the rest of the variables in the question. This is amply reflected also in the trends in the ratio of customs duty collections to total imports. The ratio declines from 1988-89 onwards right up to the end of the period under consideration. 1993-94 to 1996-97 is the only phase when it remains stable around 30 per cent.

The figures mentioned above indicate that per unit of imports, the collections of customs duty were on a consistently declining path. Any further decomposition of the sources of this phenomenon, however, requires information on the actual base subject to the tax, which is not readily available.

In summary, therefore, changes in the tax structure and compliance seem to explain a large part of the trends in the excise and customs duty collections as a proportion of GDP especially for the early nineties. The same however cannot be said of income tax, where both a change in the share of the potential base in GDP as well as in the changes in the structure and compliance contribute towards the observed trends. Interestingly, in the case of income tax, there is some evidence of an increase in coverage of the tax as well, since the ratio of actual base to potential base registers a modest increase.

d. Sales Taxes

Among the state taxes, sales tax accounts for close to 60 per cent of total own tax revenue. Trends in sales tax collections, therefore, tend to drive the trends in total own tax revenue of the states. Hence the present analysis restricts its attention to the trends in this tax alone. Total sales tax collections comprise local sales tax collections and collections on inter-state sales via the Central Sales Tax.

The yield of sales taxes has more or less steadily grown as a proportion of GDP from 1980-81. From 1989-90 it has stagnated around 3 per cent and there is seen a slightly declining trend from 1993-94. One can draw the broad conclusion that in the 1990s the yield of sales taxes has been more or less constant as a proportion of GDP.

It is difficult to construct figures of the potential base of sales taxes. While they fall mainly on the sales by manufacturers of goods, they cover also sales/purchases of some agricultural goods by the first seller/buyer, some part of sales by traders (e.g. importers, interstate sellers) and also sales of goods within a state in some cases where there is last point tax or a turnover tax. We are therefore unable to carry out an analysis on the basis of the decomposition of the ratio of sales tax to GDP, as has been attempted in the case of central taxes.

We have seen that the potential base of one of the major taxes, namely, Union excise duties did not fall as a proportion of GDP. However, the ratio of excise collections to the potential base (value added in manufacturing at factor cost) fell from about 30 per cent in 1991-92 to 21-22 per cent in the late 1990s.

This is because in the period since 1993-94, there was an extension of MODVAT credit to an increasing number of industries with a view to converting the cascading type of Union excise duties into a VAT at the manufacturing stage, on the recommendations of the Tax Reforms Committee (1991-93). Credit was extended also to excise duties paid on capital goods bought by manufacturers[1]. In order to make such reform revenue neutral, the rates of tax on the final goods are normally raised. This could not be done as part of excise duty reform as the general level of rates was already high. In fact, the rates of excise on several commodities were reduced: since the rates were high, it seemed reasonable to reduce them and at the same time some political advantage could be gained. Correspondingly, the number of exemptions should have been drastically reduced. This was not done.

As was seen earlier, the ratio of imports to GDP went up from about 7 per cent in 1989-90 to slightly more than 10 per cent in the latter part of the 1990s. However, because of the steep reduction in the import duty rates, as part of the tax reform programme, the ratio of the import duties to total imports was more than halved: from 51 per cent in 1989-90, it has come down to 24 per cent in 1999-2000. The reduction in the rates of import duties, which were raised to very high levels in the late 1980s, was quite necessary both for reducing the degree of protection and for promoting exports. At the same time, there should have been a drastic reduction in the number of exempted commodities. That was necessary not only to cushion the fall in the growth of customs revenues, but as a matter of rational tariff policy. Many of the exemptions have continued and ad hoc reductions in the rates of duties on particular commodities continue to be made. (For instance, in his Budget speech for the 2001-2002 Budget, the Finance Minister said: "In order to encourage better quality of cinematography, I propose to reduce the customs duty on cinematographic cameras, projectors and certain other related equipment used by the film industry from 25 percent to 15 per cent"!)

In the case of income taxes, the structural reform had an opposite impact on the tax ratio. The simplification of the income tax system (e.g. the introduction of one type of tax for all companies other than branches of foreign companies), the reduction in rates and some attempt to make the tax base more comprehensive together appear to have acted to stimulate the faster growth of the potential base (through the services sector going faster), to have improved compliance and accelerated the growth of the organised sector. Besides, growth in income brings a larger proportion of the earners

[1] It is also to be remembered that Modvat credit is extended to countervailing duties while their yield is shown as part of customs duties.

above the taxable income level. Some figures indicating these trends have been given earlier.

Tax reforms recommended by the Tax Reforms Committee included a comprehensive reform and overhauling of the administration. While the structural reform carried out is commendable on the whole, it must be pointed out that there has been only tardy progress in the reform of administration. What has been achieved in this area has helped, but a great deal remains to be done. Had greater effort been made to reform and modernise tax administration and had most exemptions been removed (including those granted under the income taxes), there would have been lesser fall in the ratio of excises and customs to GDP and a greater rise in that of income taxes; and the fall in the CTR would have been smaller.

As far as the states are concerned, their tax ratio did not fall during this period, despite tax competition among them, mainly in relation to sales taxes, as also competition in the grant of incentives and concessions to industries. But the states have not carried out any significant reform of their domestic trade taxes. Had they moved towards a state VAT, abolished irrational taxes such as octroi and entry tax and agreed to the phasing out of the central sales tax (inter-state sales tax) they might have suffered a reduction in the tax ratio in the short run, unless compensatory measures had been taken. However, if they had carried out reform of their sales tax administration and also reform of the structure and administration of stamps and registration in line with the recommendations of a Committee of State Finance Ministers on Stamp Duty Reform, their revenues would have grown faster.

IV. INCREASING TAX REVENUES FOR ACCELERATING GROWTH

a. The general approach

The reform of the tax system carried out in India since 1992-93 has aimed at creating a system containing a few major taxes that are simple, broad-based, equitable and economically efficient with only moderate rates, and at modernising and improving tax administration. All the reforms needed could not be/ have not been carried out. Taking stock of the situation now and learning from experience, it is our aim to suggest changes in the tax structure and in the system of administration of taxes that would enable us to attain the same objectives. We believe that broad-based. economically efficient taxes would not only promote growth but would also be income elastic since they would cover income and consumption in a fairly comprehensive manner and the moderate degree of progression built into the system would lead to a rise in revenues faster than GDP.

It has been the general practice in India to fix a target of an annual rate of growth during the plan period (5 years) and then derive several of the related variables, including the level of revenues, in the terminal year from the postulated growth rate of the economy. Even when the government had much greater physical and financial control over the economy and was responsible for a major, or at least a large, part of the investment, it could not have sufficient control over the growth rate, because the rate of growth of the economy is an endogenous variable and is affected by several exogenous forces not under the control of the government. Often the growth rate fell short of the target at the end of five years but attempts were made meanwhile to increase tax revenues to the targeted levels through additional resource mobilisation measures which imparted great instability to the tax system. Under the present dispensation of a liberalised economy, it is well nigh impossible to predict or postulate the growth rate for a five-year period.

With the economic system having been liberalised to a significant extent, the government can at best attempt to create conditions that would make possible or lead to a high rate of growth of GDP and of exports, a higher saving ratio and a high level of domestic and foreign investment. If other circumstances are favourable, a fairly high rate of growth would ensue.

We are not linking our exercise to any postulated rate of growth. The conditions favourable to a high rate of growth include also tax laws and administration that facilitate such growth and at the same time place a rising volume of resources in the hands of the government. Our recommendations regarding changes in the tax system are designed to create such a conducive and enabling system.

It is now generally agreed that taxes should have moderate rates (to induce high compliance and to minimise disincentives) should be economically rational and be equitable. Horizontal equity is as important as vertical equity. A departure from horizontal equity generally leads to economic distortions as well. A sizeable section of the tax paying public in India demand exemptions, incentives, rebates and concessional rates on various grounds often arguing that they would have all beneficial effects on the economy. While such a claim does not find firm support from experience, the concessions, exemptions and incentive provisions violate the canon of horizontal equity and seriously erode the tax bases necessitating higher rates of taxes in general. In our recommendations, we urge as strict an adherence to the principle of horizontal equity as possible. In general, concessions are not needed when the tax rates are moderate.

b. Import duties

Import duties in general have come down drastically since 1992-93. As of 2001-02, the main rates are 35 %, 25% 15% and 5%. Higher rates will be applied in special cases within the WTO framework. The declared intention of the government is to bring down the general duties mentioned above to South-East Asian levels. It is more important to have minimum variation among these limited number of rates and ensure stability than to reduce them quickly to South-East Asian levels. Stability is important. Constant changes give differing signals to the producers from time to time.

If we look at the budgets from 1989-99, we find that the import duty structure was changed in almost every Budget. Even in the Budget for 2001-02, the same practice has been continued. We recommend that since the government is not going to adopt a single rate import duty regime, a comprehensive exercise should be carried out to place specified categories of commodities such as raw materials and intermediate goods, machinery and capital goods and final goods mostly in the nature of consumer goods in the adopted rate slots. This may be done within 5-7 years.

A minimum rate of import duty of 10 per cent should be levied on all commodities which are now exempt except for a very few cases where it is felt that the commodities concerned are very important for the community and cannot be produced, given limitations of technology, etc, within the next 10 or 15 years. (A list of exempt commodities/transactions is given in Appendix A.) Some protection would thus be made available practically to all domestic producers, actual as well as potential.

We have seen that imports as a percent of GDP have gone up steadily from 7.2 in 1989-90 to 10.5 in 1999-2000 (Table 7). While import duties are not to be deliberately used as revenue raising measures, there is no need to forego revenue that would come from giving a legitimate degree of protection. Since imports are likely to rise even further as per cent of GDP, the levy of the minimum rate of tax on goods now exempt will serve also as a revenue raising measure.

There has to be an overhaul of the administration of customs including completing the process of computerisation. We deal with the administration of excise, customs and income tax separately.

c. Union excises (CenVAT)

The (potential) base for CenVAT, is, broadly speaking, the value added in manufacturing[2]. Now, value added in manufacturing at factor cost as per cent of GDP at factor cost has not fallen since 1989-90, as was shown earlier; in fact it had risen in the years 1995-97. There has been a slight fall in the years 1998-2000 (see Table 6). Even if this fall indicates a new trend, the ratio of value added in manufacturing to GDP (at factor cost) is unlikely to go below 15 per cent in the near future.

As for the yield of Union excise duties themselves whose conversion into CenVAT is almost complete (in terms of extension of tax credit), its future yield would depend on the expansion of their potential base (value added in manufacturing – value of manufactured exports) and of its legal base together with the extent of improvement in administration and compliance. Its potential base may not change much as a ratio of GDP. The legal base should be expanded by eliminating most of the exemptions. Apart from the exemptions already existing, some more exemptions were introduced recently because the single 16 per cent rate was considered too high for the concerned commodities. The list of exempted commodities is given in Appendix B. In his Budget speech for 2001-02, the Finance Minister has announced that the exempted commodities will be gradually brought under tax in four stages – an increment of 4 percentage points every year leading to 16 per cent. It may be difficult to tax several of the commonly used goods at 16 per cent. It would be advisable to have a second rate of 8 per cent for several goods used by the common people. This is suggested also because most of them are subject to sales tax levied by the states.

The exemption of the small scale sector means a serious erosion of the tax base. The upper limit defining the sector was recently raised to Rs.1 crore (was doubled). It is recommended that producers with a turnover between Rs.50 lakh and 1 crore be required to file returns, on a self-assessment basis, and pay a compounded tax at 2 per cent of turnover. They would not be entitled to input tax credit, but those CenVAT tax payers who buy from them would be granted credit for the two per cent tax paid by them.[3] The small scale producers subject to the levy would be required to maintain only records of sales for CenVAT purposes, and only two percent of their returns would be scrutinised every year on a random basis.

At present registered dealers (who are generally wholesalers) have been authorised to issue vouchers indicating the CenVAT paid by them on their purchases so that those who buy from them can claim input tax credit. Since these registered dealers buy in bulk and sell retail. they need to issue several

[2] Strictly speaking the value of exports should be excluded, but the value of imported consumer goods should be added.

[3] A more rational system would require that the small scale producers collect tax at the regular rate, remit tax to the government at a compounded rate of 2 per cent and claim no credit for the taxes paid on purchases. The producers who buy from them claim credit at the regular rate. It is however, felt that this process would be relatively more complex to administer, at least initially. In the scheme proposed here, an element of cascading continues to persist, but the extent of cascading should be no higher than in the present system.

vouchers in respect of one purchase by them. They can issue such subsidiary vouchers. This has opened up an avenue for fraud through the issue of spurious vouchers. It is recommended that on the basis of an agreement to be negotiated with the state governments, the registered dealers be required to pay CenVAT and claim tax credit. The net tax collected from them will be handed over to the states on the basis of an agreed distribution formula. This would mean that the centre would be entering a tax area reserved for the states. But such adjustments need to be done. For example, the states have been asking for the delegation by the centre of the power to tax some services. It does make sense for the centre to allow the states to levy or at least collect the tax on several localised services and keep the proceeds there of. Other adjustments such as "Returning" to the states the power to impose sales tax on tobacco, sugar and textiles have also been suggested. The centre and the states could together work out a package of changes that would enable each level to operate an efficient tax system.

On the assumption that value added in manufacturing (minus manufactured exports) would stay around 16 per cent of GDP and that the CenVAT with few exemptions would yield about 18 per cent of the base, we estimate that the government can derive 2.9 per cent of GDP from CenVAT (roughly 3 per cent).

d. Tax on services

Since the service sector has been growing faster than the primary and secondary sectors and is expected to maintain the lead in the coming years, it has been suggested by many experts and analysts that an important way by which the tax ratio can be raised is to bring the sale of most services under tax. From the economic point of view there is no difference between commodities and services in the sense they both serve to create utilities and satisfy wants. They are used for production and consumption. Along with the consumption of goods, the consumption of services should also be taxed. By the same token, if the rational way of taxing goods is through a consumption variant of VAT, the same principle would apply to the taxation of services.

The centre started levying taxes on services on the recommendation of the Tax Reforms Committee. The Committee had recommended the levy of tax on only a few services and had suggested that if the tax on services were to be extended, the then MODVAT on goods and the tax on services would have to be merged[4]. However, the centre has been bringing under the services tax an increasing number of services outside the CenVAT system. That is, the service tax is a cascading type of tax. Many who are recommending the tax on services seem to have in mind only a cascading type of service tax which would enable the government to raise a considerable amount of extra revenue.

While a large number of the services must be brought under tax, the tax on them should satisfy the same principles of taxation as the tax on goods. The additional revenue that the service tax will be bringing must be estimated net of the input tax credit that has to be granted under the VAT on goods (in respect of services used as inputs) and the credit to be given under the VAT on services (in respect of goods used as inputs).

It is also to be remembered that only a part of what is shown as the service sector in the national accounts can be brought under tax. The shares in GDP at factor cost of the various industry sectors in recent years are shown in Table 5. Agriculture, mining, manufacturing, electricity and gas, which are said to constitute the goods sector, together accounted for 52.0 per cent of GDP in 1993-94; their share came down to 47.3 per cent in 1999-00. In the latter year the service sector therefore generated nearly 53 per cent of GDP. However, all of this service output is not available for taxation: Public administration and defence will not be brought under tax. "Community Services" consist of educational, health and welfare services and the services of non-profit organisations which do not sell their services. These also cannot be brought under tax. These sectors together constitute about 14 per cent of GDP. If we go by the experience of the western countries, a large part of the

[4] The Committee had clearly stated: It is extremely important, however, that we do not commit the same kinds of mistakes as we have committed in respect of commodities. We must ensure that there will be a unified and rational system of taxation of services applicable to the whole country. This means that the

banking and insurance services cannot easily be brought under VAT. Only some of the banking services can be taxed. Also, it is going to be very difficult to tax the value generated by owner occupied houses. All in all, may be only 3 or 4 per cent of GDP generated in the sector of real estate and banking can be brought under tax.

To some extent, "trade" is already taxed under the sales tax on goods as well as under octroi and entry tax. Under the first point sales tax, importers and dealers who deal in some agricultural commodities (through a purchase tax) pay tax. But one can say that value added in trade in general is not being taxed. But this has to be taxed through the state VAT on goods and not through a service tax. Hotels are already taxed under the luxury tax and expenditure tax.

"Construction" in the organised sector can be brought under tax. We may assume it to be 3 per cent of GDP. Then, what will be available for the levy of fresh service tax would be far below the 53 per cent share of services in GDP. Even if we take the whole of construction, transport and communication, 5 per cent of GDP from banking and real estate, and 2 per cent GDP from trade and hotels, the total of services available for taxing would be only about 20 per cent of GDP. This would include the taxation of the railways (freight and passenger fare).

When one says that services are not being taxed, one really means that value added in the services sector is not being taxed; the inputs used in the services sector are mostly subject to CenVAT and sales taxes. The users of the services pay those taxes. If a value added tax is levied on the services not being taxed now, the input taxes used by the service providers will have to be given as rebate. Even so, since about 20 per cent of GDP is generated in the services sector which could be taxed, one could hope to add a net revenue of about 1 – 1.5 per cent of GDP through a VAT on services, merged with the existing CenVAT and may be about 0.5 per cent of GDP through a VAT on traders.

---

service tax must be part of a value added tax in course of time and should be levied at Central level. A

It would take considerable effort and require training of a large number of staff for putting in place a VAT covering goods and services at the central level. If collection of some localised services is delegated to the states, they also would have to integrate those delegated service taxes with their VATs. For this purpose, the state VAT should have been adopted and be in position. Hence it would not be realistic to assume that large additional resources could be raised through the taxation of services in the short run (in the coming two or three years), unless it is decided to continue the policy of extending the cascading type of service tax outside of CenVAT. We would not recommend the latter.

A sizeable portion of the revenue from the value added tax on services would come from the sector of transport and communications. Transport consists mainly of rail and road transport[5]. Under the Constitution, the power to levy tax on the railways rests with the centre (but the yield of the tax on railway fares is to be passed on to the states); the power to levy tax on passengers and goods carried by road and inland waterways rests with the states. The centre may not then be able to levy its VAT on the service of providing transport by road and internal waterways. At the same time it is not going to be easy for the states to administer a VAT on the transport of goods, since goods are transported by road across state borders. The problems that would arise from inter-state movements and differences between the state of location of the headquarters a company and the states where the transport takes place, etc. would have to be sorted out. Very little work has been done in this area. We would urge that a Committee of State Finance Ministers should be set up to study this question and suggest an acceptable scheme of non-cascading type of taxation of road transport, as was done in the case of sales tax and stamp duty reform.

e. Income taxes

We have seen earlier that the ratio of income taxes to GDP rose gradually from 2 per cent in 1989-90, with some dips in a few years, to 2.88 per cent in

cascading type of service tax should be avoided at all costs.

[5] Air transport is gradually becoming important.

1999-2000. The upward trend is clearly visible; since 1991-92, the ratio has been higher than 2 per cent and was above 2.5 per cent since 1994-95 except for the year 1997-98, the year in which the rates were suddenly brought down. If one takes the same period, 1989-90 to 1999-2000, one finds that the ratio of non-agricultural GDP to total GDP rose from 61.9 per cent to 65.3 per cent and that of income taxes to non-agricultural GDP rose from 3.23 per cent to 4.41 per cent. (Table 8) With this relative magnitude of rise in the ratio of income taxes to non-agricultural GDP if the share of non-agricultural GDP in total GDP had remained the same as in 1989-90, namely, 61.9 per cent, the ratio of income taxes to GDP would have risen to 2.72 per cent: 0.72 percentage point higher than in 1989-90. On the other hand, with the rise of the share of non-agricultural GDP in total GDP from 61.9 to 65.3 per cent, if the ratio of income taxes to non-agricultural GDP had not risen from 3.23 per cent, then the ratio of income taxes to GDP would have risen only by 0.12 percentage point. Thus the greater part of the rise in ratio of income taxes to GDP is to be attributed to the rise in the ratio of income taxes to non-agricultural GDP. This happened during a period when the rates were brought down. So the relative size of the actual base must have increased. This could be attributed, as suggested earlier, to better compliance (due to reduction in rates), better administration and extension of the system of tax deducted at source.

The increase in the relative size (share in GDP) of the non-agricultural sector should also be noted: It increased by 5.5 per cent over the period when GDP was rising at about 6 per cent per annum. Economic reforms including tax reforms can be said to have contributed to this rate of growth.

As was pointed out earlier, reliable and systematic information on the actual base brought under tax, either in the form of returned income (gross of exemptions and concessions) or assessed or taxed income (net of exemptions and concessions) is not unfortunately available. Since the rates of tax were generally reduced, it is to be presumed that the ratio of tax to the potential GDP must have risen due to the expansion of the actual base. This seems to have more than counterbalanced the effect of the reduction in rates. The ratio would have further risen if many of the exemptions had been removed; instead more were added. Example: On the recommendation of the Tax Reforms Committee, the taxation of long-term capital gains was liberalised and put on a more rational and equitable footing. The exemption of long-term gains invested in specified bonds was abolished except for the reinvestment of proceeds in one house. Within a few years, the exemption under Section 54 mentioned above was brought back. Subsequently, the range of specified financial assets in which long-term capital gains (or the entire sale proceeds of assets) could be invested was enlarged: among others all units of mutual funds also became eligible assets. Although many categories of these assets have been now made ineligible, the exemption under Section 54 continues and only recently new equity issues of companies have been made eligible assets under that Section! More serious base eroding and distortioning exemptions like tax holidays continue to be granted to industrial undertakings.

As pointed out earlier, the reform of tax administration has been minimal. Data on the taxes collected along with returned and assessed income are not available on a comprehensive basis because such information cannot be collected and stored without adequate computerisation. Without adequate information on the incomes returned by tax payers, the amount of exemptions and concessions granted, the tax collected under different heads and the effective rates of tax, tax policy is really being formulated on the basis of informed guesses and incomplete information. If many of the exemptions are removed, the administration is improved and adequate extent of computerisation is introduced, the actual base would expand fast and with that tax collections too. We suggest some steps in regard to removal of exemptions in Appendix C.

Tax revenue from the corporation tax is already income elastic. If many of the concessions are removed (the removal of some of them has already been announced), there will be no need for the levy of MAT. In any case we do not favour a MAT based on gross or net assets. A tax on companies based on assets has no logical base or economic rationale. A tax on corporate profits is needed on equity grounds only to reach undistributed profits which are not touched by the personal income tax.

We believe that in the next five or six years, the yield of income taxes can be raised by about 1.2 percentage points. With the non-agricultural GDP rising to about 68 per cent of GDP, which is likely, the ratio of income tax to non-agricultural GDP could easily grow to 6 per cent. Then the ratio of income taxes to GDP can grow to 4.08 per cent; provided the bulk of exemptions are removed and the administration is thoroughly overhauled (along with customs and excise administration).

f. State taxes

1. Sales taxes

The sales taxes are to be converted to state VATs by 2002, according to the agenda agreed to by the states themselves. Conversion to a rational VAT on commodities, based on the destination principle would involve three major steps: grant of full set-off to tax on inputs including capital goods to VAT paying manufacturers. taxation of second and subsequent sales through a VAT i.e the extension of the first-point tax to traders on the basis of the value added principle; and phasing out of the inter-state sales tax (CST) and granting refund of tax on inputs to inter-state exporters.

The first measure would involve short-term loss of revenue; so would the third measure. The second, namely, the extension of VAT to traders would bring in additional revenue. In some states, the first two measures might make the reform revenue neutral; otherwise, temporarily some higher rates might have to be adopted. CST reform would initially mean some loss of revenue. Compensatory measures would have to be undertaken. These are spelt out in the *Primer on VAT* brought out by the NIPFP. Hence we do not elaborate them here.

Apart from the above-mentioned measures, some states will have to abolish their octrois and entry taxes which are in the nature of taxes on the import of goods into cities and towns. All in all, there would be some loss in revenue in the short run. This can be counter-balanced to a large extent by the removal of exemptions and reforming administration and strengthening enforcement.

2. State excise

The revenue from state excise is mainly obtained from the tax on liquor. This revenue has not risen even to one per cent of GDP: it has stagnated around 0.80 per cent of GDP since 1989-90, while all indications are that with urbanisation and rise in incomes consumption of alcohol has gone up several-fold. The system of collecting tax on country liquor must be modernised. (Some efforts in this regard have been made in states like Maharashtra.) As for non-country liquor, the so-called Indian made foreign liquor (!), there seems to be substantial leakage of revenue in the collection of tax on it. It is recommended that the state governments should constitute a Committee of State Finance Ministers to study the problem of adequately taxing liquor, exchange experiences and make recommendations for reforms as in the case of sales tax, although in this case, the focus will be on the required changes in administrative procedures. Jointly the states should aim to raise the yield of the tax to 1.5 per cent of GDP i.e. by about 0.7 percentage point.

3. Stamps and Registration

Stamp duties and registration fees are not levied mainly with the view to raising revenues except that to some extent the stamp duty on the conveyance of property can be said to be a tax on the value of private wealth. Stamps and registration at present yield only around 0.4 per of GDP; the yield can be raised with a fairly comprehensive reform of the structure of stamp duties, the valuation of property and the administration of the registration department. In general, stamp duties on conveyance have been fixed at high levels while the methods of valuation are not satisfactory and often lead to disputes, delay and avoidance. The entire question of the reform of stamps and registration was considered by a Committee of State Finance Ministers under the auspices of the Union Finance Minister. The report of the Committee was accepted by the Government of India and the state governments. After further discussion on the details, final recommendations were made. Some of the changes recommended require legislative amendment by the Government of India, and it is understood that the Law Ministry is vetting the draft legislation. Meanwhile, the states can act in those areas where they are competent to legislate and make changes.

The rates of duty on conveyance of property should be moderate, but the moderate rates should be combined with proper valuation. High rates of duties induce avoidance as well as under-valuation of property. The Committee had recommended that rates of duty should be lowered and an independent agency should be set up for valuation of property in different parts of a state. Some states like Maharashtra have carried out a number of important reforms along with a reduction in the rates of stamp duties. Punjab, West Bengal and Bihar have also brought down the rates of duty on conveyance. Andhra Pradesh has carried out valuation of property and has fixed values of built and unbuilt properties in different parts of towns and cities. Therefore, the registration officer has no discretion to fix the value of property for registration. There is of course scope for an appeal but if the valuation is reasonable and slightly lower than market value and the rates are moderate property owners would accept the valuation and get their transactions registered. Along with the reduction in rates there should also be action to expand the base, for instance, by bringing under charge of power of attorney transactions accompanied by transfer of property.

Valuation of property by experts is extremely important. The states can jointly establish a few schools where valuers can be trained. In each state there should be an independent valuation cell, manned by personnel outside of the registration department.

Finally all property records and transactions in the department of registration must be computerised for quick action. With these reforms it should be possible to raise the revenue from stamps and registration without hindering business activity at least by 1 per cent of GDP

g. Reform of Administration

As is well known, tax administration can make or mar tax policy. In India, by and large, no serious effort has been made to modernise tax administration, although some improvements have been effected in recent years. The administration of all the taxes is based largely on traditional methods, is largely manual based and has fallen far behind the tax administration in advanced countries in terms of efficiency, helpful approach to the tax payers and standards of integrity.

The central and state governments have not thought fit to push through vigorously reform of the tax administration partly because of lack of understanding of how much an obstacle it is to the smooth functioning of the economy and of the significant part it plays in their inability to obtain sufficiently increasing revenues. As things stand today a thorough reform and modernisation of the administration of the major taxes is the most important method and requirement for increasing tax revenues along with growth.

1. Computerisation

Computerisation has proceeded very slowly. Taking the example of income tax, one finds that computerisation has not proceeded even to the extent of collecting and storing information, in respect of all income taxpayers, on their major characteristics, the income returned, exemptions and concessions availed of, assessed income and taxes assessed. Since such an information is not collected and stored in the computer, the central office (the Board) does not have information on the total income returned, exemptions granted, and tax paid or payable. We found that we could not obtain, on a reliable basis, the figures of actual base of personal income tax or corporation tax. Without this information, one cannot estimate the effects of tax rate or base changes and one cannot calculate the revenue effect of concessions. Tax policy has to be formulated in darkness on the basis of guesses[6]. Without the aid of the computer the Department is not able to identify quickly the stop-filers, or link the person in whose case tax has been deducted at source on

[6] It is indeed a matter for great regret that more than 140 years after the income tax was introduced in India, the Department does not have at the central office complete and reliable information on the number of income tax payers who file returns, their income, tax paid or payable, etc.

one item of income with the information given in his return or thoroughly explore the ramifications of a detected case of fraud. It is understood that an agreement has been reached with the staff to the effect that the income tax department can proceed with computerisation on some of their conditions being met. Proceeding speedily with computerisation on the basis of the recommendations of a total solution provider is a pre-condition for increasing the yield of income taxes to reach the level of 4 to 4.5 per cent of GDP.

The activities and the records of the excise and customs department also should be fully computerised. The successful administration of CenVAT would be greatly helped by computerisation as is borne out by the experience of countries that have succeeded in raising substantial and increasing amounts of revenue through VAT.

2. *Reducing leakage of revenue*

Simple tax laws with only a few rates for each tax and with few exemptions would considerably reduce the scope for the exercise of discretionary power of the tax officers. Correspondingly, the extent of collusion between the erring tax-payers and the errant officers would be reduced[7]. The reform of the tax structure is moving in the direction of simple laws. However, in spite of the reduction in the rates of tax, tax evasion by substantial sections of tax payers and corruption indulged in by tax officers is wide spread. Government has been content with taking sporadic action against tax evaders, large or small, and against corrupt officers. Only planned and determined deterrent action would serve to cut down evasion and corruption. This matter should be handled by a special member of the Boards in conjunction with the Central Vigilance Commissioner. He should also guide the enforcement wing of the Departments.

Computerisation and strong deterrent action against tax evaders and corrupt tax men are the two most important steps to be taken to increase revenues in the existing situation.

[7] The scope for collusion is reduced also if the departments are organised on a functional basis and one-to-one relationship between a tax payer and an officer is avoided.

h. Removing Exemptions

Another important measure needed to raise revenues (and at same time, reduce distortion and improve horizontal equity) is to eliminate a large number of exemptions now granted. We give in Appendices A, B and C lists of exemptions and concessions, most of which could be eliminated.

SUMMING UP:

The trends in the tax ratio and changes in the composition of CTR in the period 1989-90 to 1999-00 show that the ratio of states' own revenue to GDP has remained more or less constant, the ratio of income taxes has risen slightly and the ratio of customs and excise has fallen significantly – by about 2.7 percentage points. In the case of customs, the fall is to be largely attributed to the bringing down of the high import duty levels rather steeply as was required under the economic reform programme, and in the case of Union excise the fall can be said to be due to the extension of the input tax credit system to many industries and the grant of rebate of the tax on capital goods, without raising the final rates which were already high. In both cases, the fall in the ratio would have been less had the large number of exemptions been pruned. Again, not much action was taken to modernise administration and strengthen the enforcement of tax laws. These supplementary actions were needed when the effective rates were being brought down as part of the structural reform.

Similarly, if the income tax department had been computerised and administration had been toned up, the ratio of income taxes to GDP would have risen much faster. Anyway, the downward trend in the ratios of CenVAT and customs to GDP has now stopped and the upward trend in the income tax ratio is continuing. The reduction in the ratios of import duties will be now only gradual and of a much smaller relative magnitude. Also, while the tax ratio fell in the period since 1989-90, the growth of the economy was accelerated. The economy is estimated to have grown at 6.4 per cent per annum in the nineties since 1992-93 compared to 5.8 per cent recorded in the eighties. Although the tax ratio had fallen, the base of the ratio (GDP) was higher by about 40 per cent at the end of the decade.

It is a matter for great satisfaction that the basic structural reforms of the central tax system have been successfully carried out. From now on, there will not be need for significant rate reductions. If any rate reductions are desired, they could be effected gradually, over a period of time, as the tax system becomes very buoyant. The immediate task in the area of tax policy is to improve the horizontal equity of the system and accelerate the growth of the revenues without raising rates.

We must focus attention only on the major taxes which are needed to adequately tax consumption and income. The smaller taxes, except the ones that are needed as tax handles for the local authorities, may be best abolished or merged with the major taxes; for example, electricity duty should be merged with the state VAT.

We have indicated earlier that it should be possible in the medium term to raise the ratio of income taxes to GDP to about 4 per cent of GDP.

Imports have more or less steadily risen from 7.2 per cent to 10.5 per cent of GDP. It may in the medium term rise to 12 per cent of GDP. If import duties capture 20 per cent of the value of imports, the duties will form 2.4 per cent of GDP. Around 2.5 per cent of GDP can be raised from import duties if most of the exemptions are removed.

We have already shown how the revenue from the CenVAT on goods might yield about 3 per cent of GDP in the coming years. That is, there will be no rise in the ratio of CenVAT on goods to GDP. The extra revenue would have to come from the CenVAT on services. While in the long run the CenVAT on services as part of the comprehensive CenVAT, might yield about 1.5 per cent of GDP (on the assumption that the state VATs will operate independently) in the medium term one could take credit for about 0.75 per cent of GDP

A comprehensive state VAT on goods alone will enable the states to raise at least 0.5 per cent of GDP from the taxation of value added in trade. Taken together with the removal of most exemptions, other than sales by agriculturists and sales of some unprocessed food products like vegetables and milk (but not condiments, turmeric, onions, etc), and improvement in administration[8], this extension of the tax to traders

[8] The same measures in this regard as specified in respect of the central tax administration.

would enable the states to raise about 4.0 per cent of GDP from the state VATs, as against the 3.4 per cent they are raising now from sales taxes[9]

From the reformed system of state excise on liquor, stamps and registration, the tax on motor vehicles and others (like electricity duty and tax on passengers) the states could raise about 3 per cent of GDP as against 2.35 per cent in 1999-2000.

The centre should be able to raise in about 5 to 6 years, about 10.3 per cent of GDP from the major taxes considered above. (We are omitting to include the possible yield from the minor taxes to compensate for any element of overestimation in our calculations.) According to our estimate the states could raise about 7 per cent of GDP from their major taxes – an increase of 1.25 percentage points from the present level of 5.75 per cent.

Thus in our view, in the medium term of 5 or 6 years, the CTR could be raised to 17.25 per cent of GDP from the level of 14.52 per cent in 1999-2000; if most of the reform measures suggested are implemented. Reform measures, we must reiterate, include modernisation of tax administration including computerisation and strong deterrent action against tax evaders and corrupt tax officials.

The dependence of the government for revenues on direct taxes would grow. This is because the revenue from import duties will not grow as a proportion of GDP and the two major domestic trade taxes, (CenVAT and state VAT) will be of the consumption variant. If the rate of domestic saving increases as it is likely to do with the rise in incomes, total taxable consumption, that is domestic consumption minus government consumption in the form of salaries of civilian and defence personnel will fall as a proportion of GDP. If there is a single rate VAT, the yield of VAT will also fall as a proportion of GDP. However, if in addition to one or two VAT rates, there is also imposed a non-vatable levy at a higher rate on goods whose consumption will be income – elastic, then while consumption may fall as a per cent of GDP, the ratio of tax to consumption will go up, at least partly counter-balancing the effect of the fall in the ratio of consumption to GDP. However, clearly, in the longer run context the central government has to increase its dependence on the direct taxes. If the states wish to maintain their share in raising tax revenues, they should start taxing income from

[9] This is a projected figure; the actual percentage for 1999-2000 is not available.

agriculture and have an efficient system of collecting stamp duties on conveyance of property.

C:\rjc2001\rjc pap 2001\WBp incr tac rev.doc

Table 1

Taxes of the Centre and the States as per cent of GDP

Centre								
		1980-81	**1985-86**	**1989-90**	**1993-94**	**1996-97**	**1998-99**	**1999-2000**
	Central Gross Tax Revenue	9.12	10.23	10.59	8.81	9.45	8.18	8.77
1	of which Corporation Tax	0.91	1.02	0.97	1.17	1.36	1.4	1.57
2	Taxes on Income Other Than Corporation Tax	1.04	0.90	1.03	1.06	1.34	1.15	1.31
3	Customs	2.36	3.40	3.70	2.58	3.15	2.31	2.47
4	Union Excise Duties	4.50	4.62	4.59	3.69	3.30	3.03	3.16
5	Others	0.31	0.29	0.30	0.31	0.30	0.29	0.26
States								
		1980-81	**1985-86**	**1989-90**	**1993-94**	**1996-97**	**1998-99**	**1999-2000**
	States Own Tax Revenues	4.62	5.21	5.34	5.38	5.23	5.33	5.75
1	of which Sales Taxes	2.67	2.99	3.08	3.18	3.09	3.02	
2	State Excise	0.58	0.74	0.80	0.83	0.65	0.76	
3	Stamps and Registration	0.30	0.31	0.38	0.41	0.46	0.42	
4	Taxes on Motor Vehicles	0.29	0.30	0.29	0.30	0.30	0.29	
5	Others	0.78	0.87	0.80	0.67	0.73	0.84	

Table 2

Composition of Tax Revenues of the Centre and the States

(Percentage of Total)

	Centre	**1980-81**	**1985-86**	**1989-90**	**1993-94**	**1996-97**	**1998-99**	**1999-2000**
1	Corporation Tax	9.9	10.0	9.2	13.3	14.4	17.06	17.9
2	Taxes on Income other than Corporation Tax	11.4	8.7	9.7	12.0	14.2	14.08	14.9
3	Customs	25.9	33.5	34.9	29.3	33.3	28.28	28.2
4	Union Excise Duties	49.3	45.0	43.4	41.8	35.0	37.03	36.0
5	Others	3.4	2.8	2.8	3.5	3.2	3.56	3.0
	Gross Tax Revenue	100.0	100.0	100.0	100.0	100.0	100.0	100.0
	States	**1980-81**	**1985-86**	**1989-90**	**1993-94**	**1996-97**	**1998-99**	**1999-2000**
1	Sales Taxes	57.81	57.49	57.57	59.06	58.95	56.66	
2	State Excise	12.58	14.19	14.91	15.41	12.41	14.28	
3	Stamps and Registration	6.41	5.87	7.10	7.61	8.81	7.93	
4	Taxes on Motor Vehicles	6.26	5.70	5.44	5.50	5.79	5.36	
5	Others	16.94	16.75	14.98	12.43	14.04	15.78	
	States own Tax Revenues	100.00	100.00	100.00	100.01	100.00	100.01	

Table 3

Shares of the Taxes Raised by Centre and the States

A. As Percentage of GDP

			1980-81	1985-86	1989-90	1993-94	1996-97	1998-99	1999-2000
1	Centre		9.13	10.23	10.59	8.82	9.45		8.78
2	States		4.62	5.21	5.34	5.38	5.23		5.75
		Total	13.75	15.44	15.93	14.2	14.68		14.53

B. As Proportion of Total

			1980-81	1985-86	1989-90	1993-94	1996-97	1998-99	1999-2000
1	Centre		66.40	66.26	66.48	62.11	64.37		60.43
2	States		33.60	33.74	33.52	37.89	35.63		39.57
		Total	100	100	100	100	100		100

Table 4

Composition of the Combined Taxes of the Centre and the States

		1980-81	**1985-86**	**1989-90**	**1993-94**	**1996-97**	**1998-99**	**1999-2000**
Centre								
1	Corporation Tax	6.62	6.61	6.09	8.25	9.26	10.33	10.81
2	Taxes on Income other than Corporation Tax	7.57	5.83	6.47	7.47	9.13	8.52	9.02
3	Customs	17.18	22.02	23.23	18.18	21.46	17.12	17.01
4	Union Excise Duties	32.75	29.92	28.81	26.00	22.48	22.41	21.76
5	Others	2.26	1.88	1.88	2.18	2.04	2.15	1.79
6	Central Taxes	66.38	66.26	66.48	62.09	64.37	60.53	60.40
States								
7	Sales Taxes	19.43	19.37	19.33	22.41	21.05	22.36	0.00
8	State Excise	4.22	4.79	5.02	5.85	4.43	5.64	0.00
9	Stamps and Registration	2.18	2.01	2.39	2.89	3.13	3.13	0.00
10	Taxes on Motor Vehicles	2.11	1.94	1.82	2.11	2.04	2.12	0.00
11	Others	5.68	5.63	5.02	4.72	4.97	6.23	0.00
12	State Taxes	33.62	33.74	33.58	37.98	35.63	39.47	0.00
13	**Total**	100.00	100.00	100.06	100.07	100.00	100.00	60.40

TABLE 5

Share of Different sectors in Gross Domestic product at factor cost at current prices

(percent of total)

Sector\Year	1993-94	1994-95	1995-96	1996-97	1997-98	[illegible]	[illegible]	[illegible]
Agriculture, Mining and quarrying	33.5	33.0	30.8	31.5	30.4	[illegible]	[illegible]	[illegible]
Manufacturing	16.1	16.8	17.8	17.4	[illegible]	[illegible]	[illegible]	[illegible]
Elec gas and water supply	2.4	2.6	2.6	2.4	[illegible]	[illegible]	[illegible]	3.0
Construction	5.2	5.1	5.2	5.1	5.7	[illegible]	[illegible]	[illegible]
Trade hotel and Restaurant	12.7	12.9	13.5	13.8	[illegible]	[illegible]	[illegible]	[illegible]
Transport, storage, communication	6.5	6.7	6.6	6.7	[illegible]	[illegible]	[illegible]	0.0
Financing, insurance, real estate and business services	11.5	11.3	11.7	11.2	11.4	[illegible]	[illegible]	[illegible]
Community, social and personal services	12.0	11.6	11.8	11.9	12.7	[illegible]	[illegible]	[illegible]
of which a) Public administration and defense	5.6	5.3	5.4	5.3	5.8	[illegible]	[illegible]	[illegible]
b) other services	6.4	6.3	6.5	6.6	7.0	[illegible]	[illegible]	[illegible]
Total	100	100	100	100	100	[illegible]	[illegible]	[illegible]

Note: 1. Figures for 2000-01 for Trade hotel and restaurant include that of transport storage and communication

2. Breakup of community social and personal services for 2000-01 is not available

Table 6

Union Excise Duty Collections: Decomposition of Tax Ratios

	1980-81	1985-86	1989-90	1993-94	1996-97	[illegible]	[illegible]
Collections as proportion of GDP Manufacturing	31.06	32.08	30.07	25.26	[illegible]	[illegible]	[illegible]
GDP Manufacturing as proportion of total GDP with factor cost	16.00	16.04	16.95	16.06	[illegible]	[illegible]	[illegible]

Table 7

Customs Duty Collections: Decomposition of Tax Ratios

	1980-81	1985-86	1989-90	1993-94	[illegible]	[illegible]	[illegible]
Collections as proportion to Value of Imports	27.2	48.5	51.1	30.4	[illegible]	[illegible]	[illegible]
Value of Imports as proportion of total GDP	8.7	7.0	7.2	8.5	[illegible]	[illegible]	[illegible]

Table 8

Income Taxes Collections: Decomposition of Tax Ratios

	1980-81	1985-86	1989-90	1993-94	[illegible]	[illegible]	[illegible]
Personal income tax as proportion of GDP non-agriculture	1.88	1.49	1.66	1.69	[illegible]	[illegible]	[illegible]
GDP non-agriculture as proportion of total GDP	55.57	59.98	61.89	62.78	[illegible]	[illegible]	[illegible]

Figure 1: Income tax collections (percentage)

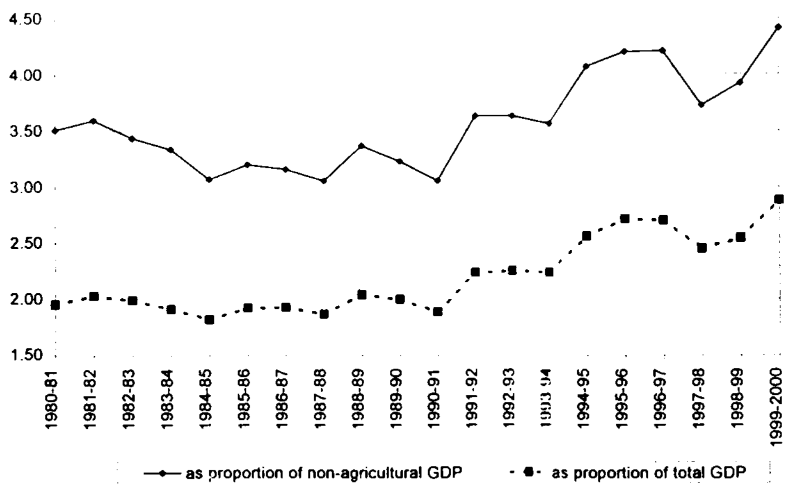


Figure 2: Union Excise Duty Collections (per cent)

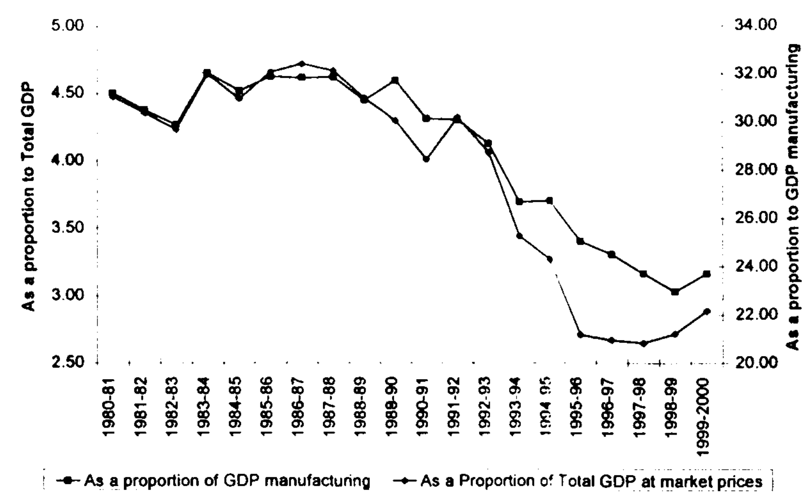
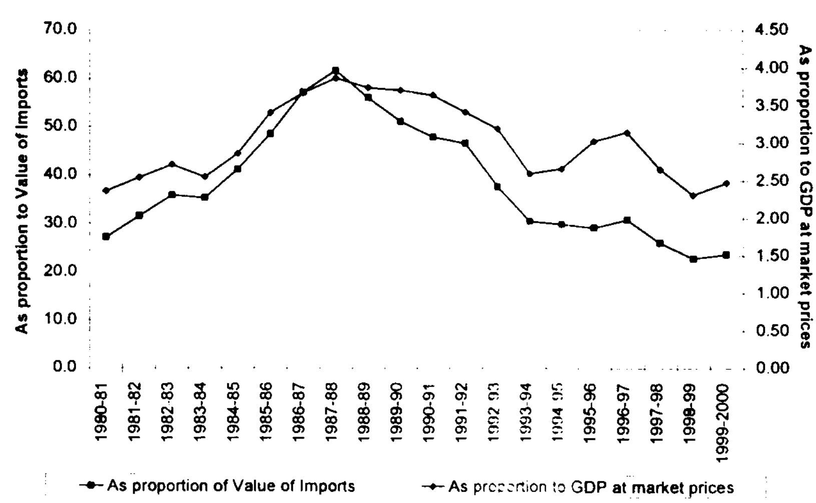


Figure 3: Customs Duty Collections (percent)



APPENDIX 7

CUSTOMS DUTIES EXEMPTIONS

Exemptions from customs duties (2001-02) can be classified into three broad categories:

1. commodity specific exemptions
2. use specific exemptions
3. user based exemptions

a. **Commodity Specific Exemptions**:

This list includes goods subject to no customs duty. There are a number of other commodities on which importers have access to concessional rates of duty.

1. Chapter 5: Pancreas, Frozen Semen, Frozen semen equipment
2. Chapter 7 : Onions
3. Chapter 8: Cashew nuts in a shell
4. Chapter 10: Meslin, Rye, Barley, Oats, Buckwheat, canary seeds
5. Chapter 27: Electrical Energy
6. Chapter 28, 29, 30 or 38: Life saving drugs/medicines, including their salts and esters, and diagnostic test kits in enlisted List 2;
7. Chapter 28 or 38: Silicon in all forms;
8. Chapter 39, 74: Copper wire.
9. Chapter 41: Raw hides and skins (other than fur skins), wet blue chrome tanned leather, crust leather, finished leather of all kinds
10. Chapter 43: Raw as well as tanned and dressed furskins
11. Chapter 49: Newspaper, journals, periodicals; music printed or manuscript; maps and hydrographic or similar charts; plans, drawings and designs.
12. Chapter 84 or 85: Braille printer, embosser or display, especially designed for computer systems
13. Chapter 85: fixed electrical capacitors: tantalum, ceramic dielectric multilayer, and parts of capacitors and resistors; data/graphic display tubes, colour with a phosphor dot screen pitch smaller than 0.4 mm; parts of diodes, transistors, photo-sensitive semi-conductor devices, mounted piezo-electric crystals; electronic integrated circuits and micro assemblies; ion implanters for doping semi-conductor materials; one set of pre-recorded cassettes accompanying

books for learning languages and essential complement to such books; video cassettes and tapes of primarily educational character; CDROM, deflection compounds used in colour monitors for computers; CDROMS containing books of educational nature, journals etc.;

14. Chapter 49 or 85: IT software or the document of title conveying the right to use IT software.
15. Chapter 89: All vessels covered by 89.06 provided they are not broken up on importation.
16. Chapter 90: Medical equipment and other goods in list 29, and related accessories; life saving medical equipment and related accessories and spares; medical equipment and goods in lists 30 and 31: goods for tubal occlusion in list 32;
17. Chapter 91: Braille watches and one-day alarm clocks and parts thereof
18. Chapter 99: blood group sera; artificial kidney; all contraceptives; unused postage stamps; commercial catalogues in book form; paper money; common salt.

b. Use Specific Exemptions:

The exemptions in this category relate the exemption to the particular use to which a commodity is to be put. The administration of these exemptions would require lot of documentation to ensure that the goods are used for the desired purpose. The elimination of exemptions for some of these sectors replaced with a duty drawback in the case of exports could provide an alternative approach to support exports. There should be no exemption for specific uses unless the commodity concerned cannot be produced in India even in the coming years.

1. All goods used for manufacture of fertilisers.
2. Chemicals used for manufacture of Centchroman.
3. Undiffused silicon water for manufacture of solar cells or solar cell modules.
4. Bulk drugs used in manufacture of the goods in exempt list 2; DL-2 Aminobutanol, Diethyl Malonate, Triethyl Orthoformate, Aceto Butyrolactone, Thymidine, Artemisinin, Maltol, for use in manufacture of Deferiprone; Goods used for manufacture of ELISA kits; Chemical contraceptive preparations based

on hormones and spermicides; Alatheon, if imported for manufacture of copper-T contraceptives.

5. Iodine for manufacture of Potassium Iodate.

6. Chemical elements doped for use in electronics, in the form of discs, wafers, etc.

7. Subbed polyester base for manufacture of medical or industrial X-ray films or graphic art films.

8. Pulp of wood and other cellulosic material, for manufacture of newsprint to be supplied to a newspaper.

9. Lining and inter-lining material for manufacture of textile garments for export.

10. TV equipment, cameras, etc imported by foreign film unit or TV team.

11. Goods in list 23 used for manufacture of laser or laser based instrumentation; apparatus for projection or drawing of circuit patterns on sensitised semi-conductor materials - direct write-on-wafer equipment, step and repeat aligners; instruments for measuring and checking semi-conductor wafer or devices or for inspecting photo masks or rectides used in manufacture of semi-conductor devices; liquid crystal devices and their parts and accessories.

12. Exemptions to facilitate exports: Materials and other specified goods used for production of goods for export or use in 100% EOUs; import of specified goods for use in aquaculture farm and export of products therefrom; for use in granite quarry for quarrying of granite by 100% EOUs/FTZs; for use in export of gems and jewellery; capital goods imported by specified importer under the EPCG scheme, and capital equipment, spare parts and such equipment as is required to maintain the above. goods imported under EPCG scheme, required for manufacture of leather garments, textile garments, agro products and products of horticulture, floriculture and poultry; goods imported for execution of an export order for job work; tags, labels, printed bags, stickers, belts, buttons, or hangers, imported by bonafide exporters. Included here are exemptions for imports against advance licenses, replenishment licenses and self declared pass book.

13. Requisites for games and sports, if certified by the apex body for that game/sport; synthetic tracks and artificial surfaces and equipment required for its

installation, if imported under the relevant scheme of Department of Youth Affairs and Sports.

14. Works of art/memorials to be put up in a public place; works of art/antiques for exhibition in public museum or national institution; animals and birds imported by a zoo.

15. Capital goods, raw materials, material handling equipment and consumables for repair of ocean going vessels by a registered ship repair unit; raw materials and parts for the manufacture of all ships and boats other than yachts and pleasure vessels, provided that upon breaking up of such vessels, the imported components would be subject to duty; parts for repair of dredgers.

16. Specified goods imported for development of software, data entry and conversion, data processing, data analysis and control data management or call centre services for exports, by software development units in STPs, under 100% EOU scheme.

17. Specified goods imported for manufacture and development of electronics hardware and software in an integrated manner in the Electronics Hardware Technology Park

c. User Related Exemptions:

These exemptions can be availed of only by specially identified importers. Except in the cases where external donor agencies are involved, and the assistance is conditional on the exemption of taxes and duties, this process of allowing exemptions only complicates the administration of the tax. Other than in the FTZs and EPZs, this is likely to pose a problem of monitoring the use of the good imported. Since at least a few of the exemptions relate to government departments and institutions, the objective of introducing such exemptions is not clear. Higher budgetary provisions with no exemptions appear to be a feasible option.

1. Reference Standard imported by Central Drug Laboratory, Calcutta.
2. Raw materials, intermediates and consumables supplied by UNICEF for manufacture of DTP vaccines
3. Any Chapter: Goods imported by a manufacturer of Handicrafts, for manufacture for exports, (list specified).

4. Imports by RBI and related institutions: Mould Vat made water-marked bank note paper, imported by authorised institutions of the RBI or Government of India; Current coins of GOI; printed Indian Bank Notes, imported by RBI, foreign currency coins imported by a scheduled bank if imported by approval of RBI and utilised as per regulations; plant, machinery, equipment etc. imported on behalf of RBI for new printing presses in Salbony and Mysore and for modernisation of presses at Nasik and Dewas.

5. Commonwealth and international reply coupons and UNESCO coupons; greeting cards, diaries, calendars imported by UNICEF; printed books and manuals,

6. Machine tools for dry-etching patterns on semi-conductor materials; micro-processors for automatic data processing machines other than mother boards; wafer probers.

7. Goods (List 11) required for construction of roads, provided the goods are imported by a person authorised for the same by Ministry of Surface Transport.

8. Audio cassettes with material from news papers, journals and books for the blind; recorded magnetic tapes, CDROMS and floppy discs imported by UGC for use in UGC approved institutes and research centres; goods imported for testing in specified test centres: DRDO labs, CSIR labs, IITs, CPRI; specimens and models for instructional purposes.

9. Goods (List 19), imported by ONGC or OIL for undertaking petroleum exploration activities on licenses issued by Government of India or a state government or for petroleum operations undertaken under specified contracts; parts and raw materials used for manufacture of goods used for off-shore oil exploration/exploitation.

10. Photographic equipment of value upto Rs 1 lakh, imported by an accredited press cameraman; PCs typewriters and fax machines of upto Rs 1 lakh imported by an accredited journalist.

11. X-ray baggage Inspection Systems imported by GOI or by police force of a state or union territory, etc.,

12. Medical and surgical instruments, apparatus and appliances including spares, if imported by a GOI department under an agreement relating to government to government assistance programme with another country; parts

required for manufacture or maintenance of the goods in the lists 29, 30, 31; goods in list 33 imported by a handicapped or disabled person for personal use; life saving medicines or drugs including diagnotic test kits imported for personal use.

13. Goods from pre-specified lists required for setting up a Mega Power Project if it is an inter-state thermal plant with capacity of at least 1000 MW or a hydel plant with capacity of at least 500 MW, or goods required for setting up Nuclear Power Project with a capacity of at least 440 MW provided the power purchasing state sets up an electricity regulatory commission, and undertakes, in principle to privatise distribution in all cities with population above 1 million; imports by Power Grid Corporation of India for setting up Rihand-Sasaram-Biharshariff HVDC Link Back to Back Station project:

14. Gifts received by charitable institutions. Red Cross, CARE and Government of India; computers and computer peripherals donated to educational, research, charitable institutes or public funded or governmental organisations, 100% EOU, STP, EHTP, and EPZ schemes; relief and rehabilitation of the earthquake affected people in Gujarat.

15. Asphalt resurfacer, acrylic resurfacer. cushion coat, acrylic colour concentrate, marking paint and polytan used for laying synthetic tracks and artificial surfaces, if authorised by Sports Authority of India for use in national or international competitions.

Out of these numerous exemptions detailed above. only the following may be considered for continuation:

i. Under a: 6,11,14,18

ii. Under b: 10 and 12

iii. Under c: 4,5, and 8

In the case of 14, only goods received by Red Cross, Care and Government of India should be exempted

In addition to the above-mentioned list, there are also some commodities, which if imported from "preferential areas", the imports are subject to a lower rate of tariff. These have not been explicitly listed here. Countries to which such preferential status has been accorded are: Sri Lanka, Bangladesh, Nepal, Bhutan, Korea, Mauritius, Seychelles and Tonga.

Note:

In the main text, it has been suggested that a minimum rate of duty of 10 per cent should be levied on most of the exempted goods. In that case, we can evolve a 3-rate duty regime: 20 per cent, 15 per cent and 10 per cent with a narrow spread. However, the exempted goods, except those lifted in (i), (ii) and (iii) above may be taxed at 5 per cent to start with. The main argument for imposing on most imports a minimum duty of at least 10 per cent is to extend protection to all producers

APPENDIX B

EXEMPTIONS UNDER CENTRAL EXCISE

Exemptions under Central excise can be classified broadly into the following heads:

a) Commodity wise exemptions:
b) Inputs provided they are produced and used up in the factory they are produced in
c) Use based exemptions
d) User based exemptions: small scale sector, Handicrafts sector, etc.
e) Manufactured goods, where the taxes have been paid on the inputs used:
f) Input or production process based exemptions.

1. **Commodity wise exemptions:**

   There is a rather long list of these exemptions, with no evident rationale linking the goods together. Considerable prunning of this list of exemptions would appear to be both feasible and desirable.

   List:

   Chapter 9: Coffee, and coffee substitutes, Green tea, spices: branded and otherwise.

   Chapter 11: Products of the milling industry including flours, groats, meal and grains of cereals and of vegetables, Tapioca starch, Maize starch, inulin, wheat gluten.

   Chapter 13: Compounded Asafoetida

   Chapters 20, 21, 22: Ice-cream and nonalcoholic beverages prepared and dispensed by vending machines, goods classified within heading 2001.10, sauces, ketchup and the like and other preparations thereof, soups and broths and preparations thereof; aerated water dispensed by vending machines; sweetmeats, namkeens, bhujia, mixture, chabena and similar edible preparations in ready for consumption form and papad; all goods classified under 2202.40.

   Chapter 24: unbranded biris, up to first clearances not exceeding 20 lakhs in any financial year, tobacco, for "hookah" or 'chilam', 'gudaku'.

   Chapter 26: Ores

   Chapter 27: Bio-gas, Lean gas obtained from natural gas; Steam

   Chapter 28: Potassium iodate, bulk drugs in List 1. anaesthetics; silicon, in all forms;

Chapter 30: Desferrioxamine injection, Deferiprone, Insulin and Zidovudine; intravenous fluids, formulations manufactured from the bulk drugs specified in List 1,

Chapter 31: All goods, other than those which are clearly not to be used-

a.as fertilisers; or

b.in the manufacture of other fertilisers, whether directly or through the stage of an intermediate product.

Chapter 32: Nitrocellulose lacquers produced in government owned ordnance factories for supply to Central Government Departments, including defence; finishing agents, dye carriers, printing paste and other products and preparations used for the manufacture of textiles and textile articles;

Chapter 33: Henna powder; shikakai powder; tooth powder;

Chapter 34: Janata soap,

Chapter 39: Surgical rubber gloves or medical examination rubber gloves

Chapter 40: nipples for feeding bottles; parts and accessories of cycles and cycle rickshaws; tyres used on animal drawn vehicles; tyres used in manufacture of power tillers, two-and three wheeled motor vehicles for handicapped persons; machinery fitted with, trucks fitted with lifting and handling equipment, other lifting handling and loading machinery, various earth leveling, compacting, excavating, boring and other such machinery, motor vehicles; tubes and flaps used in the manufacture of such tyres;

Chapter 48: Paper splints for matches, whether or not waxed; asphaltic roofing sheets;

Chapters 53, 57, 58, 63 –Goods of jute

Chapters 54 or 55 Woven fabrics of man made fibres subjected to any one or more of the following processes, calendering with plain rollers; singeing; padding; back filling; cropping; hydro-extraction; or the process of blowing carried on woven fabrics of acrylic fibre.

Chapter 54: Nylon filament yarn or polypropylene multi-filament yarn of 210 deniers with tolerance of 6 per cent; mono-filament of high density polyethyline or polypropylene; nylon mono-filament yarn, of denierage 210, 330, 420, 630, 840, 1050, 1260 or 1680 with tolerance of 4 per cent; jute felt;

Chapter 56: Metallic yarn (imitation zari)

Chapter 58: Embroidery, other than those not subjected to any process; narrow woven fabrics of cotton or man-made fibres; hair belting of wool;

Chapter 59: Rubberised textile fabrics; unprocessed cotton belting, woven

Chapter 60: Knitted or crocheted fabrics of cotton; unprocessed knitted or crocheted fabrics

Chapter 63:Blankets of wool or yarn of shoddy falling under 55.09 or 55.10, the value of which does not exceed Rs 150 per square metre; jute blankets

Chapter 68: Goods, in which not less than 25% by weight of fly-ash or phospho-gypsum or both have been used; stoneware, which are only salt glazed; sand lime bricks; articles of mica; Mosaic tiles; lightweight (solid or hollow) concrete building blocks; roofing tiles;

Chapter 69: Glassware produced by mouth-blown process; Stoneware, which are only salt glazed; sand lime bricks; primary gold converted with the aid of power from any form of gold; articles made up of gold, silver, platinum, palladium, rhodium, iridium, osmium, ruthenium; ornaments made of gold and silver with or without stones or gems; precious and semi-precious stones, synthetic stones and pearls, unfinished or semi-finished silver, platinum, palladium, rhodium, iridium, osmium and ruthenium.

Chapter 73: Metal containers; mathematical boxes, geometry boxes and colour boxes; kerosene burners, kerosene stoves and wood burning stoves of iron or steel, copper or copper alloy; bio-gas lights, bio-gas stoves and bio-gas operated hot plates of iron or steel; table, kitchen or other household articles and parts thereof, other than parts of pressure cookers; parts and accessories of cycles and cycle rickshaws.

Chapter 74: Kerosene burners, kerosene stoves and wood burning stoves of iron or steel, copper or copper alloy;

Chapter 76:Table, kitchen or other household articles and parts thereof, other than parts of pressure cookers.

Chapter 82:Pencil sharpeners and blades thereof; tools put up in sets; knives; parts and accessories of cycles and cycle rickshaws; goods used for installation of a cold storage, cold room or refrigerated vehicle for preservation and transport of agricultural produce (list 4), parts of air-conditioning machines; sewing machines, without in-built motors.

Chapter 85: Sound recorded magnetic tapes of width not exceeding 6.5 millimeters; television and sound recording media; parts and accessories of cycles and cycle rickshaws; motor vehicles principally designed for transport of more than six persons, excluding the driver, including station wagons; three wheeled motor vehicles; special purpose motor vehicles,

Chapter 90: Spectacle frames, of value below Rs. 500 per piece; all goods other than sunglasses for correcting vision;

Chapter 94: Bio-gas lights, bio-gas stoves and hot plates of iron or steel, specially designed to operate using bio-gas

Chapter 95: Sports goods; parts and accessories of cycles and cycle rickshaws.

Chapter 96: Brooms, brushes, and other cleaning and painting equipment, excluding toothbrushes; pens and ballpoint pens and parts thereof, of value not exceeding Rs. 100 per piece; pencils and parts of thereof.

Any Chapter: Cement Bonded Particle Board, Jute Particle Board, Rice Husk Board, Glass-fibre Reinforced Gypsum Board (GRG), Sisal-fibre Boards, Bagasse Board

Any Chapter: Non-conventional energy devices/systems specified in List 5

2. ***Inputs provided they are produced and used up in the factory they are produced in***

In a Value Added tax Regime, any provision of this kind does not seem necessary. The provision appears to be a remnant from the pre-VAT days and should potentially be removed, more for reasons for simplicity than revenue considerations.

List:

Lac, Vegetable saps and extracts for Ayurvedi, Unani and Siddha systems; concrete mix for use at construction site; strips and tapes of polypropylene for manufacture of polypropylene ropes; carded wool for manufacture of yarn of wool, or for hand spun yarn of up to count 10, woolen yarn of counts less than 10 for manufacturing carpets; yarn for manufacture of multiple (folded) or cabled yarn; sisal and manila twist yarn, thread, ropes and twine, all sorts, for the manufacture of sisal and manila products; woven fabrics, manufactured in one factory, supplied for processing to another factory owned by the same multi-locational composite mill; synthetic fabrics for the manufacture of shoddy blankets; polyester tow for manufacture of polyester staple fibre; parts of hearing aids for manufacture of hearing aids; mixture of graphite and clay, for manufacture of pencils or pencil leads; Printing frames used for printing of textile fabrics

3. ***Use based exemptions:***

This list relates the exemption to the particular use that the good is put to. Given that any such provision would require close monitoring and fairly detailed documentation, this method of providing support to the identified uses may not be the most efficient way of providing the support and needs to be re-examined.

List:

Chapter 17: All goods under the heading 1703.90 used in the manufacture of goods other than alcohol. (1703.90 refers to molasses other than those produced in the manufacture of sugar by vacuum pan process)

Chapters 20, 21, 22: preparations used in manufacture of aerated waters, if supplied directly to a bottling plant;

Chapter 27: Naphtha and Natural Gasoline Liquid for use in the manufacture of fertiliser or ammonia, or for shut down and start up of fertiliser plants, furnace oil for manufacture of fertilisers; residues of petroleum oils or of oils obtained from bituminous minerals, used for electricity generation, or as feedstock in manufacture of fertilisers, kerosene used in the manufacture of linear alkyl benzene or heavy alkylate, LPG used in the manufacture of Propylene or Dibutyl Para Cresol (DBPC), petroleum gases and other gaseous hydrocarbons used in the manufacture of Polyisobutylene or Methyl Ethyl Ketone (MEK), natural gas, sulphuric acid, oleum, oxygen and ammonia used in the manufacture of fertilisers,

Chapter 28: Gold potassium cyanide used for manufacture of zari, all chemicals used in the manufacture of centchroman, goods specified in List 2, used for the manufacture of bulk drugs specified in List 1, all goods used in the manufacture of fertilisers

Chapter 29: 2-Cyampyrazine; insulin and zidovudine as bulk drugs.

Chapter 38: Goods specified in List 2 used for manufacture of bulk drugs specified in List 1; finishing agents, dye carriers, printing paste and other products and preparations used for the manufacture of textiles and textile articles.

Chapter 39: Products of jute and phenolic resins manufactured by pultrusion process, containing at least forty per cent by weight of jute; plastic materials reprocessed in India out of the scrap or the waste of good falling within Chapters 39, 54, 55, 56, 59, 64, 84, 85, 86, 87, 90, 91, 92, 93, 94, 95 and 96;

Chapter 45, 48: Parts of main battle tanks intended to be used in the manufacture of such tanks.

Chapters 51, 52, 54, 55: cotton fabrics used in the manufacture of cotton absorbent lint; cotton fabrics processed without the aid of power or steam; woven fabrics of cotton when subjected to any one or more of the following processes, in a factory without facilities for carrying out the processes with the aid of steam or power: calendering (other than calendering with grooved rollers), flanellete raising, stentering, damping on grey and bleached sorts, back filling on grey and bleached sort, singeing, scouring, cropping or butta cutting, curing or heat setting, padding, expanding, hydro-extraction without the aid of power;

Chapter 59:Tubular knitted gas mantle fabric, whether or not impregnated, for use in incandescent gas mantles

Chapter 72: Stainless steel circles, for use in the manufacture of utensils.

Chapter 73: Forgings and forged products of iron or steel used in the manufacture of parts and accessories of cycles and cycle rickshaws; Castings and forgings, cleared for manufacture of sewing machines or chaff cutters; unrefined copper and unwrought copper, for manufacture of utensils or handicrafts; all goods other than trimmed or untrimmed sheets or circles of copper, used in the manufacture of utensils or handicrafts; copper strip and foil, used for manufacture of imitation "Zari".

Chapter 84: Unwrought aluminium, as well as plates and sheets, used in manufacture of utensils; aluminium extrusions, used in the manufacture of artificial limbs and rehabilitation aids, metal containers manufactured without the use of power;

Chapter 87: Recorded video cassettes of pre-specified format, intended for television broadcasting; television chassis (populated printed circuit board) used for the manufacture of broadcast television receiver sets (monochrome) other than video monitors, video projectors and projection television sets.

Chapter 87: motor vehicles for the transport of goods other than compressed or liquefied gases; parts of drawing and mathematical instruments, used in the manufacture of such drawing and mathematical instruments; kits manufactured by M/s. Hindustan Antibiotics Limited, Pimpri, for testing narcotic drugs and psychotropic substances.

Chapter 91: Parts and components used in the manufacture of watches and clocks of retail sale price not exceeding Rs.500/- per piece.

Any Chapter Goods other than electrical stampings and laminations, bearings and winding wires, used in the manufacture of power driven pumps used for handling water.

Any Chapter All goods used for building a body on a duty paid chassis falling under heading No 87.06 of a motor vehicle of Chapter 87.

Any Chapter Parts of aeroplanes or helicopters required for manufacture or servicing of aeroplanes or helicopter (other than rubber tyres and tubes for aeroplanes).

Any Chapter Aluminium ferrules, used in the manufacture of pencils.

4. *User based exemptions*

The exemption here relates to a particular user. Once again other budgetary support would appear to be more efficient way of providing help to identified "purchasers". The only other exemptions here relate to the Small scale sector, and exemptions provided to foreign diplomatic missions. While the latter has to be retained, the former needs to be drawn back since this opens the grounds for misuse of tax credit facility. The alternative scheme of concessional rate of duty along with tax credit for input taxes paid provides a more efficient system of implementing an incentive.

List:

SSI Exemption for manufacturers with turnover less than Rs 3 crore: complete exemption for sales upto Rs 1 crore with no credit for input taxes paid.

Goods produced in government factories, mines, mints, defence production units etc.

Specified lists of goods used by units in EPZs and FTZs, along with goods produced in a 100% EOU, or a unit in a FTZ.

Chapter 19: Food preparations intended for free distribution to economically weaker sections in a programme approved by GOI or any state government. (1901.19).

Chapter 27: Naphtha and Natural Gasoline Liquid for use in manufacture of Synthesis gas or ammonia for or by Heavy Water Plant at Baroda or Tuticorin.

Chapter 39: unexpanded polystyrene beads purchased by the Malaria Research Centre;

Chapter 48: security paper supplied to various government and RBI printing presses for security printing.

Chapters 51, 52, 54, 55: woolen yarn purchased by handloom cooperative societies; yarn sold to a registered handloom co-operative society; cotton yarn, supplied in plain (straight) reel hanks, or converted to hank yarn; pure cotton yarn on cross reel hanks and cotton yarn with more than 40 per cent polyester fibre by weight, when sold to Handloom cooperative societies or Handloom Development Corporations;

Chapter 54: Dyed, printed, bleached or mercerised yarn, whether single, multiple (folded), cabled or air-mingled, manufactured in a factory which does not have the facilities (including plant and equipment) for producing single or draw twisted or texturised yarn.

Chapter 54: Fabrics of polyester filament yarn containing cotton and polyester staple fibre in which the proportion of polyester staple fibre or filament yarn or both is less than 70% by weight of the total fibre content and processed by a factory owned by a registered handloom co-operative society or any organisation set up or approved by the Government for the purpose of development of handlooms.

Chapter 55: The following goods if purchased by Handloom Corporations: yarn of counts not exceeding 25 of artificial staple fibre, supplied in cross reel hanks; yarn of polyester staple fibre containing other fibre, with proportion of polyester less than 70 per cent by weight; yarn of artificial staple fibre containing polyester staple fibres, with proportion of polyester staple fibre more than 40% by weight, where the process of manufacture uses the aid of power.

Chapter 69: glass manufactured by CGCRI, Calcutta, for use Central Government departments;

Chapter 84: Coir processing machinery (List 3), supplied for Coir Development by the Government of Kerala;

Chapter 87: All railway transport equipment and parts used in such manufacture procured for use by Indian Railways or Konkan Railways;

Any Chapter: Goods supplied for the officials use of foreign diplomatic or consular missions in India

Chapter 55: Fabrics of man-made staple fibres woven on handlooms by a government approved factory, excluding fabrics containing more than 40% polyester fibre.

Note:

In some of these cases, where a final user is the buyer, zero-rating would be the correct method.

5. ***If Duty paid inputs are used***

Here the eligibility for exemption relates to the use of duty paid inputs.

List:

Chapters 51, 52, 54, 55: Cotton yarn in plain (straight) reel hanks meant for conversion into two fold yarn; yarn subjected to beaming, warping, wrapping, winding or reeling; woven fabrics of wool, if not tax credit is claimed; multiple (folded) cabled or air-mingled yarn; dyed, printed, bleached or mercerised yarn; pleated or embossed fabrics manufactured out of processed fabrics.

Chapter 53 or 56: Woven fabrics of flax and ramie, if no tax credit has been claimed;

Chapter 53, 59 or 63: Rot proofed jute products, laminated jute products and fire resistant jute products,

Chapter 54: Twisted polyester filament yarn manufactured out of textured or draw-twisted polyester filament yarn; twisted nylon filament yarn manufactured out of nylon filament yarn including crimped or textured nylon filament yarn; twisted viscose filament yarn manufactured out of viscose filament yarn including textured viscose filament yarn; twisted polypropylene filament yarn manufactured out of polypropylene filament yarn

Chapter 55: Cellulosic spun yarn (not containing synthetic staple fibre) produced out of cellulosic spun yarn (not containing synthetic staple fibre) in plain (straight) reel hanks, wound on cones on doubling machine and meant for conversion into two fold yarn and then reeling into plain (straight) reel hanks.

Chapter 56: All goods (other than dipped cords falling under sub-heading 5607.90 of the First Schedule) made from yarn, monofilament, tapes or strips on

Chapter 58: Strips of jute made from fabrics intended for supply to the Indian Army.

Chapter 59: Fabrics of jute, impregnated, coated, covered or laminated with plastics.

In these cases the products should be taxed and rebate should be granted to the duty paid on inputs. In the case of supply to Indian army, the sale should be zero-rated.

6. Input based/production process based exemptions:

Use of specific inputs or processes of production entitles the user to this form of exemptions. While the explicit financial implications of such exemptions cannot be pre-judged, these do add to the complexity of the tax system and makes it less rational.

List:

Chapter 44: 100% wood free plain or pre-laminated particle or fibre board, made from sugarcane bagasse or other agro-waste.

Chapter 48: paper and paperboard and its products manufactured from pulp of materials other than bamboo, hard woods, soft woods, reeds or rags;

Chapter 63: Made up textile articles made out of handloom fabrics

Chapter 68: Goods manufactured by Nirman Kendras and Nirmithi Kendras

Goods manufactured without the use of power: Yarn of artificial staple fibre manufactured without the aid of power; fabrics of man-made staple fibres woven on looms other than handlooms and processed without the aid of power or steam, excluding polyester mixed fabrics with more than 40% polyester; all goods in chapters 56, 58, 60; sisal and fibre and yarn thereof.

It is obvious: 1. Vat cannot be successfully administered/operated with such a large number of exemptions. 2. Vat in fact loses its meaning and 3. With two Vat rates most of the exemptions can be withdrawn.

APPENDIX C

Deductions and Concessions Under the Income-tax Act

Many deductions, concessions and outright (total) exemptions are granted for different purposes and under different heads in the Income-tax Act. Outright exemptions often take the form of tax holidays or particular types of income are totally exempt. Reduction in tax liability is effected either through deductions of amounts or percentages of income or through a tax rebate of a specified amount or percentage (or sometimes through an explicit lower rate).

Under a progressive tax system, a given deduction from total income would imply relief to each taxpayer according to his marginal rate of tax; the tax-payer subject to the higher marginal tax will naturally get a higher tax saving, though not necessarily proportionately higher. As the income of the taxpayer increases, the proportion of tax saving to income will keep falling. If the deduction is converted into a rebate form at a constant per cent of that amount, the absolute amount of tax saving would be the same for all taxpayers. Some argue that a tax rebate is a better method from the equity point of view on the assumption that only granting the same amount of tax saving is equitable. Why not a proportionate amount of saving? This is not a question of economics. The answer depends on one's value judgement. Besides, the policy maker has to strike a balance between the equity aspect and the effectiveness of a concession. A deduction for charitable contribution would be more effective as an incentive to contribute than rebate at the lowest marginal rate. The question also arises whether the part of his income a taxpayer gives to charity to benefit society is still to be considered part of his ability to pay. Also, in some cases such as medical expenses, the expenditure is akin to the cost of earning income; in other cases, the ability to pay is brought down: e.g. expenses in taking care of a disabled dependant.

In view of the above mentioned considerations, we take the view that the method of deduction is called for in some cases, and that of rebate in others. Anyway, the number of concessions should be reduced.

1. **Deductions under Chapter VI-A, in respect of payments**
   a. Individuals and HUF's can avail themselves of deductions upto a maximum of Rs.40,000 from total income in respect of payments on medical treatment, training and rehabilitation of a handicapped dependant relative (section 80 DD). This deduction is justified as the necessity to spend on the treatment of handicapped dependants (mainly children) reduces significantly the ability to pay of moderate income taxpapers.

   b. Resident individuals can claim deduction from total income upto a maximum of Rs. 60,000 in respect of expenses on medical treatment (section 80 DDB). Such expense is also akin to cost of earning income if the medical expense is on the taxpayer and can be said to reduce ability to pay if it is on a dependant. This provision is justified. However, under Section 80 D, payment of medical insurance premia upto Rs.15000 can be claimed as deduction by resident individuals and HUF's. If an assessee has been/ and is availing himself of deduction for medical insurance premia, he should not be allowed to claim deduction under section 80 DDB.

   c. Deduction is granted to individuals against rent paid for own-accommodation which will be the least of the following: the excess of actual rent paid over 10 per cent of total income, Rs 2000 per month or 25 per cent of the total income. This deduction does not violate horizontal equity because the imputed income from one owner occupied house is not taxed. It ensures rough justice between an owner occupier and an occupier of a rented house (excluding salaried persons who receive house rent allowance). This deduction may be continued.

   d. Deduction is granted to resident individuals upto a maximum of Rs.40,000 in respect of repayments of loans taken for higher studies. A new scheme of extending loans for pursuing higher studies in India and abroad is to be formulated by financial institutions according to the proposal contained in the 2001-02 central budget. It is better to extend loans at a concessional rate of interest rather than given tax deduction in respect of repayment of loan. Taking a loan for studies is an investment. The investments should be carefully chosen, i.e. the field of study should be productive of earning power. The interest subsidy will reduce the total burden of the loan. That subsidy should be reimbursed by the government to the banks. So we will have transparent public expenditure instead of tax expenditure.

e. Donations to approved charities and non-profit organizations, out of total income are eligible for 50 per cent deduction, for all assessees (in some cases 100 per cent deduction is given). Non-profit, non-governmental organizations are in general rendering important social services and working for the benefit of the poor and the down-trodden. Their services are needed especially because governance has deteriorated and the standard of delivery of service by government agencies, particularly at the lower levels, has gone down to unacceptably low levels. There may be a case for restricting the 100 per cent deduction to donations to funds set up to help rehabilitate victims of natural calamities and defence personnel who have been victims of a conflict. Since it is important to give an incentive for large donations, the deduction should continue and should not be converted into a rebate. Section 80 GGA which provides for 100 per cent deduction in respect of certain donations for scientific research and rural development may be abolished. Donations to promote scientific research are covered by section 35-(1) 3.

2. Deductions under Chapter VI-a in respect of certain incomes

a. 20 per cent of profits and gains from industrial undertakings or hotel business in backward areas and 25 per cent of profits and gains from small-scale industries in rural areas set up before April 1, 1990 have been allowed as deductions for 10 years (Sections 80HH and 80 HHA). These concessions have lapsed and should not be renewed.

b. 50 per cent of profits and gains from projects outside India could be claimed as deduction if 50 per cent of profits had been brought into India (Section 80 HHB). This concession is to be phased out by 2005-2006. This concession should not be extended to any new project which is started after April 1, 2002.

c. Profits and gains from business of execution of housing projects aided by the World Bank, subject to a maximum of 50 per cent of such profits are exempted in the hands of Indian Companies and non-corporate assessees (Section 80 HHBA). There is no rationale for extending a concession to projects financed by one agency. There is violation of equity without a compensating benefit. This concession is to be phased out by 2005-2006. We recommend the withdrawal of this concession from 2002-2003.

d. Profits and gains from industrial undertakings/ships/hotels/repair of ocean going vessels, were free from tax subject to some conditions upto 1991-92 (80-I). If this provision has not lapsed, it should be abolished.

e. Profits and gains from industrial undertakings engaged in infrastructure facility, telecommunication services, power undertakings, (and water treatment systems and solid waste management system included in 2001-2002 budget) are exempt from tax in 10 out of 15 years (section 80-IA). This should be abolished with effect from April 1, 2002.

f. Profits and gains from business of collecting and processing bio-degradable waste are free from tax subject to a maximum of Rs. 5 lakh for 5 years (Section 80 JJA). This provision is unjustified, unnecessarily distorts business decisions and as it stands is likely to be ineffective. This provision also should be abolished.

g. Another ineffective economically harmful and hard-to-implement provision is contained in Section 80 JJAA according to which a deduction from profits is to be given in respect of employment of new workmen in any industrial undertaking to the extent of 30 per cent of the additional wage bill. Now the proportions of factor combinations should be left to be decided by economic considerations, not by tax considerations. Also the provision as it stands will be ineffective. If the additional wage bill is Rs. 1 lakh, the tax saving, at the rate of tax of 35 per cent, will be only Rs.10,500. That is the wage paid is reduced by 10.5 per cent. For this small gain an employer will not find it worthwhile to substitute capital by labour, particularly when he knows that once he takes on the labourers, it would not be easy to retrench them when that becomes necessary. This provision should be abolished.

h. Sections 80 HHC, 80 HHD, 80 HHE and 80 0 provide for the exemption of export profits, earnings in convertible foreign exchange by hotels, tour operators and travel agents, profit from export of computer software and royalties from specified foreign sources, respectively. The government has decided already that the percentage of deduction from profits in these cases could be gradually reduced to zero by 2005-2006. If our international obligations do not come in the way, 20 per cent of export profits may continue to be exempt under Section 80 HHC, because exporters suffer many disadvantages as compared to their competitors abroad. All the rest should be withdrawn.

i. Section 80 R provides for the exemption of remuneration from foreign sources in the case of professors/teachers, if 75 per cent of the foreign exchange earned is brought into India. This provision is also subject to be phased out by gradually reducing exemption to nil by 2005-06. One reason for introducing the provision was that the cost of living abroad (in western countries) was very high and if foreign earnings are converted to rupees and a professor has to pay tax as a resident, he would be out of pocket. If we wish to encourage/enable our teachers, professors and scientists to go out and work for short periods of time this section may be retained and only 50 per cent of the earnings may be exempt. The loss to the exchequer will be negligible.

   If the professional service is rendered to a foreign entity from India the consideration of high cost of living does not arise. Hence Section 80 RR and 80 RRA which provide for the exemption of income in foreign exchange in such cases could be phased out.

j. A resident individual who suffers from permanent physical disability (including blindness) or is subject to mental retardation is entitled to a deduction of Rs.40,000 in computing total income (Section 80 G). This is in the nature of a gesture. This deduction may be converted into a rebate of tax at 20 per cent.

3. Savings incentives

It is not easy to stimulate net savings by individuals through tax measures. It is generally argued that the income tax is biased against savings[10]; it falls on income when it is saved and again on the return on savings. However, within the framework of an income tax, one cannot introduce devices which would

[10] If life-time income equals life-time consumption, the present value of the life-time tax paid by an early saver would be lower under a proportional expenditure tax than under a proportional income tax.

effectively raise the rate of savings, partly because savings are not very interest-elastic and partly because under the income tax there is no way of preventing dissaving with one hand, while 'saving' with the other.

The government introduced the so-called savings incentives partly under the impression that extending some concession when a financial investment is made will promote savings but mainly with a view to attracting savings into the government sector. Taxpayers in general are by now convinced that the incentive provisions which lead to reduced tax liability do indeed stimulate and enable savings. Without these incentives, "middle class" people feel, they may not be able to make those concerned investments. While not serving to raise the rate of saving, most of the existing savings incentives to some extent re-direct financial savings into particular channels. The rate of return on financial assets should depend on the risk involved, the period of investment and the productivity of activity financed. Tax incentives artificially raise the returns on particular financial assets, thereby introducing distortions in the allocation of resources.

Two important categories of financial assets investment in which entitle tax concessions are provident fund contributions (PF) and National Savings Certificates (NSC). When an individual invests in either of them, he may not be a net saver in that year. Apart from that, the amounts placed in PF and NSC need not be held there for long. Withdrawals from PF balances are allowed for many purposes and NSC's are cashed after six years. If savings to be retained in the asset for a long-term are to be promoted, then the withdrawal and cashing must be subject to the same rate of tax as the tax rate at which the rebate is given at the time of investment. This is not done. Experts are agreed that the savings incentives in general, except perhaps that for pension contribution do not promote long-term saving, introduce distortions in the allocation of savings and also violate the principle of horizontal equity. In addition, of course, they erode the base. If there is a case for strengthening the ability of the middle class to save, through the income tax, the proper way would be to bring down the rates of tax.

Under section 88, investments in specified assets such as 6-year NSC's, Employees Provident Fund (EPF) and Public Provident Fund (PPF), tax saving units of mutual funds, premia paid on life insurance, and infrastructure bonds of IDBI and ICICI, upto a total of Rs.80,000, are eligible for rebate of tax at 20 per cent. The Tax Reforms Committee (1991-93) had recommended the reduction of the then existing ceiling and partial substitution of the scheme by expanding the National Saving Scheme which was similar to the Individual Retirement Account under the U.S. income tax. Investments in the Account are tax-free but withdrawals are subject to tax. The government abolished the National Savings Scheme and the limit for the investment under Section 88 was raised and the range of eligible assets was extended. In some cases, the lock-in period is only 3 years.

The Tax Reforms Committee had also recommended that Section 80 L, under which capital income from specified assets was exempt upto a limit, should be abolished. That scheme also was inequitable and led to distortions. Why should investments in particular asset be given favourable treatment? The government accepted the recommendation and abolished Section 80 L. But soon it was restored, and the upper limit was gradually raised to Rs.15,000, with a special provision of Rs.3000 for government securities (within the overall ceiling). The Finance Minister tried to bring down the limit to Rs.9000 in the Budget for 2001-02, but has been persuaded to keep it at Rs.12,000.

Government relief bonds are free of tax with a rate of interest of 9 per cent (10 per cent cumulative). This is another distortionary provision, which also erodes the base and favours the richer taxpayers. With the rate of return on non-equity assets hovering around 10-10.5 per cent, the net of tax return to a taxpayers subject to the 30 percent marginal rate would be only around 7 per cent. The relief bond gives them 9 per cent free of tax. No wonder that several higher income non-business taxpayers are investing a sizable portion of their savings in these bonds.

We do not propose to deal comprehensively with all deductions and exemptions under the income tax. Several of them are not in the nature of savings incentives, but are intended to serve various other purposes. It may be best to abolish some of them. We are only dealing the major savings incentives and after that a few important provisions that affect the base, but a view has to be taken on their continuance or modification in an over-all policy context.

As regards savings incentives, there is no doubt that Section 80 L and the exemptions of income of government relief bonds should be phased out. We recommend that the major savings incentive should be the one contained in Section 80 CCC. At present, the pension contribution by an individual upto Rs.10,000 is deductible from income. Pension contributions by individuals are going to become extremely important in the years to come. First, people are going to live longer after retirement. Second, governments will not be able to bear any significant part of the burden of financing pension payments through contributions to social security schemes, as has been borne out by experience elsewhere. Individual earners themselves plus employers to some extent in the case of salaried workers would have to assume the major responsibility. The government should help them by recognising the pension contribution as an expense and therefore deductible from taxable income.

At present under Section 80 CCC, individuals can deduct upto Rs.10,000 from total income in respect of contribution to the pension fund or annuity plan set up by the Life Insurance Corporation. While the contribution is free from tax, the pension received (or the surrender value of the annuity) will be taxable. This is a good provision and must be enlarged. As we have seen, individuals can claim rebate at 20 per cent in respect of contributions to provident fund, purchase of NSC's etc. upto Rs.80,000 (Rs. 20,000 earmarked for infrastructure bonds); when the investment is withdrawn no tax is payable at least at 20 per cent. As indicated earlier, this is not a scheme that will increase savings, but will only re-direct the use of savings. First of all, the infrastructure bonds and the units of mutual funds (tax-saving units) should be taken out of the eligible list of assets under this Section. Then the remaining Rs.60,000 limit should be reduced to Rs.30,000. Simultaneously, the deduction limit under Section 80 CCC should be raised to Rs.20,000. Full deduction should be allowed under Section 80 CCC for contributions to pension funds as the pensions would be taxable when received. As the provident fund system gets gradually replaced by the pension system, the deduction allowed under 80 CCC can be raised upto 5 per cent of income subject to a limit of Rs.30,000. Section 88 deduction can be brought down to Rs. 20,000.

We shall then have one major savings incentive which would promote long-term savings and would be based on the expenditure tax principle.

4. Treatment of long-term capital gains

Short-term and long-term capital gains constitute income as they denote accretion of purchasing power. Short-term gains made on the sale of assets held for not more than one year are taxed as income. However, there is wide-spread feeling among the general public that long-term capital gains stand on a different footing and may not be considered part of income. But, as economists have held, they do constitute income although they need special and differential tax treatment as they can be taxed only on realisation, not on accrual. For a long time, long-term capital gains had been exempted from taxation if they or the total proceeds were invested in specified bonds for stipulated periods of time. This provision violated horizontal equity and specially favoured the richer taxpayers. The Tax Reforms Committee suggested a scheme of taxation of long-term capital gains which took care of the problems arising from the characteristics of bunching of gains and inflation. The Committee recommended that the exemption granted to long-term gains on conditions referred to above (under Section 54) be withdrawn. This recommendation was accepted and the exemption under Section 54 was withdrawn. But in a few years the exemption under section 54 was brought back. The list of assets in which long term gains could be invested to become eligible for exemption was then extended and even the units of mutual funds were made 'eligible' assets. The law was again changed on 1.4.2000, and now the gains are exempt only if the proceeds are invested in the bonds issued by the National Highway Authority or NABARD (Section 54 EB). This provision should be abolished. Let the government collect the tax and pay an interest subsidy to these two organizations, if they so desire.

5. Incomes of charitable and non-profit organizations

We have already underlined the important social role played by charitable and non-profit organizations. They have historically done yeoman service in the fields of education, health and the care of poor and the down trodden. Since their income does not accrue to any individual which can be used by him or her for personal consumption or saving, that income does not create ability to pay. Hence, the incomes of charitable trusts and non-profit organizations are exempted under the income taxes of all countries. In India, exemption of the income of such bodies are exempt under several sub-sections of Section 10 (23C) and Sections 11 to 13. The exemptions are granted under stipulated conditions. By and large, provisions in this regard have worked well. The exemptions should be continued.

When the income i.e., the surplus if any in the annual accounts, of a charitable trust is exempt from tax, it is not to be taken that all the value added by the trust is exempt. The wages, interest and rent paid by the trust would be subject to tax except the imputed rent of any building owned and occupied by the trust. A charitable trust is allowed to have only a limited amount of surplus. If a surplus higher than the permitted one is accumulated, the accumulation should be spent by the end of five years. Besides, the trust can invest its corpus only in approved securities. The trust may charge some fees for its services, but so long as the surplus has to be relatively small, the fees cannot be fixed much higher than needed.

Sometimes it is argued that commercial firms and non-profit organizations carry on similar activities; and while the former have to pay tax, the latter do not. The whole point is that in the former case the entire surplus legally belongs to individuals or corporate entities and their ability to pay is increased. But in the latter case, the ability to pay of no individual is increased.

There are numerous more urgent and productive ways of increasing revenue than curtailing the benefits enjoyed by non-profit organizations and charitable trusts. We would urge that the existing provisions governing the treatment of charitable trusts and non-profit organizations be continued.

6. Perquisities and allowances

Salaried persons have been benefiting from the inadequate or non-taxation of perquisites. However, as the Tax Reforms Committee noted, perquisites can be brought effectively and equitably under charge only if the perquisites enjoyed by the public and private sector employees are taxed on an equal basis. In the Budget for 2001-2002, the Finance Minister has proposed the value of perquisites, benefits or amenities shall be determined on the basis of their cost to the employer except in respect of houses and cars. We hope this will be done in the case of public as well as private sector employees.

The Tax Reforms Committee had asked for the removal of exemption from tax of the daily allowance paid to MPs and Members of Legislative Assemblies for attending meetings of the Parliament and Assemblies. While the government is keen to widen the base and to improve equity by taxing perquisites, the exercise could properly start with the law makers.