RATIONALISATION OF TAX STRUCTURES OF CENTRAL TAXES AND ADDITIONAL RESOURCE MOBILISATION FOR THE SEVENTH FIVE YEAR PLAN

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I. Introduction

The current income tax system can be characterised as the one with high rates and many tax concessions (Annexure 1). Union excise duty on many commodities is specific or specific-cum-*ad valorem* (Annexure 2) that adversely affects the elasticity of the tax . Enforcement of tax laws is perceived to be weak. This leaves ample scope for raising additional resources through rationalisation of the tax structures and improvement in tax administration to bring about better tax compliance rather than through an additional dose of taxation. The purpose of this study is to suggest possible reform measures for these taxes, which are given below.

II. Personal Income Tax

2. With a view to rationalising the tax structure, improving the tax compliance and mobilising resources for the Seventh Five Year Plan, the following package of reform measures, comprising five points, may be considered :

(a) Over the period of next three years, the minimum tax rate should be reduced to 10 per cent from the present level of 20 per cent, and the maximum tax rate should be reduced to 50 per cent from the present level of 55 per cent. Further, the rate of surcharge should be reduced from 12.5 per cent to 10 per cent. A three year scheme that can be used to achieve these targets is given in Table 1.

(b) The present level of exemption limit of Rs.15,000 should remain unchanged for three to four years. Oweing to the characteristics of salary income and the degree of inflation, if some relief on salary income would be warranted, it should be given through liberalisation of the provisions of standard deduction and of house rent deduction.

(c) A scheme of Special Bearer Bonds of the type that was commenced on 12th January 1981, should be commenced in the beginning of the period of the Seventh Five Year Plan with a note of caution that those who will continue tax dodging will be identified and dealt with severity.

(d) Stringent measures should be taken to identify taxdodgers and a good publicity should be given to this effect for developing a general feeling among the people that the chances of detection of the tax defaulters have been considerably increased. Also, in the due course of time, penalties on the defaulters should be increased. Emphasis should be more on identifying a higher number of taxdodgers. A small fraction of the taxpayers assessed under the Scheme of Summary Assessment should also be subject to scrutiny.

(e) The scheme of Compulsory Deposit that was introduced as an anti-inflationary measure should be abolished.

3. The proposed lower tax rate for the first income bracket would lower the benefit of non-compliance and thereby, tend to discourage non-compliance. This can go a long way in developing the culture of paying tax. In the later years, an increase in the income of these taxpayers could contribute towards tax yield thereby improving elasticity of the tax.

4. Eventhough the inflationary situation is likely to continue during the Seventh Five Year Plan, an unchanged level of exemption limit is proposed with a view to broaden the base of income tax.

5. The proposed scheme of Special Bearer Bonds would serve dual purpose: first, siphoning away black money from the economy and second, augmenting resources for financing public outlays, at a low cost.

III. Corporation Income Tax

6. With a view to mobilise resources from the corporate sector, the tax incentives currently available to the corporate sector should be pruned. In this context, specifically the provosions governing investment allowance and tax holiday should be reviewed.

7. The main objective of introducing investment allowance was to mitigate taxpayers' hardship in meeting the cost of replacement of plant and machinery under inflationary conditions. Some of the calculations done by us show that, with a reasonable rate of return on the depreciation reserve, the cost of replacement of plant and machinery can be met from the depreciation reserve even under conditions of moderate inflation. This will be true even if depreciation is allowed on straight line basis. From Table 2, it will be noted that,

with a net rate of return of 15 per cent per annum on the depreciation reserve, the cost of replacement of a plant with a life period of 5 years, can be met from the depreciation reserve even if the price of the plant increases by 6.2 per cent per annum. The degree of inflation, that can be afforded in meeting from the depreciation reserve, the cost of replacement of a plant increases with the life time of the plant as well as with the rate of return on the depreciation reserve. With a 25 per cent rate of return on the depreciation reserve, the cost of replacement of a plant with life period of 20 years can be met from the depreciation reserve even if the price of the plant increases at a rate as high as 15 per cent per annum. Therefore, for meeting the cost of replacement of plant and machinery, the provosion of investment allowance is not necessary. However, it may be desirable in the case of an indusrty whose plant and machinery is getting obsolescent fast. The scenario when an investment allowance is allowed in addition to depreciation is discussed below.

8. With the depreciation on straight line basis, an investment allowance at the rate of 10 per cent of the cost of new machinery would suffice in meeting the cost of replacement of the machinery with life period of 5 years even if the price of the machinery rises by 6.4 per cent per annum, provided the rate of return on the depreciation reserves is not less than 15 per cent. With regard to cost of replacement, the degree of inflation that can be afforded from the reserves increases with the increase in life period of the machinery and with the increase in the rate of investment allowance, the rate of return on the reserves remaining unchanged. For a machine with life period of 20 years and 25 per cent investment allowance, the cost of replacement of the machine can be met from the reserves even if its price rises by 11.4 per cent per annum. With 20 per cent rate of return on the reserves, an investment allowance of 10 per cent would suffice in meeting the cost of replacement of a machine with life period of 20 years provided the increase in the price of the machine does not exceed 13.4 per cent per annum. Thus, a reduction in the investment allowance is not likely cause any undue hardship in replacement of plant and machinery.

9. In the light of the above discussion it is suggested that investment allowance be reduced by 10 to 15 percentage points from the current level of 25 per cent (35 per cent in some cases), and the deduction under the provisions of tax holiday be reduced by 5 percentage points. However, oweing to the commitment made about investment allowance,

the proposed reduction should be implemented only with effect from 1.4.1987.

III. Union Excise Duty

10. With a view to mobilise additional resources from the Union Excise Duty, a gradual shift from specific and *ad valorem*-cum-specific levies to *ad valorem* levies is recommended. However, in the case of a few commodities for which it is not feasible to administer an *ad valorem* levy with the available administrative machinery, specific duties may be retained but the rates of specific levy should be revised annually on the basis of rate of inflation.

Table 1

A Schedule of Reform of Rate Structure of Personal Income Tax

(Per cent)

Income bracket (Rs.000)	1984-85 (actual)	1985-86 (actual)	1986-87 (suggested)	1987-88 (suggested)
	Tax rates in the assessment year			
0 - 15	Nil	Nil	Nil	Nil
15 - 20	25	20	15	10
20 - 25	30	25	20	15
25 - 30	35	30	25	20
30 - 40	40	35	30	25
40 - 50	40	40	35	30
50 - 60	50	45	40	35
60 - 70	52.5	45	40	40
70 - 80	55	50	45	45
80 - 85	55	50	45	45
85 - 100	57.5	50	45	45
above 100	60	55	50	50

Note : In the year 1988-89, surcharge should be reduced from 12.5 per cent to 10 per cent.

Table 2

Rate of Inflation that can be Afforded in Meeting the Cost of Replacement of Machinery from Depreciation Reserve

Life of Machinery (years)	Rate of return on depreciation reserve (per cent)	Rate of inflation that can be afforded in meeting the cost of replacement (per cent)
(1)	(2)	(3)
5	10	4.1
10	10	4.8
15	10	5.1
20	10	5.4
5	15	6.2
10	15	7.3
15	15	8.0
20	15	8.5
5	20	8.3
10	20	10.0
15	20	11.0
20	20	11.8
5	25	10.4
10	25	12.8
15	25	14.2
20	25	15.3

Notes: 1. In these computations depreciation is taken to be on straight line basis.

2. Investment allowance is taken as nill.

Tax Incentives for Companies

The income tax inventives available to companies can be classified into the following four broad categories :

A1.1 Deductions in the nature of depreciation/amortisation of capital expenditure

A1.1.1 Depreciation

Section 32(1)(i),(ii)	-	depreciation on building, plant and machinery, furniture and fixtures: General rate 15% Special rates range from 20% to 100%. Shift allowance - 50% for double shift & 100% for triple shift.
Section 32(1)(iia)	-	additional depreciation on new plant and machinery subject to certain exclusions @ 50% of normal allowance.
Section 32(1) (iii)	-	obsolescence allowance for plant and machinery discarded, destroyed or sold.
Section 32(1) (iv)	-	initial depreciation @ 40% on new residential and welfare buildings for low paid labour.
Section 32(1) (v)	-	initial depreciation @ 25% on new buildings for approved hotels.
Section 32(1) (vi)	-	initial depreciation @ 20% on new ships/aircraft and new plant and machinery installed in priority industries or small scale industries.

A1.1.2 Expenditure on scientific research/rural development.

Section 35(1)	-	revenue expenditure and payments to institutions for scientific research.
Section 35(2) (ia)	-	100% of capital expenditure excluding value of land.
Section 35CC	-	100% of expenditure on rural development.
Section 35CCB	-	100% of payments to institutions for programmes of conservation of natural resources.

A1.1.3 Amortisation of capital expenditure:

Section 35A	-	Patent rights and copy rights
Section 35D	-	amortisation of certain preliminary expenses.
Section 35E	-	expenditure on prospecting for minerals.

A1.2. Deductions in excess of cost

Section 32A	-	investment allowance on new plant and machinery in industries (excluding consumer industries) and all small scale industries - @ 25% (35% in certain cases)

A1.3. Incentives for industrialisation, etc. by way of exemption of a percentage of the profits

Section 80HH	-	new industries in backward areas @ 20% of profits.
Section 80HHA	-	new small scale industries in rural areas - 20% of profits.
Section 80I	-	tax holiday (25% of profits) for newly established industries (other than those manufacturing luxury/consumer goods)
Section 80JJ	-	live stock breeding, poultries or dairy farming

A1.4 Export oriented incentives

Section HHB	-	project exports
Section HHC	-	export of goods.
Sections 80N & 80O	-	export of technology.
Section 10A	-	export oriented industries in the trade zones.

Annexure 2

Commodities Subject to Specific Duty of Union Excise

Currently, many commodities are subject to specific duty of excise with some of these subject to Specific-cum-ad valorem duty. The commodities falling into specific and specific-cum-ad valorem duty categories are given below.

A2.1 Specific duty commodities

1. Aerated waters (Specific Types)
2. Maida
3. Molasses
4. Coffee cured
5. Tea other than istant tea
6. Unmanufactured Tobacco
7. Biris
8. Snuff
9. Motor Spirit
10. Kerosene Oil
11. Refined Diesel Oils
12. Diesel Oils NOS (not otherwise specified)
13. Furnace Oil
14. Coal (except calcined petroleum Coke)
15. Basic Mineral Oils
16. Lubricating Oils
17. Flushing Oil
18. Household Oil
19. Liquified Petroleum Gases
20. Vegetable Non-Essential Oils
21. Carbonic Acid (Carbon dioxide)
22. Man-made Filament yarn
23. Man-made fibres, (other than Mineral Fibres)
24. Cellulosic spun Yarn
25. Non-Cellulosic Wastes - (All sorts)
26. Cellulosic Spun Yarn & Cotton Yarn
27. Textured Yarn
28. Cotton Yarn
29. oollen and Acrylic Spun Yarn
30. Silk Yarn (Containing more than one-sixth by weight of non-cellulosic fibre)
31. Jute Yarn - (All sorts)
32. Non-Cellulosic Spun Yarn
33. Flax and Ramie Yarn
34. Embroidery

35. Silk Fabrics (other than embroidery in the piece, in strips or in motifs)
36. Jute Manufactures
37. Silver
38. Iron in any crude form
39. Iron and Steel, and Products thereof except Ferro-Alloys.
40. Steel Ingots
41. Copper and Copper alloys except Copper Pipes and Tubes
42. Zinc and Zinc Products except Zinc Pipes and Tubes
43. Lead
44. Tin Plate and Tinned Sheets
45. Cinematograph Films
46. Match Sticks
47. Lighters (Tariff item No.39)
48. Crown Corks
49. Pilfer Proof Caps
50. Wool Tops

A2.2 Specific-cum-*ad valorem* duty commodities

1. Petroleum Coke, (other than calcined petroleum coke).
2. Mineral Turpentine Oil
3. Waxes
4. Petroleum Gases, (other than liquified petroleum)
5. Blended or compounded lubricating oils and grease
6. Paper

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