

*Raising the Tax-Ratio by Reining
in the “Tax-Breaks”
An Agenda for Action*

**Amaresh Bagchi
R. Kavita Rao
Bulbul Sen**

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Introduction

India has undertaken extensive tax reform in the last decade and a half resulting in ample dividends. The tax structure has undergone a remarkable change. The proportion of direct taxes in gross tax revenue of the union government has increased impressively, from 19 percent in 1990 to 44 percent in 2004. Central direct taxes now form 4.3 percent of GDP as compared to 2.0 percent at the commencement of the reforms. Reforms of the indirect taxes have sought to simplify the structure by reducing the rates and their multiplicity. With CenVAT covering most of the commodities subjected to union excise and credit allowed for service tax paid on inputs against CenVAT, the distortions are now considerably alleviated, though not fully removed. With a 15 percent peak rate, India's customs tariff is now almost comparable to its Asian neighbours. In one respect, however, the results of the reforms remain deficient. The tax-

* Professor Emeritus, National Institute of Public Finance and Policy, New Delhi
E-mail: bagchi@nipfp.org.in.

** Senior Fellow, National Institute of Public Finance and Policy, New Delhi
E-mail: kavita@nipfp.org.in

*** On deputation from the Indian Revenue Service as Principal Consultant,
National Institute of Public Finance and Policy, New Delhi
E-mail : bulbulsen@nipfp.org.in

GDP ratio is yet to reach the level registered in the late eighties. In 2004, the ratio (taking the centre and states together) stood at 15.2 percent as against 16.1 percent in 1988.

Evidently the increase in direct taxes has not been able to offset the decline that resulted from the reduction in customs tariff and decline in excise revenue. The task facing the policymakers now is to explore ways in which the tax ratio can be pushed up without going back on the basic elements of the reforms carried out so far, namely, without raising the rates or resorting to distortionary taxation. The task has acquired urgency with government's obligation to abide by the deficit targets set under the Fiscal Responsibility and Budget Management Act and the expenditure commitments of the United Progressive Alliance. Under the restructuring plan drawn up by the Twelfth Finance Commission (TFC), incorporating the FRBM commitments of the union government, the targets set for revenue mobilisation are modest. The ratio of gross tax revenue to GDP is targeted to increase by only about 1.2 percentage points by 2009-10, that is by 0.24 percentage points every year. However, taking into account the revenue collected in 2004-05 (revised estimates) and the expenditure commitments of the government, the target for tax revenue, to meet the FRBM goals now works out to an increase of 1.3 percentage points of GDP over a four year horizon, i.e., an annual target of 0.325 percentage points. This translates into additional revenue mobilisation of about Rs 71,134 crore over four years, i.e., Rs 17,783 crore per annum.¹ Given the growing size of the economy, the target should not be too difficult to meet.

Given the constraints, however, the options are: one, tightening the administration and two, widening the base not so much in terms of the number of taxpayers brought under the net but the content of what is subjected to tax (which, no doubt, will have its impact on numbers as well). With ambitious plans for a modern information network, tax administration is gearing up to the challenges of enforcing the tax laws in an increasingly complex and sophisticated business environment but these initiatives will unavoidably take time to yield results. To improve the revenue productivity of the tax system in the short-run without tinkering with the rates is to take a look at the base of the major union taxes *viz.*, income tax, excise and customs, and explore how they can be widened keeping in view the constraints. The main thrust of such an exercise has to be a review of various exemptions and concessions – the

'tax breaks' – that abound in all the taxes and erode the base and their revenue productivity.

2. "Tax-Breaks" – The Case 'For' and 'Against'

"Tax breaks" or incentives through concession or remission in tax are provided under all tax systems of the world to serve a wide variety of social and economic purposes. Tax breaks are given in both direct and indirect taxes and in diverse forms. In developing countries these are intended, *inter alia*, to attract foreign investment and also domestic investment in desired areas, promote savings, generate employment and help the development of backward areas. In India, the laws for implementing the two major union taxes *viz.*, income tax and excise duties, all contain numerous provisions to provide 'breaks' or tax benefits in various forms.

The dominant professional opinion, however, has been that tax breaks are inefficient and costly instruments of public policy.² More often than not they fail to promote the objectives meant to be served to any significant extent. On the contrary they entail loss to revenue which often remains unquantified, and thus unknown. By eroding the tax base they force governments to rely on high rates of tax for revenue which breed evasion and generate pressures for more 'breaks'. Further, they open up loopholes for which safeguards have to be built into the law to guard against misuse, thereby cluttering up the tax statutes, adding to compliance and administration costs. They also undermine the equity of the tax system by randomly relieving the tax burden on different groups, after favouring the rich as they can get the advantage of the 'breaks' to a greater extent than others.

Expert panels appointed to review the tax system in India in recent years have come out strongly against the proliferation of tax breaks and recommended that they be weeded out. The most emphatic in this regard has been the *Kelkar Task Force on Direct Taxes* appointed in 2002. After an exhaustive review of the relevant provisions, the Task Force strongly recommended ending the "exemption raj" identifying the provisions that need to be eliminated. Earlier, the *Shome Committee*

appointed by the Planning Commission had also recommended a thorough review of the tax exemptions/concessions. Prior to that the *Tax Reforms Committee* headed by Raja Chelliah had recommended measures to widen the base by pruning the exemptions.

Following these recommendations, initiatives were taken by the government to reform the tax structure to move towards a regime of moderate rates and wider base by removing or curtailing the tax breaks and special provisions. Many of the provisions that had been in force for decades have since been removed or redesigned. Even so, quite a few continue to be in vogue. What is more, new ones have found their way into the tax statutes through the proliferation of new sections in the Income-tax Act, particularly in chapter VIA in the last three years (for example, some of the sub-sections of sections 80IA, 80IB, and section 80IC). Small scale industries (SSIs) continue to enjoy generous treatment in excise taxation constituting a big hole in its revenue yield. Exemption from excise also has been extended to industries located in specified areas.

Additions to the tax breaks and their expansion have resulted partly from pressures from 'lobbies' and also from the perception that a developing economy like ours suffering acutely from deficiencies of infrastructure, technology and government's inadequacy in many spheres cannot do away with tax incentives altogether. One school of opinion holds that despite their negative points, tax incentives have a role in developing economies to correct market imperfections, build infrastructure, and fill the gaps that governments may not be in a position to address. More importantly, in a globalising world with high capital mobility, and competing demands for foreign capital, no country can afford to take a purist view and abjure tax breaks altogether when other countries are providing them.³ As Annex to this paper would show, many countries still provide 'breaks' in their tax laws to encourage investment etc. Many of these are probably not very effective, since when one country holds out some inducement for investment, others feel obliged to follow, thus canceling out each other's expected gains. What is needed is to see that the provisions meant to provide the 'breaks' are designed carefully so as to ensure their efficacy and minimise costs. However, there can be no gainsaying that many of the incentives/breaks currently provided in the Indian tax system are inefficient and wasteful and need to be scrapped/wiped out, while the others should be duly scanned to examine whether their cost is justified by the benefits to society.

Such a review needs an exhaustive cost benefit analysis of all items of tax 'breaks' in operation, and that would require considerable time and resources. However, considering the urgency of the task, heightened by the need to raise the tax-GDP ratio to meet the increasing demands for larger government expenditure in many areas, this paper seeks to provide a brief review of some of the major incentive provisions, and identify those which seem to be flawed *prima facie* and have significant revenue implications, in order that they may be removed or reformed.

3. Forms of 'Tax Breaks'

Tax incentives/breaks are commonly provided in the following forms:

- Exclusion from the base, such as, agricultural income from Union income tax, dividend in the hands of recipients, leave travel concessions. Income arising from non-market activities like doctors treating their family members and from owner-occupation of residential property are also not usually subjected to tax, and thus fall within other categories.
- Deduction or exemption of the income depending on the source or the category of the recipient. Prime examples are the "tax holidays" given to new industrial undertakings in specified geographical areas or industry in both income tax and also excise duties, income of charitable institutions, return on certain investments like tax-free bonds; exemption of specified items from customs otherwise chargeable such as, 'project imports'. Certain items are exempted from both customs and excise duties because of their 'merit good' character like, for example, newsprint.
- Deductions in the computation of the tax base depending on the use, such as, donations for charities, and for savings in specified forms, repayment of housing loans, accelerated depreciation, investment allowance, weighted deduction for scientific research in the computation of taxable income.
- Concession in rates or higher exemption limits, like exemption of SSI's from central excise and states' sales tax.

An exhaustive or thorough review of the tax breaks provided in the Indian tax system would call for a much more extensive and intensive study than is the intention of this paper. Our focus here is on the major items of exclusions, exemptions, deductions, and concessions that erode the tax bases without commensurate benefit to the society. These are items that can be called “tax breaks” in the true sense, leaving alone those that are meant to delineate the base in a cogent way, such as deductions for cost of earning, like economic depreciation allowance or those that are prompted by considerations of equity e.g., higher exemption limit in income tax for senior citizens. The idea is to identify some areas that are in need of early reform. The items chosen for this purpose are:

- tax holidays in both income tax and excise, for exports and new industries in specified areas or sectors of the economy and incentives for promoting housing;
- exemption from income tax of charitable institutions and deductions allowed for income for gifts to ‘charity’;
- exclusion of agricultural income from the income tax base; and
- selected exemptions in central excise and customs (such as small scale industries).

There are a few other concessions/breaks in income tax, like exemption of long-term capital gains from listed equities and dividend in the hands of shareholders which, too, may be significant in terms of revenue cost. These are in principle indefensible. Yet since they have been brought in recently and are unlikely to be rolled back, we have not delved into their merits.

4. Tax Holidays

By far the most significant of the tax breaks from the revenue angle provided in the tax laws are the tax holidays provided for exports and for new industries/investments in specified geographical areas or activities/sectors to induce growth of backward regions and attract

private capital in areas which traditionally were thought to be the responsibility of the public sector but which may not attract private investment without tax benefit, like, infrastructure and environmental protection. Tax holidays have been in vogue in Indian income tax since long. Section 15C of the *Indian Income-tax Act, 1922* introduced in 1949-50 on the eve of the First Five Year Plan provided exemption of profits of new industrial undertakings in priority industries and hotels and all Small Scale Industries (SSI) in specified backward areas subject to certain limits. These exemption-rated holidays were incorporated in the *Income-tax Act 1961* through sections 80I and 80J until they were replaced by new sections. Provisions that have come in their place (for example, sections 80IA, 80IB and 80IC) allow deduction or exemption of income from new industrial undertakings (or their extensions) set up in specified industries and/or areas subject to certain limits and conditions.

The operation of these provisions gave rise to endless problems and litigation. In order to ensure that the eligible undertaking was really new, elaborate conditions were laid down in the law. Although they made heavy inroads into revenue and caused problems in administration and gave rise to inefficiencies in the economy by creating distortions, the costs and benefits of the 'tax holidays' do not seem to have been subjected to any rigorous analysis. Only recently there have been some attempts to study the cost-benefit of some of these exemptions.⁴ Drawing partly on these and the literature on the subject, we present below a brief appraisal of the major sector and area-specific tax holidays. It must be added however, that paucity of data has been a major constraint.

The tax holidays currently in operation fall broadly under two groups (i) those meant for units operating in Special Economic Zones (SEZs) and (ii) those that are sector and/or region specific.

Special Economic Zones (SEZs)

Enacted in 2005, the *SEZ Act, 2005* consolidates and, in several respects, extends the benefits which are meant primarily for promoting exports and new technology and were extended from time to time under the umbrella of free trade areas (FTAs), export processing zones (EPZs), electronic hardware technology parks (EHTPs), software technology parks (STPs) and bio-technology parks (BTPs). As a platform to promote exports, EPZs have been used in India since the 1960s with

various incentives such as free provision of infrastructural services and fiscal and non-fiscal concessions to firms operating within them.

As noted in the ICRIER study referred to above, the EPZ policy in India has evolved broadly in four phases:

- (a) Initial phase 1964-1985
- (b) Expansionary phase 1985-1991
- (c) Consolidating phase 1991-2000
- (d) Phase commencing 2000 onwards with *SEZ Act, 2005* marking a culmination.

According to the scheme introduced by the EXIM policy of 2000 and now enshrined in the *SEZ Act, 2005*, SEZs can be set up in the public, private or joint sector by state governments with a minimum size of not less than 1000 hectares. These are supposed to be self-contained areas, outside the country's "customs territory" and are given flexibility of operations. The tax incentives available to industries/infrastructure creating units operating in SEZs as defined in the Act of 2005 are briefly given below:

1. No excise or customs duties are chargeable on exports from these zones. These include sales to units located in other SEZs as well.
2. For sales made to the domestic tariff area (DTA), outside the SEZs, the transactions are treated on par with imports from the rest of the world and are subject to import duties as well as any other levy applicable, such as anti-dumping duties.
3. On imports into these zones, from outside the country or from other SEZs, there are no customs duties leviable.
4. On purchases from the domestic tariff area, these transactions are exempt from excise duty. While the Act does not presume that an exemption on sales tax too would apply, there is a possibility of the same.
5. On the income tax front, there is an income tax holiday for the first five years of operation of the enterprise on profits and gains from exports, followed by another five years during which time the tax liability is 50 percent of the profits and gains from exports. This is further, followed up by a period of 5 years when a designated amount of tax dues can be set aside in a fund to be

used within a limited time period for investment in plant and machinery.

6. Since the development of SEZs is an activity that the private sector can both initiate and participate in, the incentives apply not only to the enterprises establishing units in the SEZs but also to the enterprises undertaking the task of development of the SEZs.

Earlier, too, tax incentives designed to promote EPZs comprised exemption from customs and excise duties and also 'holiday' from income tax. Section 10A and 10B of the *Income-tax Act* which set out the holiday provisions in income tax for newly established undertakings in free trade zones and newly established 100 percent export-oriented undertakings are to be phased out in 2010. However, the *SEZ Act, 2005* seems to have given a fresh lease of life for tax incentives to SEZ units with the difference that the 100 percent exemption for income tax on income/profit from exports will now be available only for the first five years, followed by 50 percent exemption in the next five years; thereafter a fraction of the profits can be set aside free of tax for investment in the unit.⁵ This means that the incentives in income tax along with the exemption from customs and excise will be available for SEZ units even after sections 10A and 10B cease to apply.

The continuation of tax incentives for exports under the SEZ Act is questionable for the following reasons:

- The considerations that originally provided the rationale for setting up EPZs and allowing tax concessions for export-oriented units have lost their force after liberalisation.
- These incentives are not all compatible with India's WTO obligations.
- There is no evidence to substantiate that tax benefit to SEZs have served to foster their growth in recent years or played any significant role in promoting exports.

To elaborate, special dispensation for exports was considered necessary when India's economy was heavily controlled and protected, the tax system was not export friendly and Indian industry was not globally competitive.⁶ Export processing zones were conceived as 'islands' isolated from the restrictive environment that prevailed in the economy. The reforms initiated in 1991 have made a sea change in the

environment for investors and exporters. Apart from removing the regime of licences and controls, the tax system has been reformed; customs tariff has been drastically reduced and central excises have been transformed into CenVAT making for transparency and facilitating refund of domestic indirect taxes paid on inputs. Reflecting this recognition and after considering the obligations under WTO, incentives allowed in income tax for exports under section 80HHC have been phased out. What is more, the country is no longer desperately short of foreign exchange. The rupee, too, is now on a float, though “managed”. There is no ban on import of foreign technology or flow of foreign capital. Given this background, the extension of tax benefits for SEZs or export-oriented units seems uncalled for, constituting a needless drain on revenue. Not only are they unnecessary, concessions to SEZ units create distortions in another way.

For sales to DTA, the latest Exim Policy of government prescribes a condition under which sales can be made under concessional terms. The Kelkar Task Force had recommended the elimination of concessional terms for such sales, since the units are expected to benefit from superior infrastructure, especially in the SEZs/EHTPs/STPs and bio-technology parks (BTPs). Further, since other exporters cannot avail of these concessional terms in their sales, such provisions discriminate against exports from the rest of the economy. The Task Force therefore recommended that DTA sales be permitted without limitations against full payment of customs duties if the inputs are not all locally procured. Alternatively, if the inputs are all locally procured, 50 percent of the sales to DTA can be permitted on payment of central excise dues. It would be useful to pursue this line, in place of the present stand of allowing sales to DTA at concessional terms on fulfilment of an elaborate set of conditions, a process which is administration-intensive and hence less efficient and transparent. The *SEZ Act* seeks to amend the position in the direction of the Kelkar recommendations.

Secondly, in principle, there is an incompatibility between export oriented incentives and the working of the WTO agreements. Of course, the *WTO Agreement on Subsidies and Countervailing Measures* provides some flexibility to India, since it is classified as an Annex VII country with per capita income less than USD 1000. These countries are not immediately bound to phase out export-oriented incentives which are “prohibited”. However, for any commodity, where the exports from the

country account for more than 3.25 percent of the world trade, all such incentives would need to be phased out over a period of 8 years. In the Indian context, this binding condition may not apply for a number of exported commodities, since the average share of India in world trade is less than one percent. However, there might exist a few commodities where the levels are close to these limits, if not higher. It should be added that, even though these subsidies are not prohibited they are “actionable” and liable to invite countervailing duty (CVD) in case these are found to cause injury etc. to other members of WTO. Such duties have in fact been levied by countries like USA, EU. India has the dubious distinction of having the largest number of CVD actions initiated against any member country of WTO⁷ during the period 1995-2004; 28 out of a total of 108 actions were initiated against India’s exports.

Within excise duties, the option of zero-rating of export transactions can be made better use of. Since this procedure proposes only to rid the exported commodity of domestic indirect taxes, it is not considered an export incentive and hence would not invite responses such as CVD. Further, with the duty drawback mechanism in customs, there exists an effective mechanism for ridding exports of import tariffs as well. With this, the need to provide incentives gets eliminated and hence the incentive schemes within both direct and indirect taxes can be duly phased out. Kelkar Task Force too made similar recommendations and suggested the merging and consolidation of the various schemes for ridding exports of customs duties on inputs, into a few categories, with duty drawback scheme being given the pride of place, owing to its transparency. This step however, is yet to be taken; about 51 different schemes continue to persist within the customs law. In fairness and for the sake of neutrality, these benefits, as long as they exist should apply to all exporting units and not merely to those located in SEZs.

Thirdly, there is no good evidence to support the case for tax incentives for SEZ units apart from remission of customs and domestic trade taxes which, as just pointed out, should apply to all exports irrespective of whether they are located in an SEZ or outside. In fact, the ICRIER study referred to earlier, found that despite all the inducements, the growth of EPZs which was impressive in the beginning had slowed down subsequently almost continuously. After reviewing the four phases, the study concludes:

“By 2000, growth rates in exports per employment unit also declined sharply. Apparently, inducements and benefits offered to EPZ units could not offset the high costs of operating in the zones due to poor investment climate. This would partly be due to poor infrastructure and partly due to the poor quality of governance of the zones. With economic liberalisation introduced in the rest of the economy, the attractiveness of the zones might have declined further” (ICRIER Working Paper 148, p. 17).

The study clearly brings out that for improving the attraction of SEZs what is needed most is a world class infrastructure. In addition, the study emphasises the primacy of governance and simplifications like single window facilities and greater decentralisation of decision-making process to the Development Commissioner, and relaxation of labour laws within the SEZs. Fiscal incentives rank low in the attractions of SEZs; they may be used as a convenient channel for routing profits earned elsewhere through SEZs to escape taxation.

The revenue cost of tax incentives for SEZ investors is difficult to estimate in the absence of requisite data. Informal discussions with officials in the Income-tax Department suggest that the loss may be nearly Rs. 10,000 crore from the income tax holiday alone. The revenue forgone on account of excise and customs, though sizeable, should not be counted as loss since these remissions are available for exports from anywhere in the country.

The above discussion would show that the extension of tax holidays to SEZ units has been unwarranted, especially after section 80HHC benefits have been done away with. A case can at best be made for providing some inducement for infrastructure development as it tends to be front loaded in terms of investments and costs. The tax holiday for others is unjustified and should be terminated forthwith.

Sector/region Specific Tax Holidays

Even more problematic is the estimation of the cost/benefit of incentives provided in tax to new industrial undertakings set up in specified sectors and regions. Currently, these incentives are operationalised through sections 80IA, 80IB and 80IC of the *Income-tax Act, 1961*.

Section 80IA allows deduction in respect of profits and gains from industrial undertakings or enterprises engaged in development of infrastructure. This section was first introduced in the IT Act in 1991 and was amended almost every year thereafter until it was substituted by sections 80IA and 80IB in 1999. Section 80IA as it stands now holds out promises of tax holidays to enterprises engaged in the development or maintenance/operation of infrastructure facility specified in the Act, providing telecommunication service, developing and/or operating an industrial park or SEZ; in the generation and/or distribution of power or renovating or modernising distribution lines. Section 80IB allows income tax holiday to industrial undertakings other than those covered under section 80IA and applies to new industrial undertakings set up in the north-eastern (N-E) region, and Jammu and Kashmir. Tax holiday specifically for certain undertakings or enterprises set up in special category states, is now available under section 80IC inserted in the IT Act in 2003. By virtue of a sub-section introduced in section 80IB in 2004, tax holiday is now open to an undertaking developing and/or engaging in approved housing projects. Another subsection, inserted in 2004, extends the tax holiday to private hospitals set up in rural areas.⁸ All these are subject to stipulations regarding the period during which the benefit will be available, the kind of commodities the production of which will be eligible for tax holiday, and so on. Apart from income tax holiday, newly established undertakings (or their extension) producing articles of specified categories in the N-E states, Sikkim, Himachal Pradesh and Uttaranchal are entitled also to exemption from excise that would otherwise be payable and these are available mostly for ten years (in some cases upto 2012).

The rationale for tax holiday to new industrial undertakings in developing countries is simple *viz.*, that new ventures in certain areas such as infrastructure are risky, and therefore to induce private enterprise in new sectors/activities, tax holidays are an incentive offered by the government to share the risks. However, the efficacy of tax holidays to achieve this is highly questionable. After a survey of the literature on the issue, Charles McLure, the renowned fiscal expert of Stanford University, has summed up the case against tax holidays as follows:⁹

- Tax holidays are extremely difficult to administer because of the opportunities they open up for 'transfer pricing' by shifting income to related 'holiday' firms (where it will not be taxed) and shifting

deductions to non-exempt firms. This problem cannot be easily overcome, and explains the elaborate conditions laid down in the Indian income tax laws to guard against misuse. (Section 80IA runs in to 7 printed pages in an average sized book and 80IB, takes up 10 pages!). Abuse undermines both equity and revenue and is not a minor problem.

- The effectiveness of tax holidays is doubtful. Even if a firm does not cheat through transfer pricing, its marginal effective tax rate (METR) may be very high.¹⁰
- It entails loss of deductions – e.g., for depreciation, unless losses and unabsorbed depreciation during the holiday period are allowed to be carried forward.
- It creates a bias in favour of ‘footloose’ (‘fly-by-night’) industries.
- Highly profitable industries which would have come up in any case get exemption unnecessarily as a windfall.¹¹

In any case, if the assumption is that a venture in a new field/sector is risky and unlikely to earn profit initially, then tax holiday is of no use as such holidays apply only when a firm earns profits.

Region-specific tax holidays are objectionable also on economic efficiency ground, as they create a tendency to shift businesses to areas that do not have a comparative advantage for the activity in question.

Given the present environment where e-commerce is taking roots, there is a possibility of bill transactions being undertaken from areas where the incidence of tax is lower. This, however, does not imply that the goods need to be delivered out of the place where the billing is actually done. While the administrative departments of the indirect taxes would like to check for the level of activity in the enterprise, this lies outside the domain of the Income-tax Department because of tax holiday. It is thus possible that in some cases it is only the billing activity which moves to the specified jurisdiction, not the entire manufacturing activity, especially if the incentive available relates only to income tax. This would mean an erosion of the tax base in the rest of the country and not so much the generation of new incomes or expansion of the base.

The tax holidays extended to Himachal Pradesh and Uttranchal are particularly objectionable because they virtually negate whatever incentive the holidays for investment in the N-E states had been providing. As it is, an impact evaluation study of the *North-East*

Industrial Policy, 1997 which envisaged tax holiday to industries set up in the N-E states, carried out recently concludes:

- No large-scale investment has taken place as a result of the policy: Small and medium enterprises dominate the scenario, with low investment, low value added, and low employment.
- Several excise intensive units reflect only the final stage of manufacturing activity, entailing relatively low investment and employment, and figure among the major excise beneficiaries.
- Developed states within the region continue to attract most of the investment: Assam and Meghalaya account for 91 percent of the investment.
- Better connectivity with the mainland, quality of infrastructure and logistics, security concerns are identified as the driving force for the observed pattern of location of investment.
- With the tax holidays extended to Uttarakhand and Himachal Pradesh, most of the investments will flow to them, as they are strategically better placed to attract investors, with closer connectivity to the major markets and therefore having a competitive edge in attracting investment.

The study comes out with the recommendation that, what would be more helpful for the N-E states is, creation of better infrastructure — Manipur does not have a kilometer of railway line even after over fifty five years of independence — better transport facilities, transport subsidy, and interest subsidy for investment in the N-E states.

From the figures provided by the department, it would appear that the revenue forgone on account of these exemptions is to the tune of Rs 750 crore. These figures however, comprise only the taxes saved by half of the units established in Himachal Pradesh, since the other half have not yet begun manufacturing. These figures would suggest that the revenue loss is not substantial. However, one should not overlook the reported trend of relocation of industries in these states from the rest of the country. In this background, it may not be unrealistic to assume that the revenue cost of tax holiday will go up and may reach a level of about Rs. 2,000 crore in the near future.

Clearly, the tax holidays to Himachal Pradesh and Uttarakhand need urgent reconsideration. This is further reinforced by reports of large

scale migration of firms not only from neighbouring states (like Punjab in the case of migration to Himachal Pradesh) but also distant states, like Andhra Pradesh and Tamil Nadu. The cost-disability of hilly states is better neutralised through a suitable formula in the transfers recommended by the Finance Commission and the Planning Commission, rather than tax holidays. Continuation of tax holiday to firms in Himachal Pradesh and Uttaranchal may be damaging not only to the economy, but also to the entire federal system, as it is likely to create tensions among states. While the tax holiday introduced only two years ago may be difficult to take back altogether, a scaling down by 25 percent every year in income tax exemption should be given serious consideration. The tax holiday given to Himachal Pradesh and Uttaranchal (for 10 years each in case of income-tax and excise) deserves to be withdrawn immediately if the tax system and the spirit of federalism are not to suffer any further damage.

The question, however, arises on two fronts in trying to implement this:

- (i) Whether the principle of promissory estoppel is attracted if the tax holiday is withdrawn before the sunset clauses set in, as per the provisions of the statute.
- (ii) Even if there were no legal hindrances, the sensitivity involved in withdrawing a tax concession before it lapses.

As per the by now well established legal principle, where public interest is involved, the principle of promissory estoppel becomes inapplicable. In addressing both the above issues, an appropriate balance needs to be struck between the concept involved in promissory estoppel (or the obligation to fulfil a promise made) and public interest, since it was *ab initio* in the public interest that the promise was made, and it is in the public interest that thereafter there is a move to roll back the concession due to unforeseen developments. What is important is that the government has to establish with conviction that a change is warranted due to changed economic circumstances/unforeseen consequences, and hence carrying on with the concession during the promised period would be detrimental to the greater public good, although the rollback may hurt a few, who may have acted on the basis of the promise made by the state (by shifting industry to the designated

regions etc). There is enough economic rationale for the government to establish its case in this regard, if it so chooses.¹²

The tax incentive for housing also needs reconsideration. While housing is a priority area, handsome incentives are provided for investment in housing in the form of deductions for repayment of housing loan as well as for interest payment. Using data available on the loans outstanding for the banking sector and other financial institutions, one estimates the extent of revenue foregone on this count alone as Rs. 6,000 crore. There is no case for topping this up with a total tax holiday to real estate developers/builders [under section 80 IB(10)], who in any case are known to earn large profits. Real estate sector accounts for 9.6 percent of GDP in the economy, of which 4.5 percent is attributable to housing. Even if 20 percent of the value added in this sector is profits earned by the developers, the revenue forgone on this account alone would be to the tune of Rs. 8,000 crore.

As this provision, too, has been brought on board only recently, it may not be possible to withdraw it immediately but it should be phased out. For the present, it would be advisable to subject housing developers to a concessional rate of tax, say at 50 percent of the normal rate for only five years and no further extension thereafter. This will not neutralise the incentive for 'transfer pricing' altogether but will enable the tax administration to keep an eye on their finances as they will be subject to some scrutiny of their returns which total exemption would do away with. This will also enable the builders to carry forward losses, if any, to subsequent years as in the case of other losses, to be set off only against profits from real estate development.

Another category of incentives which is undergoing restructuring are related to savings, including for repayment of housing loan. These are now dealt with under the newly revived section 80C, which allows a deduction from income for investment made in the selected instruments/forms, with a ceiling of Rs 1 lakh. The budget 2005-06 announced the intentions to graduate into a system governed by the Exempt-Exempt-Taxed or EET principle. A committee has been constituted to identify the instruments to be covered by this system and lay out the modalities to govern the same. These changes seem to be on the right lines and hence are kept outside the scope of the present study.

5. Exemption of Income of Charitable Trusts/Institutions

A prominent and long standing exemption provision in Indian income tax relates to the income from property held under trust for charitable and religious purposes. Associated with it is the deduction allowed from taxable income of taxpayers for gifts made to approved charities or for charitable purposes. The relevant sections are 11 to 13A for the former and sections 80G – 80GGB for the latter. Taken together, these two seek to promote charitable activities in the society.

While the rationale for exempting the income of charitable institutions or allowing deduction for donations to charities is not in question, the tax treatment of charities has been a source of worry for tax administrators and policymakers every where. The main reason is that there is a widespread feeling that the cover of exemption is often used to promote private gain and not always or entirely for charitable objectives. Hence tax laws invariably stipulate safeguards to ensure that the concessional treatment of charitable institutions is not misused.

The strategy followed for this purpose mainly has been to define charity in such a manner that the scope for using tax exemptions for profit making is minimised, if not eliminated and to lay down specific conditions to be met by a charitable institution seeking exemption. Provisions in this regard have been in force in the Indian income tax since long. But these have undergone many changes over the years, partly as a result of court rulings and partly to meet the requirements of an evolving society. In operation, however, these changes are found to have certain weaknesses which tend to undermine the efficacy of the safeguards meant to ensure that the benefit of tax exemption goes only to genuine charities.

The weaknesses stem partly from the inadequacies of the definition of charitable purpose and also the ambivalence of the law in dealing with different types of charitable institutions. These are set out briefly below:

- (a) The definition of charity in the *Income-tax Act* as it originally stood ran as follows:
“Charitable’ purpose includes relief of the poor, education, medical relief and the advancement of any other object of general public utility not involving the carrying on of any activity for profit”. (Section 2(15) of the IT Act 1961).
 This definition occurred also in the Indian *Income-tax Act 1922*, following the English laws. While the intent was clear, viz., that activities which are wholly and truly charitable should qualify for exemption, the words “not involving..... profit” at the end, qualified the last object viz., ‘*advancement of any other object of general public utility*’. This meant that while objectives like relief of the poor, education, medical relief did not entail any tag, the pursuit of ‘*any other object of general public utility*’ had to abide by the condition that no business activity would be undertaken which is not related to the object of the trust. However, in response to pleas that this unduly restricted the source of income of charitable trusts, the words ‘*not involvingprofit*’ were dropped in 1983. This opened up the scope for using business income to be claimed as exempt when the business was held in trust for an object of general public utility.
- (b) In any case, the qualification of ‘*not involvingprofit*’ in the definition did not apply to the other three ingredients of charity, namely relief of the poor, education, and medical relief. As a result, private educational institutions, hospitals, etc. charging exorbitant fees have come up claiming exemption on the ground that their activity comes within the definition of ‘charitable purpose’. This has opened up scope for using educational institutions and hospitals for private gain while claiming exemption from tax. This is now almost common knowledge. As a recent editorial puts it, “*Profiteering and extravagant capitation fees charged by some professional colleges are a reality.....*”¹³
- (c) To bring charitable trusts under some discipline, the *Income-tax Act, 1961* (that replaced the IT Act, 1922) and the periodic amendments thereto introduced new provisions requiring any trust or charitable institutions with annual receipts of Rs. 1 crore and beyond claiming to be ‘charitable’ to file returns and observe certain rules regarding application of income. The bulk of the income of the trust (85%) was required to be applied for the purposes for which the trust is set up. Charitable trusts seeking exemption under these sections are also debarred from

engaging in any business activity not related to the main objective of the trust. However, this requirement has been diluted by the ruling of the Supreme Court in the celebrated *Thanthi Trust* case.¹⁴ There are some further restrictions as well to ensure that the trust does not have dealings with any trustees or their relatives. Trusts are also debarred from applying income by transferring funds to any other institution recognised as charitable under section 12A or section 10(23C). But all this has not prevented blatant misuse.

- (d) Certain charitable institutions are granted recognition under a provision which does not entail the kind of discipline envisaged in sections 11, 12 and 13 of the IT Act. These are those covered under subsections (iii) (ad) and (iii) (ae) of section 10(23C) of the *Income-tax Act*. Whereas charitable institutions with gross receipts exceeding Rs. 1 crore are granted certificates as charities by the tax department and, renewal of their charitable status is required thereafter every three years, also they are subject to filing of annual tax returns, those having annual receipts of less than Rs. 1 crore are not required to file returns or apply for renewal of recognition or follow the disciplines envisaged under the IT Act for other charitable institutions. The simultaneous operation of parallel provisions under section 10(23C) and sections 11, 12, 13, 13A and 13B together with dilution of the bar on carrying on any activity for profit have opened up wide scope for misuse.¹⁵

To counter these, the *Shome Committee* made a drastic recommendation requiring that for eligibility for exemption, a charitable institution must have 90 percent of its receipts from donations alone. This recommendation, however, was not accepted, presumably because it was too restrictive. The *Kelkar Task Force Report* of 2002 also did not endorse this recommendation, but wanted the parallel provisions mentioned above to be merged. That also has not happened so far. Therefore, the misuse continues, with consequent damage to the credibility of the charitable institutions' claim to serve public purpose, and also cost to revenue. Evidently some action is called for.

The need to tighten the provisions governing income tax exemptions to guard against misuse has been recognised in other countries also, like the USA, UK, and New Zealand. Several initiatives have been taken in recent years to streamline and redesign the

provisions. The UK has introduced the *Charities Bill* in May 2005 and New Zealand enacted the *Charities Act* in April 2005. Drawing on these and keeping in view India's ground realities, it is suggested that the provisions relating to exemptions of charities be redesigned on the lines below.

- An exhaustive definition of charitable purposes should be introduced, in place of the present inclusive definition, on the pattern of the UK *Charities Bill*, to prevent too wide an interpretation. The charitable purposes could be exhaustively listed as set out in the Directive Principles of State Policy in the Constitution of India, wherever these mention any activity that is in the nature of service for advancement of public good. The list of purposes could also be updated periodically to address current needs. In addition to the current objectives of relief of poverty, advancement of education and health, consideration could be given to objectives like advancement of arts, science, culture, heritage, amateur sports, environmental protection, animal welfare, relief of disability.¹⁶ It appears, a similar suggestion for having an exhaustive definition was made also by the in-house committee set up by CBDT to examine the recommendations of the *Shome Committee* referred to earlier.
- An institution serving a charitable purpose as enumerated in the exhaustive definition proposed above must in addition satisfy two other conditions, namely, it should not carry on any activity for profit i.e., business unrelated to the main objective of the trust, and two, even where an institution carries on an activity related to its main purpose, it must pass the test of some degree of philanthropy, such as by allowing free admission of meritorious students from poor families or charging concessional fees for indigent students, particularly in the case of business schools, private medical and engineering colleges, and free beds for the poor in hospitals.¹⁷
- To overcome the effect of the Supreme Court judgement that diluted the intention of the clause requiring that business activity should be 'incidental to the attainment of the objectives' of the charity, and to obviate unfair competition between tax paying business enterprises and those run by NPOs, an explanation needs to be introduced to the effect that the business would be considered incidental to the attainment of the objectives of the charitable institution **only if** the business is run to fulfill a primary purpose for which the institutions was set up, and no other business will qualify for exemption even though the revenue generated by it is used for furthering some

charitable purpose. Though strongly opposed to the idea of restricting the benefit of exemption only to donative trusts, Raja Chelliah had nevertheless acknowledged the need to insist that where a trust carries on any business it must be related to the objective of the trust/institution.¹⁸

- The provisions of section 10(23C) should be merged with those of sections 11, 12, 13 and 13A. That is to say, all charitable institutions seeking donations eligible for tax relief must submit to some minimum discipline namely, obtaining initial approval, filing of returns annually and application of income and surpluses invested in specified ratios and channels. In judging the correct application of income by these entities, the existing anomalies arising from varying definition of “income” in the provisions governing charitable institutions should be removed.
- The role of the charity commission, which is a key player in the regulation of charities in the U.K. and New Zealand, provides a good model for India as well. It is notable that the case of misuse of trust funds by trustees referred to in endnote 12 was reported to the Charity Commissioner of Maharashtra for action. A charity commission must be established in each state to both regulate and nurture the charity sector and also give the Income-tax Department adequate feedback on their activities.¹⁹
- Enforcement of the conditions regarding philanthropy may prove contentious in the case of research institutions undertaking consultancy. In their case, the test should be that the consultancy work undertaken by them is related to the principal objectives and no part of the income is used for private profit. Private hospitals are known to be resorting to the practice of declaring ‘research’ as their objective and running of the hospital as supportive of research activity. In such cases, it is necessary to see that the charges for treatment are not excessive and/or the hospital provides free treatment to the poor. This strengthens the case for a regulatory body like the Charity Commission to see that the institution functions truly as charitable institution serving the cause of public benefit.
- For sports associations and trade bodies, and clubs, eligibility for exemption will be governed by the principle of ‘mutuality’ which is well established in income tax laws.
- The civil society should also be empowered to serve as a watchdog against misuse of exemptions to charities. To facilitate this, the charitable entity must give out certain minimum information, and permit any one from the public to inspect its annual accounts/returns

on demand. A register of charities that are recognised by the Income-tax Department, if possible, on the departmental website, must also be maintained.

- In the case of institutes engaged only in research, in order to discourage the use of the institute's funds for private benefit, the fringe benefit tax (FBT) may be extended to such institutions. FBT may be imposed only when expenditure classified as fringe benefits (under the newly introduced sections 115 V to 115 WL of the Income Tax Act) exceeds a specified percentage of the gross receipts of the institution.
- The deduction allowed for donations to recognised charities may continue as at present.

In the absence of relevant data, it is difficult to quantify the likely revenue gain from tightening of the provisions governing the tax treatment of charitable institutions as suggested above. From the information available with the Planning Commission it seems there are about 12 lakh NPOs in India of which only one-half are 'registered'. The number of charitable trusts on the registers of the IT Department on the other hand is said to be around 70,000. However, how many are carrying on business or what is the amount of the income derived from business is not known. The number of charitable institutions granted recognition under section 10(23C) is also not available. A study of 100 trusts carried out by the Committee set up by the CBDT to examine the suggestions of the *Shome Committee* had found that 59 percent of their income amounting to Rs. 43 crore was received from business. A study commissioned by the Planning Commission shows that 60 percent of the income of charitable trusts is derived from business. The *Shome Committee* had estimated the revenue cost of the exemption of charitable trusts (and gifts to charities) at Rs. 5,750 crore for 2000-01 (p. 114 of the report). The fact that the leading 100 trusts derive more than half of their income from business lends support to this estimate. The likely gain to revenue from tightening the provisions governing charitable trusts and donations may therefore be put at not less than Rs. 8,000 crore now, apart from the benefit it may secure in terms of forcing profit-making educational and research institutions to open their doors for the poor.

6. Exclusion of Agricultural Income from Union Income Tax

By virtue of a provision in the *Income-tax Act* that embodies the law for the levy of income tax in India, income derived from agriculture, which constitutes no less than one-fourth of the country's GDP, is excluded from the tax base. The very first item in the section that enumerates the receipts/incomes that will not be included in computing the total income is "agricultural income" [Section 10(1)].

This, it is widely felt, constitutes a major constraint on the base of the centrally levied income tax. Apart from offending horizontal and vertical equity, exclusion of agricultural income from the base of income tax provides an avenue for evasion in that incomes earned from non-agricultural sources can be camouflaged as agricultural and so passed off as non-taxable. For these reasons it has been suggested from time to time that the dichotomy between agricultural and non-agricultural incomes should be ended. This, however, has not been found possible because, under the Constitution, taxation of agricultural income comes under the powers assigned to the states. To minimise the scope for evasion, the *Committee on Taxation of Agricultural Wealth and Income* (K.N. Raj Committee of 1972) had recommended that where an income tax assessee happens to show any part of his/her income as agricultural, such income should be included in his/her total income for rate purposes. This was also implemented soon after, but the results have not been very significant. The *Kelkar Task Force* had estimated the amount of revenue lost through such evasion at Rs. 1,000 crore a year and had recommended full taxation of incomes shown as agricultural by income tax payers. However, no action has been taken on these recommendations so far. Following the *Raj Committee's* recommendations, wealth tax was extended to agricultural land also, but was given up after a few years.

Whether the agricultural income of only those who have taxable non-agricultural income can be brought under taxation without violating the canon of equity enshrined in Article 14 of the Constitution is a moot point. The proper remedy seems to be to bring agricultural income squarely under the net of central income tax. For various reasons, it is

time, some consideration was given to finding ways to bring this about. Apart from considerations of equity, the reasons, briefly, are as follows:

- Exclusion of agricultural income from the income tax base is a legacy of history dating back from pre-independence days (and not just a creation of the constitution) and does not stand to reason now. When income tax was first introduced in India in 1860, agricultural income was taxed on the same footing as other incomes. However, after a transitional period from 1860 to 1886, the law that laid the basis of income taxation in India on a permanent footing viz., the *Act of 1886*, excluded agricultural income from the tax base on the ground that by that time a cess had been imposed on land revenue which was already quite burdensome and so subjecting agricultural incomes to income tax would amount to double taxation.²⁰ The constitutional scheme of assignment while assigning the power to tax agricultural income to the states, stipulated that 'agricultural income' will have the same meaning as given in the *Income-tax Act*. However, whereas in the 1800s and even till the time of independence, land revenue comprised a substantial proportion of government's revenues, at present land revenue (including surcharges and cesses based on land revenue) and *agricultural income tax* (introduced in a number of states since 1938) account for a relatively small proportion, approximating barely 0.7 percent, of the total tax revenue of states, *vide* figures for RE 2003-04 and BE 2004-05.²¹ Thus, the argument about double taxation, which provided the original rationale for exclusion of agricultural income from central income tax is no longer valid.
- The *Raj Committee* after examining the *pros* and *cons* of subjecting agricultural incomes to income tax came to the conclusion that this would not be advisable since determination of income and costs of cultivation is highly problematic. (how to value family labour, capital etc?) Things have changed dramatically since then. A striking development on the agricultural front in recent years has been its growing commercialisation and corporatisation through contract farming, and extensive use of R & D inputs. This is happening mainly in the seeds sector where capital intensive activity is required for creation of new breeds and strains through hybridisation, production of transgenics etc., to meet the economic challenge of crops which give better yield. Agricultural activity by corporates is also taking place in respect of crops of export interest, with companies including MNCs, engaged in integrated growing, processing and

marketing/export activity, as the exported agro product has to meet the increasingly higher phyto-sanitary standards set by importing countries. This is prevalent not only in the case of plantation crops, like tea and coffee, but also in the case of corporates with integrated activities, like corporate vineyards which market their wines, companies engaged in commercial floriculture, horticulture, etc. Agriculture is therefore emerging as a commercial activity, which, like other income-yielding activities, justifies taxation on the same footing.

- Under the definition of agriculture as given in the *Income-tax Act*, the income derived by cultivation of land and processing of agricultural produce to make the crop marketable is to be treated as 'agricultural'. This has opened up scope for companies engaged in activities like hybrid seed farming to claim exemption. Cases have gone up to the courts in which the taxability of incomes of seed farms using modern technology has been disputed. Court rulings, however, have been conflicting.²² These disputes would be set at rest if agricultural income was brought squarely under the income tax base. No doubt this will result in some tax liability for MNCs (along with domestic companies) engaged in agriculture or activities allied to agriculture, like hybrid seed farming, but that would bring about some certainty in the tax regime they face, which they generally prefer. In any case, so far as MNCs are concerned, income tax paid in India is mostly rebatable against the tax payable in their home country.
- It may be pointed out that with the current exemption limit for personal income tax at Rs. 1 lakh (effective limit would work out to Rs. 1.50 lakh if not higher if the deductions available for medical insurance, savings in specified forms etc. available under the resuscitated section 80C, are taken into account) marginal and small farmers who constitute 93 percent of farm holdings will not come into the tax net.²³ From the statistics of net income (surplus) from farming available from published sources, it would appear that with such an exemption limit, no small farmer is likely to come within the net of income tax unless they are engaged in cultivating high value crops like sugarcane.²⁴ In fact very few farm holdings of even the medium size would cross the exemption limit.
- While taxation of agricultural income has long been the preserve of the states, states can be persuaded to agree to a tax rental arrangement whereby the tax on agricultural income will be passed on to the state of origin. Alternatively, it would be better, if states

may be persuaded to agree to a constitutional amendment to enable the centre to tax agricultural income on the same footing as non-agricultural income. In return, the states may be allowed to “piggyback” on the personal income tax levied by the centre at a rate to be agreed upon between the centre and the states as is the practice in USA and Canada.²⁵

- Levy of income tax on agricultural incomes should not stand in the way of village *panchayats* imposing a land tax like the crop-specific tax on agricultural holdings.²⁶ Any tax payable to local governments should be deductible from income to be subjected to income tax.

For an idea of the revenue potential of the proposal put forward above, one needs detailed information regarding size distribution of land holdings and net surplus per hectare for different crops grown across the country. Such a detailed exercise would need to be undertaken for any separate, specialised paper on the subject, and is therefore not undertaken for this global paper on tax breaks. However, data on farm incomes suggest that an average net surplus from growing rice/wheat may be taken at Rs. 20,000 per hectare, assuming an yield of 4 tonnes per hectare and net surplus earned from a tonne of rice at Rs. 5,000 per quintal (For some crops the net surplus may be as high as Rs. 30,000 per hectare).²⁷ A farmer with land holding of 8 hectares or more would thus be liable to pay income tax. Data on farm holdings indicate that the number of medium farmers (5-14 hectares) is in the region of 90 lakh and of large holdings 14 lakh.²⁸ It may thus not be unreasonable to assume that about 60 lakh farmers are likely to come within the income tax net.²⁹ With a tax of 10 percent on Rs. 3 lakh income which was taken as the average farm income of farmers in the large and upper range of medium categories, tax payable by farm households would be Rs. 15,000 each. That should yield a revenue of at least Rs. 10,000 crore (taking into account the revenue gain from the closure of the loopholes now open to income taxpayers). This excludes the likely revenue accretion from taxing the plantations and other companies engaged in agriculture which now do not pay any income tax or bear only partial taxation.³⁰

7. Exemptions for Small Scale Industries

Small scale industries account for approximately 35 percent of total exports and 40 percent of value added from industry, but contribute very little to the exchequer, as they enjoy generous treatment in taxation. The rationale for protection to the small scale sector, first articulated in the *Industrial Policy Statement of 1948*, was promotion of employment, wide dispersal of industrial growth, and also the Gandhian ideology of self-supporting village economy. Moreover, SSIs, it was felt, needed support from government to neutralise their handicap in facing competition from large producers, such as lack of easy access to credit and high cost of capital, constraints in marketing, lack of access to information, difficulties in obtaining industrial licenses in the pre-liberalised regime, and so on. The SSI policy was implemented through various measures of support to small scale industries during the Second Plan period and onward, like concessional credit, capital subsidy, rebate on sale of products, purchase preference in government procurement, and so on. Concessional tax treatment played a prominent role in this endeavour.

However, the policy of protection to SSIs through reservation and tax concession has come in for criticism. Studies by several noted economists³¹ and a number of official committees³² have concluded that the policy of protecting small scale sector with 'reservation' over a wide range of industrial products (running to over 800 items at one stage) and fiscal support like tax concessions have not been beneficial either for the economy or even for the small scale sector. Further, besides concerns regarding quality of products of the SSI, it is found that the claim of large employment generation by SSIs is questionable. To quote the mid-term appraisal of the Tenth Five Year Plan, "The Office of Development Commissioner of Small Scale Industries under the Ministry of SSI has recently completed the Third SSI Census (reference year 2001-02). Employment per SSI unit has reduced from 6.29 percent to 4.6 percent between 1988 (the reference year for the previous Census) and 2001-02" (para 8.13).

Economic liberalisation initiated in the early nineties and the opening up of the Indian economy made reservation of products for the

SS sector to the exclusion of domestic large producers untenable.³³ Accordingly, the ambit of reservation for SSIs has been progressively reduced,³⁴ although not removed completely.

Along with the other support schemes, the tax concessions have undergone more changes. For instance, the tax holiday for SSIs in income tax has been phased out, while the concession in excise duty continues, though in a different form than in the past. Under the scheme now in operation,³⁵ a producer of specified goods with a clearance of not more than Rs. 4 crore in a given year does not have to pay any duty on the first Rs. 1 crore of clearances in the following year. 'Specified goods' now cover a wide range of products; only a few are left out. This concession is however not available in respect of specified goods bearing a 'brand name' of another producer, except where the brand is one of KVIC, a state *Khadi and Village Industry Board*, *National Small Industries Corporation* etc. or where the goods are ancillaries for a branded final product. Until the year 2005, producers availing the exemption could opt for paying duty at a concessional rate and claim credit for CenVAT paid on inputs. The option has now been withdrawn. Even so, substantial tax benefits are available to SSIs till date. Further, their magnitude seems to have been enlarged over the years. However, their cost remains unknown.

Before attempting an estimate of the fiscal impact of such concessions, it is useful to recognise that given the change in the structure of excise duties over time, with comprehensive introduction of the tax credit principle, there are difficulties in advocating the case for exemptions. The CenVAT tax credit mechanism allows credit for input taxes and thereby eliminates the need for providing specific exemptions, more so in the case of units producing intermediate goods. Exemption from tax in this scenario means that the manufacturer cannot get credit for input taxes paid, which therefore get embedded in the price of the good. This has two consequences—

- (i) regular registered units who potentially can purchase their inputs from SS units, may be reluctant to do so, since they would not be able to avail any input tax credit.
- (ii) exporters too may be unwilling to source their goods from exempt SS units, since the benefits from zero-rating gets considerably curtailed.

Further, such exemptions open up avenues for tax evasion, since exempt units do not have the opportunity to avail of input tax credit, a market gets generated for such unutilised invoices, which undermines the effectiveness of the tax system.

To overcome the problems of absence of economies of scale faced by the SS sector, there is a constant lobby pressure for expanding the ambit of excise exemption by raising the level of clearances for qualifying for the benefit. This overlooks the fact that 'small scale' is not a homogenous sector. What these units need most is institutional credit on reasonable terms, raw material at reasonable prices and market access. In the absence of help in this regard, tax concessions go more to the benefit of those who supply capital to village producers, as pointed out by the *Dandekar Committee* in the 1980s. The situation does not seem to have changed materially even after twenty-five years.

Recommendations for the SS Sector

The policy of protection to SSIs has clearly outlived its utility. It is worth noting that the case for protection through tax concession put forward in policy documents in the past invariably mentioned that such protection should be given only for a limited period. It is a pity that the transitional phase has not ended even after half a century.

The arguments for extension of small scale exemption and expansion of their ambit periodically emanate mostly from the lobby of what may be called the "modern small scale industry". These are the industries that are most dynamic. The main advantage in this case is the low wages they pay and gains from operating in the unorganised sector. The dynamism now displayed by them owes more to dereservation than to tax concessions. Hence, as the mid-term appraisal of the Tenth Plan emphasises, dereservation should be accelerated. Excise concessions under these circumstances are redundant and detrimental to efficiency. Further, it would be useful to point out that, a high ceiling puts the tiny village and cottage industries sector at a disadvantage whereas it is the latter that are most labour-intensive and therefore deserving of concessions. There can, therefore, be a case for assisting the tiny and cottage units only.

Taking the above issues into consideration, it is felt that exemptions should be limited to units with clearances of no more than

Rs. 50 lakhs in both the previous and the current years. At present, some categories of clearances are excluded when computing the volume of clearances eligible for exemption for the previous year/the current year, like (i) exports, and (ii) value of branded goods ineligible for excise exemption, i.e., with regard to goods which a small scale unit undertakes to manufacture for a big brand. In our view, with the introduction of CenVAT and service tax, which are creditable against duty payable by the purchaser of the goods (provided he is a registered dealer) there is no logic for excluding clearances of any category while determining the eligible size of clearances for exemption. In short, the benefit of exemption should apply only to **really small** units, who, by our criteria, do not ordinarily have clearances of more than Rs. 50 lakhs in the previous/current year, inclusive of all items which are currently excluded while computing the clearance. All other units should be fully taxed with the benefit of credit for tax paid on inputs.

Revenue Cost of Excise Concessions: An Estimate

According to official estimates³⁶ the SSI sector accounts for about 40 percent of GDP from manufacturing in the Indian economy. 'Industry' in turn accounts for 29 percent of GDP. Thus, in terms of contribution to GDP, the share of SSI works out to 11.2 percent. It would however not be correct to take this proportion of GDP in full as constituting the base for excise taxation. It is necessary to exclude the value added of tiny or village units which are out of the tax net in any case and also the value of products like exports, which necessarily have to be left out of taxation. Allowance has also to be made for the credit for tax on inputs produced by SS units which are used by large scale producers and get taxed in the hands of the latter.

After allowing for these adjustments, the net taxable component of SSI production is estimated at about 2.5 percent of GDP.³⁷ Applying the average rate of CenVAT of 16 percent to this base, the loss of revenue comes to 0.4 percent of GDP. Taking the estimated GDP figure for 2004-05 at Rs 2,838.1 thousand crore, the estimated loss of revenue from excise exemption to SSIs works out to Rs 11316 crore for the last financial year and **about Rs. 12,560 crore for the current financial year**. This leaves out the revenue forgone through excise concessions in a major segment of Indian industry, viz., textiles, which operates under a different regime specific to textiles.

8. Some General Observations and Conclusion

Apart from major taxes of income tax — personal and corporate — excise and customs, service taxation is an area that needs further attention. The present status of taxation under this tax is one of taxation of selected services, with the provision of credit extended both for service tax paid by CenVAT assessees and for CenVAT paid by service tax assessees. Taxation of selected services however, means that the rest of the services are exempt from taxation. As suggested by the *Govinda Rao Committee*, it is important to consider comprehensive taxation of services with a small negative list. This would help in making a transition to a comprehensive goods and services tax at the central level.

Apart from the exemptions discussed above, all the indirect taxes — excise and customs as well as service tax — as discussed above, have lists of commodities which are exempt from tax in general. In customs, there are exemptions provided to a class of goods used by the IT/electronics industries as also for goods used for manufacture of steel intermediaries. Exemptions of these kinds had some value in a regime where the tariff rates were high and/or import quotas existed. However given that the rates of tariff now are nominal, there is no case for providing exemptions and concessions within customs barring items for which India is committed to provide exemption as per the *Information Technology Agreement, 1996*.³⁸

Similarly, within excises, there are selective exemptions e.g. for food processing. A full scale study of tax cost of exemption should look at all these. The estimate presented here should therefore be taken as being on the conservative side.

Overall Estimates of Cost to Revenue

In sum, the revenue gain from proposals put forward would come to roughly the following amounts:

Export incentives	Rs 10,000 crore
Area Based exemptions	Rs 2,000 crore
Charities	Rs 8,000 crore
Agricultural incomes	Rs 10,000 crore
Housing	Rs 8,000 crore
Small scale industries	Rs 12,560 crore
Commodity based exemptions in excise and customs	Rs 4,000 crore
Total fiscal implications	Rs 54,560crore

As would be evident from the discussion, the above estimates are based on conservative assumptions. Further, since only the important tax incentives have been taken into account in this discussion, the figure for total revenue forgone would be significantly higher if all the others are taken into account. The tax ratio would exceed the *Twelfth Finance Commission* target if reform measures recommended here are implemented early on in the four year period being considered.

Annexure

Tax Incentives in Selected Developing Countries³⁹

Argentina

Inward Investments:

The exemption, suspension, and deferment of taxes granted under the incentive schemes have been replaced by the granting of tax credit bonds, which are delivered by the government by means of a current account based on theoretical fiscal cost declared by the companies and in so far as the investment objectives stated for recent years have been reached. The system, in addition, allows the companies to renounce the benefits by 40 percent of the taxes originally waived as a result of the industrial promotion scheme and 100 percent of the amount offset against the current account mentioned above. This mechanism implies a significant reduction of industries in these schemes, since only those in a position to comply with the objectives included in each investment project will remain.

Mining Activity:

An investment regime was created, under which mining ventures will enjoy fiscal stability (i.e., tax rates will remain same) for a term of 30 years, except for value-added tax, which will adjust to the general regime. Furthermore the regime grants incentives for profits tax, tax on assets, import duty and any other tax for introduction of certain assets. Law 24402 establishes a regime under which credit lines are granted for the financing of value-added tax on the purchase/definitive import of new capital goods available for export industries or on infrastructure works for the mining industry. Interest is payable by the national government.

Export Incentives:

Exports are exempt from value-added and excise taxes. The temporary importation of raw materials and intermediate and packaging goods for the manufacture of products for export is free from duties.

Brazil

Inward Investments:

Total or partial exemption from duty and excise tax on imported equipment is granted on certain approved investment projects.

Regional Incentives:

Income tax exemption or reduction is available for companies being set up in specified regions within Brazil, to accelerate the development of less developed regions and industries considered to be of importance to the economy.

Capital Investments:

Approved investment projects are granted accelerated depreciation on nationally produced equipment and access to low cost financing. Sales of some capital equipments are exempt from state sales and service tax.

Other Incentives:

Corporate taxpayers can apply a percentage of their income tax liability on deposits for reinvestment and investment in their own approved investment projects. These approved investment projects are normally granted total or partial income tax exemption. Excise and sales and service tax exemptions are granted for export of manufactured goods.

China

Inward Investments:

Foreign investment enterprises of a production nature that expect to operate in China for more than 10 years can apply for an exemption from income tax for two years, beginning from the first profit making year and a 50 percent reduction in the following three years. A reduced income tax rate of 15 percent may be possible for enterprises operating in Economic and Technological Development Zones or in special economic zones.

Capital Investments:

When a foreign investment enterprise reinvests its share of profits or capital reserve or enterprise development and expansion reserve for a period of at least 5 years, it may obtain a tax rebate of 40 percent of income tax paid by the enterprise and attributable to the foreign investor. If the foreign investor reinvests his profit in an export-oriented or technologically advanced enterprise for a period of at least 5 years, the investor may receive a full refund of the income tax already paid on the reinvested amount.

Egypt

An investment and guarantee law effective as of May 11, 1997 offers the following incentives:

1. Profits of a project formed under this law are exempted from tax on industrial and commercial profits and from corporate taxes. Also, profits distributed by these projects are exempted for five years as of the beginning of fiscal year following the start of production or of practicing the activity.
2. The tax exemption is extended to 10 years for companies established within certain areas.
3. A tax exemption of 20 years is available for companies operating outside the Old Nile Valley.

Indonesia

Tax Incentives

Inward Investment Corporations making new investment or expansion investment in priority sectors, especially in export-oriented industries, including hard-crop plantation, mining or other businesses as stipulated by Presidential Decrees and/or in remote areas are entitled to the following tax incentives.

1. Reduction of taxable income up to 30 percent of the investment.
2. Accelerated depreciation.
3. Extension of period for loss carry forward up to a maximum of ten years.
4. Reduction of branch profits tax.

Additional incentives are provided if the investment or expansion is made in eastern Indonesia designated as the Integrated Economic Development Area (KAPET).

Permanent establishments that reinvest their after-tax profits in Indonesia within the same year, or in the following year at the latest, are exempt from income tax on these profits.

Other incentives/Income earned by venture capital companies in the form of profit sharing from their investments in Indonesia is exempt from tax, provided that certain conditions are fulfilled.

Korea

1. Foreign invested companies that engage in high technology businesses, or that settle into foreign investment area, can apply for 100 percent exemption from corporation tax for seven years and a 50 percent reduction for three years thereafter in proportion to the ratio of investment. In addition, 100 percent tax exemption on acquisition tax, registration tax, property tax, and aggregate land tax is available for foreign-invested enterprises for 5 years after commencement of business, with 50 percent exemption for the following 3 years.

2. When advance approval is obtained, royalties paid under a high-technology inducement contract are totally exempt from withholding taxes for the first five years.
3. Various tax incentives to stimulate exports include, zero-rated VAT of export goods and refunds of customs duties paid for imported raw materials used to manufacture export goods.

Capital Investments:

Tax credits are available for qualifying investments in energy saving, pollution control, vocational training facilities, facilities for productivity enhancement, technology, human resource development and so on.

Other Incentives:

Gains on transfer of stock by a domestic person to a holding company established under the Anti-Monopoly and Fair Trade Act are not taxed until the domestic person sells the stock of the holding company acquired at the stock transfer.

Malaysia

Inward Investments:

1. *Pioneer Status:* Corporations in the manufacturing, agricultural, hotel and tourism, or in any industrial or commercial sector that participate in promoted activity or produce promoted products are eligible for pioneer status. For these incentives are given by way of an abatement of 70 percent of the profits for five years. Moreover, corporations undertaking projects of national importance, high-technology companies, and companies granted “strategic knowledge-based company” status, high technology companies engaged in promoted activity are granted full exemption on profits for a period of five years.
2. *Deductions for export expenses:* Resident corporations in manufacturing, hotel, tourism, and service sectors are entitled to double deduction for certain expenditure incurred on promotion of exports.

Capital Investments:

1. *Investment Tax Allowance (ITA):* A corporation may be granted an ITA of 60 percent of capital expenditure incurred on a factory or plant and machinery used for the purpose of approved manufacturing, agricultural, hotel and tourism, knowledge intensive or other industrial or commercial activity (other than one granted pioneer status) for a period of five years. The ITA incentive is enhanced for the following:
 - (a) Projects of national and strategic importance may be granted ITA of 100 percent, to be utilised each year against the whole of its profits without restriction.
 - (b) A high technology company or company involved in promotional activity, may be granted ITA at the rate of 60 percent, which would be available for setoff against its profit without any restriction.
 - (c) A project located in the eastern corridor of Malaysia may be granted ITA at the rate of 80 percent, which would be restricted to a maximum of 85 percent of profit and utilised each year.
 - (d) A company involved in technical and vocational training in Malaysia, may be granted ITA of 100 percent of qualifying capital expenditure, incurred within a period of 10 years, restricted to 70 percent of annual profits.
- (2) *Industrial Adjustment Allowance (IAA):* A manufacturing corporation that undertakes approved industrial adjustment programme may be granted an IAA of up to 100 percent of capital expenditure on factory, plant and machinery incurred without a period of five years.
- (3) *Reinvestment Allowance:* A corporation that embarks on a programme to expand, modernise, automate or diversify its manufacturing or processing business is entitled to a reinvestment allowance of 60 percent of capital expenditure incurred within a period of 15 years.
- (4) *Venture Capital Company:* A company investing in approved venture companies in the form of start up or seed capital is given a deduction equivalent to the value of the investment.

Other Incentives:

There are a number of other tax incentives provided to the following types of activities/enterprises:

- An operational headquarters company that provides qualifying services to related companies abroad;
- an “international procurement centre” company incorporated in Malaysia;
- approval “international trading companies” incorporated in Malaysia, with 60 percent Malaysian ownership, with minimum annual sales of RM10 million;
- “regional distribution centres” acting as collection and distribution centres for finished goods, components, and spare parts;
- high-technology industries based in the Multimedia Super Corridor at Kuala Lumpur, which is designed to be the R&D centre of industries based on information technology;
- gains from realisation of investments by unit trusts;
- companies providing R&D services to third parties;
- foreign fund management companies incorporated in Malaysia;
- shipping business from the operation of Malaysian Ships;
- resource-based industries;
- approved training expenditure/approval service projects;
- offshore trading through websites in Malaysia;

Special incentives have also been extended to the inter-national offshore financial centre (IOFC) established in Labuan, a federal territory of Malaysia.

Pakistan

Inward Investments and Capital Investments:

1. Profits and gains derived from an electric power generation project set up in Pakistan are exempt.
2. Profits and gains derived by a company from the export of computer software and its related services developed in Pakistan are exempt through June 30, 2016.
3. Profits and gains derived by a joint venture capital company registered under Venture Capital Companies and Funds

Management Rules 2000, between July 1, 2000 and June 30, 2007, are exempt.

4. Profits and gains derived from running a recognised computer training institution or computer training scheme, are exempt from tax for 5 years. This provision is effective through June 30, 2005.

South Africa

Tax Incentives

Inward investment Taxpayers with manufacturing operations or similar processes that receive cash grants (see “Other incentives”) are entitled to exemption from tax on such grants.

Capital investment The available capital incentives are:

1. Assets brought into use after December 15, 1989 □ A 20 percent per annum rate of depreciation applies to plant and machinery. An accelerated rate of $33\frac{1}{3}$ per cent per annum is applicable for new and unused plant and machinery acquired and brought into use in a process of manufacture under an agreement concluded during the period commencing on July 1, 1996 and ending on September 30, 1999. Plant and machinery brought into use after March 1, 2002 which was acquired in terms of an agreement concluded after March 1, 2002, will qualify for a 40 percent allowance in the first year and a 20 percent allowance in the following three years. Machinery and equipment used for farming are depreciated at the rate of 50 percent in the first year, 30 percent in the next year, and 20 percent in the final year.
2. Residential buildings, initial allowance—Housing projects of not less than five units qualify for an initial allowance of 10 percent of cost in the year in which they are completed and rented for the first time.

Other incentives

1. Small and Medium Enterprise Development Programme (SMEDP) replaces the Manufacturing Development Programme (MDP). The SMEDP has a significantly higher investment ceiling

of R100 million and attracts lucrative cash based tax-free benefits. The incentive will consist of a tax-free establishment grant for two years paid quarterly on qualifying assets. The project may qualify for a third year of the establishment grant subject to the attaining of a human resource remuneration ratio expressed in terms of the cost of manufacturing of at least 30 percent. A three-year cash grant of 50 percent of the cost of training new staff resulting from a new expansion or project will be payable in terms of the Skills Support Programme. This incentive is capped at 30 percent of the annual wage cost provided an approved training programme is in place.

2. The Minister of Trade and Industry may approve special allowances for strategic industrial projects where the costs of industrial assets will exceed R50 million within the first three years.
3. Applications for the reimbursement of the transfer cost of new plant, machinery and equipment to SA from abroad will be considered on merit. The grant will be limited to US\$150,000 for investments not exceeding R20 million, and US\$50,000 for investments not exceeding R5 million.

Sri Lanka

The tax incentives offered are categorised into two groups with varying incentives:

Group 1:

Comprises areas like non-traditional exports and export-oriented services, agriculture and agro-processing, information technology and allied services, industrial and machine tools manufacture, electronics, small scale infrastructure projects. The incentive for this group are zero tax rate for first 3 years, 10 percent tax rate for the next two years and 20 percent tax rate from 6th year onwards. However, concessionary rate of 15 percent will be applicable to agriculture and exports from the 6th year onwards.

Group 2:

Comprises pioneering investments in:

- a) Power generation, transmission and distribution
- b) Development of highways, railways, seaports, airports, water services and any other infrastructure projects.

There is tax holiday of 5 to 12 years from the date of commencing commercial operation and thereafter income is taxed at 15 percent.

Incentives and concessions are also offered in respect of companies engaged in research and development; new venture capital companies; non-performing industries undergoing rehabilitation; companies exporting non-traditional goods; corporate profits from agriculture, fisheries, livestock, construction, tourism and provision of overseas management services; profits and incomes earned in foreign currency.

Thailand

Inward Investments: Tax incentives include:

1. Exemption or reduction of import duties on imported machinery.
2. Reduction of import duties on imported raw materials and components.
3. Exemption from corporate income taxes from 3 to 8 years.
4. Exemption of upto 5 years from withholding tax on goodwill, royalties or fees remitted abroad.
5. Exclusion from taxable income of dividends derived from promoted enterprise during the income tax holiday period.

Additional Incentives to encourage exports/for enterprises located in investment promotion zones:

Incentives include reduction of 50 percent of corporate income-tax for 5 years after the termination of a normal income-tax holiday or from the date of earning income and allowances to double the cost of transportation, electricity and water supply for deduction from taxable income.

Capital Investments: There are no incentives.

Other Incentives:

Commercial banks granted license to undertake international banking facilities business in Thailand are entitled to the following:

1. A corporate income tax rate of 10 percent on the net profit from international banking facilities business.
2. Exemption from withholding tax on interest paid to foreign depositor or lender where the funds are used for offshore lending.
3. Withholding tax exemption on interest income paid to a foreign depositor or lender where the funds are used for lending to a state enterprise under approval of Ministry of Finance.
4. Exemption from profit remittance tax for offshore lending business.
5. Exemption from specific business and municipal tax on gross income.
6. Stamp duty exemption for international banking facilities.

Apart from these, tax incentives are also provided to attract foreign firms to establish regional headquarters in Thailand.

Endnotes

- ¹ Based on GDP projections of *Twelfth Finance Commission*.
- ² See for instance, the papers in *Fiscal Incentives for Investment and Innovation* ed. by Anwar Shah (New York, OUP, 1995).
- ³ Vide for instance, Tax Incentives by Alex Easson and Eric Zolt (World Bank Institute, 2002).
- ⁴ For example, “Export Processing Zones in India: Analysis of the Export Performance” by Aradhna Aggarwal (Working Paper No. 148, Indian Council for Research on International Economic Relations 2004) and “Impact Evaluation Study of North-East Industrial Policy, 1997” by Tata Economic Consultancy Services.
- ⁵ A new section 10AA is to be inserted in the *Income tax Act, 1961* by the *SEZ Act, 2005*. This is to come into effect from a date yet to be notified.
- ⁶ Because of protection from foreign competition on the one hand and impediments to the free play of market forces on the other. Even then, whether tax incentives were an efficient means to promote exports was open to question because selective concessions are invariably distortionary and inefficient. A more efficient route would have been an appropriate exchange rate policy.
- ⁷ http://www.wto.org/english/tratop_e/scm_e/scm_stattab6_e.xls.
- ⁸ Vide sections 80IB(10) and 80IB(11B). Section 80IB allowed tax holiday to a number of other activities such as setting up and operating cold chain facilities for agricultural produce, companies carrying on scientific research, and so on. Most of these have been phased out.
- ⁹ “Tax Holidays and Investment Incentives: A Comparative Analysis” by Charles E. McLure in International Bureau of Fiscal Documentation, August/September, 1999.
- ¹⁰ METR is the percentage by which taxation changes the rate of return on a marginal investment. METRs can exceed 100 percent (for example, for equity financed investment,) if depreciation is very slow and inflation is high or they may be negative (McLure, *ibid.*).
- ¹¹ This seems to be the case with holidays allowed to ‘multiplex’ units that enjoyed tax holiday under the IT Act until recently.
- ¹² A full-fledged paper on regional tax holidays is under preparation by NIPFP, which proposes to address in detail the economic and legal arguments on the principle of promissory estoppel and public interest.
- ¹³ Times of India editorial, 18 August, 2005.
- ¹⁴ Decision dated 31.1.2001 cited in 247 ITR 785.
- ¹⁵ How glaring this can be is brought out in a recent case, involving St. Xavier’s School, Pune, reported in the Indian Express (Mumbai edition), July 20, 2005.
- ¹⁶ These are the exhaustive list of objectives in the *UK Charities Bill, 2005*. Some of these also feature in the US legislation.

17 The percentage of free/concessional facilities to be extended by each category of charitable institution would depend on a detailed consultation with their representatives, which government should undertake. As a broad guideline, it is felt that institutions with gross receipts of over Rs. 1 crore should dedicate at least 10 percent of these receipts to subsidised facilities. For those having gross receipts below this threshold, 5 percent of such receipts is recommended for this purpose.

18 "Taxation of Charitable Trusts" by Raja J. Chelliah, *Economic and Political Weekly*, 29 December 2001.

19 The mere fact that the charity commissions in several states are not functioning well at present is not adequate reason for running down the institution, *per se*, as suggested by some. Rather, strengthening of these defunct offices is the need of the hour. A Central Charity Commission functioning as an autonomous Statutory authority may be considered, to bring independent and objective regulation to this sector. However, if, on the US pattern, the tax department has to be made the sole regulator for the charitable sector, then the Exemptions Wing of the Income-tax Department has to be adequately geared up.

20 Taxation of Income in India by V.K.R.V. Rao (1931).

21 RBI Study of State Budgets 2004.

22 See, for example the contrasting decisions in CIT vs. *Soundarya Nursery* (1998) 241 ITR 530 (Madras) where income from development of seeds has been held to be exempt as income from agriculture while in CIT vs. *Jalna Seeds* (2002) 246 ITR 156 (Bombay), Assistant CIT vs. *Kanchanjanga Seeds* (2001) 81 ITD, ITO vs. *Navbharat Seeds* (1989) 32 ITD 703 (ITAT Ahmedabad) and *Pro Agro Seeds vs. Jt. CIT* (2003) 126 Taxman 37 (ITAT Delhi) such income has been held to be taxable as non-agricultural income.

23 *Vide* CMIE Report on Agriculture, 2005.

24 See, *A Fiscal Domain for Panchayats* by Indira Rajaramn (OUP, 2003).

25 For a suggestion to this effect see 'Tax Assignment in the Indian Federation' by Amaresh Bagchi in *India's Economic Reform and Development, Essays for Manmohan Singh ed.* by Isher Ahluwalia and IMD Little (OUP 1998).

26 Such as proposed by Indira Rajaraman in *A Fiscal Domain for Panchayats* (OUP, 2003).

27 Rajaraman, *ibid.* Data pertaining to 1996-97 show that the net surplus from sugarcane was as high as Rs. 42,825 (*vide* Rajaraman *op cit*).

28 CMIE Report on Agriculture, 2005.

29 It is assumed that only 50 percent of the medium farmers would have taxable income.

30 Plantation crops, like tea ,coffee and rubber bear tax on only 25-40 percent of their income, depending on the crop grown.

31 An incisive critique of the policy is provided in a working paper of the Centre for Development Economics, Delhi School of Economics published in 1997, "Policy on Modern Small Scale Industries: A Case of Government Failure" by Suresh Tendulkar and T.A. Bhavani). A paper written for a conference in Helsinki, by Dipak Mazumdar in 1988 articulated a scathing criticism of India's small scale policy, "Import Substituting Industrialisation: The Indian Experience in the Textile Industry", EDI Word Bank. A more recent critique is contained in an NCAER publication of 2001, *Small Scale Industry Policy in India: A Critical Evaluation* by Rakesh Mohan.

32 *The Expert Committee on Tax Measures to Promote Employment* (Dandekar Committee) of 1980 was particularly critical about several aspects of the protection policy for the SS sector. Other committees that took a look at the tax treatment of SSIs are the *Committee on Indirect Taxation of 1976* headed by L.K. Jha, Nayak Committee (1992), Abid Hussain Committee (1997) and the S.P. Gupta Committee (2001), to name the notable ones. Only the S.P. Gupta Committee seemed to be in favour of continuing and even widening the scope of the tax concession.

33 The removal of Quantitative Restriction implied that goods reserved for SSI could be imported into the country but not produced by domestic large scale units.

34 As of March, 2005, 506 items continue to be on the reserved list.

35 Formulated in Notification Nos. 8 /2003 & 9/2003 – CE as amended in 2004 and 2005.

36 *Vide* Report of the Study Group on Development of Small Scale Industries, Planning Commission, 2001.

37 Details about the adjustments made are spelt out in 'Tax Breaks for the Small Scale Sector-An Appraisal', NIPFP Tax Research Unit Working Paper No 3, 2005 (forthcoming).

38 A Multilateral agreement with WTO, to which India is a signatory.

39 Source: Corporate Taxes: Worldwide Summaries 2003-04, Pricewater House Coopers (2003).