सत्यमेव जयते

TAX REFORMS COMMITTEE

INTERIM REPORT

December, 1991

Government of India, Ministry of Finance (Department of Revenue)

CONTENTS

1

Introduction

1.1. The Government of India constituted a Committee of experts to examine the structure of direct and indirect taxes through their Resolution dated 29th August, 1991, under the Chairmanship of Dr. Raja J. Chelliah, former Member, Planning Commission and Finance Commission and currently Professor Emeritus, National Institute of Public Finance and Policy. This Tax Reforms Committee was appointed in pursuance of the Government's commitment, reiterated by the Finance Minister in his Budget Speech presenting the Union Budget for 1991-92, to make the tax system simple, credible, yet progressive, in which people realise that honesty is the best policy. The Tax Reforms Committee consists of the following members:

1.	Dr Raja J. Chelliah	Chairman
2.	Shri S.V. Iyer	Member
3.	Shri V.U. Eradi	Member
4.	Dr Amaresh Bagchi	Member
5.	Shri V. Rajaraman	Member

1.2 Shri Gautam Ray, Deputy Collector, Customs and Central Excise, is the Secretary of the Committee and Shri Arbind Modi, Deputy Commissioner of Income Tax, is the Additional Secretary.

1.3 The terms of reference of the Committee are to examine and make recommendations on -

a. ways of improving the elasticity of tax revenues, both direct and indirect, and increasing the share of direct taxes as a proportion of total tax revenues and of GDP;

b. making the tax system fairer and broad-based, with necessary rate adjustments, particularly with regard to commodity taxation and personal taxation;

c. rationalisation of the system of direct taxes with view to removing anomalies, improving equity and sustaining economic incentives;

d. identifying new areas for taxation;

e. ways of improving compliance of direct taxes and strengthening enforcement;

f. simplification and rationalisation of customs tariffs with a view to reducing the multiplicity and dispersion of rates and to eliminate exemptions which have become unnecessary;

g. reducing the level of tariff rates, keeping in view the need for mobilising resources to facilitate fiscal adjustment and the objective of promoting international competitiveness;

h. simplification and rationalisation of the structure of excise duties for better tax compliance and administration;

i. the scope of extending the Modvat Scheme;

j. any other matter related to the above points or incidental thereto.

1.4 The Committee was to submit its Interim Report to the Finance Minister by the 30th November, 1991, containing such recommendations as the Committee considers important for immediate implementation. With the approval of the Finance Minister the date of submission of this Report was extended to 23rd December, 1991.

1.5 The approach of the Committee was to deliberate on the need for reforms in all important areas in the direct and indirect tax systems in order to set the trend for inaugurating a new era in the development of tax policy, structure and administration. It was, therefore, decided that in the Interim Report itself, we should examine the case for introducing certain fundamental reforms in the direct tax and indirect tax systems in line with the aforesaid goal so that the changes that are required to be brought in immediately are conceived as an integral part of the reforms suggested by the Committee. As may be seen in the following chapters, the Committee has recommended certain radical changes to reorient our tax system in the new direction. Our aim has been to make this Interim Report as exhaustive as possible within the short time of about three months at our disposal.

1.6 In addition to the valuable assistance which the Committee has received from the Secretary and the Additional Secretary, we also derived considerable benefit from the services of Shri T.R. Rustogi, Collector (Adjudication), Customs and Excise, Chandigarh and Shri V. Sridhar, Deputy Director, Anti-evasion, Madras.

1.7 The Committee is greatly indebted to Dr. B.N. Goldar, Reader, Institute of Economic Growth and Consultant to the National Institute of Public Finance and Policy (NIPFP) for the basic study and analysis he conducted in helping us to work out our recommendations for restructuring the import tariff. In this work he was able to draw upon the results of the research project on India's Import Tariff which had been carried out at the NIPFP. In the area of direct taxes, Dr Arindam Das-Gupta, Fellow and Shri Pawan K. Aggarwal, Senior Economist at the NIPFP, provided the Committee with an analysis of income tax data and helped us in the preparation of appendices. They also helped us in various other ways in our study of the direct taxes.

1.8 We are grateful to all the Chambers, Trade Associations and individuals who have sent us representations and suggestions. Owing to the limited time at our disposal, it was not possible for us to give an opportunity for oral representation to various Chambers of Commerce and Industry. However, the Committee visited Bombay on 19th and 20th October, 1991, during which time meetings were held with some eminent experts in taxation and law as well as with some prominent merchant chambers in the city. The Committee hopes to visit Calcutta and Madras before submitting the final Report.

1.9 We would like to acknowledge also the considerable help that we have received from the administrative and other staff of NIPFP particularly Mrs. Rita Wadhwa, for editing the report. Competent secretarial support was provided by Miss Sushila Panjwani, Private Secretary to the Chairman, Shri S.B. Mann, Shri M.C. Aggarwal, Shri Digvijay Mishra and Shri B.K. Srivastava.

2

DEVISING A SOUND TAX SYSTEM

Introduction

2.1 Taxes are compulsory payments which citizens in a country are required by law to make to the government for defraying the cost of providing public services and financing transfer payments. Since the market exchange system cannot be applied to the supply of public goods, their cost of production has to be met out of taxes instead of sale prices.[1] This immediately raises the question of the basis of allocating the costs i.e. of the basis of determining the distribution of tax payments.

2.2 Since taxes are payments without a direct *quid pro quo* and are meant to cover the cost of common services, it is generally accepted that individuals' or households' tax liabilities should be according to their respective abilities. Such a basis is considered fair. If this be granted, it would follow that those with equal abilities should make equal tax payments and those with higher abilities should be asked to make larger payments. This rule sounds simple enough, but in translating the principle into practice, a number of problems arise, and it also becomes clear that several other considerations have to be brought in. The major problems and considerations are:

a. How should ability be measured? Two alternative tests of ability to pay, income and consumption, are generally accepted as the best single tests available.[2] How do they compare in terms of fairness and in terms of measurability, conceptually and in practice?

b. Once a test of ability is chosen, there arises the question of justly treating those with differing abilities. Should those with higher ability be asked to pay proportionately more, or, purely in terms of justice, should the payment increase more than proportionately with an increase in ability? There is no answer to this question to be derived on objective grounds. In modern industrial societies characterised by a high degree of inequality of income, it is generally agreed that there should be some degree of progression in the tax system, such, that the average rate of tax increases with income, but it is not easy to specify the exact degree of progression needed to mete out justice as between tax payers with differing abilities.

c. Fairness is only one aspect to be taken into account; there are other important aspects and taking them into consideration brings in further complications. Since taxes are unrequited payments which cut into the potential economic welfare of the taxpayers, they affect their economic behaviour - choice of consumer goods, choice of occupation, and techniques and location of production as well as incentives to work, save, invest and take risks, unless the tax is in the nature of a poll tax unrelated

1. To the extent that the government supplies private goods or goods that partly partake of the nature of private goods, for example, "merit" goods, taxation could be on the basis of benefit principle.

2. Additional tests, such as a person's health status, ownership of wealth, place of residence and so on may be used along with either income or consumption to refine the ability to pay measure.

to any aspect of the behaviour of taxpayers, except the fact of being alive. There are cases where affecting the behaviour of the consumer or the producer may be socially desirable, but in general non-poll taxes tend to reduce consumer welfare and productive efficiency. In the choice of tax design and deciding upon the degree of progression, the objective of minimising loss of welfare and adverse impact on economic efficiency must be kept in view. Thus in the choice between consumption and income as the basis of taxation as well as in deciding upon the degree of progression, not just fairness but also the impact on economic efficiency has to be taken into account.

d. Where the criteria of equity and efficiency point in different directions, there would have to be compromises. Taking into account all the relevant aspects of equity and also the requirements of preserving economic efficiency would result in a complicated system. While it might be theoretically very appealing, its complicated nature would pose serious administrative problems. If a proposed tax structure cannot be effectively administered because of its inherent complexity, its theoretical merits would be of no avail, because what counts is the tax system as it operates. Administrative ease and simplicity are, therefore, important requirements.

It can, then, be stated that a sound tax system should strive to satisfy the criteria of administrative ease and simplicity, fairness (equity among tax payers) and economic efficiency. Where these criteria conflict, there would have to be reconciliation, but no one criterion can be completely ignored; otherwise, it would be either unacceptable or unworkable.

e. This leads us to another desirable characteristic: the acceptability of the tax system. A tax system cannot be satisfactorily implemented unless it is generally acceptable to the target taxpayers i.e. taxpayers towards whom the tax system is targetted. The degree of willingness to comply with the tax law depends firstly on non-economic factors, such as, the social milieu and the degree of civic consciousness on the part of the population as well as the threat of prosecution in case of breach of law. Given the extent of willingness to comply, the acceptability of a tax structure or system will crucially depend on the perception of the population of its fairness - in its inherent structure as well as in the system as it operates, the reasonableness of its burden and its simplicity which lowers the cost of compliance. The manner in which the tax proceeds are used by the government also determines the willingness to bear the burden of taxation. The fairer the system is perceived to be, the higher, other things being equal, the burden the population will be willing to bear; similarly if the leaders of the government are perceived to be using the proceeds of the taxes productively and in the public interest, there would be greater general willingness to pay due taxes. Reasonable rates of taxes are also an important factor in determining the acceptability of the tax system.

f. Simplicity, certainty and stability are also essential characteristics of a sound tax system. A complicated tax system is difficult to administer, and to comply with at low or reasonable cost. It also spawns disputes and litigation because of differing interpretations of complicated provisions in the tax law. Tax structures and laws in several developing countries had become complicated for two major reasons: The first was the desire on the part of policy makers and their advisers to use the tax system for achieving many objectives besides raising revenue. Great trust was placed in the tax system in this regard in the post-war years until the seventies. This had led to the introduction of a plethora of incentive provisions into the tax laws. Since then, there has been a general disillusionment with the effectiveness of the provisions and a growing conviction that the provisions have made the tax law too complicated to understand and to enforce, leading to much disputation. Also, with many deductions and exemptions the rates of tax had to be higher in order to raise a given amount of revenue.

2.3 The second reason why the tax system had become complicated and difficult to enforce was the desire strongly felt in the post-war years to make the direct tax system the main instrument for the reduction of economic inequalities. This had led to the introduction of highly progressive rates of income tax supplemented by a gift tax, a long-term capital gains tax and in some countries (as in India) a net wealth tax. Apart from the impact on incentives which these taxes exerted, the taxpayers began to look for loopholes to minimise the tax burden which they considered to be too high. Attempts at avoidance and evasion were countered by the enactment of additional provisions in law. With this process continuing on the basis of "hide and seek", the law got more and more complicated.

2.4 It must be recognised, however, that the various objectives alluded to above still require to be kept in view when simplifying taxes. The issue here is not the desirability of the pursuit of objectives such as economic growth, health and education for all and removal of poverty. Taxes, particularly direct taxes, are only one of the possible instruments available to the government to further these objectives. Expenditure policy, interest rate policy, restructuring of the legal framework, public distribution and public works programmes are among the other instruments at the disposal of the government. Any modification of tax provisions which reduces its simplicity, certainty or stability in order to pursue objectives other than the objective of raising revenue required by the public sector in an equitable manner should be undertaken only after carefully weighing the relative merits of alternatives instruments.

2.5 It would also appear that in India, the major and minor levies imposed by the Centre and the States together add up to a substantiated total burden which most people are unwilling to bear. In fixing the rates of any one particular tax, say, the stamp duty or property tax, the existence of and the rates of other related taxes are rarely taken into account. For example, the burdens of stamp duty and property tax are not taken into account in fixing the rates of income tax on rental income from house property, net wealth tax and capital gains tax. Besides, the impact of inflation on real tax liability is generally ignored with the result that the total tax burden often tends to rise inequitably.

2.6 Earlier, the choice between income and consumption as the basis of taxation was indicated as one of the basic questions to be solved, since a neutral poll-tax solution was rejected as unjust and unacceptable. It would have been ideal if one could reach income or consumption directly in all cases. If that were possible, income or consumption of the individuals (or households) would be directly measured and after making suitable modifications, the tax would be levied on the base so measured. The major problem in working out a practical scheme of taxation, especially in a developing country with a large population with low income/consumption, is that it is administratively too expensive - indeed, it is not even possible (because of, for example, lack of documentation) - to arrive directly at a measure of income in the case of the majority of people. If the base can be measured, for example a year's income, then a tax at an appropriate rate could be levied achieving just the degree of progression desired. Since income and consumption cannot be measured directly for the majority of people in India, the taxes are often levied on the sales of products by importers, manufacturers and domestic traders. These indirect taxes are inferior to the direct taxes based on direct measurement of income and consumption, because they cannot be calibrated according to the abilities to pay of the different taxpayers. Also, it is difficult to make them progressive with respect to income. Nevertheless, the major part of the tax revenue in India and most other developing countries is raised through such taxes. In this context two important questions arise: (a) how best to gradually raise the ratio of direct taxes to total taxes and (b) what is the best way of levying taxes on commodities and services, such that there would be least interference with efficient allocation of resources? It is also possible to vary the rates of taxes on different commodities, such that the incidence of the indirect taxes is at least mildly progressive with respect to consumption expenditure of different (per capita) expenditure groups i.e. the tax will form a larger proportion of expenditure for the higher expenditure groups. This would generally not mean that indirect taxes paid will be progressive with reference to income, because as the income of an individual or household rises, the proportion of consumption tends to fall. If, however, a progressive direct tax is levied, in addition to the indirect taxes, the total tax system will become progressive. In this sense, it can be stated that the larger the proportion of revenues raised through direct taxes, the more progressive a tax system can be made to be. This assumes that direct taxes are enforced in a fair manner, on all sections of the population liable to pay these taxes under the law.

2.7 The level of income (or consumption) at which an individual should become liable to pay a direct tax has always been a controversial point in developing countries. In developed industrial societies, with per capita income well above US $ 10,000 and with the major part of economic activity in the organised sector, the great majority of earners are made liable to pay income tax. In a developing country, with the majority earning low incomes and with the unorganised sector predominating, it is mainly the administrative consideration that has to determine the level of personal income at which income or consumption tax should become payable. That is, the main question to ask is: what is the level below which it would not be possible to enforce and collect the tax from earners in all walks of life? The second question to ask is: given the indirect taxes individuals are paying, at what level of income can one be asked to pay additional sums by way of direct taxes? Answers to these questions would indicate a fairly high multiple of per capita income as the appropriate level in India[3]. However, as economic development proceeds, and per capita real income rises, the direct tax system must bring within its net a larger proportion of the earning population. The design of the tax system must be geared to that objective.

Income vs Consumption As the Base of Taxation

2.8 Traditionally, income has been taken as a test of ability to pay (or index of potential welfare), and direct taxation has been mainly based on income, although to the extent that there were indirect taxes, consumption has been implicitly used as an additional base. In recent years, fiscal theorists have made a strong theoretical case for making consumption, instead of income, as the basis for direct taxation. The superiority of consumption for this purpose is said to arise on account of three major causes: (a) conceptual difficulties in defining and measuring income for tax purposes and the difficulty in applying the definition in practice, which often lead to horizontal inequity (b) whereas the income tax is biased against saving, a consumption based tax is neutral - unlike the income tax, a consumption tax does not reduce the rate of return on saving[4] and (c) the complications and iniquities caused by inflation, under the income tax, which cannot be easily or fully remedied.

2.9 Consumption indeed has several merits as base of direct taxation, except that income that is not consumed during life time will escape taxation. However, no country in the world has thought fit to switch over to taxation of consumption. This is partly because of the tremendous and rather long-lasting transitional problems involved. But the main cause is the difficult prob-

---

3. Contrary to this, let us stipulate that the income tax threshold should be fixed at Rs. 10,000 per year at today's prices. It would be almost impossible to collect income tax from the millions of unorganised, self-employed workers, traders and producers who would be earning Rs. 833 a month or somewhat more. Also , as this might represent family income, and some indirect tax will be paid out of it, there may be little justification for an additional direct levy at a monthly income level of Rs. 833.

4. This statement applies without qualification to a proportional tax. If the tax is progressive, higher consumption in the latter part of life would be subjected to higher rates and this may weaken the incentive to save. However, if there is no taxation of inheritance or estate passing on at death, the consumption tax still has an advantage over an income tax.

lem of determining the annual consumption of each assessee, which would call for far more information than the determination of income. Thus records must be kept and checked of not only current transactions, such as flow of income and expenses of production, but also all capital transactions, such as borrowings, and sales and purchases of assets. The taxpayer will feel unduly burdened by being required to maintain a record of not only what he is earning, but also how he is living. Besides, a switch over to the consumption basis in personal taxation would require a suitable change in the basis of taxation of corporate profits and that will create complications in the international taxation of company income. The Indian experience with administering a personal expenditure tax confirmed fears that the administration of an expenditure tax was beset with almost insurmountable problems although it would be true to say that the degree of compliance was made low by clamping a progressive expenditure tax on the top of a highly progressive income tax. The Study Group on Taxation Expenditure, appointed by the Government of India towards the end of 1985, came to the conclusion that "the administration of a universal, classical type of expenditure tax would be extremely difficult even in an industrial country. In a developing country, such as India, given the large share of cash transactions, the fact that a substantial number of taxpayers do not maintain proper accounts and the limited capability of the tax administration, the administration of a full-fledged expenditure tax would simply not be feasible".[5]

2.10 The introduction of an expenditure tax in place of the income tax may be ruled out. However, it would be useful to consider briefly the inherent defects of a progressive income tax, pointed out by the proponents of an expenditure tax so that our reform proposals in relation to direct taxation may be so formulated as to have a simple system which at the same time would minimise the more serious (inevitable) shortcomings of a real world income tax.

Definition of Income and Equal Treatment of Equals

2.11 If equitable taxation should be in accordance with the capacity to pay of the taxpaying unit[6], and if income is to be taken as a measure of the capacity to pay, it must be so defined for tax purposes as to reflect adequately the potential economic welfare of the individual concerned, i.e., the capacity he has to spend during a year without affecting his net worth as at the beginning of the year. This means that the definition must be comprehensive enough to include all accruals of spending power. The conventional definition of income does not do so. Ideally, we need a comprehensive definition of income for tax purposes. Such a definition of income would include, apart from gifts received,

a. all earnings including labour, investment and business income net of costs of earning and depreciation;

b. net accrued capital gains i.e. net increases in the value of capital assets owned;

c. value of services or utility of non-business assets owned net of costs of maintenance and depreciation;

d. imputed value of the services rendered by the members of the family; and

e. casual receipts like lottery prizes.

2.12 The conceptual basis of the definition is clear:the definition equates income to consumption plus change in net worth. It is not possible, in practice, to measure satisfactorily all the elements included. First, imputation of proper values to items of income in kind flowing from non-business assets and services rendered by the members of the family unto themselves is almost impossible and therefore, they have to be left out of the definition. This is not, however, considered a serious problem except for house

5. Study Group on Taxation of Expenditure - Final Report, Government of India, Ministry of Finance (Department of Revenue), 1987, p. 121.

6. This could be an individual or a household. Our discussion will be with reference to an individual tax payer.

property. Second, in regard to changes in the present value of all assets owned by an individual, problems arise when they are not normally marketed. Two such cases may be mentioned: (i) the change in the current value of pension rights; and (ii) the change in the value of the assets of closely owned businesses. Third, even when market values are known, taxing an increase in capital value on the basis of an accrual instead of a realization basis will create hardship. Fourth, under a comprehensive income tax, strictly speaking, the pro-rata share of each shareholder in the undistributed profits of companies should be allocated to him and included in his taxable income. This cannot be done for reasons which are well recognised. Fifth, even in the absence of inflation, it is difficult to accurately measure economic depreciation. Since depreciation allowance has to be granted on the basis of rough estimation, the measurement of business income is at best an estimate: the true magnitude cannot be known.[7]

2.13 If the pro-rata share of undistributed profits of companies cannot be taxed directly in the hands of the shareholders, the introduction of a personal income tax will lead to the formation of incorporated entities wherein large undistributed profits would be retained to avoid tax. The intention would be to take profits out in course of time in the form of capital gains. To prevent such means of avoidance, a tax has to be imposed on the profits of corporations. This leads to the phenomenon of the so-called double taxation of dividends, which apart from the extra burden placed on equity holders, creates a bias towards debt finance. Further complications that arise because of the progressive rate schedule will be discussed later in the Chapter.

Income from Owner Occupied Houses

2.14 The real income flowing from non-business assets such as consumer durables has to be 'left out for administrative reasons and perhaps could be ignored. But it would not be proper to leave out the real income or utility flowing from owner occupied houses, because rental income from house property has to be included in taxable income. There would be taxpayers who would be renting their houses and living in rented houses in other places for reasons of business or for some other reason. As against this, those taxpayers who live in their own houses do not have to pay rent. The two groups would be treated equally only if the imputed income from owner occupied houses is included in taxable income. But imputation of income is not easy when a house has not been rented at all or for a long time. Also, if in course of time rents rise substantially, the imputed income might become a large part, or exceed, the other income of the owner-occupier. Hence a neat solution is not possible, and often the income from owner occupied houses is not subjected to tax. Thus the comprehensiveness of the definition of income is further eroded.

Problems with A Progressive Income Tax (i.e., with A Progressive Rate Schedule)[8]

2.15 Certain problems inherent in a progressive income tax regime are discussed below:

a. The taxpaying unit

We have so far taken the individual as the appropriate tax paying unit and have dealt with the problems of measuring his income. Many would, however, hold the view that a nuclear family should be the unit which should be asked to pay tax according to its collective capacity. This proposition is based on the contention that the family members share costs and becity of the taxpaying family is to be measured, the incomes of all the members would have to be aggregated. In effect this would mean that the wife's income should be added to the husband's. Women, particularly working women, however, would like to be treated as

7. Estimation is required also in relation to valuation of change in inventories.

8. Formally, an income tax with an exemption limit and a single tax rate above the exemption limit is also a progressive tax but suffers from the problems to be discussed here only to a small extent. Such a tax will be discussed later.

independent entities and not as appendages to their husbands. Moreover, when a wife's income is added on to her husband's, the first slab of her income will in effect get taxed at the marginal rate applicable to the husband. This acts as a disincentive to her to take up remunerative work. This problem would not arise if the tax is proportional over a common exemption level for a family. With a progressive rate schedule it seems unjust to ask the second earner (wife usually) to start paying tax at rates determined by someone else's income. Those who argue for the combined taxation of the husband and wife wish to apply the rules of equity as between families and assume that husbands and wives are willing to share equal tax liabilities and the residual incomes. However, this may not be, and often is not, the case in practice.

On the other hand, if the incomes of a husband and wife are taxed separately, much discrimination arises between a single earner family and two-earner families under a progressive rate schedule with separate exemption levels. Families with the same income can have widely differing tax liabilities. Thus one finds that under a progressive rate schedule of income tax, it is not easy to find a solution to the equitable treatment of families combined with an acceptable treatment of the incomes of spouses in two-earner families. Some solutions have been attempted such as the quotient system in France and the use of different schedules for joint and single returns in USA; however, apart from the fact that they introduce complications, they also have other shortcomings. [9]

b. The time period of measurement

Income is a flow; it has to be measured per unit of time. Since a year is the normal accounting period for governments, the annual income is taken for calculating the tax. Under a proportional income tax, the choice of accounting periods of different durations would not make any difference to total life-time income tax liability. But a progressive income tax discriminates against those incomes fluctuate widely as against those who have steady income, if life-time tax liabilities are compared. The latter will pay a lower rate of tax over life-time. An earner whose major part of life-time income is concentrated in a few years, e.g., an actor, a dancer, will be paying a much higher rate of tax than a steady-income earner like a salaried person if the rate of tax is calculated as the ratio of life-time tax to life-time income. Since life-time averaging is an administrative impossibility, spreading over of the high incomes of artists, etc. over a few years only is allowed. The steeper the progression, the more unjust (generally) the system becomes as between those with fluctuating incomes and others with steady incomes, with life-time incomes being the same.

c. Treatment of capital gains and corporate profits under a progressive rate schedule

Thus we see that a progressive rate schedule of income tax creates additional problems while exaggerating the inherent weaknesses of the choice of income as the base. Two other rather intractable problems caused by the introduction of the progressive rate schedule may be pointed out. The first relates to the treatment of capital gains. Although many laymen do not often think so, capital gains are as much income as any other beneficial receipt; only it would be difficult and unfair to tax them on the basis of accrual. They have to be taxed on the basis of realization. However, taxing on the basis of realization encounters the problem of "bunching": often gains accruing over a number of years are realized in one year, and if the gains are fully included in that year's taxable income, under a progressive

9. For a discussion of this issue see, for example, O.E.C.D., How Direct Taxes Affect Individuals and Couples: Old Values and New, Paris, 1977.

rate schedule, they would be taxed at a higher rate than they would have been, had the gain in each year been taxed as part of the income of that year.[10] There is no administratively feasible, satisfactory solution to this problem. Some kind of averaging of the gain over the period can be thought of, or long-term gains could be taxed at a lower rate or only a portion of the gain may be added to income. However, all these are second best solutions.

The second intractable problem arises in relation to taxation of corporate profits. It was pointed out earlier, that, if there were no tax on corporate profits, there would be a tendency to convert all businesses into corporate entities in order to avoid personal taxation through retention of profits. However, if there is a separate corporate profits tax, as in India, it falls on both distributed and undistributed profits. But equitable treatment requires that distributed profits at least must be taxed even in the hands of the company at the marginal rates applicable to the individual shareholders. This is not easily done. Dividends are also made taxable in the hands of the shareholders, presumably because it is held that a company is a separate entity and because generally the rate of corporate profits tax is lower than the top marginal rate of personal income tax. This tax regime, however, leads to double taxation of dividends which results in a high tax burden on investment income and a corresponding reduction in the rate of return on saving invested in equity capital. Attempts have been made in some industrial countries to mitigate this burden through systems of "partial integration" such as the tax credit or imputation system and the split-rate system. These, however, are complicated and lack the simplicity of the classical system. If the top marginal rate of personal income tax and the rate of the corporate profits tax are made equal, dividends could be made exempt in the hands of the shareholders. But even this will not be a satisfactory solution because many shareholders would be subject to lower marginal rates.

2.16 We may conclude, that, in practice one has to live with a far from comprehensive income tax levied mainly on the basis of realization, and not on the basis of accrual. Furthermore, measurement of net business income cannot be accurate because economic depreciation can only be a rough estimate. In these circumstances, the introduction of a progressive rate schedule increases the degree of horizontal inequity and creates complications in the treatment of capital gains, family income and corporate profits. Progression is desirable for the purpose of reducing economic inequalities. However, if income cannot be or is not defined comprehensively and all of it is not captured for tax purposes, among those who have equal capacity, some will be affected more harshly than others.

Income Tax and Economic Incentives

2.17 A tax on income is in a sense a subsidy on leisure. It tends to induce the taxpayer to substitute leisure (or pleasurable activities) for income-earning work. Similarly, a tax on income tends to induce the taxpayer to substitute consumption for saving in so far as it reduces the rate of return on saving by driving a wedge between the rate of return on investment and that on saving. The strength of this effect depends on the degree of responsiveness of saving to changes in net interest rate. Since an income tax, particularly one with a progressive rate schedule, discriminates against fluctuating incomes, if the law provides for only limited offsets it would also tend to discourage risk taking. Thus, the income tax tends to make the taxpayer substitute leisure for consumption and an easier life for work, saving and risk-taking. As against this substitution effect, there could be income effect: by reducing disposable income, the income tax might induce the taxpayer to work harder, save a larger proportion of income and to be more daring

10. If the gain arising in a year is realized in the same year, it can be included in that year's taxable income.

in an effort to maintain disposable income at a certain level. (There are other rewards for the accumulation of wealth besides the monetary return and the desire for these rewards strengthens the income effect.) *A priori*, it is difficult to say which effect will predominate. However, it can be said that the income effect depends on the average rate of tax and the substitution effect depends on the marginal rate of tax. Hence, for economic efficiency reasons it may be desirable to have a structure with a relatively high average rate and a relatively low marginal rate. It would seem reasonable to assume that under a moderate flat rate tax, the income effect is likely to be stronger, whereas under a progressive rate schedule, the substitution effect might predominate as the higher marginal rates are approached[11]

2.18 It was pointed out above that the impact of the income tax on the incentive to save is dependent on the responsiveness of savings to interest rate. There is a school of thought which believes that saving essentially depends on the level of one's (disposable) income. Households and individuals with higher incomes tend to save a larger proportion of income. The income tax by reducing disposable income reduces the ability to save of the taxpayers, if not the willingness to save. The more progressive the tax, the greater the fall in household savings, because those with higher incomes generally save a higher proportion of their income. This is an important point to keep in view, given the fact that governments do not generally save out of their tax revenues. And if the tax falls differentially on different forms of savings and investment, as the real world income tax often does, it would distort the allocation of savings in the economy (of course, some of the allocative effects might be considered socially desirable). Thus, in practice the distortionary effects on the allocation of savings and the impairment of saving capacity may be more important than the possible adverse effect on the willingness to save.

2.19 Until the 1980's, highly progressive income tax rate schedules were common, combined with fairly high corporate profits tax rates. However, these co-existed with tax concessions in the form of exemptions and deductions for promoting savings, investment and various types of activities: Examples are deductions for savings invested in provident funds and insurance or in individual retirement accounts, investment allowance or investment credit, tax holiday and exclusion of income derived from certain activities like poultry farming. Taken together, these provisions, apart from complicating the law and eroding the base, created distortions. For example, the investment allowance was found to result in differing marginal rates of tax in different industries. Besides the incentive provisions, often tax shelters or loopholes were provided consciously or unwittingly. As illustrations, one may cite the full deductibility of house mortgage payments under the U.S. income tax law which also fully exempted imputed income from owner-occupied houses, and the full deductibility of interest payments by the taxpayer under the Swedish income tax which had a very high top marginal rate. Such deductibility in Sweden enabled the rich taxpayers to borrow money to buy appreciating assets which were sold later to reap capital gains taxable at lower rates. This was profitable because the effective rate of interest paid was low due to the high marginal rate of tax on income. All the incentive provisions and tax shelters taken together with the inherent shortcomings of an income tax on a non-comprehensive basis - which is all that is possible - resulted in an iniquitous system. Slow realization of this led to the demand for reform towards a broader base with lower rates. But the urge for reform would not have been as strong as it turned out to be but for the impact of inflation which led to further disenchantment with a highly progressive income tax.

The Impact of Inflation

2.20 Inflation also creates problems in income taxation. Mainly these are:-

11. This discussion assumes that loop holes for avoidance are not available and the taxpayer is not inclined to resort to evasion of tax. These two routes might well sustain incentives.

a. **"Bracket creep"**

Inflation magnifies the problem of making a progressive income tax operate in an equitable manner. As is generally known, with inflation, the exemption level and the bracket limits have to be suitably adjusted upward. Since this is not often done or not done promptly or adequately, taxpayers are pushed into higher tax brackets with a rise in their nominal incomes only, with no increase, or even with a fall, in real incomes. Bracket adjustment for inflation is, therefore, necessary with a progressive rate schedule; with a flat rate tax, only the exemption level needs to be indexed.

b. **Valuation of income from capital assets**

There is an even more difficult problem, that of measuring correctly capital income under conditions of inflation. If the value of the capital invested, such as bank deposits or bonds, depreciates in real terms because of inflation, the interest or return earned must be reduced to the extent of capital depreciation, before applying the indexed rate schedule. But this is not usually done, so that a taxpayer who has a bank deposit of Rs.10,000 and receives an interest payment of Rs.1,000 at 10 per cent has to pay tax on the Rs.1,000, even if inflation during the relevant year has been 10 per cent and the value of his bank deposit has depreciated by 10 per cent. If the depreciation in the value of this capital asset is to be taken into account for tax purposes, then real appreciation in other capital assets owned by the assessee, if any, should also be taken into account. It is difficult to do such adjustments for changes in the values of all capital assets owned, because that would involve estimation of accrued but unrealized real capital gains and losses. The assessees who are borrowers may gain through the fall in the real interest rate under inflation. As pointed out earlier, estimating economic depreciation is difficult even under conditions of price stability. With inflation, granting normal depreciation on the basis of historic or original cost becomes inadequate. Since there are several problems with current cost accounting, for partially taking into account the impact of inflation on the cost of replacement of productive assets such as machinery, often accelerated depreciation is granted, but the rates of acceleration have to be arbitrarily set. Thus, all in all, inflation makes the income tax fall unequally on, and discriminate among, incomes from capital of individuals with different portfolios and capital incomes from different sources or different types of economic activity[12]. Such discrimination will mostly be unintended and inequitable.

There is no doubt that taxpayers whose capital income comes mostly from non-appreciating capital assets (e.g. bank deposits, units of the Unit Trust of India) are treated most unfairly by an income tax under conditions of inflation, and also that investment in such assets is discouraged.

c. **Capital gains and "bunching"**

Finally, inflation further complicates the problem of adequate and equitable treatment of long-term capital gains. As pointed out earlier, with taxation of gains on realization basis, one needs to recognise the "bunching" of gains. Because of inflation, the bunched gains have to be deflated i.e., gains have to be indexed. This means, strictly speaking, the purchase price of every asset sold on which long-term gain or loss is made must be converted to the price in the year it is sold. Thus, the date of purchase must be recorded in every case and must be available for verification, if necessary. Apart from such inconvenient procedure, it is not clear if capital gains should be fully indexed while other types of incomes are not. In practice, some simple method of ameliorating the impact of inflation and of bunching is resorted to, such as taking only half the gains into account or fixing a flat rate for long-term gains. It may be noted that under a flat rate income

12. We do not deal here with the consequences for income tax of hyperinflation.

tax, bunching would not create a problem in most cases, once the exemption level is indexed.

2.21 It is obvious that the higher the degree of progression, generally speaking, the greater the distortions and inequities caused by the income tax with a progressive rate schedule. Partly with a view to mitigating such undesirable effects, as noted earlier, many concessions and deductions as well as incentive provisions were introduced in the progressive income tax system in most countries. Often while mitigating some undesirable effects, as also noted earlier, these mitigating provisions create other distortions. For example, if the interest on government's borrowing instruments is made tax free, that would in a way take care of the loss due to depreciation in the value of the bond due to inflation; however, funds would flow into the government sector at the expense of investment in other sectors (e.g., company debentures), and assessees in different marginal tax rate brackets would gain differentially. Furthermore, government agencies borrowing on the basis of tax free instruments would pay a lower rate of interest than other borrowers in the market. Hence at the margin, they could profitably undertake projects that would yield a lower rate of return than investors in the other sectors borrowing at higher rate of interest. That again would be a distortion from the economy's point of view. Similarly, as mentioned, several concessions to business investment have been shown to result in widely differing marginal rates of tax on different industries. In view of all these difficulties, problems and shortcomings of a highly progressive income tax co-existing with multiple concessions and deductions, the opinion of fiscal experts as well as informed public opinion has tended to move in favour of a moderately progressive income tax with a broad base, providing only for the minimum of deductions. Pure theorists would favour a moderately progressive personal expenditure tax because of the inherent defects of the income tax; however, given the administrative and other difficulties involved in implementing the personal expenditure tax, in practice, in countries where tax reform has taken place during the 1980s, reform has taken the form of changes in the income tax in the directions pointed out above.

The Taxation of Net Wealth

2.22 It was argued by some fiscal theorists, in days before the expenditure tax began to find favour, that a tax on net wealth would be a useful supplement to the income tax. Since the real world income tax cannot reach or tax adequately all forms of income, it would be desirable to make up for the deficiencies through a tax on capital. But this could be done better perhaps through a tax on estate passing after death. Even if that was correct, another argument for an annual wealth tax was that possession of wealth signified additional capacity to pay; it gave the owner economic power, a sense of security and higher capacity to take risks. This is true but it is not easy to quantify this capacity: it is not clear how wealth should be valued to reflect such additional capacity. The market value or book value will not adequately represent the present value of future earnings. Next, on efficiency grounds, it has been argued that a tax on capital would induce a more productive use of assets. Thus the possession of jewellery and unbuilt or unfarmed land would be penalised and the burden of the levy could be reduced by shifting capital to areas of higher return. However, if this objective is to be achieved, it is the original cost of investment rather than the market value that should be taken as the basis of the levy. This is because market value is often influenced by the prospect of capital appreciation representing capitalization of expected higher future earnings. Someone who has invested in the shares of a good company will typically receive a low ratio of return to market value than another who has invested the same amount in a bank deposit. Should we induce the former to move out of investment in equity? Another argument in favour of the annual net wealth tax is based on administrative grounds. It is argued that the levy of this tax would help in the better enforcement of income tax, because the information on wealth holding could be used to cross-check the information on earnings. Lastly, it could be argued that inequalities should be reduced by directly tackling the most important source of inequalities - the concentration of wealth in the hands of a relatively small proportion of the population. This has probably been the most important motive for the levy of the net wealth tax in countries ruled by labour or socialist parties.

2.23 The real justification for levying an income tax with a highly progressive rate schedule has also been the desire to reduce economic inequalities. We have seen how an income tax with a highly progressive rate schedule creates horizontal inequities as well as economic distortions. A political decision may be taken that the overriding objective should be to reduce inequalities and that, therefore other side effects could be ignored. But before such a decision is taken, the impact of these other effects must be fully weighed.

2.24 It has been pointed out that the income tax is biased against saving, because it involves double taxation of savings. That is why a direct tax on personal consumption has been suggested as a substitute for the income tax. As the Meade Committee clearly brought out, taxing only consumption is roughly equivalent to excluding income from capital from the base of the income tax.[13] Therefore, taxing income from capital through an income tax and subjecting the capital itself to an annual tax (which amounts to an additional tax on income from the capital at varying rates depending on the rates of return) is against the expenditure tax principle which stresses neutrality towards saving. While the expenditure tax taxes saving only once, when it is spent, a combination of income and wealth tax, so to speak, taxes it thrice. One could counter by saying that reduction of inequalities is such an important political objective that one has to accept some weakening of the incentive to save among the rich. A society can take such a view; however, taxing wealth with an annual levy sufficiently heavily to make a dent on inequalities and granting concessions under the income and corporate taxes to promote savings are contradictory policies.

2.25 No doubt the return on wealth could be used to cross-check the information given in the income tax return. This administrative convenience must be set against the severe problems encountered in equitably administrating the tax on net wealth. In one sense, the information which must be presented by the assessee and monitored by the assessing officer is even more than that needed for administering a personal expenditure tax. This follows from the identity:

Income = consumption + increase in net worth.

For measuring consumption (which by definition is realized), one has to take realized income and subtract from it the realized increase in net worth. But in order to measure net worth at the end of a year, if the net worth of the previous year is known, the realized and unrealized change in net worth during the current year must be measured. This not only means that the assessees must maintain and produce information regarding all incomings and outgoings on capital account and accrued but unrealized changes in the values of assets, but also that tax authorities should have the means of verifying the statements made by the assessees in this regard and thus monitoring changes in realized and unrealized values of assets and liabilities.

2.26 Valuation of assets and checking the veracity of claims regarding liabilities have proved to be intractable problems. Measuring net worth involves working out the current market value of assets. This is difficult, if market quotations and prices are not available. Thus, important items of wealth such as houses, particularly owner-occupied houses, works of art, unquoted shares of private limited companies and assets used in business by partnerships and proprietorships cannot be properly

13. The Structure and Reform of Direct Taxation: Report of a Committee chaired by Professor J.E. Meade, (1978), George Allan and Unwin, London. It can be easily shown that under a proportional income tax, exempting saving is equal to taxing, saving and exempting the return from it.

valued. So, in practice the net wealth tax becomes an inequitable and distorting levy.

2.27 One of the important objections raised by two British fiscal experts, Kay and King, is that, for many practical reasons, the present value of pension rights cannot be included in the net worth tax base.[14] This is a source of major inequity.

2.28 Those who had advocated a combination of income and net wealth taxes with progressive rate schedules had not anticipated that inflation would be a persistent, if not a permanent, problem in modern economies, more so in the developing than in the developed ones. The impact of inflation on the operation of the wealth tax is superimposed on its impact on the operation of income tax. To minimize this impact, the exemption level and the bracket limits must be indexed for inflation. If not, the combined impact could become quite iniquitous and detrimental, particularly when some assets cannot be adequately valued and others are completely left out because valuation is well nigh impossible, as in the case of valuable works of art.

Indirect Taxes

2.29 In the combined tax revenues of the Centre and the States, taxes on commodities and services, generally called indirect taxes, account for 85.4 per cent. Taxes on commodities form 80.3 per cent of the Central Government's gross tax revenues. The economic and re-distributive impact of the indirect taxes is therefore of far greater importance in our country. Direct taxes were taken up for discussion first only because in a sound, progressive tax system, revenues from direct taxes should form a substantial, if not a major portion of tax revenues, and the aim of Government is to raise the ratio of direct taxes to total tax revenues as well as to GDP.

2.30 The major purpose of indirect taxes is to raise revenues for the government on the basis of the consumption of individuals (households). This proposition is based on the assumption that the incidence of indirect taxes except taxes on exports will ultimately rest on final users of commodities in the country, though the government will be collecting the taxes from producers and/or traders.[15] Indirect taxes could be used for achieving other objectives. Keeping aside other objectives such as re-distribution, it could be argued that the indirect tax structure should be such as to have the least impact on the pattern of consumption by individuals. The basis for this argument is that inducing consumers to change the pattern of their consumption involves loss of welfare, just as inducing them to alter their choice between work and leisure or between consumption and saving does. The so-called optimal theory of indirect taxation tries to identify a pattern of commodity taxation that would generate the least loss of welfare, given the revenue that the government seeks to raise through this means. The optimal theorists obtain the solution which says that rates of taxes on different consumer goods should be fixed such that the demand for them should be reduced proportionately. Since the price elasticities of demand for different consumer goods are different, this solution would require multiple rates and that the commodities the demand for which is most inelastic should bear the highest rates. When the demand for a commodity is highly inelastic, its consumption will be reduced by a tax to the least extent and hence the loss of welfare will be small. But the solution which this theory suggests cannot be applied in practice because, firstly, it is not possible to estimate the (changing) elasticities of demand for in-

---

14. 14. Kay, J.A., and King M.A., The British Tax System, Fourth Edition, Oxford University Press 1986, p. 77. It is true that pension rights would get extinguished if the person concerned dies. But then similarly, the value of capital assets might collapse at a later date.

15. 15. To the extent households undertake non-business investment, e.g., building a residence, they may bear some burden through such investment in addition to the tax they pay through consumption.

numerable commodities bought by consumers (final users). Secondly, the type of indirect tax system which the optimal tax theory suggests would be a multi-rated retail sales tax covering all consumer goods and services; the entire burden will be concentrated at the retail level and it will be impossible to administer the tax with such a number of rates. It will be also difficult to administer a value added tax - which is a superior alternative to the retail sales tax - with multiple rates.[16] From the point of view of raising revenues, therefore, it is best to adopt a structure which will leave the relative prices of inputs and consumer goods unchanged, i.e., a tax structure or tax that would least disturb the choices of consumers and producers. As the Indirect Taxation Enquiry Committee Report (1978) pointed out, the bulk of the revenue could be raised through such a "neutral" tax.[17]

2.31 There are, of course, other objectives that might be stipulated for indirect taxes. First, it is generally desired that indirect taxes must fall more heavily on the better off consumers. This re-distributive objective would justify some differentiation in rates. That would mean a departure from neutrality: one needs to work out here a compromise between the objectives of efficiency and equity. Second, the State, acting on behalf of society, might desire to discourage the consumption of harmful commodities such as alcohol and levy higher rates on those commodities. And third, higher rates of taxes on some raw materials could be levied to induce economy in the use of those materials in production or consumption for reasons of conservation and protection of the environment. Excises could be a useful instrument in dealing with "externalities" in the form of social costs.

2.32 Departures from neutrality must be justifiable and intended. From looking at the tax structure in several countries, one could make the inference that those who advised governments to levy multiple rates on different commodities either had assumed that the State had the right to interfere with the pattern of consumption as it liked and could ignore any loss of welfare involved, or were unaware that unnecessary and unintended interference in the form of tax-induced changes resulted in loss of welfare that could and should be avoided. Similarly, unintended changes in relative factor prices that would affect producers' choice of location and of factor mix should be avoided on efficiency grounds.

2.33 The criterion of neutrality would suggest that different imported commodities should be subjected to the same rates of taxes as the corresponding domestic products. Here again, departure from neutrality could be justified on the basis of a non-revenue objective, namely, giving some degree of protection to domestic industry especially in a developing country. However, the protective import duties should be just sufficient to give a reasonable degree of protection. They should not be fixed at high levels merely to raise revenue. While raising import duties may be a convenient way of increasing revenues, the adverse impact of high duties on the efficiency of resource use in the economy would be disastrous in the long run.[18] It is also to be noted that widely varying rates of protective import duties would lead to inefficient allocation of resources in the economy. The spread of protective import duties must be moderate and the differentiation in rates must be deliberately made for achieving specific economic and social goals.

2.34 The principles of indirect taxes that we have recapitulated above are by now well accepted not only by fiscal theorists but also by policy makers in most countries which have reformed or are trying to reform their tax sys-

---

16. See in this connection J.K. Shirazi and A. Shah, "Introduction : Tax Policy Issues for the 1990s", The World Bank Economic Review (1991), Vol.6, No.3.

17. Government of India, Indirect Taxation Enquiry Committee, (Jha Committee) Final Report, Ministry of Finance, 1978, p.119.

18. Exceptions could be made if for strategic or social reasons, self-sufficiency is to be aimed at or vulnerable sections have to be protected; e.g., defence, industries and agriculture.

tems. The general theory and principles of indirect taxation have already been explained in some detail by the Jha Committee (1978). We have outlined the principles briefly only as a background to the proposals for reform we shall be making. These proposals will be in line with the direction of reform initiated with the introduction and extension of Modvat and with the proposals for reform expounded in the Long-Term Fiscal Policy document.[19]

2.35 The basic criteria underlying our reform proposals are:

a. The unity of the common market must be preserved. This means that taxes should not be barriers to the movement of factors and trade within the country and that they should not distort location decisions.

b. Tax cascading should be avoided, i.e., indirect taxes should not be levied in such a way that prices of the taxed commodities would rise by more than the revenue going to the government.[20]

c. The system of indirect taxation should not lead to unintended changes in the relative prices of inputs. Strictly speaking and in the long run, capital goods should also be governed by this rule, namely, the effective price of capital should not be increased by taxes on it.

d. If indirect taxes taken together are to result in a desired degree of progression with respect to consumer expenditure through their impact on the relative prices of final goods, it should be possible to control and measure their incidence. If indirect taxes fall on final products as well as raw materials and intermediate goods, if there are multiple levies on the same products, if multiple rates are used and if no set-off is provided at later stages of production and sale for taxes paid at the earlier stages, then the pattern of incidence on final commodities would be uncontrolled and fortuitous. Additionally, there would be cascading and unintended changes in the relative prices of inputs. It is, therefore, necessary to ensure that multiple levies by different authorities, if unavoidable, should be only at the final stages and a set-off must be provided at every stage for tax paid at the earlier stage, if any.

2.36 The constitutional division of taxing powers in a federal country makes it often more difficult to construct a simple and rational system of indirect taxes there than in a country with a unitary constitution. If the division of tax powers between the different levels of government does not create complications[21], or if the constitution is unitary, the indirect tax system should, ideally, consist of the following components:

a. A comprehensive value added tax (VAT) covering sales of most goods (except those by agriculturists) and many services, should be levied at a single rate or at a few rates. Tax theory and international experience indicate that this constitutes the best "neutral" way of raising the bulk of the indirect tax revenue. A single-rate tax is the easiest to administer; a tax with two or three rates would be manageable. The VAT will apply to domestic products as well as imports, but exports will be exempt.

b. Selective excise duties with a limited number of rates should be applied to mostly consumer goods in order to differentiate the burden falling on groups of consumers at different levels of income and to discourage the consumption of certain goods. Excises could also be levied on certain raw materials or inputs, if their use is to be discouraged, e.g., petrol and diesel. The excises will be outside the VAT system and will not be entitled to rebate since the

19. Long Term Fiscal Policy , Government of India, Ministry oFinance , 1985.

20. See Interim Report of the Jha Committee (1977), pp.6-9 for an exposition of the phenomenon of cascading.

21. It is possible to devise a system of division of tax powers and sharing of tax revenues which will not come in the way of constructing a rational indirect tax system. This task has been largely accomplished, for example, in the Constitution of the Federal Republic of Germany.

idea is to raise the prices of the concerned goods. By introducing the rate differentiation through a separate excise, the administration of the *main tax, viz.,* VAT, is *prevented from becoming complicated.* Corresponding to the excises, countervailing duties should be imposed on imports, which also would not be entitled to rebate under the VAT.

c. The third element would consist of protective import duties. As indicated earlier, the level of protective duties must be just high enough to yield a reasonable degree of protection, and the spread of the duties must be moderate so as not to cause misallocation of resources in the economy. Higher taxation of imports for re-distributive and regulatory purposes would be achieved through the countervailing duties.[22]

d. If the VAT does not cover services, a separate tax can be levied on selected consumer services such as entertainment and restaurant services. Services that enter into production as inputs must not be subjected to tax unless the tax is rebateable against a VAT. Thus the duty on electricity sold to (taxable) producers in India is a "bad" tax, since it cannot be rebated against the Modvat or sales taxes. The same is true of the goods tax imposed on transport vehicles used to carry inputs.

2.37 It is clear that cascading type of sales taxes or across-the-board manufacturing excises cannot form part of a sound indirect tax system. In addition to the VAT, if there is to be a sales tax, it should be in the form of a retail sales tax. The VAT is best administered by the Central Government. In a federal country, the arrangement could be that the proceeds of a VAT levied by the Central Government would be shared with the states and that in addition the states could levy a retail sales tax falling mostly on their respective residents. In order to make the administration of the sales tax easy and simple and to avoid diversion of trade, it is best to levy the tax at one or two rates with minimum inter-State differences in rates. If the centrally administered VAT does not cover services, the States could be empowered *to levy a tax on selected consumer services such as entertainment and restaurant services.*

2.38 In federal countries, inter-State trade and commerce is assigned to the federal or Central Government. If only a VAT is levied covering imports, manufacturing and trade (with small traders being exempt), there will be no special tax on inter-State trade as such. Inter-State sales and intra-State sales will be treated on par as the tax paid on any sale to a taxable entity will be refunded at the subsequent stage. If the Central Government does not levy a comprehensive VAT, but, say, only a VAT at the manufacturing stage and the States levy a retail sales tax, then inter-State sales by *manufacturers* would be covered by the Central Government VAT and would be treated on par with intra-State sales by manufacturers, and inter-State sales between traders will not be taxed (since retail sales taxes will fall only on sales to final users). Both the above systems would be satisfactory from the points of view of efficiency and inter-State equity.

2.39 If the States in a federation are empowered to levy first-stage or multi-stage sales taxes, the questions will arise as to how the Central Government should use its power to regulate inter-State trade and whether it should introduce a tax on inter-State trade as a supplement to taxation of intra-State sales by the States. In considering this matter, the guiding principles must be that there shall be no effective tax barrier to the movement of goods across State boundaries and that one State should not be empowered to pass on any part (or more than a negligible part) of the burden of its taxes to the residents of other States.

22. If the import of some goods is not to be allowed at all, it is better to ban their imports rather than clamp extremely high import duties.

3

LEVEL AND COMPOSITION OF CENTRAL TAXES

Tax Level and Revenue Growth - The Trends

3.1 By international standards, the level of taxation in India is fairly high. The ratio of the tax revenue of government (Centre and the States taken together) to GNP ("the tax-ratio" as it is called) currently stands at a little over 19 per cent (Table 3.1). For countries with similar per capita income, the average tax-ratio is around 12-13 per cent. At the time when the country launched its first Five Year Plan, the tax ratio was less than 10 per cent. Even in 1970-71 it was less than 12 per cent. While the ratio is still way below that of industrial countries, if tax ratios are regressed on per capita GDP, India stands above the "trend" line (Chart 3.1). Sustained efforts towards raising resources for the government through taxation in the last two decades have pushed up the ratio of taxation to its present level. However, the growth in tax revenue that underlies this impressive rise in the tax ratio has come about more through changes made in the base and the rates of the taxes from year to year than from an automatic increase in response to changes in incomes and prices. The increase is also accounted for, largely, by the rise in the level of commodity taxes consisting principally of the Union excise duties and customs at the Central level and sales taxes at the level of the States.

3.2 Of the tax revenues of the government (Centre and the States combined), roughly two-thirds (67 per cent) are collected at the Central level. The proportion seems to have remained steady over the years. The ratio of Central tax revenue to GDP has gone up from 8 per cent in 1970-71 to nearly 13 per cent in 1989-90 as the aggregate tax ratio has moved up from 13 per cent to 19 per cent during the same period (Table 3.2). Over the 20 years, 1971-90, Central tax revenues (gross) grew at the rate of 15.8 per cent per annum as against a growth rate of 13.8 per cent in GDP and 14.9 per cent in non-agricultural GDP. The growth has been faster during the 1980s than in the 1970s (16.2 per cent as against15.3 per cent vide Table 3.3). However, the buoyancy of the Central taxes with respect to GDP registered a decline, though slight, during the 1980s compared to the 1970s (1.2 as against 1.3 vide Table 3.4). Direct Taxes consisting mainly of income tax - personal and corporate - had a slower growth than that of non-agricultural GDP. During the entire period of 1970-71 to 1989-90, major direct taxes registered a growth rate of 14.4 per cent per annum, while non-agricultural GDP grew at the rate of 14.9 per cent (Table 3.3). The gap between the growth in direct taxes and that of non-agricultural GDP has widened during the 1980s (15.6 per cent as against 16.5 per cent).

3.3 Revenue from principal direct taxes collected at the Centre as a proportion of non-agricultural GDP has declined from 3.95 per cent in 1970-71 to 3.7 per cent in 1989-90. The decline has been sharper in non-corporate income tax (from 2.2 per cent to 1.9 per cent vide Table (3.5). Excise duties recorded a slower growth than direct taxes during the reference period of two decades as a whole but customs duties have grown steadily at more than 20 per cent during the period. As a result, the ratio of customs duties to GDP has gone up from 1.32 per cent in 1970-71 to 4.56 per cent in 1989-90. Union excise duties as a proportion of GDP have also increased but not to the same extent (4.4 per cent to 5.7 per cent, vide Table 3.2).

3.4 In the total gross tax revenues of the Centre, customs and excise duties taken together account for about 78 per cent while major direct taxes contribute less than 20 per cent (vide Table 3.6).

3.5 While the trend towards greater dependence on taxes on commodities is not peculiar to India, indeed it is common to developing countries in general, it is a matter for concern that the share of taxes on income particularly personal income tax has registered a sharp decline over the years and despite efforts to raise more revenue from these taxes, no appreciable improvement seems to have come about. On the other hand, customs duties having registered a decline in the 1960s have gone up steadily and now account for more than one-third of the total Central tax revenues. These trends were noted briefly in the Long Term Fiscal Policy document also and one of the policy aims set for the government in the LTFP was to raise the share of direct taxes in the total tax revenues of the Centre. This aim has not materialised.

3.6 While the dichotomy between direct and indirect taxes may not be very rational, concern at the trends depicted above arises from the fact that findings of studies on the incidence of indirect taxes suggest that the incidence of excise and customs is probably progressive across expenditure classes but is unlikely to be so if measured against income, as saving propensity is higher among the upper income groups.

3.7 Table 3.7 gives effective tax rates (tax paid as percentage of gross income) at different income levels measured in 1970-71 prices for selected years from 1967-68 to 1987-88. During these 20 years, several changes were made in the income tax provisions. These changes related to the exemption level, tax schedule and savings incentives in the form of exemptions, deductions and tax credits.

3.8 The figures in Table 3.7 show that as a result of all the changes taken together, the effective tax rates increased at all income levels (in 1970-71 prices) between the years 1967-68 and 1973-74, and subsequently declined for incomes above Rs.40,000 with a sharply marked decline for incomes above Rs.75,000. The highest effective tax rate for most income levels above Rs.40,000 was obtained for the year 1973-74 when the top marginal tax rates were the steepest. However, for income levels between Rs.10,000 and Rs.20,000, the highest effective tax rates were obtained in the year 1987-88.

3.9 Since the reduction in the marginal tax rates started after 1973-74, one could consider the trends since that year. It is seen that between 1973-74 and 1987-88, there has been a steady reduction in effective tax rates for income above Rs.40,000. While for incomes of Rs.10,000 to Rs.25,000, there was an increase in the effective tax rates, for an income level of Rs.30,000, there has been no significant change. These changes can be explained in terms of (a) significant reduction in top marginal tax rates, (b) inadequate inflation indexation and (c) increase in the marginal tax rates at lower end of the income scale.

3.10 That, there had been inadequate indexation even after allowing for tax relief is born out by the fact that for income levels between Rs.10,000 and Rs.30,000 (in 1970-71 prices) the effective tax rate has risen. For income levels between Rs.10,000 and Rs.15,000, the rise in effective tax rate has been more than 24 per cent. This has been so, in spite of higher tax relief in relation to gross income availed of by the low and middle income taxpayers.

3.11 It may be noted that the effective tax rate was still high in 1987-88 (46 per cent) at the income level of Rs.2 lakh (this corresponds to Rs.7.7 lakh in 1987-88 prices). Due to general optical illusion, it does not appear to be too high if the income is converted into 1977-78 or 1990-91 prices. See Table 3.8 which shows that at a level of Rs. 1 lakh in 1990-91 prices, the effective tax rate was only 20.2 per cent. It is also to be noted that if effective tax rates are compared for the years 1967-68 and 1987-88, the effective tax rate has risen for income levels between Rs. 10,000 and Rs. 1 lakh (in 1970-71 prices). For income levels between Rs. 10,000 and Rs. 25,000 the rise in effective tax rate has been as high as around 80 per cent. There was a reduction in the effective tax rate only for incomes above Rs. 2 lakh. It cannot be denied, however, that as compared with the situation in 1967-68 or 1973-74, the index of progressivity has declined from about 20 per cent to 16 per cent, while the average effective tax rate has increased from 13 per cent to 16 per cent.

3.12 The top marginal rate of income tax now applies to incomes above Rs.1 lakh which is equivalent to about Rs.18,500 in 1967-68. This is the result of inadequate indexation, which has raised effective tax rates at the lower end of the income scale. There would thus seem to be a case for raising the income level at which top marginal tax rate should apply and for more adequate indexation. Secondly, the various deductions given in the name of incentives, etc. result in differing degree of relief at different income levels.[23] It would be preferable to eliminate most of them so that a smooth degree of progress can be achieved. Thirdly, it should be pointed out that this analysis is based on income that is disclosed. The picture may look very different, if the burden of tax paid is calculated with respect to true income. If it is assumed that evasion is higher at higher income levels, then the degree of progression would be lower than shown here. However, it is believed that there is considerable evasion even at the lower end of the income scale. What must be specially attempted is to encourage and compel greater disclosure of income particularly at low and high income levels.

3.13 What seems needed for achieving this is not raising the marginal nominal rates as such but improving average rate and eliminating the deductions and tax shelters which abound in the personal income tax. Vertical equity of the tax system as a whole taking into account those falling below the taxable limit will improve substantially if the average rate of income tax could be raised and a larger proportion of income which is escaping the tax net at present could be brought under taxation. Equally urgent is to reform the system towards a more rational structure of indirect taxes with less reliance on customs duties than at present and a widened base of taxes on domestic goods and services.

23. Aggarwal, Pawan K., Bagchi, A. Das Gupta A., Pandey, Rita and Prasad, M.S., Income Tax Concessions for Savings, Housing and Foreign Exchange Inflows. National Institute of Public Finance and Policy (mimeo), 1991.

TABLE 3.1
Combined Tax Revenue Receipts of the Centre, States and Union Territories

(Rs. crore)

Financial Year	Gross domestic product at current prices	Combined tax revenue	Col. (3) as percentage of Col. (2)
1	2	3	4
1960-61	15254	1350	8.85
1961-62	16097	1543	9.59
1962-63	17212	1865	10.84
1963-64	19671	2325	11.82
1964-65	22981	2599	11.31
1965-66	24063	2922	12.14
1966-67	27389	3261	11.91
1967-68	32187	3456	10.74
1968-69	33943	3759	11.07
1969-70	37328	4200	11.25
1970-71	39708	4752	11.97
1971-72	42248	5575	13.20
1972-73	46473	6436	13.85
1973-74	56954	7389	12.97
1974-75	67039	9223	13.76
1975-76	71201	11182	15.70
1976-77	76536	12332	16.11
1977-78	87351	13237	15.15
1978-79	93880	15528	16.54
1979-80	102442	17683	17.26
1980-81	122427	19844	16.21
1981-82	143216	24142	16.86
1982-83	159395	27242	17.09
1983-84	186723	31525	16.88
1984-85	208577	35813	17.17
1985-86	233476	43267	18.53
1986-87	259055	49539	19.12
1987-88	294266	56976	19.36
1988-89	351724	66925	19.03
1989-90@	395143	76762	19.43

@Revised Estimates.

Source: Ministry of Finance, Indian Economic Statistics (Public Finance).

TABLE 3.2
Revenues from Taxes as Percentage of Gross Domestic Product (1970-71 to 1989-90)

Financial year	Corporation Income tax (CIT)	Income tax other than CIT	Wealth tax	Major direct taxes	Customs duties	Union excise duties	Total Central tax revenue	States' tax revenue
1970-71	0.93	1.19	0.04	2.17	1.32	4.43	8.08	3.85
1971-72	1.12	1.26	0.06	2.45	1.65	4.88	9.17	4.01
1972-73	1.20	1.35	0.08	2.63	1.84	5.00	9.70	4.15
1973-74	1.02	1.30	0.06	2.40	1.75	4.57	8.91	4.05
1974-75	1.06	1.31	0.06	2.43	1.99	4.82	9.43	4.30
1975-76	1.21	1.74	0.08	3.04	1.99	5.40	10.69	4.98
1976-77	1.29	1.58	0.08	2.95	2.03	5.52	10.81	5.27
1977-78	1.40	1.15	0.06	2.61	2.09	5.09	10.14	4.98
1978-79	1.33	1.25	0.06	2.65	2.61	5.69	11.21	5.29
1979-80	1.36	1.31	0.06	2.74	2.85	5.87	11.69	5.53
1980-81	1.13	1.18	0.06	2.37	2.79	5.32	10.76	5.41
1981-82	1.38	1.03	0.05	2.47	3.01	5.19	11.07	5.76
1982-83	1.37	0.98	0.06	2.42	3.21	5.06	11.10	5.95
1983-84	1.34	0.91	0.05	2.31	3.00	5.50	11.14	5.78
1984-85	1.23	0.93	0.05	2.21	3.39	5.36	11.29	5.90
1985-86	1.22	1.07	0.07	2.37	4.07	5.53	12.24	6.21
1986-87	1.21	1.11	0.07	2.39	4.41	5.56	12.66	6.42
1987-88	1.17	1.08	0.03	2.29	4.65	5.58	12.79	6.56
1988-89	1.26	1.22	0.04	2.52	4.53	5.40	12.75	6.42
1989-90	1.20	1.27	0.05	2.51	4.56	5.67	13.07	–

Note: Shares of Gift tax and other direct taxes which were also in force during the period are not shown as they were negligible throughout.

Source: Computed from Table 3.9

TABLE 3.3
Growth Rates of Central Taxes and Income 1970-71 to 1990-91

(Per cent)

Item	Average annual growth rates		
	1970-71 to 1979-80	1980-81 to 1989-90	1970-71 to 1989-90
Corporation income tax	14.42	17.15	15.79
Income tax other than Corporation income tax	12.76	14.83	13.80
Major direct taxes	13.25	15.61	14.43
Customs duties	20.96	20.03	20.49
Excise duties	14.10	14.31	14.20
Total tax revenue	15.29	16.22	15.75
Gross domestic product (GDP)	12.04	15.58	13.81
Non-agricultural GDP	13.33	16.50	14.92

TABLE 3.4
Estimates of Buoyancy of Different Taxes during 1970-71 to 1989-90

Item	Buoyancy with respect to GDP			Buoyancy with respect to NAGDP		
	1970-71 to 1979-80	1980-81 to 1989-90	1970-71 to 1989-90	1970-71 to 1979-80	1980-81 to 1989-90	1970-71 to 1989-90
Corporation income tax	1.317	0.949	1.060	1.157	0.877	0.966
Income tax other than Corporation income tax	1.054	1.140	0.889	0.923	1.052	0.808
Major direct taxes	1.182	1.028	0.970	1.036	0.950	0.883
Excise duties	1.224	1.066	1.069	1.075	0.987	0.974
Customs duties	1.594	1.492	1.521	1.393	1.387	1.385
Total central tax revenue	1.295	1.184	1.167	1.136	1.097	1.063

Source: Computed from Table 3.9.

TABLE 3.5
Revenues from Union Direct Taxes as a Percentage of NAGDP

Financial Year	Corporation Income tax CIT	Income tax other than CIT	Major direct taxes
1970-71	1.70	2.17	3.95
1971-72	1.97	2.23	4.33
1972-73	2.12	2.38	4.65
1973-74	1.92	2.44	4.49
1974-75	1.87	2.31	4.29
1975-76	2.03	2.93	5.10
1976-77	2.09	2.57	4.80
1977-78	2.33	1.91	4.34
1978-79	2.16	2.03	4.29
1979-80	2.13	2.05	4.29
1980-81	1.82	1.91	3.83
1981-82	2.18	1.64	3.92
1982-83	2.12	1.52	3.73
1983-84	2.10	1.43	3.62
1984-85	1.88	1.42	3.39
1985-86	1.83	1.60	3.53
1986-87	1.78	1.62	3.50
1987-88	1.70	1.58	3.33
1988-89	1.88	1.81	3.75
1989-90	1.78	1.89	3.74

Source: Computed from Table 3.9.

TABLE 3.6
Revenue from Taxes as Percentages of Total Central Tax Revenue

(Per cent)

Financial years	Corporation income tax (CIT)	Income tax other than CIT	Wealth tax	Gift tax	Major direct tax	Customs duties	Union excise duties
1970-71	11.55	14.72	0.08	0.48	26.83	16.34	54.85
1971-72	12.19	13.80	0.09	0.65	26.73	17.97	53.22
1972-73	12.37	13.87	0.09	0.80	27.13	18.98	51.54
1973-74	11.48	14.61	0.09	0.71	26.90	19.63	51.29
1974-75	11.22	13.89	0.08	0.62	25.82	21.08	51.10
1975-76	11.33	16.31	0.07	0.71	28.41	18.65	50.53
1976-77	11.90	14.62	0.07	0.73	27.32	18.79	51.04
1977-78	13.78	11.31	0.06	0.55	25.70	20.59	50.21
1978-79	11.89	11.19	0.06	0.53	23.66	23.27	50.75
1979-80	11.62	11.19	0.06	0.54	23.41	24.42	50.20
1980-81	10.48	10.95	0.05	0.51	21.99	25.93	49.43
1981-82	12.45	9.33	0.05	0.49	22.33	27.19	46.92
1982-83	12.34	8.87	0.04	0.51	21.77	28.93	45.54
1983-84	12.03	8.20	0.04	0.45	20.72	26.94	49.33
1984-85	10.89	8.21	0.05	0.46	19.61	30.00	47.51
1985-86	9.99	8.76	0.04	0.54	19.33	33.23	45.19
1986-87	9.58	8.73	0.03	0.53	18.87	34.80	43.88
1987-88	9.11	8.48	0.02	0.27	17.88	36.38	43.61
1988-89	9.91	9.54	0.02	0.28	19.74	35.54	42.36
1989-90	9.16	9.69	0.02	0.35	19.21	34.93	43.39

Note: Row sums for central taxes add up to less than 100% as minor levies are not reported individually.

Source: Computed from Table 3.9.

TABLE 3.7

Effective Income Tax Rates and Tax Relief due to Deductions in Selected Years at Income Levels in 1970-71 Prices

Average gross income in 1970-71	Effective income tax rates (tax paid as a percentage of gross income)					Relief due to deduction as a percentage of gross Income				
	1967-68	1973-74	1977-78	1984-85	1987-88	1967-68	1973-74	1977-78	1984-85	1987-88
5,081	0.88	3.20	4.29	NA	0.00	0.51	0.38	0.33	NA	2.74
10,000	4.97	6.46	7.98	7.73	8.80	0.71	0.66	0.68	0.52	5.90
15,000	8.02	11.66	12.90	14.28	14.46	0.62	0.91	0.75	0.63	6.07
20,000	10.65	16.74	18.59	19.43	19.87	1.27	1.08	0.95	0.66	6.01
25,000	13.01	21.29	22.90	24.58	23.73	2.15	1.37	1.15	0.70	5.96
30,000	15.68	26.21	27.08	28.09	26.44	2.96	1.60	1.19	0.72	5.91
40,000	21.20	34.17	31.56	33.13	31.71	4.64	1.87	1.38	0.73	5.78
50,000	25.32	40.19	40.53	38.18	34.54	4.98	2.02	1.35	0.74	5.04
75,000	32.96	50.12	49.13	43.01	40.52	7.48	2.20	1.34	0.60	3.52
100,000	38.18	58.12	53.03	46.72	42.94	7.50	2.15	1.23	0.52	3.15
200,000	49.49	70.97	62.90	51.21	45.95	7.66	1.95	0.74	0.43	3.21
Average	13.00	13.89	15.69	14.32	16.27	2.23	0.85	0.79	1.11	5.51
Kakwani's index of tax progressivity (per cent)	20.44	20.95	17.82	19.06	16.41					

Source: Computed from All India Income Tax Statistics, various issues. Directorate of Income Tax.

TABLE 3.8

Effective Income Tax Rates and Tax Relief due to Deductions in Selected Years at Income Levels in 1990-91 Prices

Average gross Income in 1990-91 prices	Effective income tax rates (tax paid as a percentage of gross income)					Tax relief due to deducation as a percentage of gross income				
	1967-68	1973-74	1977-78	1984-85	1987-88	1967-68	1973-74	1977-78	1984-85	1987-88
25,000	0.88	3.20	4.29	0.00	0.00	0.51	0.38	0.33	0.32	2.74
30,000	1.84	3.79	5.05	1.21	1.76	0.62	0.38	0.40	0.36	3.39
40,000	3.56	5.09	6.57	4.60	5.42	0.72	0.47	0.55	0.44	4.69
50,000	5.08	6.58	8.10	7.99	9.08	0.70	0.67	0.69	0.52	6.00
75,000	8.15	11.92	13.22	14.53	14.72	0.61	0.91	0.74	0.63	6.06
100,000	10.88	17.00	18.91	19.75	20.22	1.28	1.10	0.98	0.66	6.01
200,000	21.54	34.58	31.63	33.45	31.89	4.75	1.87	1.40	0.73	5.73
500,000	38.42	58.62	53.16	46.89	43.01	7.51	2.14	1.22	0.52	3.17
1,000,000	49.64	70.97	63.26	51.29	45.99	7.65	1.93	0.73	0.43	3.18
Average	13.00	13.89	15.69	14.32	16.27	2.23	0.85	0.79	1.11	5.51
Kakwani's index of tax progres-sivity (per cent)	20.44	20.95	17.82	19.06	16.41					

Source: Computed from All India Income Tax Statistics, various issues. Directorate of Income Tax.

TABLE 3.9
Revenue from Taxes

(In crores of rupees at current prices)

Financial years	Corporation Income tax (CIT)	Income tax other than CIT	Gift tax	Wealth tax	Major direct taxes	Custom duties	Union excise duties	Total Central tax revenue	GDP at factor cost	NAGDP at factor cost
1970-71	371	472	15	2	860	524	1759	3207	39708	21771
1971-72	472	534	25	4	1035	696	2061	3872	42248	23925
1972-73	558	625	36	4	1223	856	2324	4510	46473	26319
1973-74	583	741	36	5	1365	996	2602	5073	56954	30396
1974-75	709	878	39	5	1632	1333	3231	6322	67039	38003
1975-76	862	1241	54	5	2162	1419	3845	7609	71201	42362
1976-77	984	1209	60	6	2260	1554	4221	8271	76536	47073
1977-78	1221	1002	48	6	2277	1824	4448	8858	87351	52467
1978-79	1251	1177	55	6	2490	2449	5342	10525	93880	58029
1979-80	1392	1340	64	7	2804	2924	6011	11974	102442	65354
1980-81	1377	1440	67	7	2891	3409	6500	13149	122226	75577
1981-82	1970	1475	78	8	3531	4300	7421	15816	142876	90191
1982-83	2185	1570	90	8	3852	5119	8058	17696	159395	103244
1983-84	2493	1699	93	9	4294	5583	10222	20722	185991	118493
1984-85	2556	1928	108	11	4602	7041	11151	23471	207869	135875
1985-86	2865	2511	153	12	5541	9526	12956	28671	234159	156879
1986-87	3160	2879	174	9	6222	11475	14470	32974	260442	177927
1987-88	3433	3192	101	8	6734	13702	16426	37666	294408	201950
1988-89	4407	4241	122	7	8778	15805	18841	44474	348896	234138
1989-90	4729	5004	179	8	9920	18036	22406	51636	395143	265141

Notes: 1. GDP = Gross Domestic Product.
2. NAGDP = Non-agricultural Gross Domestic Product

Source: Budget Documents,, Government of India, Report of the Comptroller and Auditor General of India, and Report of the Centre for Monitoring the Indian Economy, various years.

TABLE 3.10
Tax Revenue of General Government and Gross Domestic Product of Selected Countries

Country	Tax to GDP ratio (per cent)	Per capita GDP (U.S.$)	Estimated tax ratio (Per cent)	Significance
(1)	(2)	(3)	(4)	(5)
Zaire	23.21	150	8.57	99
India	16.96	300	12.99	
Kenya	20.63	330	13.60	95
Indonesia	15.00	450	15.58	
Bolivia	10.24	580	17.20	99
Yemen Arab Republic	12.36	590	17.31	
Egypt	21.71	680	18.21	
Dominican Republic	13.69	730	18.66	95
Thailand	15.40	850	19.63	
Paraguay	8.94	990	20.61	99
Chile	23.49	1310	22.39	
Peru	10.88	1470	23.13	99
Mauritius	21.20	1490	23.21	
Costa Rica	21.79	1610	23.71	
South Africa	23.94	1890	24.73	
Brazil	21.41	2020	25.15	95
Hungary	53.11	2240	25.81	99
Panama	22.62	2240	25.81	
Argentina	20.28	2390	26.23	99
Yugoslavia	26.07	2480	26.46	
Oman	9.70	5810	31.89	99
Spain	32.05	6010	32.11	
Ireland	39.15	6120	32.22	99
Israel	40.97	6800	32.90	99
Singapore	13.45	7940	33.88	99
United Kingdom	37.07	10420	35.62	
Australia	30.79	11100	36.02	95
Belgium	45.77	11480	36.24	99
Netherlands	47.76	11860	36.44	99
Austria	40.84	11980	36.51	95
France	41.89	12790	36.92	95
Germany	39.41	14400	37.68	
Finland	35.17	14470	37.71	
Denmark	51.81	14930	37.91	99
Canada	34.40	15160	38.01	
Sweden	49.13	15550	38.17	99
Norway	45.51	17190	38.81	99
United States	28.15	18530	39.29	99
Switzerland	31.56	21330	40.19	99

Note: 1. GDP: Gross Domestic Product
PCGDP: Per Capita Gross Domestic Product

2. Estimated values of the tax ratio are based on the following relationship between the tax ratio and per capita GDP:

$$\text{Tax ratio} = -23.3839 + \underset{(5.75)}{6.3775} \text{ Log(PCGDP)}$$

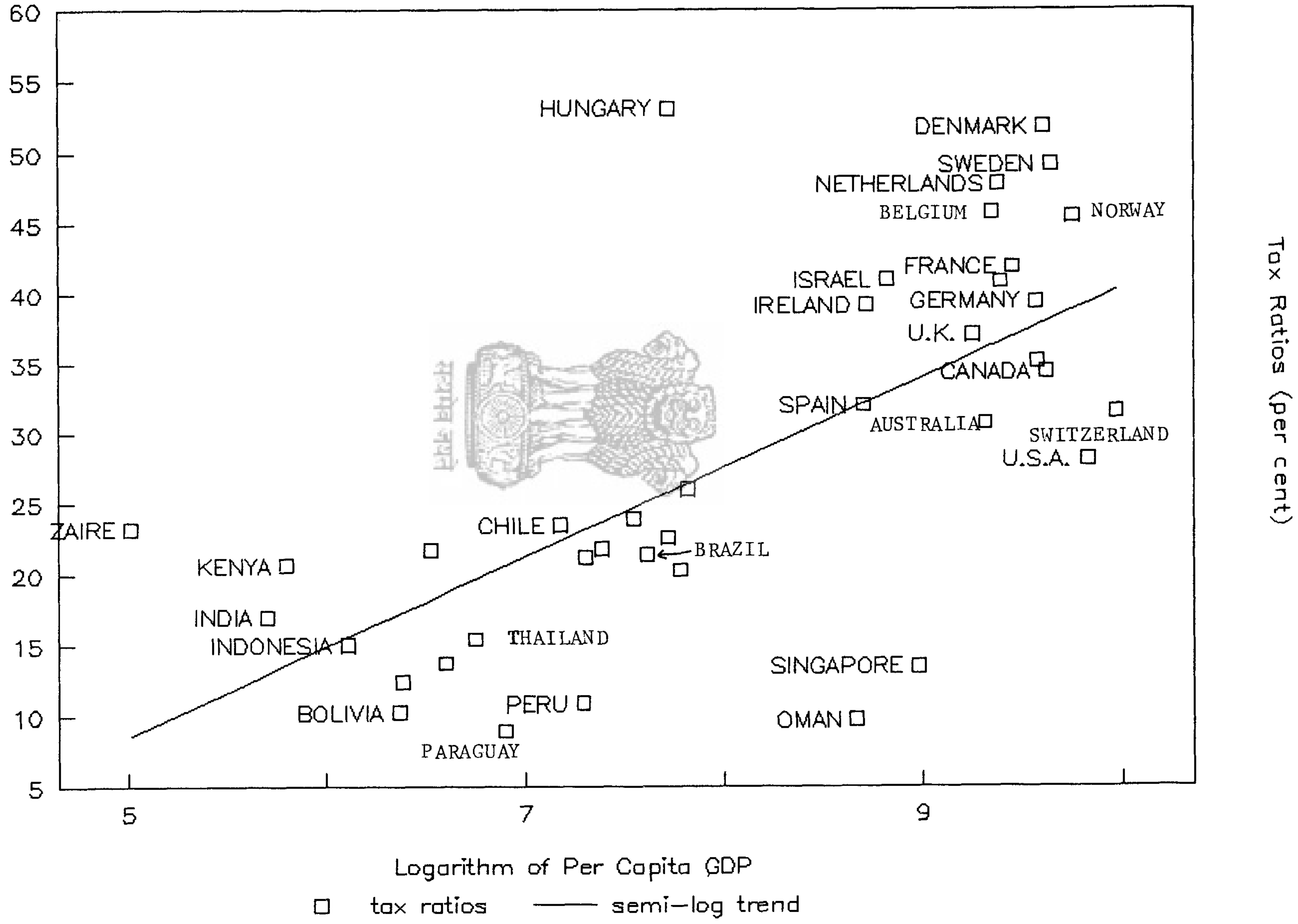
R-Squared = 0.47

Figure in parentheses is t-ratio.

Source: Government Finance Statistics International Monetary Fund.

Chart 3.1

Tax Ratio Vs. Per Capita GDP(Year 1987)



Source: Table 3.10.

4

A BRIEF EVALUATION OF THE CENTRAL TAXES

The Situation in Regard to Income and Wealth Taxation in India

4.1 In independent India, the policy of direct taxation has been mainly influenced by the desire to reduce economic inequalities along with the objective of encouraging saving and investment in desired directions. This being so, the structure of income taxation, personal and corporate, broadly resembled those in several developed countries, particularly those which were long ruled by political parties with a pronounced socialist bias.

Tax Rate Schedules

4.2 The top marginal rate of income tax, which had been brought down to 77 per cent in 1956 was gradually raised until it had reached 97.5 per cent in the early seventies - a rate similar to that prevailing in the United Kingdom. However, unlike in the United Kingdom, a tax on net wealth had been introduced in the fifties, similar to the wealth tax prevailing in some of the Scandinavian countries, and the marginal rate of wealth tax was gradually raised to reach 8 per cent. Alongside of such highly progressive personal income and wealth taxes, a separate tax on corporate profits was being levied, whose rate was gradually raised from 45 per cent in 1959-60 to 55 per cent in 1965-66. (This was the rate applicable to widely held public limited companies with profits above Rs.25,000; closely held companies were subject to tax at higher rates).

The Income Tax Base

4.3 Under the Indian Constitution, income from agriculture is a State subject and cannot be taxed under the Indian Income Tax. This, in itself leads to a narrowing of the tax base and opens up avenues of tax avoidance. Furthermore during the years when the rates of progression were being increased, the government experimented with various types of incentive provisions and generally increased the number and variety of such provisions partly to soften the impact of high progression and partly to induce the taxpayer to save more and to invest in what was considered socially desirable directions. As in the rest of the world, there was disillusionment with the results achieved through a combination of high progression in direct taxation and multiplicity of concessions and incentive provisions. Then, from mid-seventies top marginal rates were brought down, and attempts were made to rationalize and consolidate the system of incentives. Nevertheless, as we shall see below, the combined effect of the marginal rates of income and wealth taxes still results in a high degree of progression along with a corporate tax rate of 45 per cent which, although far more reasonable than in the past, still adds considerably to the total burden on investment income.

Income Tax Compliance

4.4 So far we have not dealt with the difficulties of enforcing highly progressive direct taxes caused by stiff taxpayer resistance. In countries such as the United States, United Kingdom and Sweden, it has been generally held that outright evasion of taxes was not a wide spread phenomenon, but of course rich individuals could find several loopholes for legal avoidance. In certain other industrial countries tax evasion was reported to be on a fairly significant scale. The government of Australia, for example, recognised this phenomenon and as part of the recent tax reform action has introduced new provisions and initiated new enforcement methods to check evasion. In our country it is recognised that evasion of taxes, both direct and indirect, is being practised on a very wide scale, making nonsense of the attempt to collect taxes in a fair manner and to mitigate economic inequalities. As pointed out by the study on Aspects of Black Economy in India by the National Institute of Public Finance and Policy [24], high tax rates constitute only one cause for the creation of black money. However, it is an important cause. For several reasons, which we shall detail later, it has not been possible to effectively check the wide-spread evasion. Action would, therefore, have to be taken both to alter the structure of taxation and to improve and strengthen methods of enforcement including more severe penalties for those who indulge in large scale tax evasion.

Anomalies and Inequities under the Indian Income Tax

4.5 However, even if direct tax evasion were not being practised on such a large and alarming scale, as in India today, there would still be an urgent need for a thorough restructuring of the tax system because, while evasion of tax by particular sections of potential taxpayers is an important cause of inequity (for example, inequity between honest and dishonest taxpayers and inequity between those who mainly receive monetary salaries on the one hand and others with monetary salaries plus several perquisites or with non-salary incomes, on the other hand), several anomalies and inequities are inherent in the tax structure and interaction of the progressive system with inflation in any case causes inequities and disincentives that need to be minimized.

4.6 It was pointed out earlier while discussing the definition of income for tax purposes that in practice, it is not possible to levy a tax on income defined on a comprehensive basis and that this leads to unequal treatment of equals and, by implication, often equal treatment of unequals. Even in the best real world income tax system, these inequities cannot be eliminated. But the Indian income tax system contains several provisions in the nature of tax shelters which have been deliberately introduced to mitigate the impact of the progressive tax on particular classes of taxpayers and particular types of income. In some cases a tax shelter might arise because not having that shelter might create administrative problems or severe hardships to some taxpayers: an example is the exemption of imputed income from an owner-occupied residence, although some economists would hold that at least part of such income should be subjected to tax. But there are other cases where tax shelters have been deliberately provided to benefit particular groups of taxpayers or shelters have been created by the taxpayers themselves through resort to receipt of income in kind instead of in money. If we start with the law makers themselves, we find that Members of Parliament and Central Government ministers receive fairly low salaries that could be directly subjected to tax; they are then granted sitting allowances at the rate of Rs. 500 per day which are exempted from tax. A proportion of government servants as well as ministers and Members of Parliament are provided with living accommodation for which they are charged very nominal rents although the market rent for the accommodation would be far far higher than the rent charged. Here again those who are lucky enough to have such accommodation receive high income in kind which is entirely free from tax. In a similar manner, top personnel in the organised private sector receive perquisites which are not fully subjected to tax. Use of a telephone provided by the employer for official purpose, but also used for personal purposes to a virtually unlimited extent - a facility commonly available to higher level officials in the private and public sectors - is another example of receipt of income in kind which is exempt from tax. The so-called leave travel concession which is given on a reimbursement basis and is excluded from taxable income is yet another

24. Shankar N. Acharya and Associates, Aspects of Black Economy in India, National Institute of Public Finance and Policy, New Delhi, 1986.

example of an untaxed perquisite available only to a selected group of income tax assessees. The argument here is not that the concerned officials in the private and public sectors and ministers and MPs should not enjoy the relatively high standards of convenience and living which they do enjoy because of the perquisites; it is better that if a progressive income tax is to be levied and levied equitably, all these perquisites should be converted into money and added to the monetary salaries of the individuals concerned; then the total income should be subject to tax. However, that might in fact substantially reduce the privileges.

4.7 There are a number of anomalies and inequities in the provisions currently applicable under the Income-tax Act, 1961. Anomalies arise through differentiation among certain taxable entities, without any economic rationale underlying such differentiation. Further, anomalies arise because of the way in which income from different sources is taxed. Yet other anomalies arise because of differentiation between different groups of taxpayers such as government and non-government employees or residents and non-residents.

4.8 In Appendix I, effective income tax rates at different levels of income at 1990-91 prices are given for the three selected years: 1967-68, 1977-78 and 1987-88[25] A comparison of tax burdens across these years reveals that, for those with income lying between Rs.50,000 and Rs.1 lakh, the heaviest tax burden was in the year 1987-88 which is the most recent year for which published income tax statistics are available (Table I.1). In contrast, the tax burden on those with incomes above Rs.5 lakh was the lowest in the year 1987-88. This implies that while the burden on the the middle income taxpayer has risen by the changes in the tax structure over this period, it has declined for the high income taxpayers. However, it should be noted that the tax burden on the high income tax payers was unduly high in the earlier years.

4.9 It is also the case that tax shelters and lightly taxed perquisites have led to substantial differences in the effective tax rates of persons having income from different sources. The effective tax rates of different types of taxpayers are given in Tables I.6 and I.7 in Appendix I. It may be seen from Table I.6 that, on an average in the year 1990-91, effective tax rates for taxpayers with the same comprehensive income could vary between 17 and 29 per cent. Similar variation is observed in the other years examined. Table I.7, which gives effective tax rates for different types of taxpayers with different levels of income, shows that the variation in effective tax rates at the income level of Rs.50,000 has increased between 1967-68 and 1987-88, and declined in 1990-91. Discrimination in the tax treatment of different types of taxpayers was found higher in 1990-91 than in 1967-68. At income level of Rs.2 lakh and Rs.10 lakh discrimination in tax treatment of different types of taxpayers increased over 1967-68 in 1978-79 and declined thereafter (Table I.7). It may be seen from Tables 1.8 to 1.10 that the changes in tax relief provisions have resulted in an increase in discrimination in the tax treatment of different types of taxpayers, over time.

4.10 It may also be seen from these tables that, among the salary earners, the lowest tax burden is on government servants who stay, at nominal rent, in government housing and on private sector executives receiving fringe benefits. Further, house-owners and those able to take advantage of depreciation provisions on new capital equipment and machinery are the other groups of taxpayers with a relatively light tax burden. On the other hand, those with income from house property and salary earners (if they

25. That is, income tax assessment years 1968-69, 1978-79 and 1988-89.

receive no perquisites) are found to shoulder the highest tax burden. It should be mentioned that the conclusions in this and the preceding paragraph are based on the assumption that imputed income of a taxpayer from a owner-occupied house was 20 per cent of his gross income, wherever applicable.

4.11 From this account it becomes clear that equity would be vastly improved if we could move towards less progression combined with more adequate coverage.[26]

Net Wealth Taxation in India

4.12 A review of the operation and impact of the net wealth taxation in India is long overdue. If the main objective of the imposition and continuation of the tax is to make a dent on inequalities in the non-agricultural sector, the tax can be said to have failed in its main objective. After the tax has been in operation for 35 years, the yield of the tax is only around Rs.200 crore - an infinitesimal portion of total wealth in the hands of the rich which has grown enormously. If the tax had been indexed properly, the yield would have been lower than it is. Reliable information is not available on the value of actual wealth assessed. The general exemption level was only Rs.0.60 lakh in 1988-89 in 1970-71 prices. The exemptions granted for approved investments under Section 5(1A) of the Wealth Tax Act amounted to Rs.1.26 lakh in 1970-71 prices. With the lowering of the exemption in real terms to this level, the yield should have risen much more.

4.13 Valuation, as is to be expected, has been a major problem particularly with regard to real estate and wealth in the form of business assets in unincorporated enterprises and unquoted shares of smaller companies. As regards residential houses, in the light of experience and in order to avoid disputes, Rule I-BB was formulated according to which the value is now calculated as a multiple of the net maintainable rent in respect of accommodation that has been rented out. However, in case of houses which fetch rents, part of the rent is often shown for tax purposes as payment for furnishings and amenities. The assessable capital value then gets underestimated. For owner-occupied houses, the valuation of the house property is determined on the basis of the municipal valuation and on the basis of fair rental value if municipal valuation is not available. For understandable reasons, the value once calculated is frozen at that level so long as it is occupied by the owner. Any expenditure incurred in improving the interior of the house or its external appearance, e.g., wood work, marble flooring, subsequent to the occupation, is not, and cannot easily be, taken into account. If the same amount had been invested in company shares or in own business, it would have been includable in taxable wealth (above the exemptions provided in the law). A very large amount of wealth gets embodied in owner-occupied houses without attracting tax liability. Similarly, residential houses owned by widely-held public limited companies and occupied by the members of the top management (Chairman, Directors, etc.) and passenger cars owned by such companies and made available for personal use to directors and high level officials are not subject to the net wealth tax. Costly furnishings, valuable works of art, the present value of future pension rights, have all to be excluded for reasons explained earlier. Apart from the unequal treatment involved, all the exclusions have distortionary effects.

4.14 On the other hand, an honest taxpayer who invests his resources productively gets subjected to high burden of taxation of income and wealth, at higher levels. If his income exceeds Rs.1 lakh (which in 1990-91 prices is equivalent to Rs.43,079 in 1980-81 prices and to Rs.20,314 in

---

26. Incentive provisions deliberately introduced in the Indian Income-tax Act to encourage various activities, such as for saving, for industrial location, for adoption of appropriate production technology, for earning foreign exchange and so on have not been dealt with here in detail. As has been pointed out earlier, many of these incentive provisions lead to unintended economic distortions and to inequities which, however, may be international. It has also been noted that such provisions should be introduced only after a careful examination of the advisability of using the income tax as compared to one of the many other policy instruments available.

1970-71 prices) and his wealth is not less than Rs.27 lakh (Rs.11.64 lakh in 1980-81 prices), he is subjected to a marginal rate of wealth tax of 2 per cent. Then an investment (addition to wealth) during a year of Rs.1,000 yielding, say, a 10 per cent rate of return will mean the following additional annual tax liability:

Income tax	:	Rs.56
Wealth tax	:	Rs.20
Total	:	Rs.76

Thus, against an additional income of Rs.100, the additional tax liability would be Rs.76, yielding a marginal rate of tax of 76 per cent. This is the rate that would determine investment decisions even if part of the wealth already owned should appreciate in value (such appreciation will attract additional wealth tax liability). With inflation, and with no indexation, the marginal tax burden might become unbearably high. With an eight per cent rate of inflation - roughly the average for the last decade - an investment (e.g., in a bank deposit, a savings bond, a debenture and even a new equity share) of Rs.1,000 would depreciate by 8 per cent. Then the return net of such depreciation would be only Rs.20, but the tax on the nominal return would be Rs.56 and the wealth tax Rs.20: The investment yields a negative rate of return. The taxpayer would have been better off had he invested Rs.100 in an appreciating asset with no return such as gold jewellery. For if such an asset should appreciate by more than the rate of inflation, say 10 per cent, the taxpayer would not have to dip into his capital to pay additional tax.

4.15 Since the wealth tax rates are not indexed for inflation in India, nor the exemption level, the taxpayer would have to pay additional wealth tax on the wealth he already owned at the beginning of the year, should its value arise in response to inflation except for the residential house he occupies. If the increase in the value of the total wealth is only 8 per cent, he would be paying more wealth tax on the same real wealth. In order for him to be better off, the nominal value of his wealth should appreciate significantly more than the rate of inflation.

4.16 If the inflation continues, additional wealth tax would be paid every year on the nominal increase in the value of the wealth over the base year level. If after, say, ten years the taxpayer realizes capital gain on a part of the assets he holds, capital gains tax would have to be paid on the nominal gain as well as the real gain on which he has been paying tax at 2 per cent each year.

4.17 Such onerous and perverse consequences could not have been deliberately intended. We may say that they are rather the unintended consequences of the interaction of inflation and the high combined marginal burden of income and wealth taxes.

4.18 Unintended high burdens arise in some cases because the laws governing different taxes falling directly or indirectly on the same bases are formulated independently without co-ordination. Let us take as an important example the taxes falling on rental income and house property. Someone who had invested several years ago in a fair-sized house in one of the exclusive localities in the capital city might be able to rent out his house now at Rs.40,000 to Rs.50,000 per month. If the annual rent received is Rs.6 lakh, the rateable value for the MCD property tax will be Rs.5,40,000. Since rateable value above Rs.20,000 per annum attracts basic property tax at 30 per cent, property tax payable will be around Rs.1,62,000 (additional levies like education tax are ignored). Taking credit for a 25 per cent rebate on prompt payment, the net property tax payable comes to Rs.1,21,500. The income tax payable on a rental income of Rs.6 lakh, after allowing for the personal exemptions and other permissible deductions, will be Rs.1,98,212. The value of the house for wealth tax purposes is determined by multiplying the rental income net of allowance for maintenance and property tax by a factor of 12.5. In this case, it will be Rs.48,56,250. The annual wealth tax liability will be Rs.60,875.

4.19 Hence the total tax liability will be

Property tax	:	Rs.1,21,500
Income tax	:	Rs.1,98,212
Wealth tax	:	Rs. 60,875
Total		Rs.3,80,587

4.20 This liability works out to 63.43 per cent of total income. Most would agree that such a high burden at 63 per cent of income provides a strong incentive to avoid or evade taxes. In the case of real estate, other levies such as stamp duties going upto 15 per cent of value also influence the attitudes of taxpayers. Thus, it is that in most cities and big towns in India, it is virtually impossible to buy property paying its true price in "white" money unless the seller is a public (housing) authority.

Tax Evasion and Lack of Effective Enforcement

4.21 It has been implicitly assumed in the discussion of the incentive and other effects of direct taxation that taxes are paid and are collected according to the rates and provisions laid down in the law. On that assumption, it has been shown that taxes can fall unequally on different groups of taxpayers and the burden could increase unreasonably with the growth of one's income as a result of the interaction of inflation and high rates in a largely unindexed system. But widespread evasion of taxes in large magnitudes can effectively blunt the edge of progression and sustain incentives. Industrialists, professionals, traders, entrepreneurs in services, artists - all continue to work hard and accumulate wealth despite high taxes because many of them pay only a fraction of the taxes they should be paying. This is also true of salaried individuals who conceal their investment income wholly or partly. High tax rates in a system without indexation and lack of effective enforcement are the main factors contributing to large-scale evasion. Lack of effective enforcement means very little fear of being detected and punished. Even that little fear disappears if punishment in case evasion is detected can be avoided through the payment of bribes.

4.22 It would be fair to say that the Income-tax Department which is in charge of all the Central Government direct taxes is in a shambles. It cannot complain of lack of manpower, but the majority of personnel is constituted by inspectors and clerks who are not adequately trained and are paid fairly low salaries. The Department has competent men and women but not adequate facilities in most places. Record keeping is abysmal. A modern computer-based information system has not been built up. Statistics on assesses, incomes assessed, taxes paid, etc., collected and published are unreliable because of inadequate and varying coverage. The Income-tax Department can boast of a large number of honest officers and of able senior staff who diligently apply the law. However, it seems to have fallen behind its counterparts in the rest of the world in modernising administration, devising methods of collecting tax related economic information on potential assessees and effectively checking widespread evasion by small and medium businesses. The Enforcement Directorate concentrates on tackling evasion by the potential large taxpayers and they can claim credit for unearthing large concealment in several cases.

4.23 Detection of evasion is not followed in most cases by swift retribution. Unfortunately, our legal procedures are such that delaying tactics by the accused assessee can tie up the Department in court action for years. The regular courts are in any case clogged with pending cases. And when a verdict comes after many years, the guilty assessee can usually hope to escape with a fine.

4.24 While the Income-tax Department must accept its due share of blame for the failure of the system, its tasks are made very difficult by the combination of high rates and the amoral attitude to tax obligations of a large section of the potential assessees as well as the nexus between influential assessees and political elements.

4.25 The inherent defects of a progressive real-world income tax, the iniquities caused by tax shelters, the unequal and onerous impact of the interaction of inflation and the combined effect of all direct taxes, the unsatisfactory state of tax administration and the disadvantages it suffers from because of external factors, the inability of the legal system of the country to cope with the problem of growing delinquency, and the resultant impunity with which taxes are evaded - all of this requires that we thoroughly re-structure the tax system and overhaul its administration.

4.26 We have so far not touched upon the complexity of the direct tax laws. The multiplicity of objectives which have been sought to be achieved through the tax system and the constant alterations made to the provisions either in response to pressures or in an attempt to check attempts at avoidance or because of a narrow viewpoint taken in terms of maximising revenue, have led to difficult-to-understand definitions, qualifications and provisos to the grant of various concessions and sequencing of the claims for different allowances and set-offs which together have resulted in a complex code. To be sure an income tax law cannot be made very simple in the conditions of a modern economy if it is to be equitable and productive. However, the aim must be to make it as simple as possible for the majority of taxpayers.

4.27 Finally, before turning to a discussion of indirect taxes, we would like to reiterate a point made earlier, viz., the direct tax burden to be imposed on assessees at different levels of income, especially at the lower end of the scale, should not be unrelated to the respective indirect tax burdens they are asked to bear.

The Structure of Indirect Taxes levied by the Central Government in India

4.28 Before the introduction of Modvat in 1986, the indirect taxes levied by the Centre - Customs, Union excise and the Central sales tax - taken by themselves, or the Central indirect taxes and the taxes levied by the States and the local authorities - taxes on intra-State sales, the passengers and goods tax, the electricity duty and the octroi - taken together did not constitute an integrated and "rational" system, but represented a juxtaposition of various levies that acted and reacted on one another mostly unhindered by governmental intervention. They were all cascading type taxes, except for the limited operation of Rule 56-A of the Central Excise Rules, which provided for set-off, and the concessional treatment or exemption granted to inputs in the sales tax laws of some States. The taxes were levied at multifarious and widely differing rates. It was a truly irrational system from the economic as well as equity point of view; and the misallocation of resources and the loss of welfare caused by the high and disparate import duties and the multi-rated cascading type excise and sales taxes was palpable. While the unduly large number of rates - textile products alone had 125 excise duty rates in 1975 - resulted in classification disputes, the high rates spawned evasion abetted by corruption. It is in this context that the Indirect Taxation Enquiry Committee (Jha Committee) was appointed by the Government of India 1976. The two major recommendations of that committee were that the Union excise duties should be converted in a phased manner into a value added tax at the manufacturing stage and that the States should be persudaded to levy only retail sales taxes. The Committee also put forward important suggestions for reform of the import tariff.

4.29 The introduction of the Modvat in 1986 represented a major step in the reform of the Central indirect tax system. Under the Modvat, taxes paid on inputs that get incorporated in output or get consumed in the process of production qualify for set off. The Modvat has been extended to cover all taxable products other than petroleum products, tobacco products and textiles. To the extent the Modvat operates, the Union excise does not cause any cascading and does not cause distortions in the producers' choice of inputs. The exporters are greatly benefited, because all inputs are relieved of excise and/or countervailing excise on imports. However, what had been accomplished represented only the first stage of reform; after that the reform process seemed to have stopped in its tracks. In fact, there has been some backtracking in so far as rates have been multiplied and there has been a shift back to specific duties.

4.30 While a major step was taken in reforming the Union excise, there has been no real progress in restructuring or reducing the level of import duties. In fact, in pursuit of the revenue objective, the duty rates have been considerably raised in recent years, contrary to what had been envisaged in the Long Term Fiscal Policy document. As of date, the Indian import duty structure presents a bewildering picture of combination of "basic" and "auxiliary" duties with the combined rates on different goods varying widely and often consisting of double application of ad valorem and specific duties. The duty rates range from over 400 per cent ad valorem to zero per cent with the bulk of the imports falling in the duty rate range of 50 per cent to 150 per cent. The average effective rate is around 85 per cent excluding zero-rated items (around 50 per cent if they are included). The most glaring aspect of the tariff is the imposition of high duties on metals (60 per cent), chemicals (150 per cent) and machinery (80 per cent) in general. The statute gives only the maximum rates. The actual rates applied to different products and varieties of a product are fixed through numerous executive notifications. The notifications altering duty rates or granting exemptions (for a particular class or classes of users sometimes are issued so frequently, that it is impossible to keep tract of them without the expenditure of much effort. However, recently certain improvements were made in the import duty regime. These include: reducing the multiplicity in auxiliary duty rates, reduction of duty on drug intermediates and components of machinery, rationalisation of duty structure for electronic industry with raw materials, piece parts, components and finished goods in the ascending order and lower duty (25 per cent) on machineries connected with exports.

4.31 As things stand today, excises are also being levied at many rates. The existence of specific duty rates on a large number of commodities not only leads to revenue inelasticity with respect to nominal income, but implies often, differentiation in ad valorem rates even where it is not justified or needed and unintended changes in the relative burdens in ad valorem burdens on different commodities when prices change. This happens because the numerous specific duties cannot be fine tuned constantly, as prices change, to restore the original burdens. This means that the pattern of final incidence on consumers changes solely due to price changes. This violates the rule that the tax system should not bring about unintended changes in relative prices.

4.32 The petroleum, tobacco and the textile sectors remain outside the Modvat system. While petroleum products represent a special case and tobacco products do not enter the productive process with different stages of manufacturing in any significant way, the whole textile sector cannot justifiably be kept out of the Modvat scheme. Their exclusion represents a significant distortion which must be remedied.

4.33 Under the Modvat scheme, as noted earlier, only taxes levied on inputs that go into production or get used up in the process are eligible for set-off. This means that excise taxes that fall on machinery, accessories, fittings, tools, office equipment and vehicles continue to cause cascading. There is no economic, technical or administrative justification for keeping these goods used in production out of the Modvat credit scheme except the argument that in a developing country, capital goods should be subject to tax in order to discourage the use of capital. On the other hand, in many countries, capital goods have been treated like other inputs precisely to concentrate the tax on consumption and to encourage saving. Also it is wrong to classify all non-incorporated "inputs" along with machinery proper as capital goods. An exhaust fan in a factory is as essential as the raw material used. If the cascading and other effects caused by the tax on the exhaust fan is to be ignored or to be tolerated, then why should one bother about the effects of the tax on the raw material? In the ultimate analysis, taxes on all inputs, tools, accessories and machinery used in the process of production would have to be made eligible for set off; one could perhaps make out a case of excluding the inputs used in the construction of the building, office furniture and fittings (but not office equipment) and air conditioners and refrigerators (other than those essential for the production and/or preservation of the concerned product).

4.34 The special treatment accorded to the small and tiny sectors under the excise tax system represents another distortion and is the source of much trouble. It is widely agreed that the concessional tax treatment extended to the small-scale sector has been a source of substantial tax evasion. Apart from that, exemptions and concessions create problems in the proper and smooth functioning of the VAT regime. From the other side, the members of the small-scale sector, at least the honest ones, can legitimately complain of harassment by the Excise department. One has to devise ways of reducing evasion, removing distortions and at the same time safeguarding the interests of the small-scale producers.

4.35 The application of many rates has led to several and continuing classification disputes. Under the present system of enforcement of excise, before any product can leave the factory premises to be sold, an approval of price quoted and the classification list has to be obtained from the concerned excise officer. Both price and classification can become, and often do become, subjects of dispute. Much time, effort and money is expended by the Department and assessees in the disputes regarding classification. Most of these disputes could be avoided if the attempt at fine tuning through multi-rate differentiation is given up. To be sure, problems of valuation get accentuated if the tax system stops at the manufacturing stage: there is then a temptation for the producers to underestimate value at the taxing stage. (Under a multi-stage value added tax, the total value of a commodity, as incorporated in the price to the final buyer, is brought under tax and hence there is no gain in underestimating value at an intermediate stage.) However, it would appear that many valuation disputes arose in the past because of absence of clear rules regarding includable and excludable items of expenses or costs and the treatment of price discounts. Assessing officers would also seem to have the tendency sometimes to be more strict than they need be for fear of audit objections. It should be possible to cut down these disputes through the laying down of clear rules, in the light of case-law.

4.36 There has not been much progress in the reform of the cascading type of sales taxes being levied by the States. For example, the recommendation of the National Institute of Public Finance and Policy, which undertook studies of sales tax systems at the request of several State Governments, that, at the very least, the sales tax on inputs paid by taxable producers/dealers should be allowed to be set off against tax payable on the output as a matter of general principle has not been accepted by most of those Governments. Some of the States levy a multistage tax on a few commodities in addition to a cascading type of single-stage, first-point tax. In this report, we are concerned mainly with the taxes levied by the Centre. The only sales tax levied by the Centre is the Central sales tax which applies to inter-State sales.

4.37 The Central Sales Tax Act, 1956 authorises the States to impose a tax on inter-State sales emanating from within their respective territories. The exporting State levies the tax and keeps the proceeds. The maximum rate of tax, uniform for all commodities, is prescribed by the Central Government. The tax was imposed on the recommendation of the Taxation Enquiry Commission (TEC), 1953-54. That Commission had felt that the producing State (the State of origin) should get a small part of the total sales tax burden that could be imposed on a commodity. They had stressed that only a small burden should be allowed to be placed by the State of origin.[27] Accordingly, they recommended that inter-State sales tax be levied by the Central Government at the rate of one per cent of value on sales between registered dealers in any two States. The power to levy the tax has in effect been delegated to the States along with the power to fix the rates subject to the ceiling and to grant exemptions.

4.38 Any tax on inter-regional trade within a national market is not considered a legitimate way of raising resources for the government. This rule is strictly observed by countries which come together to form a common market or a free trade area. The TEC had conceded a slight departure from this rule. In course of time, the Central Government was persuaded to raise the ceiling rate, in stages, to 4 per cent in the mistaken belief that such increases would enable the States as a whole to raise more resources.[28] It is fair to say that in raising the rate of

27. Report of the Taxation Enquiry Commission (1953-54), Vol.III, p.57.

28. To the extent that the exporting State imposes a tax burden, the importing State has less "head room" for imposing its own burden. Its potential revenue drops. The exporting State gains at the expense of the importing State.

Central sales tax, the consequential adverse effects on costs and pattern and location of production were not given any weight. The Central sales tax on inputs not being eligible for set off has cascading effects and also alters the relative prices of factors. It is a barrier to trade; it works against dispersal of industries and tends also to encourage vertical integration. In short, it violates one of the basic principles of a sound indirect tax system which we have expounded earlier, namely, the indirect tax system should be such as to help preserve the characteristics of a common market.

4.39 It is also clear that the inter-State sales tax is biased in favour of a few States who are generally more advanced and are net exporters to other States. In 1988-89, the share of only four States, namely, Maharashtra, Gujarat, Tamil Nadu and West Bengal, in Central sales tax collections amounted to 53 per cent of the total, whereas, the share of these four States in State sales tax collections was only 44 per cent. Part of this 44 per cent represents taxes on inputs which are also exported to the consuming States to the extent that a given State is a net exporter of manufactured products. This is so unless the State concerned grants full set-off for the local sales tax paid on inputs. But Maharashtra, for example, grants set-off for taxes paid on inputs only if the output is sold within the State; this means that taxes on inputs going into that part of output which goes to the other States falls on the residents of those States. Maharashtra's share in Central sales tax collections of all the States is as high as 21 per cent, whereas its share in State sales tax collections is 9.07 per cent.

4.40 When the rate of Central sales tax was raised gradually, it became profitable for manufacturers to establish stock depots and warehouses in centres in various States to whom they could consign their products; the sales to wholesalers or users were then effected in the consuming States on which the local sales tax was paid. Some of the major producers of raw material, such as, petroleum products and steel would have anyhow done this even in the absence of a tax on inter-State sales because of the inconvenience of directly dealing with a large number of buyers from a Central point. However, there is no doubt that the Central sales tax at 4 per cent gave a fillip to consignment transfers. Apart from this, tax evaders camouflaged sales as consignment transfers and escaped taxation.

4.41 There were, in fact, three types of consignment transfers:

a. Genuine transfers by manufacturers to their warehouses, stockyards and local offices;

b. consignment of components and parts from one plant in a State to another plant outside that State, both belonging to the same firm e.g., engines being sent to the plant where aircraft frames are being manufactured; and

c. sales camouflaged as consignment transfers.

4.42 With a sizeable volume of consignment transfers taking place, the States complained of a huge loss of revenue due to avoidance and evasion of Central sales tax. The loss of revenue was more for the more advanced, industrialised States than for the backward States. Besides, the first two categories of transfers mentioned above minimised or reduced the taxation by the producing States of the residents of other States, led to lower costs of production in the economy through lesser cascading, and provided more "head room" for taxation of the concerned products by the consuming States.

4.43 As often in sales tax matters, however, the economic aspects were ignored. The States demanded that the "loophole" of consignment transfers should be closed. In response to this demand and on the suggestion of the Law Commission, through the Constitution (46th Amendment) Act, 1982, the Central Government was empowered to levy a tax on consignments in the course of inter-State trade.

4.44 If a tax on consignments in the course of inter-State trade is introduced, enterprises might be deterred from opening stockyards and also evasion of inter-State sales tax through the camouflaging of sales will be cut down. This will increase the total of inter-State sales tax collections. However, clearly the net exporting States will gain at the expense of the net importing States. And if the total sales tax burden is to be taken to remain constant, then the importing States will have to reduce the level of rates of their taxes falling on goods which would now come bearing the burden of inter-State sales or consignment tax. Hence the total of sales tax potential would not increase.

4.45 Consignment transfers of categories (a) and (b) mentioned above have helped minimise the harmful effects of inter-State sales taxation at 4 per cent. Once these routes are closed, the barrier to inter-State trade implicit in the inter-State sales tax at 4 per cent will become fully effective. At the same time, the cascading and distorting effects will be increased. On the other hand, if there is an inter-State sales tax with a significant burden and no consignment tax, there will be avoidance of the former. In attempting to reform inter-State sales taxation, all these considerations have to be kept in view.

Tax Administration

4.46 The state of tax administration in respect of both direct and indirect taxes leaves much to be desired. As regards direct taxes, the methods of administration have not undergone changes and improvement which have become possible with the development of the new information technology. As already indicated, record keeping is in a bad shape, and new methods of detecting evasion are not being developed. Unscrupulous taxpayers who indulge in large scale tax evasion can continue to do so with impunity either because there is little chance of detection or because they have made suitable arrangements with the tax officers. We must also point out that the facilities provided to the Income Tax Department are woefully inadequate in most cases.

4.47 It must be recognised that no improvement in the tax system is possible unless the state of tax administration is considerably improved and tax officials can be made to fear that punishment will fall on them sooner or later if they break rules or accept illegal gratification; it is equally important that taxpayers must be made to feel that the chances of detection of tax evasion and punishment have increased significantly. This is not possible without an improvement in administration.

4.48 Lowering of tax rates in the case of all the three major taxes - customs, excises and income taxes - will be conducive to greater voluntary compliance and will automatically lower the level of harassment and corruption. Nevertheless, conscious efforts have to be made to improve administration and devise methods of reducing collusion between tax officials and taxpayers. While we wish to bring a larger number of small potential taxpayers within the tax net, it is necessary to ensure that they would not be subjected to harassment. The information which we have gathered leads us to believe that such harassment is common in respect of excises and income tax. It is necessary to pay special attention to this problem if we wish to bring in the small scale sector effectively within excise tax system. In the case of the income tax, the smaller taxpayers do not have to get into contact with the tax department so much because of the adoption of self-assessment procedure. Even then it would be desirable to devise simpler methods of collecting income tax from the smaller businesses.

5

GUIDING PRINCIPLES OF TAX REFORM

5.1 The description of the tax structure and the actual operation of the tax system which we have given in brief in the foregoing pages would make it clear that the rational restructuring of the major taxes, improving tax administration and drastically reducing tax evasion through a combination of inducing voluntary compliance and increasing the chances of detection and punishment is a daunting task. However, it is essential that for the well-being of the nation, for economic progress and for ensuring an equitable sharing of the burden of taxation, this task must be taken up and accomplished. The Government's grave concern in this regard is evident from the comprehensive terms of reference given to the Committee which require us to recommend the lines of radically transforming the system.

5.2 The task before us is formidable because not only is the tax structure complicated and its indirect tax component far from rational, but also tax compliance is low and tax evasion is widespread. This is partly because of high rates, partly because of the venality of many taxpayers and partly because of inefficient tax administration with corrupt elements, whose morale has also been affected by political interference.

5.3 In this situation we wish to keep before ourselves the following guiding principles:

a. The tax system and its burden must be acceptable to the citizens i.e., the potential taxpayers.

b. Given our past experience and the present totality of circumstances affecting the tax system and its operation, it is better to have moderate rates with broader bases.

c. While the tax structure should be progressive, it should not be such as to induce the generation of unaccounted income and wealth.

d. The tax system must be rational from the economic point of view. For this purpose, the structure once established must remain stable unless and until the economic conditions undergo a radical transformation. Ad hoc changes from year to year will undermine rationality and reintroduce complications.

e. The tax system and law should be as simple as possible: it should have the strictly limited objectives of raising revenues for the government in a fair and efficient manner, achieving redistribution and discouraging some industries and the use or consumption of some products as well as granting a reasonable degree of protection to domestic industries. A simple system will have only a limited number of rates and exemptions or deduction and give the least possible discretionary power to the tax officials for interpreting the law.

f. Methods of tax administration should be modernised and tax enforcement should be visibly improved.

g. The tax reforms suggested should be fully or at least nearly, revenue neutral in their totality; however, the system should become more income elastic.

5.4 These are the guiding principles which we shall follow in formulating our reform proposals. Before we outline our proposals a few comments may be in order. There would be no point in undertaking a reform of the tax system unless the Government intends to preserve the reformed structure. For this to be possible, the growth in Government expenditure must be in consonance with the growth in Government revenues, arising from the growth in national income at more or less stable prices and the inherent elasticity of the tax system. If the growth in expenditure is not contained within this limit, continuous increases in tax rates and alterations in tax bases become necessary. Then the reform of the system gets nullified and we get back soon to a complicated and irrational tax structure. This is what has happened in the past. For example, the very timely and valuable plan of reform of the import tariff structure contained in the Long Term Fiscal Policy (1985) had to be abandoned, and quite contrary to that plan, import duty rates were raised across the board and substantially in order to raise revenues to cover at least part of the rapid increase in Government's expenditure. Now that the ratio of tax revenues (of the Centre and the States) to GDP has reached around 18.5 per cent and the ratio of total revenues around 21.5 per cent, the Government should rely on the interaction of the growth of the economy and an income elastic tax system for obtaining increases in revenues. The traditional concept of ARM (additional resource mobilisation) through annual increases in rates, alterations in bases and new levies, should be given up as a regular component of fiscal planning. Instead of accelerating growth which would automatically give more revenues, the traditional approach attempts to produce growth through ARM. In the event, the cumulative effect of continuous ARM has distorted the growth pattern and has stifled the disclosure of taxable output and income. If ARM is to be avoided, on the one hand, Government expenditure growth must be controlled; and on the other, the tax system must be made income elastic. It will be our endeavour to ensure that our recommendations for reform will significantly enhance the income-elasticity of the tax system of the Centre.

5.5 We referred earlier to the importance of the acceptability of the tax system and its burden and indicated that such acceptability depended partly on the perception of the public as to how usefully and productively the government and its administration was using the proceeds of the taxes. Today in India, while the crucial role of the government is recognized in all quarters, there is wide spread feeling among the electorate that there is considerable waste in government expenditure, that there is excess staff and that the tail to teeth ratio is unduly high. And with it all, it is generally felt that the public which pays the taxes gets poor service and members of the public are treated often not as the masters who pay but as supplicants. The control of the growth of public expenditure, increase in its productivity and efficiency and prevention of waste are necessary for inducing greater voluntary compliance with the tax laws and for generating the needed moral sanction to enforce the laws rigorously where such compliance is not forthcoming.

5.6 Thus the control of the growth of public expenditure and a perceptible increase in its efficiency are prerequisites for the success of the tax reform programme. It can be expected that the reformed tax system, if implemented with a reasonable degree of efficiency, would exhibit an income elasticity between 1.1 and 1.2 per cent, i.e., if national income or GDP grows at 10 per cent, tax revenues could be expected to grow between 11 and 12 per cent. A 5.6 per cent real growth rate of the economy could produce a real revenue growth of 6.2 to 6.7 per cent. That suggests the limits to the growth of Government's revenue expenditure in real terms.

5.7 We have noted earlier that the power to grant exemptions and deductions in respect of excise and customs, through executive notifications, has led to great instability and to a complicated and irrational tax structure. The multiplication of rates flowing from reductions and end-use exemptions effectively increases categories of classification, which in turn increases the extent of administrative discretion as also creates administrative complications. If the reformed tax structure is to survive, the power to alter statutory rates through notifications must be drastically curtailed.

5.8 One more cause that has led to distortion in the Central Government's tax structure should be mentioned here. As a result of the recommendations of the successive Finance Commissions, more particularly those of the Seventh and

Eighth Commissions, the proportions of the net proceeds of personal income tax and Union excise duties to be shared with the States have become 85 per cent and 45 per cent respectively. This has meant that if the Centre has to raise additional resources for its own use, as part of Planning Commission stipulated ARM or because of the need to meet some additional expenditure approved by Parliament, say, to the extent of Rs 1,000 crore, it would be necessary to raise Rs.1,818 crore through excise duties, or Rs.6,667 crore by way of raising the income tax yield. Of course, Union surcharges could be levied and the entire proceeds could be kept with the Centre, but this device is frowned upon by the States and can be resorted to, only occasionally. The pattern of sharing of two important taxes with the States that has emerged has been one of the reasons why the Central Government has been resorting to increases in import duty rates to raise additional resources; the Government has also found it necessary to keep the taxation of corporate profits fairly high.[29] The task of fiscal adjustment at the Centre has been rendered more difficult because of the compulsions arising from the formula of tax sharing with the States. What is more, the States have been demanding that the corporate profits tax should also be brought within the divisible pool. In the light of experience, it is necessary to re-examine the Constitutional provisions regarding tax sharing. The existing Constitutional provision is that the proceeds of income tax shall be shared with the States and those of Union excise duties may be shared with them if the Parliament so decides. The percentages of the taxes to be shared with the States are not specified in the Constitution, but are left to be decided by the President after he considers the recommendations of the Finance Commission in this regard. At present tax devolution to the States constitutes around 24 per cent of gross Central Government tax revenues. With the consent and co-operation of the States the relevant Constitutional provisions could be amended to the effect that 25 per cent of the aggregate tax revenues of the Centre shall be shared with the States. There would be certainty then for the States and the Union regarding what revenues would accrue to their respective budgets and the Centre would not have to distort its pattern of taxation by being virtually compelled to raise non-shareable taxes.

29. The rate of corporate profits tax for widely held companies was brought down to 40 percent after the elimination of major incentive provisions in the 1990-91 budget. The rate has since been raised to 45 per cent, and with a 12 per cent surcharge (on profits above Rs.75,000), the tax burden has been raised to 50.4 per cent.

6

INCOME TAX

Scope and Directions of Reform

6.1 In the present report, on the direct taxes side, we shall deal mainly with the personal income tax, that is, the income tax on non-corporate entities, and the tax on wealth. In the second report, we shall deal with the tax on corporate profits and several problems relating to business taxation, which we are not able to deal with in this report for want of time.

6.2 In formulating our proposals for restructuring the direct taxes, we have attempted to build a structure that is fairly simple, would generally be seen to be reasonable in respect of rate levels and, therefore, would be acceptable, and hence could be enforced effectively. The rate structure while imparting progressivity to the tax system should not give substantial inducement or alibi for generation of black income and wealth. On the contrary, the tax system should give ample scope and inducement for undertaking productive work, earning income, even high income, in legal ways and accumulation of wealth in productive forms. All of this would benefit the economy not only in terms of the growth of the economy but also in respect of Government revenue growth.

6.3 In designing the overall scheme of direct taxes, we have kept one major aim in view: in a country where only a small proportion of the population pays direct taxes, what is really important is the proportion of those taxes to total tax revenues, because that determines the amount taken from the upper income groups for transfer to the poorer sections (directly or indirectly). It also determines the progressivity of the tax system as a whole. The progressivity of the direct taxes structure by itself is also important because it affects the distribution of the tax burden within the income tax paying groups, but in a developing country the proportion of direct taxes to total tax revenue is far more important. Per contra, in a developed economy, where almost all earners are liable to pay income tax, the progressivity of the direct taxes itself is a major determinant of the progressivity of the tax system as a whole. On our part, we should concentrate on substantially increasing the amount of direct taxes to be garnered from the potential direct taxpayers, given the threshold level.

6.4 While earning of income and productive investments should not be discouraged, "unproductive" forms of wealth, possession of amenities by the richer sections beyond the reach of the common people and "luxurious" forms of consumption could legitimately be taxed - and without producing harmful economic effects, provided the rates are not fixed at levels which could be regarded as too high and provide a strong impetus for evasion.

6.5 The role of the upper income groups in the population in the provision of savings to the economy must be duly recognised. A good part of the household savings comes from the income-tax paying urban groups and the better-off farmers. An analysis of NSS data along with the data on income and saving collected by the National Council of Applied Economic Research(NCAER)[30] indicates that the top 10 per cent of the households, who could be assumed to have annual incomes that would become liable to tax would save on an average around 40 per cent of their disposable income. If the Government succeeds in collecting on an average 20 per cent of their income through the income tax, then given the saving rate of 40 per cent, these households would be consuming only 48 per cent of their income, i.e., they would be contributing to taxes and saving 52 per cent of their pre-tax income. If one assumes a saving rate for them of 30 per cent (to err on the lower side), direct taxes and saving would still constitute 44 per cent of their income; the share of consumption would be 56 per cent. The consumption is valued at market prices; this value includes indirect taxes. These taxes form around 30 per cent of the consumption of the upper income groups who can be identified with the income-tax paying class (assuming of course full forward shifting of indirect taxes). Therefore, their consumption net of taxation would be only 39.2 to 33.6 of their income (depending on the assumption made about their rate of savings). The total of direct and indirect taxes contributed by the groups would constitute 36.8 to 34.4 per cent of their income. This is on the assumption that the Government is able to take away on the average 20 per cent of their income in personal income (or direct) taxes and that all their income is reported for tax purposes. This represents a hypothetical situation.

6.6 Given the low saving rate of the corporate sector and the large dissavings of the government sector, it is extremely important to enable the household sector to save at least as much proportion of their income as they are doing now. It seems to us eminently reasonable to aim at taking 20 per cent of the income of the potential income tax paying class through direct taxes. As Table 18 in Appendix 2 shows, at present the average effective rate of tax for the income taxpayers as a whole is about 16.3 per cent. It has been estimated that not more than 30-35 per cent of legally taxable income is being disclosed, on the average (the disclosure by different potential taxpayers varying from 0 to 100 per cent). If through the measures we recommend, the Government could succeed in inducing disclosure of 60 per cent of legally taxable income and capturing 20 per cent of it through income tax, the yield would rise by 2.5 times[31]. The average rate of tax could be raised to 20 per cent by removing a number of deductions and some tax shelters and by inducing greater disclosure by the richer groups subject to higher marginal rates of tax. Greater disclosure by those who are already paying tax, especially those in the upper brackets and bringing into the net those who are totally evading tax, by employing simpler, presumptive methods of taxation, could raise the total disclosure to 60 per cent of true income. Even if the disclosure is raised to only 50 per cent and the average rate of tax is raised to only 18 per cent, the revenues will increase by 1.8 times. Thus the major thrust must be towards increasing the extent of disclosure and coverage in terms of both number ot taxpayer and the amplitude of the base.

6.7 The income tax can become a very iniquitous method of raising revenues if the tax provisions result in unfair and unequal treatment of different individuals in similar economic circumstances or if the law is not applied to all sections of the taxpayers with equal effectiveness. As is well known, the existing income tax structure is riddled with anomalies and tax shelters, which make the system unfair as between equals. However, according to the common perception of the honest taxpayers, the most unfair aspect of the system is that tax compliance and tax enforcement are both so lax that a large number of potential taxpayers get away without paying any tax and that many of those with high incomes who do pay the tax are disclosing only a part of the

30. Some rough estimates were made using the data in Household Income and Its Disposition, NCAER, 1980 and the data on consumer expenditure for 1973-74 and 1977-78 available in NSS 28th and 32nd rounds.

31. If 16 per cent of the 30 per cent disclosed is Rs. x., one per cent of 30 per cent = x / 16 and 20 per cent of 30 per cent = 20x / 16 = 5x/4 ; and 20 per cent of 60 per cent = 5x/4 x 2 = 2.5 x.

income or are able to find ways of splitting incomes. We, therefore, need to address ourselves to the task of improving horizontal equity in both these respects.

6.8 Despite its shortcomings and the problems of administering it, taxation of income is practised in most countries of the world primarily because income constitutes the best single index of economic power. If taxation is to be based on the principle of ability to pay, it is difficult to find a superior alternative. However, if it is to provide a reliable index of taxable capacity, "income" must include all ingredients of economic power acquired by a taxpayer over a given accounting period (usually a year) whether such power is actually exercised through consumption or stored by saving as reflected in net accretion to one's wealth over the period. Measuring the net accretion to wealth between two points of time is far from simple as it calls for valuation of assets on a notional basis. Netting for depreciation of assets or disinvestment also presents problems. Then there are problems of valuation of perquisites and services of consumer durables like owner-occupied house, and distinguishing "personal" from business in expenses booked under business in the case of those having income from business and profession. Income tax systems all over the world seek to circumvent these problems by devising rules for the computation of income and valuation of perquisites and notional income (like imputed rent of owner-occupied dwellings). Rules are often laid down specifying what deductions are to be allowed in computing income under different heads. For practical reasons, these rules usually focus on important items of income and consumption which would otherwise remain out of the tax net or leave wide discretion in the hands of tax officials. The Indian income tax also contains elaborate provisions to make sure that important ingredients of accrual of economic power do not go untaxed because of ambiguities in the concept of income as it has evolved over the years or because of the ill defined boundary between personal expenses and costs of earning. The results are, however, not entirely satisfactory. The reasons are as follows:

6.9 First, partly because of problems of valuation, no income is imputed from owner occupied houses since the assessment year 1987-88. Earlier, income from owner occupied dwellings used to be assessed notionally subject to a maximum of 10 per cent of the total income. In equity, imputed income from owner occupied dwellings should be assessed to tax at the going rate of rent in the neighbourhood. Presumably, on consideration of the problem it might create for taxpayers in finding the necessary cash to pay the tax, the restriction of the imputed rent to 10 per cent of other income was laid down in the law when the imputed income for owner occupied houses was taxed. While the elimination of imputation of the value of owner occupation was in line with the practice in other countries, deduction is allowed upto Rs.5,000/- for interest paid on mortgage or loans taken against an owner occupied dwelling.

6.10 Second, problems of valuation and also administration have also precluded inclusion of all non-monetary benefits enjoyed by income earners from various activities (e.g., perquisites of employment). Rules are no doubt laid down for the valuation of important forms of perquisites but these operate in a somewhat arbitrary fashion and discriminate between different classes of taxpayers (e.g. between employees of the public sector and those in the private sector). For those earning income from business and profession, the line between "personal" and "business" in expenses like those on travelling and entertainment has been extremely difficult to draw. As a result, arbitrary limits have been prescribed for the deductibility of expenses under such heads as also items like remuneration or payments made to directors of companies and their relatives which provide wide scope for discretion and disputes. All this has lent support for the plea that the tax should be levied on what constitutes "real income", that is, income determined according to accepted accountancy practices and not on a base delineated in the income tax laws through all kinds of rules and restrictions.

6.11 The inequities and anomalies resulting from the exclusion (or inadequate valuation) of certain ingredients of economic power (like provision of perquisites and imputed income from dwellings) on the one hand and arbitrary limits on deductibility of expenses incurred in earning income on the other have been compounded by the plethora of provisions allowing exemptions for income from certain activities and services and deduction for specified purposes to promote social and economic objectives. The erosion of the tax base that has taken place as a result and the consequent ill effects on equity and efficiency are well known and in fact have provided the main motivation for tax reform throughout the world towards a wider base of the income tax with moderate rates. Highly progressive rates have little significance when there are so many relief provisions and loopholes and evasion is widespread. Both vertical as well as horizontal equity require that the income tax be levied on a comprehensive income base comprising all major ingredients of one's taxable capacity, having regard of course to considerations of administrative and compliance problems. At the same time every endeavour should be made to see that the restrictions put on deductibility of expenses do not unduly expand the base by denying deduction for legitimate costs of earning income. These are the directions in which the proposals put forward in this report are designed to reform the present income tax system.

6.12 Measures for widening the income tax base and rationalising the structure are considered under the owing broad heads:

a. Re-structuring the tax rate schedule;

b. Rationalising the definition of the tax unit;

c. Elimination or rationalisation of exemptions and deductions;

d. Widening the scope of taxation of perquisites and fringe benefits;

e. Redesigning the scheme of taxation of capital gains;

f. Reviewing the expense deduction rules; and

g. Redesigning the treatment of intermediaries like partnerships, cooperatives, etc.

6.13 Equity in income taxation requires that all incomes in whatever form received should be brought into the tax base after allowing for legitimate costs of earning. It is, therefore, necessary to ensure that all those having taxable income are brought into the tax fold. In a developing economy with a large unorganised sector this presents acute problems. There are a number of "hard-to-tax" groups comprising small traders, small manufacturers, contractors, transport operators and so on. How to induce those among these groups who could reasonably be presumed to have taxable income to pay some tax without exposing them to hassles associated with income-tax assessment is dealt with in the section "Taxation of 'hard-to-tax'groups" of this Chapter.

The Rate Schedule

6.14 The fairest,[32] the simplest and the most easily administrable form of income tax is a moderately progressive flat, or single marginal rate, income tax levied on a comprehensive base. The progression will be attained through the granting of an exemption for a nuclear family. Thus, if the first Rs.50,000 of annual income is exempt and the flat rate of tax above that level is 30 per cent, a person (or family) with an income of Rs.51,000 will pay a tax of Rs.300, which will yield an average rate of 0.58 per cent, while an income of Rs.3 lakh will bear a tax of Rs.75,000 which gives an average rate of 25 per cent. With further rise in income, the average rate will approach and approximate to 30 per cent. With such a flat rate income tax, most of the defects in, and the problems caused by, an income tax with a progressive rate schedule will virtually disappear:

a. If it is stipulated that (i) a family will be granted a composite exemption level which will be shared by the husband and wife, if both are income earners, (ii) the property incomes of minor children will be aggregated with the income of one of the earning parents and (iii) one individual can claim

32. In terms of horizontal equity in the broadest sense.,

exemption only once, that is, in one capacity, then justice will be meted out between single-earner and double-earner families without penalising the second earner and attempts at splitting income will be rendered unprofitable. Formation of multiple partnerships will be of no avail. One would have straightaway solved the problem of taxing partnerships and Hindu undivided families.

b. With a moderate single rate, almost all the deductions and tax-preferences could be eliminated making the task of administration easy. All those with taxable incomes can opt for tax deduction at source to the maximum extent possible. Tax deduction at source can become an important way of collecting tax.

c. Full integration of personal and corporate income taxes can be achieved by applying the same single rate to both incomes and exempting dividends in the hands of the shareholders.

d. With a single rate, the inequality in the treatment between steady and fluctuating incomes as well as between incomes that are concentrated during a short period in life and those that are spread over a long period will be greatly reduced.

e. All capital gains can be taxed as ordinary income, with long-term gains being suitably indexed for inflation; with a single rate, "bunching" does not cause any serious problem.

f. There will be need only for the indexation of the exemption level; there will be no bracket creep.

g. Inflation will still create problems, but the interaction of inflation and income taxation will produce much less iniquitous effects than under a progressive schedule.

6.15 Certain basic problems inherent in the taxation of income will of course remain, for example, taxation only on the basis of realisation, impossibility of full capital income adjustment under inflation and need for estimation of depreciation. However, it can be stated that given the problem of assessing incomes on an annual basis in the real world, a single rate income tax offers the fairest and also administratively the simplest way to tax incomes. Perhaps it is the only kind of income tax that could be satisfactorily administered in a typical developing country. More often than not, a structure of taxes which appears highly progressive in the statute remains progressive only on paper and turns out to be highly iniquitous and distortionary.

6.16 However, a single rate cannot be pitched at a high level. Therefore, the rate of progression that can be achieved will inevitably be moderate. This would be considered a demerit of the system, by many.

6.17 On the other hand, since the rate will have to be around 30 per cent, the exemption level will have to be fairly high; that would leave out some incomes which could reasonably be brought within the income tax net with a lower tax rate.

6.18 We have, therefore, to opt for a system of personal income tax with more than one rate. The Committee, therefore, recommends, for the present, the following tax rate schedule for different taxable entities:

a. In the case of individuals, the exemption limit should be fixed at Rs.28,000. The marginal rates of tax (inclusive of surcharge, if any) should be :

   i. 20 per cent for total income in the range of Rs.28,000 to Rs.50,000;

   ii. 27.5 per cent for total income in the range of Rs.50,000 to Rs.2,00,000; and

   iii. 40 per cent for total income exceeding Rs.2,00,000.

b. In the case of a Hindu undivided family, the existing distinction between a specified HUF and a non-specified HUF should continue. The rate schedule for non-specified HUF should be the same as recommended in the case of individuals. In the case of specified HUFs, the exemption limit should continue to be fixed at Rs.12,000. The marginal rates of tax (inclusive of surcharge, if any) should be 27.5 per cent for total income in the range of Rs.12,000 to

Rs.1,00,000 and 40 per cent for total income exceeding Rs.1,00,000.

c. In the case of local authorities, tax should be levied at a proportional rate of 30 per cent.

d In the case of domestic companies, the tax rate (inclusive of surcharge, if any) should, within the next three years (i.e., by assessment year 1995-96), be reduced to the same level as the maximum marginal rate of tax (inclusive of surcharge, if any) in the case of individuals i.e., 40 per cent. Further, the existing distinction between companies in which the public are substantially interested and companies in which the public are not substantially interested for the purposes of tax rate, should also be abolished within the next three years.

6.19 In view of the new scheme of taxation of partnership firms, AOP and BOI recommended by us in the later part of the report, there is no necessity for prescribing a separate tax schedule for registered firms.

6.20 The exemption limit of Rs.28,000 for individuals has been fixed after indexing for inflation the exemption limit of Rs.8,000 for the assessment year 1976-77 (income earning year 1975-76). The Committee is aware that the exemption limit in India for individuals is relatively high compared to other countries. However, unlike in other countries where separate exemptions are given for children and other dependents, in India there is no such provision. (Earlier, an allowance was given for dependent spouse and children. These were done away with for simplicity). A lower exemption limit for individuals with suitable exemptions for dependents and minor children has the disadvantage of being complex both for the taxpayer and the tax administration. Besides, as pointed out in Chapter 4, the exemption level fixation has to keep in mind also the administrative feasibility of collecting direct taxes from the low income unorganised sector. Recognising these facts, the Committee considers it appropriate to recommend a suitable increase in the exemption limit with a structural change in the tax treatment of the non-wage income of minors which we discuss later in this report. Further, the Committee is also of the view that while marginal rates of tax need to be reduced, the average rate should be relatively high. This being the objective and with increase in the exemption limit, it is important that the entry point rate of tax is not made very low. For the time being the Committee recommends that the entry point rate of tax is maintained at the existing rate of 20 per cent.

6.21 The opinion has been expressed in some quarters that it would be better to have a lower entry tax rate for the reasons that in that case we could have a lower exemption level and that potential taxpayers would not keep off the tax net for fear of having to pay a high rate. It is presumed that a high entry rate would frighten off potential taxpayers at the lower end of the income scale. The Committee does not think it would be desirable to lower the exemption level as well as the entry tax rate. It has already been pointed out that while a single rate system is the ideal form of income tax, devoid of most of the problems associated with the progressive rate schedule, a rate schedule with a very little spread would be the second best alternative. With a low entry rate, the number of rates would multiply leading up to the maximum marginal rate and we would be back with all the problems associated with a progressive rate schedule - problems mainly related to violation of horizontal equity. Our aim is precisely to try to minimize these problems. It has also been pointed out that from the point of view of minimizing the adverse impact on incentives, it is better to have a tax system with a fairly high average rate and a moderately high marginal rate: such a combination can be obtained only with a reasonably high entry rate. Furthermore, our studies and inquiries reveal that the potential taxpayers at the lower end of the scale desire to keep away from getting included in the income tax paying group more from the fear of having to deal with the Income Tax Department and from an expectation that in course of time they would become subject to a high marginal tax. Now that we are reducing the top marginal rate and have evolved a simplified procedure for payment of tax by small businesses, both these apprehensions will lose much of their strength. Of course, taxpayers are intelligent enough to calculate that the actual ratio of tax to income that they would have to pay is going to be fairly small even though the entry rate is 20 per cent because that rate will apply only to the excess of income over the exemption level. Thus, according to the rate schedule that we have proposed, a person with a taxable income of Rs.30,000 would have to pay only 1.3 per cent of his income in tax. It would be even lower should he avail himself of deductions provided for investment in provident fund/insurance or in NSS.

6.22 The rate schedule and the exemption level recommended above is intended to be a transitional arrangement. The objective of the reform is to introduce a two-rate schedule. We recommend that within the next three years, the Government should move over to a system with two rates as follows:

a. The exemption level for individuals should be indexed upward subject to a minimum of Rs.30,000.

b. A rate of 27.5 per cent for incomes between Rs.30,000 and a level to be arrived at by increasing the Rs.2 lakh level, now recommended.

c. 40 per cent at income in excess of that level.

6.23 We are convinced that the simple and moderately progressive system we recommend will lead to considerable growth in revenues within a few years. It will then be possible to raise the exemption level in real terms and also fix the lower rate at 27.5 per cent under a two-rate system as suggested above. All this is however, contingent on a thorough revamping of the administrative procedures and practices and evolving more effective methods of enforcement on the one hand and a radical reform of the existing provisions relating to the coverage and measurement of the base and treatment of intermediaries like partnership firms, cooperatives and so on, on the other.

Tax Unit

6.24 Fairness in the tax system requires that it should treat equals equally: those with similar abilities to pay should bear similar tax burdens, and the tax burden borne by different individuals should not differ in arbitrary or capricious ways. Thus, as has been explained in detail in chapter 4, horizontal equity requires measuring of the "ability to pay" on the basis of a comprehensive income concept. A concomitant dimension of the horizontal equity lies in defining the tax unit fairly. The question assumes importance under a system of progressive taxation in which it is possible to reduce one's tax liability by simply splitting one's income and assets among one's family members without losing control over their disposition. It is in this context that the question arises whether the individual or the family should be regarded as the appropriate tax unit, and if it is to be the family, what should be its definition.

6.25 In deciding whether an individual or a couple or a family (spouses and minor children) or some other grouping should be the unit of taxation, it is important to bear in mind, inter-alia, the following considerations:

a. Tax liability should be unaffected by marital status, i.e., there should be no financial reward or penalty for marriage (Consideration-I), and

b. Couples with equal incomes should pay the same taxes (Consideration-II).

6.26 In the case of an individual as a unit of taxation, the tax is levied on the income of the individual, with no regard for the individual's family circumstance. Arguments in support of the individual as the tax unit are the following: First, a person's tax liability should be independent of his or her marital status so that taxation remains neutral with respect to marriage. Second, an individual's tax liability should be independent of the earnings and circumstances of others, even those in the same family. Third, individual taxation treats a married man with a non-working wife in the same way as a single man with identical income (i.e., no tax concession is granted to a married man which is only logical as the marrying and maintaining a non-earning spouse is the choice of the individual). Also two people can live off a given income as well as a single individual without much additional expenditure because of economies of scale. Fourth, the individual basis generally reduces the marginal rate of tax leading to a substitution effect in favor of work effort. Lastly, taxation on the basis of individual as the tax unit is simpler, both in terms of compliance and administration, as there is no requirement of reporting of income of all members of the family.

6.27 The disadvantages of the individual basis are threefold. First, while it is neutral to marriage, it results in a situation where a married couple's tax liability depends on the relative incomes of husband and wife. Thus, a couple with all their income received by one partner pays more tax than a couple with an equal joint income, half received by each partner. This violates the second consideration. Second, the individual basis ignores the fact that households and families are the basic units in which civilised societies are organised, and that the needs and characteristics of a household differ fundamentally from those of a single person. Finally, the individual basis runs into difficulties in the assessment of investment income, as such income can be split among the family members to minimise the tax liabilities of the combined unit.

6.28 With family as the basis of taxation, the major advantage is that if all income of the couple is aggregated and then taxed as though it were received by a single person, couples with equal incomes will pay equal amounts of tax.

6.29 The couple basis, however, suffers from certain disadvantages. Given a progressive rate schedule, marriage increases the combined liability of both spouses by moving them into a higher tax bracket. Hence, such a tax system is not neutral with respect to marriage.

6.30 Further, the couple basis goes against efficiency considerations, as under this system, the marginal tax rate of the second earner (whose earnings are typically below those of the primary earner) is substantially higher than it would be under an individual basis.

6.31 Another disadvantage of the couple basis is related to the difficulty of maintaining financial privacy within marriage and the problems of fixing responsibility for compliance. Withholding of information by one of the spouses can put the other in difficulty in complying with the tax laws. Thus, compliance and administration are both difficult in family unit taxation.

6.32 In a progressive tax structure, both the individual basis and the couple basis will result in anomalies and problems, and the question as to which set of anomalies is less objectionable is largely a matter of social choice. The only perfect solution to the problem is to have a flat rate tax.

6.33 However, as long as the rate structure remains progressive some way needs to be found to serve the objective of equity while keeping in view the problems of compliance and administration. On a balance of considerations, the Committee is of the view that complete integration of the incomes of both the spouses or, for that matter, all adult members in the family is not feasible or necessary. However, the existing safeguards in the income tax law for aggregation of incomes in the case of splitting of assets should continue, with modifications.

6.34 The modifications relate to the treatment of minor children in a family. Under a progressive rate structure, there is always an incentive to shift the ownership of assets to children in the family. The present income tax law attempts to prevent the shifting of income from assets without shifting the full ownership. The result is a whole catalogue of legal distinctions and provisions for clubbing of incomes.

6.35 Some arguments could be advanced for the exclusion of the income of the minor children from that of the parents. However, in reality as well as in law, minors cannot administer their property nor can they take decisions on the disposal of income. These fall on the guardian, usually the father or the mother, who for all practical purposes, treat and use these incomes as part of their own. In most families the income of dependent children is taken into account in family decision making. The inclusion of a child's income with that of his parents nullifies tax avoidance schemes under which property or investment income can be diverted to the children.

6.36 On the negative side, it can be argued that to include in family income the part-time earnings of, say, a school-going child and to tax them at full marginal family rates would be unfair. It would also be unenforceable as these earnings would seldom be reported.

6.37 On the other hand, exclusion of children's income from the income of their parents extends privileged tax treatment to families whose children happen to possess property not acquired by them on their own and is often the outcome of efforts on the part of the parents to split their incomes. In this view of the matter the investment income of minor children ought to be aggregated with the income of their parents with separate treatment of earned income on the same lines as those accorded to the earnings of an adult.

6.38 At present, in India the income of the minor admitted to the benefits of any partnership is included in the income of the parent, irrespective of whether or not either parent is a partner in the same firm. Further, any income accruing to a minor from any asset transferred to him by the parents or the grandparents is included in the income of the parent or grandparent who has transferred such income-generating asset. However, in respect of all other income accruing to him, the minor is a separate taxable entity. Keeping in view the rationale for aggregation of minor's income with that of the parents, the Committee recommends that -

a. All incomes of a minor, other than wage income should be aggregated with the total income of -
   i. The parent having the higher income where the total income of one parent or of both the parents happen to fall below the exemption limit for individuals;
   ii. Any one of the parents at the option of the parents where the income of both the parents exceeds the exemption limit; and
   iii. If over time the income of the parent, with whom the income of the minor was aggregated earlier, goes below the exemption limit, the parent having the higher income.

b. It follows that the income of the minor arising from assets transferred to him or her by any one including his grandparents should be aggregated with the income of the parent as recommended above.

Exemptions and Deductions

6.39 Over the years, despite scepticism of fiscal experts over their efficacy, tax incentive packages have been widely used in a variety of forms for diverse purposes. In India, a plethora of tax incentives have been built into the income tax law. In recent years, several of these incentives have either been removed or the quantum reduced. Even so, a large number of them still continue, particularly those purporting to promote "savings", exports, new industrial units, tourism, poultry farming, book publishing, rural development, environment and other socio-economic activities.

6.40 As pointed out in Chapter 4, one of the motivating factors underlying the sweeping reform that has taken place in the 1980s in many countries of the world is the disenchantment with tax incentives as an instrument of promoting social and economic objectives. Apart from the fact that they invariably open up loopholes, tax incentives have come in for strong criticism primarily on account of research findings casting strong doubt on their efficacy in achieving the objectives underlying them. Studies have shown that the effect of many of the incentive provisions at best is marginal. Moreover, often there is no means of quantifying or verifying the extent of the benefit derived from each of the provisions and the cost as well as the benefit to the society remain unknown. Multiplicity of the provisions, with all kinds of conditions and stipulations to guard against misuse, makes both administration and compliance burdensome. Furthermore, the deductions often tend to confer unduly large tax benefit on taxpayers with higher incomes who are more resourceful and who can take full advantage of the tax concessions. This reduces the progressivity as well as the horizontal equity of the tax system. Another objection to tax incentives is that by altering the rates of return in unintended (and often unforeseen) ways, they tend to distort the allocation of resources. If the income tax system is to be made simple and equitable and least distortionary and the rates are to be reduced substantially, most concessions and deductions except for costs of earning should be removed.

a. Incentives for saving

One of the objectives of the Government has been to use the income tax to promote savings. For this purpose, several provisions have been introduced in the scheme of taxation of personal income. In fact, these constitute the most significant set of incentives provided in the law of personal income tax.

Basically, the incentives for personal "savings" are provided under the Income-tax Act in three forms. These are -

i. exemption of income from specified financial assets subject to certain monetary limits (Sections 10(15) and 80-L);

ii. deduction from income, on a netting principle, of the whole of the funds invested in the National Saving Scheme, certain schemes of Life Insurance Corporation of India and the equity linked saving scheme of mutual funds (Sections 80-CCA and 80-CCB);

iii. rebate in tax payable as a percentage of the funds invested in specified financial assets or construction of house property (Section 88).

6.41 The objective underlying the tax incentive schemes for savings coming under (i) and (iii) evidently is to encourage the flow of savings into specified financial assets, mainly those which are either directly sponsored by the Government or by public financial institutions. Section 80-L provides for deduction from taxable income, of dividends from Indian companies, income from bank deposits, income from units, etc. upto Rs.13,000 in the aggregate. It may not be wrong to say that most of the concessions (except that under Section 80-CCA) were introduced on an ad hoc basis from time to time without adequate examination of the total impact of the different schemes put together. Often the concessions given to the various financial assets cancel out the relative advantage given to any particular asset and thus revenue is needlessly lost. It is extremely doubtful whether these concessions really help to raise domestic savings; it would seem that they merely serve to induce the flow of available savings into specified channels, except for deduction provided under Section 80-CCA.

6.42 While the impact of the tax incentives on savings remains uncertain, the liberal tax treatment of investment income under the present scheme of Section 80-L and Section 10(15), favour upper bracket taxpayers more than those in the lower brackets. It may be noted that the public sector bonds providing for unlimited exemption of interest from income tax as well as exemption from wealth tax also confer unduly large benefits on savers who are taxpayers and, particularly, the rich taxpayers. It is obvious a higher interest rate to stimulate savings benefits all savers - taxpayers and others, the richer and poorer taxpayers - equally.

6.43 Further, the tax privilege accorded to investments in Life Insurance Policies, mutual funds, Public Sector Companies and other financial institutions is not quite conducive to the efficient use of domestic savings. The tax advantages insulate the institutions from competitive forces. It may be argued that institutional saving has the advantage of risk pooling and offering opportunity to economies on transaction costs. But that scarcely argues for any special inducement such as a tax concession. Thus, the elimination or reduction of the tax benefits is not likely to have any adverse effect on the institutions per se.

6.44 For reasons mentioned above, the Committee recommends the abolition of the tax concessions now available:

a. under Section 10(15)(iic) in respect of interest on notified Relief Bonds;

b. under Section 10(15)(iv)(h) in respect of interest received from any public sector company in respect of notified bonds or debentures;

c. under Section 10(15)(iv)(i) in respect of interest received from Government on deposits in notified scheme out of moneys due on account of retirement;

d. under Section 80-L in respect of income from specified sources.

6.45 The current concessions in income tax for savings in the form of tax rebate for contribution to Provident Fund, and investment in Life Insurance Policies, unit linked insurance plans, superannuation funds, National Savings Certificates and housing contractual schemes suffer from the defects pointed out above and further constitute unnecessary and, in many ways costly, impediments to the implementation of the income tax.

6.46 Since taxpayers, especially among the lower fixed income groups usually put their savings in provident fund, life insurance and invest in fixed deposits in banks, UTI, etc., and derive benefit from tax concession going with them and also since and the tax payers in lower income brackets will not benefit as much from reduction in tax rates immediately, it may not be possible to eliminate some of the incentives for savings completely, or at one stroke. The Committee, therefore, recommends that the tax rebate allowed under Section 88 for investment in provident fund, NSCs, etc. should continue to be allowed at the entry point rate of tax but only for investment upto a reduced maximum level of Rs. 10,000/-. Further, the tax concession should be restricted to contributions to provident fund, life insurance policies and repayment of loans taken for purchase or construction of a residential house property. The reduction in the total quantum of tax benefit attached to these schemes would merely reduce the undue privilege flowing to the relatively better off taxpayers who will be benefitting from the rate reductions. The return on savings in certain forms will still be wholly exempt from tax (e.g., interest on deposits in the provident fund and bonus on life insurance policies as these are not easily withdrawable).

6.47 Section 80-CCB of the Income-tax Act provides for deduction from income, on a "netting" basis, of the whole of the funds invested in the equity linked saving scheme (ELSS) of mutual funds upto Rs.10,000 in a year. The scheme, however, provides for concessional tax treatment of the return from investment in the ELSS thereby violating the very principle of expenditure tax on which basis it was supposed to be formulated. We have already pointed out how tax benefits go against efficiency in the deployment of funds by protecting certain institutions and distorting investors' choice and why removal of tax benefits will not adversely affect the institutions. We also observe an improved buoyancy in the capital market which we expect to be further reinforced on account of the proposed reduction in income tax rates and exemption of shares from wealth tax. The Committee, therefore, recommends the abolition of the tax concession under Section 80-CCB for investment in equity linked saving scheme. For similar reasons, the Committee also recommends the withdrawal of the tax concession under Section 80-CCA for any investment in the Jeevan Dhara or Jeevan Akshay annuity plans of the Life Insurance Corporation of India.

6.48 Further, with a view to encouraging real savings and making available resources to the Government, the Committee recommends that the existing ceiling of Rs.40,000 for deposits in the National Savings Scheme under Section 80-CCA should be increased to Rs.50,000.

6.49 The Committee is of the view that the aforesaid recommendations would not in any way adversely affect savings in the economy. The issue relating to taxation of dividends will form the subject matter of the final report of this Committee.

b. Incentives for rural development, environment, etc.

6.50 Under Sections 35-CCA and 35-CCB, 100 per cent deduction is allowed for donations to associations/institutions for carrying out rural development programmes or programmes of conservation of natural resources and afforestation. A new provision (Section 35AC) has been inserted in the Income-tax Act by the Finance (No.2) Act, 1991 to provide for deduction of payment of any sum to a public sector company or a local authority or to an association or an institution carrying out any project or scheme for promoting the social and economic welfare, or upliftment of the public. If the taxpayer is carrying on a business or profession, Section 35-CCA or 35-CCB or 35-AC is operative; the deduction is not subject to any monetary limit and if forming part of the business loss for the year, can be carried forward and set off against profits in the subsequent years. For assessees not carrying on a business or profession, Section 80-GGA is applicable but the aggregate of deductions under Chapter VIA of the Act including this deduction cannot exceed the gross total income for the year. In other words, in the case of a non-business assessee, the deduction relating to donations cannot form a part of the loss for carry forward and set off against profits in subsequent years.

6.51 Alternatively, an assessee interested in social and economic welfare or upliftment of the public or rural development or conservation of natural resources or afforestation can make donations to tax-exempt charitable trusts. Such an assessee can, in the computation of the taxable income, claim, under Section 80-G, 50 per cent deduction for such donations.

6.52 However laudable the objectives, tax incentives do not seem to be the right vehicle for motivating private agencies engaged in business activity to take up philanthropic pursuits on their own. Further, these provisions discriminate between associations/institutions approved under these provisions and those not so approved but carrying on the same socio-economic activity and between taxpayers engaged in business or profession and others. Moreover, as pointed out at the outset, the use of the tax system for promoting such objectives undermines the equity of the system, creates complications in administration and leads to all kinds of distortions and anomalies. For a thorough reform of the tax system towards simplicity and equity and substantial reduction of rates, it is absolutely necessary to eliminate all such incentives/concessions in the tax system except for the essential few. It is to be noted that the provisions relating to these concessions are an important cause of disputes and litigation. The Committee, therefore, recommends the amalgamation of the provisions of Sections 35-AC, 35-CCA, 35-CCB and 80-GGA with Section 80-G. The 100 per cent deduction at present allowable under Sections 35-AC, 35-CCA, 35-CCB and 80-GGA should be restricted to 50 per cent as in the case of deduction for other donations under Section 80-G. Further, deductions should be allowed only in respect of donations to an approved association/institution and not for expenditure incurred on an in-house programme.

c. Incentives for new industrial undertaking, book-publishing, poultry farming, etc.

6.53 The benefits allowed at present under the income tax law to promote growth of new industries, book-publishing, poultry farming, etc., are the following:

i. deduction of 20 per cent of the profits from newly established industrial undertakings or hotel business, subject to the condition, inter-alia, that the same is established in a backward area and begins to manufacture or starts functioning before 1st April, 1990. This deduction is available for eight assessment years (Section 80-HH);

ii. deduction of 20 per cent of the profits from newly established small-scale industrial undertakings subject to the conditions, inter-alia, that the same is established in a rural area and begins to manufacture or starts functioning before 1st April, 1990. This deduction is available for eight assessment years (Section 80-HHA);

iii. deduction from profits from industrial undertakings, ships, hotels and cold storage plants, subject to the conditions inter-alia, that the unit is newly established anywhere in India and begins to manufacture or starts functioning before 1st April, 1991. This deduction is available for 10 assessment years. The quantum of deduction is 30 per cent and 25 per cent of profits in the case of companies and non-corporate assessees respectively (Section 80-I);

iv. deduction from profits from industrial undertakings, cold storage or ship or the business of a hotel where the business starts functioning after 31-3-91 (at specified rates and subject to specified conditions) (Section 80-IA);

v. A deduction of 33-1/3 per cent from profits from the business of poultry farming (Section 80-JJ);

vi. deduction of 25 per cent of the professional income of authors of text books in Indian languages (Section 80-QQ);

vii. deduction of 20 per cent of profits from the business of publication of books. (Section 80-QQA)

6.54 In keeping with the approach towards reform proposed in this Report, the Committee recommends that all the above provisions be removed from the Income-tax Act. In the case of existing taxpayers, some of these incentives would continue to be available along with the reduced tax rates proposed by us. This would discriminate against new taxpayers. With a view to removing this bias against new taxpayers, the existing taxpayers could either be denied the benefit of the incentives with immediate effect or, in the alternative, be subjected to a higher rate of tax. While the former approach could be assailed as a breach of promise on the part of the Government, the latter would lead to complexity in the law and increase the burden of compliance and administration. Since the existing taxpayers would considerably benefit from the reduced tax rates, there would not be a net increase in their income tax burden even if these incentives were to be removed with immediate effect. Further, in the case of other incentives, apart from the general drawbacks of incentive provisions, these would become unattractive as a consequence of the considerable reduction in the tax rates. The Committee, therefore, recommends the abolition of all the incentives listed above with immediate effect for all taxpayers. This would mean that taxpayers who have established their new industrial undertakings or hotels, etc., even prior to the specified date, would not henceforth be eligible for the tax benefits they have been enjoying under the above-mentioned provisions. While this abolition would have no adverse economic consequences, there would come about a major simplification of the tax law. Any support to be given to specific industries or locations in specific areas should be through subsidies.

d. Incentives for foreign exchange related earnings

6.55 A number of tax incentives[33] have been incorporated in the income tax law for encouraging the flow of foreign exchange into the economy. Given the present external payments situation of the country, it is obviously necessary to reward activities that bring in net foreign exchange into the country. Also, it is agreed that our exporters suffer from several disadvantages in competing in the world market partly because of high costs and partly because of high rate of protection given to import substitution. It is, therefore, necessary to continue many of the incentive provisions incorporated in the Income tax Law benefiting earners of foreign exchange. However, the Committee feels that the large number of provisions should be examined with a view to rationalising them and eliminating or at least reducing those which do not help in any significant way in the earning of foreign exchange. With the gradual reduction of the rates of import tariff, the bias against exports would be reduced. Similarly, with the rationalisation of the indirect tax system on domestically produced goods, Indian exporters should be benefiting from the consequent cost reduction. Hence, the provisions such as Sections 80-HHC, 80-HHE etc. need to be kept under review. The Committee would discuss issues relating to these concessions in the second Report.

Taxation of Perquisites of Fringe Benefits

6.56 A major source of erosion of the personal income tax base all over the world where the tax is in vogue is the practice of providing benefits to employees in non-cash forms - "fringe benefits as they are called. These benefits are given in many forms ranging from rent free or concessionally charged residential accommodation to free use of motor vehicles, free or subsidised travels, travel benefit, medical benefit and so on. Certain employers like airlines provide benefits

33. Sections 80-HHB, 80-HHC, 80-HHD, 80-HHE,80-O, 80-R, 80-RR and 80-RRA of the Income-tax Act.

which are exempted from tax even though paid in cash. Strictly speaking, under an equitable system of income taxation based on the comprehensive income concept, all such benefits should be brought under taxation as otherwise equity suffers and there is also an impetus for wasteful use of resources (e.g., on needless travel and excessive medication). Problems of valuation and also of finding the necessary funds to pay the tax often preclude the taxation of fringe benefits in the hands of employees at their full market value. For this reason some countries (Australia and New Zealand for example) have introduced a tax on fringe benefits payable by the employer. While a fringe benefits tax on the employer provides one way of bringing these under taxation, in the present situation, the Committee feels that given the existing framework of fringe benefits taxation under the Indian income tax, a better alternative would be to tighten those provisions and make them more comprehensive.

6.57 While on considerations of equity, the appropriate taxable unit is the employee, the choice of employer as a taxable unit is administratively more practicable. The Committee is, therefore, of the view that while the existing provisions for taxation of perquisites in the hands of the employee need to be tightened and made more comprehensive, the employer should also be made to pay a tax on fringe benefits which remains untaxed in the hands of the employee either on account of concessional valuation of perquisites in the hands of the employees or on account of problems of allocation of collective enjoyment of benefits.

6.58 In India, fringe benefits are taxable in the hands of employees by virtue of Section 17 of the Income-tax Act, 1961. The present Act does not define perquisites as such: only certain items have been included in that expression. Rule 3 gives the methods of computation of certain specific perquisites such as residential accommodation, furnished or unfurnished, motor car for personal use; other conveyance for personal use; and gas, water and electricity charges paid for personal use. These perquisites are included in the taxable income of the employees and are not taxed separately. Similarly, a number of items of perquisites are excluded from the total income subject to certain conditions and limits.

6.59 At the employer's end, the existing law provides for disallowance of certain categories of expenditure in the computation of the employer's total income. There is no tax as such on employers on account of fringe benefits allowed to the employee.

6.60 The existing scheme of valuation of perquisites for taxation in the hands of the employee or the implicit taxation of fringe benefits in the hands of the employer is far too liberal and inequitable as it discriminates amongst employees in the Government, the public sector, the private sector and across salaried persons and self-employed persons. In fact the rules of valuation have,for decades,not been revised to keep pace with inflation.

6.61 At present, the value of rent-free accommodation provided by the employer to an employee, getting a salary exceeding Rs.2,000 per month is considered as a taxable perquisite and included in the salary income of the employees. Where the accommodation is provided at a concessional rent the difference between the value as rent free accommodation and the rent paid by the employee is included in the taxable salary. However, the rules for valuing the perquisite by way of rent free accommodation do not capture the entire cost incurred by the employer in providing the rent free accommodation.

6.62 Under the existing rules for valuing perquisite by way of free or concessional housing, in the case of Government employees, including those working for public sector undertakings or bodies controlled and financed by Government and occupying accommodation allotted by the Government, the value of rent-free unfurnished accommodation is taken at the rent that would be payable, had the accommodation not been provided free of rent. In the case of public sector employees, the perquisite value of rent-free unfurnished accommodation is taken at 10 per cent of the salary of the employee for the period during which the accommodation is occupied by him. In the case of employees in the private sector, however, if the fair rental value of the accommodation in Bombay, Calcutta, Delhi and Madras exceeds 60 per cent of salary and at other places if it exceeds 50 per cent of salary, the perquisite value is determined at 10 per cent of salary plus the fair rental value of the accommodation in excess of 60 or 50 per cent of salary respectively.

6.63 For the purpose of the aforesaid rule, fair rental value of any accommodation owned by the employer means the rent which a similar accommodation would realise in the same locality or the municipal valuation in respect of accommodation, whichever is higher. Where the accommodation is hired by the employer, it is the actual rent paid for the accommodation.

6.64 Where the accommodation is furnished the perquisite value of unfurnished accommodation is increased, in all cases by the actual hire changes for the furniture or 10 per cent per annum of the original cost of furniture if it is owned by the employer.

6.65 It may thus be seen that both in the case of public sector employees and employees in the private sector, the actual cost or the shadow cost of the accommodation if owned by the employer in providing residential accommodation to the employees is not fully captured in taking the perquisite value in the hands of the employees. This concession has been provided on the consideration that in view of the high cost of residential accommodation in metropolitan and other cities, if the perquisite was to be valued at the real cost to the employer and taxed in the hands of the employees, the cash salary paid to the employees may not be sufficient to pay the tax on the perquisite value.

6.66 One consequence of this tax concession to the employees has been the tendency of providing a remuneration package to the employees, the major part of which consists of free high cost housing. Since the cost incurred by the employer in providing such housing is deducted in computing the employer's income chargeable to tax, the employers consider only the after-tax outgo in reckoning the cost of providing housing to their employees.

6.67 Where an employer does not provide any residential accommodation, the employee is in receipt of a fixed sum as house rent allowance (HRA). Under the present law, the HRA is includable in the computation of total income. However, Clause (13A) of Section 10 of the Income-tax Act read with Rule 2A exempts the least of the following amounts:

a. amount of HRA received;

b. expenditure on rent in excess of 10 per cent of the salary;

c. 50 per cent of the salary if the accommodation is in Delhi, Bombay, Calcutta and Madras and 40 per cent of the salary if the accommodation is at any other place.

6.68 Similarly, in the case of the self-employed, the tax laws provide relief under Section 80GG in respect of rent paid in excess of 10 per cent of total income for furnished/unfurnished residential accommodation subject to a maximum of Rs.1,000 per month or 25 per cent of total income, whichever is less. However, this relief is inadmissible if the taxpayer or his spouse or minor child or the HUF of which the taxpayer is a member, owns a house at the place where he performs his duties or the taxpayer has a self-occupied property anywhere in India.

6.69 As is evident, the rules of valuation vary across taxpayers within the same income range. This violates the norms of horizontal equity. Further, the rules for valuing the perquisite by way of rent-free accommodation do not capture the entire cost incurred by the employer in providing the rent-free accommodation. This arises partly due to problems of valuation and partly due to liquidity crunch in the case of an employee. It is difficult to determine what the value of the compensation would be in a free market economy. Similarly, in some cases, the value of the in-kind compensation would be unusually high and tax on such value could lead to appropriation of the entire cash compensation.

6.70 Even so, both on equity and efficiency grounds, the right course would be to tax the value of all fringe benefits including free or concessional housing at the market value and compensate the employee by paying appropriately higher salaries. That might force many of the senior officials and ministers in the Government to move out of the huge bungalows they are occupying at present in Delhi and the State capitals. But it would curb the wasteful use of scarce social resources in real estate in urban areas. Provision of wasteful housing to senior executives will be curbed in the private sector too and they might be compelled to look for new moderate accommodation. After all structural adjustment should entail some serious adjustment in the life style of the elite too. However, given the existing situation a radical reform, though eminently desirable, does not seem to be feasible. The Committee, however, is strongly of the view that a beginning ought to be made in this direction by a more realistic valuation of free or concessional housing than at present.

6.71 In view of the foregoing, the Committee recommends that -

a. The present distinction in perquisite valuation of rent-free accommodation or concessional rent accommodation or concessional rent accommodation between employees of the Government, companies in the private sector and public sector and other autonomous bodies be abolished.

b. The perquisite value of both the rent-free accommodation and concessional rent accommodation should be taken to be equal to twenty per cent of the salary or the expenditure incurred by the employer in providing housing, whichever is lower. This rule should be made applicable to all employees irrespective of whether the employee is in the private sector or in the public sector or in the Government. However, where the expenditure incurred by the employer in providing housing is fully recovered from the employee, the perquisite value should be taken to be nil. Further, the perquisite value should be taken to be nil in all cases where the annual income under the head 'Salary' (excluding non-monetary benefits or amenities) does not exceed Rs.36,000.

c. The provision of clause (13A) of Section 10 of the Income-tax Act providing for exemption of house-rent-allowance as per rule 2A should be abolished.

d. All taxpayers, whether enjoying a rent-free accommodation or concessional rent accommodation or in receipt of house rent allowance or receiving no such benefit on account of being self-employed should be entitled to relief under Section 80GG of the Income-tax Act for rent paid.

e. For the purposes of computing relief under Section 80GG, 'rent paid' should mean the rent actually paid as increased by the amount of HRA that would otherwise have been admissible to the taxpayer.

f. The existing provisions of Section 80GG of the Income-tax Act should be modified to provide for deduction in respect of rent paid in excess of ten per cent of salary upto a maximum of twenty per cent. The limit of Rs.1,000 under Section 80GG of the Income-tax Act should be removed. Further,since the income from a let-out property is taxable and the income from a self-occupied property is deemed to be nil, the benefit under this provision should be available regardless of whether the taxpayer or his spouse or minor child or the Hindu undivided family of which he is the Karta has a self-occupied property anywhere in India.

g. Where the expenditure incurred by the employer in providing housing to its employee is in excess of twenty per cent of the salary of the employee, such excess which remains uncaptured in the tax assessment of the employees, should be subjected to a separate fringe benefit tax in the hands of the employer at the proportional rate of 30 per cent. The tax so paid by the employer, however, should not be allowed as a deduction in the computation of profits of the employer.

h. The expenditure incurred by the employer in providing housing to its employees should be the rent which a similar accommodation would realise in the same locality _or_ actual rent paid if accommodation is hired by the employer _or_ the municipal valuation in respect of the accommodation, whichever is higher.

6.72 Tables 6.1 to 6.3 below give the impact of the aforesaid recommendations on taxpayers under different conditions.

TABLE 6.1
Impact on Monthly Income of Change in Perquisite Valuation of Concessional Rent Accommodation

(Rupees)

		Existing			Recommendation
		Government	Public sector	Private sector	Applicable to all employees uniformly
1.	Fair rental value	4,000	4,000	4,000	4,000
2.	HRA received	NIL	NIL	NIL	NIL
3.	HRA foregone	1,000	1,000	1,000	1,000
4.	Rent paid	300	300	300	300
5.	Salary of the employee	10,000	10,000	10,000	10,000
6.	Professional income	NIL	NIL	NIL	NIL
7.	Perquisite value of house	NIL	700	2,700	2,000
8.	Gross total income	10,000	10,700	12,700	12,000
9.	Deduction U/S 80-GG	NIL	NIL	NIL	300
10.	Total income	10,000	10,700	12,700	11,700
11.	Tax payable by the employer	NIL	NIL	NIL	600

Notes: (1) The increase in the monthly tax burden (computed on the basis of the proposed tax rate schedule) on account of the new method of perquisite valuation would be Rs.470/-, in the case of Government employee, Rs.275/- in the case of public sector employee and reduction in the tax burden of Rs.275/- in the case of a private sector employee. However, the employers in the non-Government sector will have to bear a tax burden of Rs.600/- pm.

(2) For row 9, the figure in the last column is calculated as row 3 + row 4 - 10 per cent of row 5.

(3) For row 11, the figure in the last column is calculated as 30 per cent of (row 1 - row 7).

TABLE 6.2

Impact on Monthly Income of Change in Perquisite Valuation of Rent Free Accommodation

(Rupees)

		Existing			Recommendation
		Government	Public sector	Private sector	Applicable to all employees uniformly
1.	Fair rental value	4,000	4,000	4,000	4,000
2.	HRA received	NIL	NIL	NIL	NIL
3.	HRA foregone	1,000	1,000	1,000	1,000
4.	Rent paid	NIL	NIL	NIL	NIL
5.	Salary of the employee	10,000	10,000	10,000	10,000
6.	Professional income	NIL	NIL	NIL	NIL
7.	Perquisite value of house	NIL	1,000	3,000	2,000
8.	Gross total income	10,000	11,000	13,000	12,000
9.	Deduction U/S 80-GG	NIL	NIL	NIL	NIL
10.	Total income	10,000	11,000	13,000	12,000
11.	Tax payable by the employer	NIL	NIL	NIL	600

Notes: (1) The increase in the monthly tax burden (computed on the basis of the proposed tax rate schedule) on account of the new method of perquisite valuation would be Rs.470/-, in the case of Government employee, Rs.275/- in the case of public sector employee and reduction in the tax burden of Rs.275/- in the case of a private sector employee. However, the employers in the non-Government sector will have to bear a tax burden of Rs.600/- pm.

(2) For row 9, the figure in the last column is calculated as row 3 + row 4 - 10 per cent of row 5.

(3) For row 11, the figure in the last column is calculated as 30 per cent of (row 1 - row 7).

TABLE 6.3

Impact on Monthly Income of Change in the Method of Computing Exemption of HRA

(Rupees)

		Existing			Recommendation
		Government	Public sector	Private sector	Applicable to all employees uniformly
1.	Fair rental value	NIL	NIL	NIL	NIL
2.	HRA received	1,000	1,000	1,000	1,000
3.	HRA foregone	NIL	NIL	NIL	NIL
4.	Rent paid	4,000	4,000	4,000	4,000
5.	Salary of the employee	10,000	10,000	10,000	10,000
6.	Professional income	NIL	NIL	NIL	NIL
7.	Perquisite value of house	NIL	NIL	NIL	NIL
8.	Exemption U/S 10(13A)	1,000	1,000	1,000	NIL
9.	Gross total income	10,000	10,000	10,000	11,000
10.	Deduction U/S 80-GG	NIL	NIL	NIL	1,000
11.	Total income	10,000	10,000	10,000	10,000
12.	Tax payable by the employer	NIL	NIL	NIL	NIL

Notes: (1) There will be no change in tax liability. However, it will have the benefit of simplicity since Section 10(13A) will stand abolished but the concession will be available under Section 80-GG which will apply uniformly to all taxpayers.

(2) For row 9, the figure in the last column is calculated as row 3 + row 4 - 10 per cent of row 5.

(3) For row 11, the figure in the last column is calculated as 30 per cent of (row 1 - row 7).

6.73 Clause (5) of Section 10 of the Income-tax Act provides for exemption in respect of the leave travel allowance and allowance for travel on retirement, to any place in India, received by an employee from his employer, subject to the conditions and limits laid down in Rule 2B of the Income-tax Rules. Similarly, Clause (6) of Section 10 of the Income-tax Act exempts passage money and value of free or concessional passage received by an individual non-citizen of India, from his employer, subject to prescribed conditions. Keeping in view the adverse effect of the exclusion of fringe benefits from the taxable base on the horizontal equity of the tax system, the Committee recommends that at least 80 per cent of the leave travel allowance, home travel allowance, travel allowance on retirement, passage money and such other payments should be subjected to tax. Also, on efficiency grounds, it would be preferable to convert the concession into a cash grant of an appropriate amount.

6.74 Similarly, there does not seem to be any justification for exempting the allowances received by legislators, i.e. MPs and MLAs by virtue of their membership of Parliament and State legislatures. There is not enough justification for even exempting the daily allowance which is given to the legislators when they attend the sessions of the legislatures in the headquarters. Widening of the tax base cannot carry conviction until the legislators themselves agree to the inclusion of such allowances in their tax base. The Committee, therefore, recommends that the allowances paid to legislators should be fully subjected to tax.

6.75 Similarly sub-clause (ii) of Clause 14 of Section 10 of the Income-tax Act provides for exemption by notification[34] in respect of any allowance granted to an employee either to meet his personal expenses at the place where he performs his duties or he ordinarily resides or to compensate him for the increased cost of living, subject to the limits specified in the relevant notification. While recognising the need for monetary incentives to encourage people to work in distant places, at times far away from civilization, it is also necessary to ensure that wages and salaries are not paid in the guise of these allowances. The Committee, therefore, recommends that the exemption in respect of allowances covered under sub-clause (ii) of clause (14) of Section 10 of the Income-tax Act should not exceed 10 per cent of salary.

6.76 Further, since the allowance granted to an employee working in any transport system to meet his personal expenditure during his duty performed in the course of running of such transport from one place to another place is basically in the nature of daily allowance normally paid to an employee while on tour, such allowance should, more appropriately, be covered for exemption under sub-clause (i) of Clause (14) of Section 10 of the Income-tax Act.

6.77 Another form of benefits given to employees in the organised sector is the concessional loan for acquiring durables like houses or motor cars/scooters. These loans are given at concessional rates with easy payment instalments. Employees of nationalised banks get house building loans at 5 per cent interest rate payable in 120 instalments. Few even within the organised sector, get these benefits. The Committee recommends that all such loans should be deemed to have been given at the rate of 12 per cent and any concession implicit in the interest actually charged should be treated as a fringe benefit and taxed accordingly. However, where the concessional interest loan is utilized for construction of a house property or any other income generating asset, the perquisite value of the concessional interest loan should also be allowed as a deduction in the computation of

34. The various allowances so far notified are special compensatory allowances in the nature of uncongenial climate allowance, snow bound allowance, avalanche allowance, border area allowance, remote area allowance, difficult area allowance, disturbed area allowance, tribal area allowance, childrens' education allowance, any allowance granted to an employee to meet the hostel expenditure on his child and any allowance granted to an employee working in any transport system to meet his personal expenditure during his duty performed in the course of running of such transport from one place to another place.

income from such house property or any other income generating asset.

6.78 In addition to the aforesaid, the Committee further recommends that the value of all other perquisites as contained in Rule 3 of the Income-tax Rules should be revised upward to take account of inflation since the values were last fixed or revised.

6.79 The Committee has, in the interim report, decided to recommend the taxation of fringe benefits in the hands of the employer only in the case of residential accommodation that is provided rent free or at a concessional rent to the employees. Other areas of fringe benefit taxation in the hands of the employer would need to be further explored and would therefore form the subject matter of the final report of the Committee.

Taxation of Capital Gains

6.80 Capital gain is the term used for the amount by which the price at which a capital asset is sold, net of any expense incurred in connection with the sale of the asset, exceeds the price at which the capital asset was purchased. Like interest or dividends, capital gain is a return on investment or a form of compensation for forego-ing current consumption opportunities. Since capital gains like interest and dividend income increase the ability to pay of the person receiving them, they should form a part of taxable income.

6.81 Special treatment of capital gains under an income tax regime is merited, however, for two related reasons. Firstly, the capital gain realised when a capital asset is sold is usually the accumulated appreciation in the value of the asset over a number of years. Secondly, taxing gains each year, as they accrue, would strain the finances of individuals who have yet to receive these gains in hand. As discussed earlier,[35] 'bunching' of capital gains in the year in which the asset is sold pushes the seller into a higher marginal tax bracket if the value of the asset is sufficiently high. With no special treatment accorded to capital gains, a progressive income tax would discriminate against those whose income from capital assets is in the form of capital gains as compared to, for example, interest or dividends which are realised as they accrue. As has also been pointed out, under inflationary conditions, an income tax liability may arise, even if there is no net accretion to the purchasing power of an individual. Bunching of capital gains makes the problem of inflation particularly severe for this form of income even under a proportional income tax.

6.82 It is often argued that not all capital gains are the same. Differential tax treatment of anticipated and windfall gains is often advocated on the ground that the former are the reward for risk taken in setting up new enterprises, forego-ing assured income for a number of years, good management or deliberate Government policies. While this argument has some merit[36] providing special encouragement to desirable saving behaviour and entrepreneural activity, it is a general issue not restricted to the taxation of capital gains alone. Also, the fact remains that both windfall and anticipated gains lead to the accretion of economic power in the hands of an individual.

6.83 The final issue that requires to be raised in the context of capital gains taxation is the so called "lock-in" effect. The 'lock-in' effect arises because the after tax proceeds from an asset sale are less than the sale price. Consequently, the resources available for reinvestment in other assets are reduced. An individual who, in the absence of capital gains taxation, would have switched his or her investment funds to a more productive asset may, in the presence of the tax, find it unprofitable to do so. The lock-in effect, consequently, leads to a misallocation of resources in favour of less productive activities and lowers the efficiency of use of investment funds.

35. See Chapter 4.

36. See for example, the Meade Committee Report op.cit., Chapter 9.

6.84 In designing any structure of capital gains taxation, it is necessary to ensure that the horizontal and vertical equity of the tax is maintained vis-a-vis other forms of income by keeping in view the bunching problem, the special problems raised by inflation and the lock-in problem.

a. The treatment of capital gains under the Income-tax Act

6.85 Because of the considerations described above, long-term capital gains are generally given concessional treatment in the income tax systems. At present, capital gains are taxed under the Indian income tax in the following manner:

i. A distinction is made between long-term and short-term capital gains. In the case of equity shares, long-term capital gain arises if the period of holding is in excess of one year. For all other assets, long-term capital gain arises if the period of holding is more than three years.

ii. Long-term capital gains are exempt from tax, if the sale proceeds are invested in specified assets for three years or more.[37] This is an imperfect substitute for a 'roll-over' provision designed to counteract the lock-in effect.

iii. A further exemption of long-term capital gains is provided, subject to certain conditions, if they are invested in a residential house.

iv. Tax free roll-over is also allowed in respect of gains from the sale of a residential house and land used for agricultural purposes.

v. The Income-tax Act provides for deduction of long-term capital gains up to Rs.15,000 and a further deduction of a fraction of the long-term capital gain in excess of Rs.15,000. The fraction differs depending upon the status of the taxpayer and the nature of the asset (Section 48). It is unrelated to the length of the period of holding. Similarly, another section provides for complete exemption of long-term capital gains from a residential house where the sale consideration does not exceed Rs.2,00,000 and proportionately where the sale consideration exceeds Rs.2,00,000. These provisions are also intended to give rough and ready relief for inflation, to counteract bunching and to exclude capital gains which are relatively small, from the tax base to keep administrative costs down. The reliefs are, however, not related to the actual extent of inflation that has occurred. Under the existing system, the threshold of Rs.15,000 assumes great importance: it provides an incentive to realise net gains upto the threshold each year and to defer the realisation of gains beyond this amount.

vi. As an additional measure to offset the effect of inflation, all appreciation before 1.4.1974 in the value of assets is excluded from taxation.

6.86 The existing system of taxation of long-term capital gains is cumbersome and has many shortcomings. As noted above, the provision of a separate threshold for long-term capital gains induces deferral of realisation of the gains, in any one year beyond the threshold. If capital gains constitute income, there seems to be no justification for providing a separate exemption level just because the gains are of a long-term nature. Second, the minimum holding period for the gains to be classified as long-term differs among assets for which it is difficult to find a rationale. Third, the fractions of long-term gain above the threshold subject to tax have been fixed arbitrarily at two different levels for two categories of assets. Fourth, while a roll-over provision in the case of house property and industrial land and building has justification, exemption given to long-term capital gains on condition of investment for a minimum period in specified financial assets earning lower rates of interest than obtainable on financial assets in general, tends to distort the flow of funds in the capital market and discriminate in favour of income in the form of capital

37. Also the proceeds realised from the sale after three years of, the specified assets are not taxed.

gains in return for investment in specified assets which may not be conducive to efficiency. The requirement that the entire proceeds should be invested in the assets eligible for exemption and not just the gain could entail loss of income to the assessee with a long-term capital gain but it is not quite clear why such an indirect method of taxing capital gain at a concessional rate should be resorted to. To make the system of taxation of long-term capital gains simple and more equitable, we make the following recommendations:

b. Reforming Capital Gains Tax

6.87 Since in periods of inflation capital gains can largely be nominal, an equitable capital gains tax must provide for indexation for inflation. Indexation for inflation should ideally relate to the entire period beginning from the date of acquisition of the asset to the date of sale. However, that can give rise to considerable problems of compliance and administration. Non-availability of records of the purchase dates of assets would lead to an avoidable increase in the cost of compliance of taxpayers and the cost of verification by tax authorities. Hence, we recommend that:

i. the cost of all assets acquired prior to a cut-off date be converted into the value of the asset on the cut-off date.

ii. the value of the asset should, thereafter, be indexed for inflation for the subsequent period of holding in the manner described below.

6.88 Since valuation as on 31.3.1974 has to be established for the computation of capital gains according to the present law, there would be no additional administration and compliance cost as a result of this measure. For the present, the same date may continue to be the cut-off date.

6.89 For computing capital gains for taxation, the cost of acquisition of an asset should be increased by a cost-inflation index (CII) which should be equal to 75 per cent of the consumer price index for urban non-manual employees (CPI) for the entire period of holding or from a specified cut-off date, as may be appropriate (Table 8.1). Similarly, the cost of any improvement undertaken to the asset should also be inflation indexed using the CII. The logic of limiting indexation to 75 per cent of the CPI is that the tax schedule applicable to other incomes will not be automatically indexed to inflation.

6.90 Inflation indexation of the cost of the asset would require that the index should be readily available to the taxpayer. The CPI is usually available only four to five months after the close of the financial year. This would be too close to the due date for filing income tax returns. Keeping this in view, the Committee recommends that an asset sold at any time during the year should be deemed to have been sold on the first day of the financial year.

6.91 We further recommend that :

i. a long-term capital asset be defined to mean a capital asset transferred after one year from the end of the financial year in which the asset is acquired. To compute long-term capital gains, all long-term capital assets should be deemed to have been acquired on the last day of the financial year in question, and transferred on the first day of the financial year in which the transfer takes place. The method of deeming the acquisition and transfer of a capital asset with reference to the closing and opening date of the financial year respectively, has the merit of simplicity. The need to maintain date-wise records of purchase and sale of assets will be done away with and only year-wise records of purchase and sale of assets need be maintained.

ii. long-term capital gains should be treated like other income in all ways except for the rate of tax. While there will be no separate exemption level for long-term capital gains, income in the form of such gains would be entitled to all concessions applicable to other income.

iii. long-term capital gains duly indexed will be subject to tax at the marginal rate applicable to the assessee in the concerned year subject to a maximum of 27.5 per cent. (When the switchover is made to the two rate system, long-term capital gains will be taxed at the lower rate in all cases.). If income other than capital gains is below the general exemption limit, the tax on long-term capital gains will be applied to the excess of the sum of other income and long-term capital gains over the exemption level.

TABLE 6.4

Cost Inflation Index for Computing Long-Term Capital Gains

Year of acquisition of asset	Year of transfer of asset	
	1991-92	1992-93*
Prior to 1.4.1974	2.80	
1974-75	2.40	
1975-76	2.35	
1976-77	2.35	
1977-78	2.24	
1978-79	2.18	
1979-80	2.06	
1980-81	1.89	
1981-82	1.74	
1982-83	1.64	
1983-84	1.53	
1984-85	1.43	
1985-86	1.38	
1986-87	1.29	
1987-88	1.21	
1988-89	1.14	
1989-90	1.08	
1990-91	1.00	

Note: *The cost inflation index for asset transferred in 1992-93 will be: 'A' + 'B' where A = CII and B = [CPI (1991-92) - CPI (1990-91)] / CPI (1990-91), for asset transferred in 1991-92.

iv. what is stated in iii above applies to non-corporate assessees. In the case of corporate assessees, the indexed long-term capital gains will be subject to a flat rate of 40 per cent. When the rate of tax on corporate profits is reduced to 40 per cent, as per our recommendations, the rate of tax on long-term capital gains for the corporate assessees should be fixed at 30 per cent.

v. in the case of firms, the income from capital gains should be apportioned among the partners in the ratio of their share in the partnership. This income should be treated as capital gains in the hands of the partners.

6.92 As noted earlier, at present, there are several roll-over provisions under the Indian Income Tax. Roll-over is allowed in the following situations:

i. Reinvestment of the capital gain from the transfer of a residential house in another residential house [Section 54].

ii. Reinvestment of the capital gain from the transfer of land used for agricultural purposes in any other land to be used for agricultural purposes [Section 54B].

iii. Reinvestment of the capital gain from compulsory acquisition of land and building forming part of an industrial undertaking in any other land or building for shifting or re-establishing the industrial undertaking or setting up another industrial undertaking [Section 54D].

iv. Reinvestment of the net consideration from the transfer of any asset, in specified assets like capital gain units of the UTI and Capital Gains Bonds of the HUDCO for a period of three years [Section 54E].

v. Reinvestment of the net consideration from the transfer of any capital asset in a residential house subject to the condition that the residential house is the only house owned by the taxpayer [Section 54F].

vi. Reinvestment of long-term capital gains arising from the transfer of plant or machinery or land or building used in an industrial undertaking situated in an urban area in any one of these assets in an industrial undertaking set up in any area other than an urban area [Section 54G]

6.93 Relief under the provisions of Sections 54E and 54F is granted on one basis while relief under the other sections listed is allowed on a different basis. Additional provisions stipulate the period within which sales proceeds must be rolled-over to benefit from roll-over relief. Yet other provisions lay down permissible uses of sales proceeds pending roll-over (through the Capital Gains Account Scheme). Taken together, these provisions are among the most complex and confusing provisions in the Indian Income-tax Act and also offend equity and efficiency.

6.94 As has already been pointed out, roll-over relief in general violates equity because those who accumulate savings from realised but reinvested capital gains benefit from tax deferral whereas those who make the same savings out of taxed income do not. Some asset holders can,therefore, save out of tax-free income while others have to save out of taxed income. In fact, under Section 54 E of the Income-tax Act, capital gains tax can be avoided altogether by investing for three years in approved securities.[38] The economic inefficiency arising from the lock-in effect must be dealt with in a less inequitous way.

6.95 In view of this, we recommend:

a. Roll-over provisions should be retained but the special exemptions granted in Section 53 and 54E of the Income-tax Act should be withdrawn. Roll-over relief should, however, be granted uniformly in each roll-over section of the Income-tax Act in the following manner:

The gain should be computed after adjusting the costs of acquisition and improvement by the cost inflation index as recommended earlier.

ii. The fraction of the capital gain that is allowed roll-over relief should be equal to the proportion formed by the cost of the newly purchased asset (new asset) to the net sale consideration from the sale of existing asset (old asset).[39]

b. In the case of a new asset, capital gain should be reckoned as the sale price less the inflation adjusted cost of the old asset. The inflation adjusted cost of the old asset should however, be calculated for the entire period of holding of the new asset and the old asset. Where the old asset is acquired prior to the cut-off date, the cost of acquisition and the period of holding of the old asset should be reckoned to be respectively, the value of the old asset on the cut-off date, and the period from the cut-off date.

c. The existing Capital Gains Accounts Scheme should be replaced by a simple scheme along the lines of a money-multiplier scheme [40] promoted by some banks in the country.

d. The existing method for computing the period for re-investment, with reference to the date of transfer should be replaced by a method whereby the period is computed with reference to the financial year in which the asset is transferred. Accordingly, the period specified for re-investment should be either within the financial year immediately preceding or within two succeeding financial years immediately after the

38. There is an implicit tax in that the interest rate on specified securities is usually below that on other assets.

39. For example, if the net sale consideration from the asset sale is Rs.1 lakh, the inflation adjusted capital gain is Rs.50,000 and an eligible new asset is purchased for Rs.70,000, roll-over relief should be allowed for (Rs.50,000 x 70,000/1,00,000) or Rs.35,000 of the capital gain in the country.

40. Under the scheme, the sale proceeds of the asset is deposited in a designated current account. Whenever balance in a current or savings account exceeds Rs.10,000/-, the excess is automatically moved into a higher yield fixed deposit, in multiples of Rs.1,000. Similarly, when the depositor needs funds in excess of the balance in the current account, the required amount is immediately moved back into the current account, in multiples of Rs.1,000.

financial year in which the original asset is transferred.

6.96 At present the Income-tax Act[41] provides for set off of capital losses (both short-term and long-term) only against capital gains. However, the amount of long-term capital loss allowed to be set off is scaled down by a fraction which differs according to the status of the taxpayer and the nature of the asset.

6.97 At present, there are some restrictions against set-off of capital losses against income from all other sources. These restrictions are intended to counteract tax avoidance through the mechanism of "buying" capital losses. There is no need to make any further change in the existing scheme of allowing set-off of capital losses only against capital gains. Since we have recommended the removal of the provisions relating to scaling down of long-term capital gains and in any case there being no rationale for scaling down of long-term capital losses, the Committee recommends that the provisions relating to scaling down of long-term capital losses should also be removed. Further, we also recommend that capital loss should be computed after adjustment of the cost of the asset by the cost inflation index.

6.98 Capital gains in case of depreciable business assets are deemed to be short-term capital gains irrespective of the period for which assets are held. The gain in the case of these assets is computed as the sale consideration of the asset less the aggregate expenditure incurred in connection with the transfer of the asset less the written down value of the block of assets at the beginning of the previous year less the actual cost of any asset falling within the block of assets acquired during the previous year. These provisions are based on the existing scheme of allowing depreciation on a block of assets, as against any specific asset, which makes it impracticable to segregate from the written down value of a block of assets, the written down value specific to a particular asset within the block which is transferred.

6.99 It has been represented to the Committee that capital gains arising from transfer of business assets should be allowed the same tax treatment as any other capital asset. Since the existing scheme of tax treatment of capital gains from business assets is closely linked to the simplified scheme of allowing depreciation on a block of assets, acceptance of the suggestion will lead to an increased burden of administration and compliance. Nor would there be any justification on grounds of equity. In any case, there would be a very small number of taxpayers in whose case the capital gains would be greater than the written down value of the block of assets so as to result in increased tax liability in the same year. The Committee, therefore, does not favour any change in the existing provisions relating to tax treatment of capital gains from depreciable assets used for business or profession.

Expense Deduction Rules

a. General

6.100 While exemptions and deductions, intended to serve the objectives of social and economic policy, erode the tax base with all its attendant evils, the income tax law also contains provisions imposing restrictions on the deductibility of certain expenditures which normally figure in the computation of income as cost of earning. These restrictions are felt to be needed on account of the well known fact that the line between expenses for earning and personal consumption are not always very clear and leaving it entirely to the choice of the taxpayer or the discretion of the tax officer is not desirable as that creates disputes and opens up a wide area for bargaining. Representations were received by the Committee arguing for the removal of such 'artificial' restrictions so that 'real' income is taxed. While appreciating the concern underlying these representations and the hardship

41. As amended by the Finance [No. 2] Act. 1991

caused by unduly harsh restriction on the deductibility of 'business' expenses, the Committee notes that such restrictions are not peculiar to the Indian income tax and in fact are in operation in the income tax systems of many other countries. The justification for their restriction lies mainly in the fact that 'expense accounts' are often used to camouflage personal consumption and the business expense deduction rules laid down in the law and as interpreted by the Courts are not quite adequate to counter this practice. Given this background, it is difficult to press for the removal of all such restrictions. However, the Committee is of the view that the existing provisions seeking to restrict the deductibility of certain expenses in business be reviewed and limits prescribed be revised. The recommendations in this regard are set out below:

Nature of the expense		Existing limits	Recommendations
I.	Entertainment expenditure under Section 37A	@ 0.5% or Rs. 5,000, whichever is higher for profits upto Rs. 10 lakh; @ 0.25 % on the next Rs. 40 lakh and @ 0.125 % on the balance profits.	Actuals upto Rs. 10,000/- and 50% of the balance.
II	Expenditure on gift items, under Rule 6B.	Rs. 200 on each article of gift.	Expenditure on gift should be deemed to be entertainment expenditure
III.	Expenditure on Hotel under Rule 6D.	Rs. 200/- per day in Bombay, Calcutta and Delhi and Rs. 150 in other places for employees whose salary is Rs. 1000 pm or more.	Actuals upto Rs 1,500 and 75% of the amount in excess of Rs. 1,500/-
IV.	Expenditure for services in connection with any proceeding before the Income Tax Authority	Rs. 10,000.	Actuals

b. Expense deduction in the computation of 'income from house property'

6.101 Sections 22 to 27 of the Income-tax Act contain provisions relating to the computation of income chargeable under the head "Income from House Property". Under these provisions the owner of a house property becomes liable to be charged on the income from any building, alongwith land appurtenant to it, worked out on the basis of the "annual value" of such property.

6.102 The basis of computing the "annual value" of the house property is the reasonable expected annual rent, rather than the actual rent. The actual rent is relevant only when it exceeds the notional reasonable expected annual rent. Under the existing provisions, the "annual value" is reduced by the amount of -

i. the Property tax levied by a municipal authority and borne by the house owner ; and

ii. rupees three thousand six hundred for each residential unit for 5 years from the date of completion of such residential unit.

6.103 Source specific exemptions distort the equity, (in particular, horizontal equity) of the tax system. Since the scheme of the Income-tax Act envisages the integration of all sources of income for determining the tax liability, there is no rationale for extending a separate exemption limit for such residential units. The Committee, therefore, recommends that the deductions of Rs.3,600 in respect of each residential unit forming part of a building for a period of five years from the date of completion of such a building at present allowable under second proviso to subsection (1) of Section 23 of the Income-tax Act should be withdrawn. Further, since the proposed lower rates of personal income tax will also benefit taxpayers having income from house property, the deduction for construction of new residential units should be withdrawn from the Assessment Year 1993-94 for all taxpayers even in respect of residential units in a building completed prior to the implementation of this recommendation.

6.104 Sub-section (1) of Section 24 lists the permissible deductions from the "annual value" of a house property determined under Section 23. One of the items provides for standard deduction at 1/6th of the "annual value" towards repair of the house property. It is allowed irrespective of whether or not any expenditure is incurred on repairs. It has been represented to the Committee that the restriction of the deduction for expenditures on repairs to 1/6th of the "annual value", whether actually incurred or not, provides a disincentive to property owners incurring expenditure on repairs. It has been suggested that where the expenditure actually incurred on repairs is more than 1/6th of the annual value, such expenditure should be allowed in full and not artificially restricted to the ad hoc deduction of 1/6th. While it may be true that repairs for some years may exceed the standard deduction of 1/6th of the "annual value", in some others it may be less than 1/6th. Hence over the life time of a property, the expenditure on repairs may not exceed 1/6th of the actual rent or reasonable expected rent. The present scheme of deduction for repairs of a house property is, therefore, reasonable and has the merit of simplicity, both from the administration and taxpayers' viewpoint. It may, therefore, be retained subject to the modification suggested below.

6.105 Another item under Section 24 of the Income-tax Act relates to deduction in respect of collection charges. This deduction is based on actuals subject to a maximum of 6 per cent of the "annual value" of the property. The Committee is informed that, more often than not, taxpayers claim deductions of the entire 6 per cent of the "annual value" of the property as collection charges, irrespective of the actual expenditure incurred. Such a claim is either on account of misinformation about the actual legal position or with intention to reduce tax liability. In either case, this leads to avoidable disputes and administrative work, without any significant revenue implication. The Committee recommends that an amount equal to 1/5th of the "annual value" of the property be allowed as a statutory standard deduction both for repair of the house property and collection of rent.

6.106 Another item under Section 24 of the Income-tax Act relates to deduction in respect of the current interest liability on money borrowed for the acquisition, construction, repair, renewal or construction of the property. The interest, if any, payable in respect of the period prior to the previous year in which the property has been acquired or constructed is allowed as a deduction in five equal and yearly instalments. As a measure of simplification and to facilitate early recovery of the interest paid in respect of the pre-completion period, the Committee recommends that the number of years in which the interest on borrowed capital relating to pre-completion period that should be allowed as a deduction in the computation of "income from house property" should be reduced from five to three.

Treatment of Intermediaries

a. Partnerships

6.107 A partnership, as defined in the Indian Partnership Act is the relation between persons who have agreed to share the profits of a business carried on by all or any of them, acting for all. Persons who have entered into partnership with one another are called "Partners" and collectively called "Firm" and the name under which the business is carried on, is called the "Firm name". The definition of a partner includes a minor admitted to the benefits of a partnership.

6.108 The Income tax law in India has from its very inception taken into account this relationship, which continues to be the most dominant form of business organisation, particularly amongst the trading community, as forming the basis of a separate taxable entity. This is despite the fact that a firm is not a separate judicial person unlike a corporate body.

6.109 The existing scheme of taxation of firms, as it has evolved over the years, is primarily based on the felt need for countering tax avoidance through this medium. The existing scheme can be characterised as follows:

a. The method and quantum of taxation differs according to whether the firm is registered under the Income-tax Act or not. However, in order that a firm may get registration, it has to satisfy certain conditions and comply with some formalities.

b. Amongst the registered firms, a distinction is made between professional and non-professional firms. The rates of tax are lower for the professional than for non-professional firms.

c. In the case of unregistered firms, tax is levied at the rate applicable to an individual,on the firm itself as a distinct taxable entity for purposes of the Act. The firm pays the tax in discharging its own liability and not on behalf of the partners. However, a partner in an unregistered firm is exempt from income tax in respect of his share in the profits of the firm provided the tax has already been paid by the firm. Though the partner's share of profits is exempt from income tax, it has to be included in his total income for purposes of determining the rate of tax applicable to his income together with income from all other sources.

d. In computing the taxable income of a firm, any payment of interest, salary, bonus, commission or renumeration by the firm to any partner of the firm is not an allowable deduction.

e. With a view to counteracting tax avoidance through the mechanism of partnership firms, the tax law provides, with certain exceptions, for aggregating with one spouse's income, the share income of the other spouse from a partnership firm in which both the spouses are partners.

f. The income of minors admitted to the benefits of any partnership is included in the income of the parent, irrespective of whether or not either parent is a partner in the same firm.

g. Any loss suffered by a registered firm which cannot be set-off against any other income of the firm, is apportioned amongst the partners for set-off against their income from all other sources. Unabsorbed loss, if any, is allowed to be carried forward for adjustment by the partner in the subsequent assessment year. However, in the case of an unregistered firm, any loss which cannot be set-off against any other income of the firm is allowed to be carried forward for adjustment by the firm in the subsequent assessment year.

h. Tax deducted at source from payments made to a firm are allowed as a credit against total tax payable by the firm on its income.

i. For purposes of registration, a firm has to satisfy certain conditions. It has to make an application in the prescribed form to the Assessing Officer duly signed by all the partners (not being minors) personally. Such application is required to be accompanied by the instrument of partnership, specifying the individual share of the partner in the profits and losses of the firm.

6.110 It is well recognised that a good tax system should be neutral to the type of business organisation and form of ownership and control. Accordingly, all non-natural persons must be taken to serve only as conduits. Profits ought to be taxed at the appropriate income tax rates in the hands of the persons who come together to form the entity. Hence, both equity and efficiency considerations require that the profit of a partnership firm should be assessed only in the hands of partners. However, some compromises may have to be made therein for administrative reasons.

6.111 Based on the above principles, various schemes for taxation of firms and their partners could be evolved. One possible scheme could be to tax the profits of a partnership and also the share of the partners in the post-tax profits of the firm. This is the scheme which is now in operation.

However as noted, it results in double taxation. It is also administratively burdensome as it entails rectification of partners' tax assessments as a consequence of any change in the declared income of the firm. The number of such rectifications can be very large. Further, any laxity on the part of the tax administration in carrying out such rectification can lead to revenue loss. However, to mitigate the full impact of double taxation, the profits of the partnership firms are taxed at progressive but low rates of tax and the post-tax income is compulsorily apportioned amongst the partners in the ratio of their share in the partnership, for tax at the appropriate income tax rates in the hands of the partners.

6.112 An alternative and in our view more equitable scheme could be not to tax the income of a partnership firm but to tax at the appropriate income tax rates, the partners in respect of their shares in the profits of the firm. Under this scheme the income tax liability will be fully borne by the partners at their respective rates of tax. Hence, the scheme would be neutral to the form of organisation in which the business is carried on.

6.113 Based on the foregoing, the Committee recommends :

a. Scheme of registration of firms for income tax purposes should be abolished. All firms should be treated alike for income tax.

b. The existing separate tax on the income of the firm should be abolished. The firm should be required to calculate capital gains and its income other than capital gains separately. The income other than capital gains should be apportioned amongst the partners in the ratio of their share in the profits of the firm, for taxation in their hands at the appropriate income tax rates. In computing the income of the firm, it should be allowed, as against the present practice, to claim as a deduction any payment of interest, salary, bonus, commission or remuneration to any of its partners.

c. Where new partners are admitted to the benefits of a partnership at any time during the accounting year after the end of the first three months, the share of the new partners in the profits of the firm should be ignored and profits should be apportioned amongst the old partners in the revised ratio of shares.[42] However, this should only be in respect of the financial year in which the new partners have been admitted. This however will not apply when a firm is reconstituted on the death of a partner.

d. Where a firm has any income from capital gains, it will be eligible to claim "roll-over" relief wherever permissible. Any capital gain (after allowing for the "roll-over" relief) or loss incurred by the firm should be apportioned amongst the partners in the ratio of their share in the profits of the firm. However, the partners should not be allowed any "roll-over" relief in respect of such share in the capital gains. The relief for "bunching" of gains should be allowed to be claimed by the partners in their personal assessments.

e. All association of persons and bodies of individuals should be taxed in the same manner as firms.

f. Where the shares of partners in a firm or of members in the AOP or BOI are not specified, they should be presumed to be equal amongst them and no partner or member should be allowed to claim differently at anytime in the future in respect of profits of the year for which such presumption is made.

g. The firm or AOP or BOI should not be allowed any credit for the tax deducted at source from payments received by it. However, it should be allowed to apportion the same

42. For example, if firm X has three old partners A, B and C having a share of 40 per cent , 20 per cent and 20 per cent respectively in the profits of the firm and a new partner 'D' having a share of 20 per cent, the revised ratio of share of 'A' is to be determined by the formula:
(Share of 'A') 100 / (sum of the shares of 'A', 'B' and 'C') equals to 40 per cent X 100 / 80 per cent is equal to 50 per cent.

amongst its partners in the ratio of their share in its profits.

h. The firm should be required to pay advance tax on behalf of partners in respect of the income of the partner from the firm and income from all other sources along the same lines as the facility available under sub-section (2), (2B) and (3) of Section 192, to both the employer and the employee, in respect of deduction of tax at source. The advance-tax paid by the firm on behalf of the partners should be deposited with the Central Government through a single challan. The firm should after the end of the previous year be required to submit separate annual statement regarding advance-tax paid on behalf of the partners.

i. Every firm should be required to issue a certificate to every partner indicating the amount of interest, salary, bonus, commission or remuneration paid by it, the share of the partner in the profits of the firm, the share of the partners in the tax deducted at source on payments received by the firm and the advance-tax paid by the firm in respect of income of the partners.

j. Notwithstanding the fact that there would be no tax liability on the part of the firms, AOPs and BOIs, they should be required to file their returns of income irrespective of their level of income. Where the firm files the return of income voluntarily but after the due date, they should be required to pay one-half per cent of the computed income of the firm subject to a minimum of Rs.200, as a late fee for every month of default. If the return is filed in response to a notice issued after the end of the assessment year and the firm has not deposited the Advance tax in the appropriate manner, the firm should be assessed to tax at the maximum marginal rate of tax for individuals and also be required to pay late fee as indicated above. In such a case, distribution of income in the partners' hands would not arise.

6.114 The scheme of taxation of firms proposed above, though equitable, has the limitation of being administratively burdensome like the existing scheme of firm taxation. A large number of rectifications of partners' tax assessments, as a consequence of any change in the declared income of the firm, would still have to be carried out. Any laxity on the part of the tax administration to duly carry out such rectification of partners' tax assessments would impair the equity of the system and also lead to revenue loss. Hence, there is need to properly modify the above scheme to secure administrative feasibility and simplicity. The Committee, therefore, recommends that in a case where the returned income of the firm is increased as a result of additions or disallowances, the difference between the assessed income and the income declared should be taxed at the maximum marginal rate in the hands of the firm but exempt from any additional tax liability in the hands of the partners. However, in a case where loss is returned and where the additions made result in a reduction in the loss or in the computation of a positive income, the income or loss computed should be apportioned amongst the partners and consequential rectifications should be carried out in their tax assessments.

6.115 The Committee is aware that the levy of a separate tax on registered firms was introduced primarily on the consideration that many taxpayers might otherwise find it easy and convenient to reduce their tax liability by setting up firms with relatives and friends as partners, some of whom may merely be their "benamidars" or namelenders. An apprehension could be expressed that our recommendation to abolish the firm tax could increase the practice of using "benamidars" or manipulation to vary the tax liability of partners. After due consideration, the Committee has come to the conclusion that the problem of "benamidar" partners should be tackled only by sustained investigation under the Benami (Prohibition) Act, 1988 without causing undue distortion in the tax structure. Where it is established that a partner in a firm is the benamidar of any other partner of the firm or is an undisclosed benamidar of an outsider and any one or more of the other partners knew or had reasons to believe that it was so, the whole of the income of the firm (including any income payments to the partners) should be taxed at the maximum marginal rate.

6.116 We put forward the above scheme as part of the rationalisation of the tax structure. It would reduce the administrative burden without impairing the equity of the system. The number of rectifications and the number of challans required to be processed, both by the bank and the tax office, would be reduced considerably. The staff and the officers could then be more fruitfully engaged in investigation and other important work.

b. Co-operative Societies

6.117 As in the case of partnership firms the Income-tax Act provides separate rates of income tax for cooperatives. These rates range from 10 per cent in respect of total income upto Rs.10,000 to a maximum of 35 per cent on total income exceeding Rs.20,000.

6.118 Cooperatives are taxed on a concessional basis primarily on the consideration that the principle of "mutuality" operates in their case. It is well established in law that no tax can be levied in respect of profits of truly mutual societies on the reasoning that no one can make a profit out of one self. However, this principle is not strictly observable in the case of many cooperatives and hence the case for levying a tax on cooperatives. Strictly speaking, in equity the correct way of taxing the cooperatives would be to attribute the surplus, if any, earned by them to the members. However, this does not seem to be practicable. That is why cooperatives are subjected to tax as separate taxable entities. The Income-tax Act, however, provides for concessions (Section 80-P) apart from allowing moderation in the rate of tax. This concession is given in the form of deduction of whole of the profits from a business of banking or extending credit facilities to the members of the society or cottage industry or purchase of agricultural implements, seeds, etc., and supply of these to the members of the society or marketing or processing of agricultural produce to the members of the society or fishing or allied activities or supply of milk subject to certain conditions. Further, the interest or dividend received from another cooperative society, income from is also exempt from income tax. A further sum of Rs.40,000 is exempt in the case of a consumer cooperative society and Rs.20,000 in other cases. While there could be a case for concessional treatment of cooperatives because of "mutuality", there is no justification for concessional treatment in a situation where there is a complete breakdown of the principle of mutuality. In a case where profits accrue to the cooperative society both on account of transactions with members and non-members, it is necessary, though extremely difficult, to separate the profits attributable to transactions with members for exemption from income. An ad-hoc estimation of such profits has, therefore, to be made. Further, in respect of income arising from transactions with non-members, the cooperatives are no different from a company. Consistent with the principle of equal treatment of equals, cooperatives should be subjected to the same form of tax treatment as companies. The Committee, therefore, recommends the redesigning of the scheme of taxation of cooperatives on the following lines:

a. The deduction, presently available to cooperative societies under Section 80-P, in respect of whole of their profits from business, should be restricted only to 20 per cent of their profits. However, all other deductions under Section 80-P should be abolished.

b. The income exemption limit for cooperative societies should be fixed at Rs.25,000.

c. The total income of the cooperative society, in excess of the exemption limit, should be subjected to tax at the flat rate of 30 per cent.

Taxation of "Hard-to-Tax" Groups

6.119 Implementation of the income tax encounters problems everywhere in the case of certain sections of the population such as farmers, self-employed persons, professionals and small enterprises who usually do not maintain accounts in a verifiable form. In developing countries, the problem is particularly acute because of preponderance of the unorganised sector in the economy. In India, nearly forty per cent of the industrial output is accounted for by small enterprises. Enterprises operating in the services sector (e.g. traders, restaurant keepers, barber shops, beauty parlours, repair shops, transport operators) are mostly unincorporated and the bulk of them come under the "small" category. Bringing all these enterprises under taxation is beyond the capacity of any tax administration. Hence threshold limits are laid down in every tax, be it sales tax, excise or income tax. Exemptions and concessions also are extended to the "small" sector to encourage handicrafts, promote employment, conserve power and serve a variety of social and economic objectives.

6.120 It is, however, well known that not all those who elude the tax net by claiming to be "small" are that small. In other words, many of them simply misuse the benefit of exemption to defraud revenue. Equity demands that some way is found to bring them under taxation. In the case of income tax, widening of the base in terms of coverage cannot proceed far unless all those who belong to the small or medium category and yet enjoy incomes which are in reality well above the prescribed threshold come within the tax fold. This is required for revenue and for raising the contribution of direct taxes to the exchequer as well as for equity. The same considerations apply to the "hard-to-tax" groups who cannot be regarded as small, yet manage to underreport their income because of inherent problems of verification. How to bring the small enterprises and other hard-to-tax groups effectively under taxation without giving rise to excessive administrative and compliance burden is a challenging task that needs to be addressed, if the tax system is to be reformed to improve the share of direct taxes in government revenue and achieve greater equity.

a. The presumptive method as an instrument of taxing the hard-to-tax groups

6.121 Faced with the problem of determining "actual income" many countries practising income taxation have found it expedient to apply what is called the "presumptive" method, whereby the tax is levied on income determined or estimated on the basis of certain indicators. In essence, presumptive taxation envisages the application of simple methods for assessing the tax base, or in some cases, the tax itself instead of going through complicated legal and accounting processes. Under this method, only the income which a taxpayer could be reasonably presumed to earn in a given situation as reflected by his investment or assets or scale of business is sought to be taxed. Apart from its administrative ease, the presumptive approach is commended by fiscal experts also on equity and efficiency grounds. To the extent it helps to realise some reasonable amounts of tax from those who currently contribute little to the exchequer, while, those with similar earnings are obliged to pay more in taxes simply because their income sources provide little scope for concealment, presumptive taxation helps to achieve greater equity. It has also the merit of promoting efficient use of resources, as under this method only presumed and not actual incomes are taxed. When the tax is levied on "average" income and effort, as advocated by one of its early proponents, there is a built-in incentive for efficiency as incomes above the average do not attract any additional tax while those who do not make the optimal use of their assets or earning capacity get penalised.[43] The celebrated Musgrave Mission on Tax Reform in Bolivia recommended the presumptive approach for the effective taxation of small enterprises and the estimated income method for the hard-to-tax groups.[44]

6.122 A well known example of presumptive taxation is the "forfait" system of France. Under this system, the tax base is estimated by using

43. "Presumptive Income Taxation: Administrative, Efficiency and Equity Aspects" by Vito Tanzi and Milka Casanegra de Jantscher, IMF Working Paper WP/87/54 (1987).

44. Fiscal Reform in Bolivia (Harvard Law School, 1981)

indicators rather than accounting records. Income tax payable by farmers, unincorporated enterprises and professionals whose gross receipts fall below the stipulated levels are assessed under the "forfait" system. This system, however, has the disadvantage that the tax is negotiated on a case by case basis. The other widely known example of presumptive taxation is the "takshivs" of Israel whereby certain objective indicators like physical inputs and number of employees are relied upon to estimate the income of business enterprises who do not maintain proper accounts or records. In contrast to the "forfait" the estimates are made on an industry-wide basis, and automatically applied to individual taxpayers in accordance with the specified 'objective' indicators rather than being in any way negotiated between taxpayers and officials. Land taxes of many countries including the land revenue system which has been in vogue in India for centuries essentially incorporates the presumptive principle. In some Francophone African countries, a presumptive tax on gross receipts is levied on corporate entities instead of a tax on net profits, thereby avoiding the problems of determining net profits. Sometimes a tax based on net wealth and gross receipts or gross assets is used as a minimum income tax. Columbia introduced a presumptive system of taxation based on gross receipts, applicable to all taxpayers other than those having income mainly from employment. Presumptions are sometimes based on visible signs of wealth, each item being assigned an income equivalent. The items specified for the purpose commonly are residential houses, number of domestic servants, cars, private planes, etc. A more recent example of presumptive taxation based on investment or assets is the tax imposed in Mexico since 1989 on the value of assets employed by a taxpayer in business. Levied at the rate of 2 per cent on gross business assets, the tax is designed to approximate the income tax that a taxpayer ought to report, judged by the average rate of return on assets productively employed in business. Credit is allowed against this tax for the income tax paid, which implies that the assets tax constitutes a minimum income tax.[45]

6.123 To reduce evasion, Turkey introduced a "Living Standard Assessment System" in 1983. Under this system, assessment was made on presumption based on selected indicators of living standards. Anyone participating in an activity related to agriculture, trade or professional practice was presumed to have an income of at least TL 800,000 (TL 450,000 for second class merchants). Additional incomes were attributable to characteristics like ownership of residential property, automobiles, employment of personal servants, foreign travel, etc. A partial presumptive approach has been adopted in the Philippines under a "Modified Gross Income Tax System" whereby deductions allowable against salary incomes are limited to specified fractions of the gross income. A similar approach is now proposed for computing taxable business income ("Simplified Net Income Tax" system).

6.124 Examples of the application of the presumptive approach can be found in the Indian Income Tax too. For a long time income from house property was assessed in the Indian Income Tax on a presumptive basis - "the sum for which the property might reasonably be expected to let from year to year". Since 1976, the presumed income serves as the floor for assessment of house property income. This resulted from the stipulation that where the amount received or receivable by the owner is higher than the presumed rent, "actual" will be taken into account for purposes of income taxation.[46] Sections 44B, 44BB, 44BBA and 44BBB of the Income-tax Act also follow the presumptive principle in as much as they prescribe percentages to be applied to gross receipts of certain businesses for computing taxable profits (e.g. for shipping business of non-residents, business of exploration of mineral oils, aircraft operation of

45. "Fine Tuning the Mexico Assets Tax" by John A. McLees, Tax Notes International, February, 1991.

46. Section 23(1) of Income-tax Act, 1961. Municipal property tax in India is based essentially on presumed "fair rent".

non-residents and for computing the profits and gains of foreign companies engaged in the business of civil construction, etc. in certain turnkey power projects).

6.125 However, presumptive taxation also has its problems. Determination of taxable capacity or potential on the basis of physical characteristics like wealth or business assets calls for an idea of the reasonable rates of return or income equivalent for each item of asset in different sectors of business. Such estimation of parameters is required also where taxable income is sought to be arrived at on the basis of gross receipts. After all, not all lines of trade yield the same rate of net profit. Hence in Israel, the "takshiv" is established for different trades and activities depending on the type of service provided, the equipment used, location, number of employees, etc. The financial results of a sample of establishments in a given line of business are also looked into and the average profitability is discussed with the representatives of the trade in question. More than 80 "takshivs" have been evolved in this way. All this calls for elaborate exercise and deployment of considerable administrative resource. Not all countries can afford to undertake such exercises. Presumptive taxation has come in for criticism also on account of the scope it provides for those having above average incomes to get away lightly. In Turkey, uniform application of modest living standard assessments in all regions resulted in low tax assessment in middle and high income regions particularly for middle and high income taxpayers. Presumptive assessment may open up opportunities for evasion as some may be induced to seek re-classification as members of hard-to-tax groups or show their income as derived from lightly taxed sources. Heavy reliance of the "takshiv" on precise factors tended to transform the tax on income in Israel into a tax on the factors set out in each "takshiv". This can induce taxpayers to minimise their tax liability by underreporting or altering the factors which carry relatively large weight in the computation of presumptive income. Presumptive taxation based on gross incomes also does not seem to be of much avail where the receipts are understated. No amount of refinement of formulae for arriving at net income can help, if the actual gross receipts are not disclosed. However, on balance, resumptive taxation should be easier to administer than our seeking to tax actual incomes. After all, physical indicators should be more amenable to verification than references of income. Because mainly of its administrative merits, developing countries are falling back on the presumptive approach as the only practicable way of taxing small enterprises and the hard-to-tax groups effectively. Given the present structure of the economy and the limitations of the administration, the principle of presumptive taxation merits serious consideration in the Indian context too.

b. Presumptive taxation : Possible approaches

6.126 Presumptive taxation can in principle be based on "potential" income whereby the potential is estimated with reference to the investments, the rated capacity of the plant or equipment installed in business, the average productivity of land in the case of agricultural income or the maintainable rent in the case of property. While this approach has the merit of efficiency, its implementation can be objected to on equity grounds since the potential may often not be realisable because of factors beyond the control of the taxpayers. This would be particularly true of income from manufacturing and trading though for taxation of real estate and agriculture it might be more suitable than taxation of "actual incomes". For presumptive assessment of taxpayers in non-agricultural activities (small traders, small scale producers) therefore, one has to look for ways of determining income presumptively which could be said to reasonably approximate "actual incomes". The tax would be levied on income *ex post* but determined presumptively and not on income *ex ante*, so, to say. This is the approach which underlies the suggestions made by the Musgrave Mission on tax reform in Bolivia to which reference has been made earlier.

6.127 For effective implementation of income tax the Bolivian Tax Mission had suggested that taxpayers be divided into three groups: (a) the very small taxpayers who should be exempted altogether; (b) the various small taxpayers who should be subject to a presumptive tax; and (c) other taxpayers, who should come under the regular income tax and enterprise tax rates. The latter group, the Commission recommended, should be divided into those who usually fail to keep proper records and accounts and so should be assessed on an estimated basis and those who file regular returns supported with records and documents. Under the scheme recommended by the Mission, a simple presumptive income approach would be applicable to small taxpayers who should eventually be subjected to the estimated income approach. For applying the presumptive income approach the Mission went on to suggest:

a. All taxpayers should be grouped by category of business activity and by gross sales (rather than by capital value). However, as gross sales would be difficult to determine directly, benchmarks might be needed.

b. Within each category, the tax payable should be so fixed as to approximate the average tax that would have been paid normally, keeping in view the likely margins in different business activities, the exemptions available under the regular income tax and administrative costs. A simplified return showing gross sales should be prescribed for this group of taxpayers.

6.128 The above scheme should be available only to small firms. For others, to whom regular income tax procedures would apply, the Musgrave Mission suggested that a procedure be developed by which the declared net income can be reviewed, where the taxpayer fails to maintain proper accounts. For this too, taxpayers should be grouped under various categories classified by activities and turnover. However, under the estimated income approach, unlike under the presumptive income system, no flat net income or rate of tax would be assigned to all taxpayers within each category. Only guidelines would be laid down for estimating the income of individual firms. These guidelines would be based on certain average relationships that hold for firms in a given category, as has been done for the "takshivs" of Israel. Formulation of guidelines for various economic activities in which assessment is difficult would require: (a) the estimation of sales or gross receipts; (b) the estimation of deductions for non-accountable or non-verifiable costs; and (c) deduction of accountable costs. Tax based on income estimated under the guidelines would be set as the minimum to be departed from, only if declarations are furnished supported with accounts satisfying rigorous standards. The aim should be to encourage all taxpayers to maintain proper accounts and suitable incentives should be provided for the purpose.

6.129 For professionals also, the Musgrave Mission suggested, the guidelines for estimated income or GEI approach. For implementing the GEI approach in the case of both small enterprises and professionals (developing the GEIs and updating them), the Mission suggested that a technical unit should be created within the Finance Ministry or the Revenue Department. The task should be entrusted to economists who would work with tax assessors and in consultation with representatives of various trades and professions.[47]

6.130 We consider that the scheme suggested by the Musgrave Mission for Bolivia as outlined above should be given serious consideration in India, with appropriate modifications, but only for non-corporate taxpayers. For inducing traders and manufacturers operating on a small scale but enjoying taxable income to make some contribution to income tax, the Committee recommends two simple schemes based on the presumptive approach. The first variant which we call the scheme of presumptive taxation envisages a very simple system under which one is required only to pay a lump-sum tax in lieu of income tax. This scheme will apply only to traders and manufacturers having a total business turnover of between Rs. 3 lakh to Rs. 5 lakh. Under the other scheme, the net income of the taxpayer will be

47. Fiscal Reform in Bolivia, op.cit., Chapter 17.

estimated as a specified percentage of the gross turnover in business (the percentages depending on the type of business activity). This we call the estimated income scheme (EIS). The specifications of the two schemes are outlined below:

i. Presumptive tax scheme

Under this scheme, traders and manufacturers deriving income from business should be allowed an option to pay tax in a lump-sum of Rs.1,000/- without filing any return, if their total turnover in business happens to fall between Rs.3 lakh and Rs.5 lakh as estimated by themselves.

It is possible that even such small traders/producers have income from other sources like brokerage commission, interest, dividend, property, etc. The facility of this scheme should not be denied to them so long as income from these sources remains modest. For brokerage income, this limit may be fixed at Rs.25,000. But tax at the rate of 20 per cent may be realised from such income without going through the process of aggregating such income with income from other heads. When the trader/producer has income from other sources, again the scheme would still be open to the trader or producer if the receipts from such other sources do not exceed Rs.10,000. Here 'receipts from other sources' would include receipts in the nature of interest, dividend, property, salary, etc. However, in such cases the taxpayer should not be permitted to claim any refund of tax deducted at source on such receipts.

Taxpayers opting for this scheme should not, however, be allowed any deduction on account of savings incentives or any other provision of the Income-tax Act. As mentioned earlier, no return need be filed by persons opting for this scheme. Nor should they be required to make any advance payment of tax in instalments. It should suffice if they pay the tax in one lump-sum any time before the 15th of March during the accounting year.

ii. Estimated income scheme (EIS)

Persons having business turnover of more than Rs.5 lakh or brokerage or commission receipts exceeding Rs.25,000 or receipts from other sources above Rs.10,000 should come under the alternative scheme, namely the Estimated Income Scheme (EIS). Under this scheme, net income from business will be presumed to be equal to -

(a) eight per cent of the turnover from trading or manufacturing operations;

(b) fifty per cent of the receipts from brokerage or commission;

(c) ten per cent of receipts from contracts relating to construction of roads, bridges, buildings, other public works and transporting. This is in line with the scheme of estimating income taxation for contractors as outlined in sub-section 'c' below.

(d) eighty per cent of receipts from other sources, being in the nature of interest, dividend, export incentive schemes or any other receipt of similar nature.

6.131 'Receipts from other sources' for this purpose will not include any receipt falling under the heads 'salaries' or 'income from house property' or 'profits and gains from business or profession'. The income estimated in the aforesaid manner will be aggregated with income from profession and income under the heads like 'salaries' and 'house property', if any, to determine the gross total income. Taxpayers opting for the scheme will be eligible for deductions allowed for savings and specified activities as may be available under the Income-tax Act from time to time. The total income so computed should be subjected to tax at the appropriate rates.

6.132 Unlike in the case of presumptive taxation, tax due under the EIS should be paid in advance in three instalments and the provisions in the Income-tax Act relating to the payment of advance tax should apply.

6.133 The EIS should, however, be restricted to persons whose turnover and/or receipts do not exceed Rs.25 lakh.

6.134 Features which would be common to the two schemes proposed above are the following :

a. A simple statement as indicated in Statement 6.1 or Statement 6.2 as may be appropriate, should be furnished by taxpayers coming under these schemes to the nearest income tax office.

b. The challan and statement forms should be made available freely in all bank offices or branches, market committees, office of trade associations, etc.

6.135 The presumption underlying the schemes outlined above is that the owners of the firms report their turnover correctly and that their net profit ratio is on an average around 8 per cent of their sales. Suppression of sales figure is, however, a common method of tax evasion. It is, therefore, necessary to devise a way of checking the reliability of the amounts of turnover reported by traders/producers without casting too heavy a burden on the taxpayers or on the department. A system of operating such checks can be evolved once the traders/producers start filing their statements showing the value of their fixed assets, power consumption, number of employees, size of and rent paid for the premises, etc. Based on these statements and work of special cells to be set up for this purpose, the average relationship between these variables and the scale of business turnover can be worked out by using statistical tools. However, to begin with, for the first three years, the statements of turnover may be accepted without any question, unless there is strong evidence to the contrary.

6.136 Similarly, the net profit ratios also can be established for different trades/activities with information which would be furnished by the taxpayers deriving income from business. The 8 per cent ratio suggested above is intended only to help initiate the implementation of the presumptive approach.

6.137 If the presumptive approach is to find acceptance, every attempt should be made to estimate the ratios separately for each separate activity and for different locations as has been done in Israel for the "takshivs." Once these ratios are set up they should be given wide publicity (subject to periodic revisions) so that they can be used for self-assessment by taxpayers having income from business on their own and also by tax officers as a check against gross understatement. In other words, these ratios can be used as benchmarks or guidelines for estimating business incomes where verifiable accounts are not maintained. Incomes computed on the basis of the ratios should be accepted without any question. Any variation above or below the norms so set up beyond, say, 10 per cent, should be subjected to scrutiny and approval by the next higher official.

6.138 In order that the presumptive income approach suggested above for small enterprises does not come under any legal attack, it would be necessary to make the presumptions rebuttable but only on presentation of well-documented accounts and records. It is relevant to note in this context the judicial rulings by the high courts on the legality of Section 44AC of the Income-tax Act. This section was introduced in the law by the Finance Act 1988 stipulating that the profits and gains of certain trades (forest contracts and excise contractors) would be computed as prescribed percentages of the purchase price for securing the right to sell the goods in question, in auction. The legality of the section was challenged on several grounds. One was that taxation of presumptive income is beyond the competence of Parliament as presumptive income cannot be regarded as income as understood by entry 82 of the List 1 of the Seventh Schedule to the Constitution which authorises the Centre to levy the tax on income other than agricultural income. Another contention was that it is discriminatory and arbitrary and is thus violative of Article 14 of the Constitution which guarantees equality of all before law. Yet another contention was that it violates Article 19(1)(g) as the rates are "confiscatory" and thus amounts to imposition of unreasonable restriction on the freedom to carry on trade or business. While some high courts have upheld the validity of the provision[48],

48. Kerala High Court in P.K. Kutty Haji v. Union of India (1989) 176 ITR 481.

in at least two cases, the courts have taken the view that the section in question violates Articles 14 and 19(1)(g) of the Constitution, although the legislative competence to tax presumptive income has not been questioned by the Courts. However, instead of striking down the section, it has been "read down" to make it consistent with the requirements of Articles 14 and 19(1)(g). The effect of the reading down is that the section has to be treated as an "adjunct to and as explanatory to Section 206C" which enjoins deduction of tax at source so that after the tax is collected in the manner provided in section 206C, a regular assessment would be made where the profits and gains of business in the goods in question will be ascertained in accordance with Sections 28 to 43C of the Income-tax Act.[49] From the tenor of the judgements quoted above, it would appear that presumptive assessment may not be sustainable in law unless a chance of rebuttal is allowed to the taxpayer. It may, however, be expected that, if the norms or ratios are fixed at reasonable levels, most taxpayers with relatively small scales of business activity will welcome and opt for the presumptive taxation scheme. It will also help induce a culture of compliance with tax laws which is essential for better collection of revenue and for inspiring confidence in the fairness of the system.

c Scheme of presumptive taxation for contractors and truck owners

6.139 The share of construction industry in the direct tax collection is not commensurate with the potential of this industry. In fact, tax evasion is rampant in this field. Investigation of tax evasion in this area of economic activity has not yielded satisfactory results both on account of the nature of the industry and deficiencies in accounting practices. At present, the law provides for withholding of tax at rates which are fixed ad-hoc, tending to be high for small contractors. Consequently, a significantly large proportion of the amount collected from contractors through the mechanism of tax deduction at source gets refunded at the end of the year resulting in infructuous work for the department. In the past, in many cases of contractors engaged in the construction of roads, bridges, buildings, other public works and transporting, income was estimated at a presumed rate of 10 per cent of contract receipts in cases where material is supplied by the party placing the contract and 12.5 per cent in cases where no material was supplied. The Committee recommends that 10 per cent of contract receipts from all contracts relating to construction of roads, bridges, building, other public works and transporting, should be presumed to be the income in such cases and the same should be formalised in law.

6.140 There are a number of areas where income could be derived on the basis of physical indices. The Committee can immediately think of a number of areas in which this method could be utilised like buses, trucks, taxi cars, marriage halls, larger saloons, beauty parlours, tailors, dyers and cleaners. While studies need to be carried out for estimating the income from these businesses, the Committee recommends that a beginning may be made by prescribing that each truck with an inter-State permit could be presumed to yield an income of Rs 4,000 per month. Similarly each truck with a State permit could be presumed to yield an income of Rs 3,000 per month.

49. Andhra Pradesh High Court in A. Sanyasi Rao v. Government of Andhra Pradesh (1989) 178 ITR 31 and Orissa High Court in Sri Venkateswara Timber Depot v. Union of India (1991) 189 ITR 741.

STATEMENT 1

FORM NO. _____

(for taxpayers opting for the presumptive tax scheme)

ASSESSMENT YEAR WARD/CIRCULE/RANGE PAN/GIR NO.__________

NAME (SURNAME FIRST)(IN BLOCK LETTERS) ______________________________

STATUS

OFFICE ADDRESS (IN BLOCK LETTERS)

TELEPHONE __________ PIN __________

RESIDENTIAL ADDRESS (IN BLOCK LETTERS)

TELEPHONE __________ PIN __________

INFORMATION RELATING TO BUSINESS

1. Name in which business is carried on ______________________
2. Names and addresses of branches/godowns ______________________
3. Nature of business ______________________
4. Number of employees ______________________
5. Bank accounts
   (name of the bank, address and Account No.) ______________________
6. Estimated payment for electricity ______________________
7. Rent paid ______________________
8. Turnover ______________________
9. Brokerage or commission ______________________
10. Other receipts

COMPUTATION OF TAX

		Amount (in Rs.)
1.	Tax on income from turnover	1,000
2.	Tax on brokerage or commission	
3.	Total tax paid	

STATEMENT 2

FORM NO. _____

(for taxpayers opting for scheme of presumptive taxation)

ASSESSMENT YEAR WARD/CIRCLE/RANGE PAN/GIR NO.____________

NAME (SURNAME FIRST)(IN BLOCK LETTERS)

STATUS

OFFICE ADDRESS (IN BLOCK LETTERS)

TELEPHONE __________ PIN ___________

RESIDENTIAL ADDRESS (IN BLOCK LETTERS)

TELEPHONE ______________ PIN ________

INFORMATION RELATING TO BUSINESS

1. Name in which business is carried on ____________________
2. Names and addresses of branches/ godowns ____________________
3. Nature of business ____________________
4. Please indicate the names and addresses of dealers from whom purchase of more than Rs.50,000 made during the year ____________________
5. Gross turnover/sales: (name of the commodity)
   (a) _________ __________
   (b) _________ __________
   (c) _________ __________
   (d) _________ __________
   Total ____________________
6. Number of employees ____________________
7. Bank accounts (name of the bank,address and Account No.) ____________________
8. Estimated payment for electricity ____________________
9. Estimated payment for telephone ____________________
10. Rent paid

COMPUTATION OF INCOME

		Amount (in Rs.)
1.	Turnover	
2.	Brokerage or commission	
3.	Contract receipts	
4.	Receipts from other sources	
5.	Income from trading (6% of col.1)	
6.	Income from brokerage (If col.1 is positive, 80% of col.2; if col.1 is nil, 50% of col.2)	
7.	Income from execution of contract works (12.5% of col.3)	
8.	Income from receipts from other sources (80% of col.4)	
9.	Total Income (col.5 + col.6 + col.7 + col.8)	
10.	Tax on total income	
11.	Tax paid:	
	(a) advance tax	
	(b) TDS	
	(c) Self assessment	
	Total	
12.	Tax payable/refund	

7

TAXATION OF WEALTH

7.1 In Chapter 3, we had pointed out that, given practical limitations, substantial inequities are caused by the imposition of a tax on net worth or wealth. In the context of inflation, when a progressive tax on income itself discriminates against income from capital, an additional levy in the nature of a wealth tax further tilts the scale against savings. Problems of valuation result in the relative under-taxation of certain classes of assets and this taken together with the exclusion of several types of assets necessitated by practical and administrative considerations introduces further distortions.

7.2 The wealth tax was imposed in India with the twin major objectives of reducing inequalities and helping in the enforcement of the income tax through cross checks. Neither of these objectives can be said to have been fulfilled to any significant extent. Even though the threshold level for the wealth tax has not been adequately indexed through the years, the total yield of the wealth tax is estimated to be only Rs 255 crores in 1991-92. This suggests that the impact of the wealth tax has been minimal. In one way or another, it has not been possible to effectively enforce the tax on those who control large corporate wealth; additionally large-scale evasion of tax must be taking place associated with the evasion of income tax. As already pointed out, one of the causes underlying evasion is the onerous combined burden of the income and wealth taxes even at moderately high levels of income. One possible line of action is to reduce the rates of wealth tax alongwith the increase in the exemption level and then try to enforce the tax more effectively. However, a low rated tax on net wealth would not be of much help in reducing inequalities. On the other hand, all the disadvantages and demerits of a tax on wealth would remain. In fact, there seems to be no case for the tax system to discourage accumulation of wealth in forms which increase productivity and income to the benefit of the community at large.

7.3 As regards the other major objective of enforcing the income tax more effectively through checking the consistency of the information provided in the returns on wealth and income, it is known that the two taxes in respect of one taxpayer are not being assessed simultaneously. "In fact, until 1975, while there were statutory limitations for the completion of income tax assessments, the law laid down no time limits for the completion of assessments of wealth, gift and expenditure taxes. Even after the amendment in 1975, the reluctance to integrate the proceedings for the assessment of these taxes with the income tax proceedings was apparent in the provision of different time limits for income tax assessments (2 years) and the assessments for wealth tax and gift tax (4 years)".[50] It is of course possible that when he considers it necessary or useful for the assessment of the income of an assessee, the income tax officer looks at the wealth tax return, though given the most unsatisfactory way in which files are maintained, it might often not be possible for him to retrieve it readily. However, a taxpayer is not likely to furnish inconsistent information in his income and wealth tax returns. In any case, information on wealth holding can be required to be furnished by all large income

50. Final Report of Study Group on Taxation of Expenditures, op. cit., pp. 107-108.

tax payers without being asked to pay a tax on all wealth.

7.4 The Committee, therefore, recommends that the tax on wealth should be abolished in respect of all items of wealth other than those which can be regarded as unproductive forms of wealth or other items whose possession and use could legitimately be discouraged in the social interest. The details regarding the wealth tax on items of "unproductive" wealth that we propose are discussed below. At this point, we would like to explain our general approach: while the tax system should be reasonably progressive, it should not come in the way of saving and accumulation in legitimate ways and in productive forms. The burden on the rich should be made heavier than on the ordinary taxpayer through a moderately progressive income tax, annual taxation of non-productive forms of wealth, particularly those that cannot be easily concealed, and indirect taxation at adequately high rates on all forms of non-essential or luxurious consumption. Excise taxes at high rates are already being imposed on almost the whole range of what may be described as luxury products. While some of these rates would need modification, in general fairly high rates would have to be continued. Apart from the indirect taxation of luxury products, there are also in existence other luxury taxes such as the tax on foreign travel, the tax on air travel and the expenditure tax on expenditures incurred in hotels and restaurants. These taxes together with the progressive income tax, and the annual tax on unproductive forms of wealth which we are recommending, would fulfil the objectives of making the overall tax system progressive and substantially reducing the after tax inequalities in consumption. By the same token, those who refrain from such types of consumption and contribute to the savings of the community would be rewarded.

7.5 Our recommendations in respect of the net wealth tax are as follows:

a. An annual tax on the aggregate capital value, in excess of the specified exemption level, of the following items of wealth will be levied in the hands of individuals, Hindu undivided families, and all companies.

b. The items on which wealth tax would be levied are: residential houses, motor cars (other than those used in the business of running them on hire), bullions and jewellery (other than those used as stock-in-trade) , yachts and boats and planes (other than those used for commercial purposes) and urban land.

c. Residential houses should include all farm houses within 25 kilometers from the local limits of any municipality or cantonment board.

d. The valuation of the above items for wealth tax purposes would be according to the procedures now being adopted under the Wealth tax Act. However, the rules regarding valuation of residential property would be required to be re-examined as there is a general feeling that these rules are a little too liberal. Simultaneously, efforts should be made to suitably adjust the rates of stamp duty on transfers of property and the level of municipal property tax. The objective should be that the total burden of all these taxes on property income should be reasonable.

e. Any liability specifically incurred for acquiring the assets which are liable to wealth tax and charged against them will be deductible from the computed value of the assets before the tax is applied.

f. The first Rs 15 lakh of the net value of the taxable items of wealth will bear nil tax. Any excess of net value over that level will bear tax at one per cent of value.

g. The existing provisions in the Wealth tax Act will apply to taxable items of wealth transferred to members of one's family without adequate consideration. However, in line with our recommendation in respect of income of minor children, we recommend that the net value of the taxable items of wealth in the hands of any minor child should be aggregated with the net value of such assets in the hands of the parent whose taxable assets have a higher value if one or both of them are not liable to pay wealth tax and with the net value of the taxable assets of either parent if both of them are liable to pay the wealth tax.

h. Although only items of wealth mentioned in (b) above will be subjected to wealth tax, all income tax payers whose gross total income exceeds Rs.1 lakh should be required to file a net wealth statement in the form indicated in Statement 3. For this purpose, all assets should be valued at cost. The statement should form an integral part of the return of income. The statement should not give details of individual items of wealth, but only values of specified categories of wealth, e.g., equity shares and debentures, bank deposits and money invested in partnerships or in own business.

7.6 The wealth tax on items of unproductive wealth is already being paid by closely held companies. The definition and rules being applied in this regard to closely held companies will be applied to widely held public limited companies. We have recommended that within a few years the same rate of tax of 40 per cent should be applied to the profits of all domestic companies. By a parity of reasoning, we consider it necessary to recommend that the net wealth tax should be levied on all companies. While there is a substantial difference between large corporations and closely held companies, over a rather wide range, the distinction is more technical than real. Besides, most of the items of wealth selected for taxation legally belonging to the companies are being used freely by the directors of companies and top management. When individuals not connected with public or private corporations are asked to pay tax on the value of houses and motor cars in excess of Rs 15 lakh, it is not fair to exempt highly valued houses and cars which are in effect used as private property by captains of industry. However, since they do not own these assets, they themselves cannot be taxed. The only alternative is to impose the tax on the companies. It is for the shareholders to decide whether the tax amount attributable to company passenger cars and residences, allotted to some of the directors and employees should be recovered from the individuals using them for their own purposes (or for the purposes of their families), or should be borne by the company itself.

7.7 We recognize that several passenger cars owned by large companies would be used largely or solely for business purposes. However, there is a tendency in general both in public sector and private sector companies to employ an excess number of cars. (While in industrial countries in general, every executive except perhaps the very top management is expected to use his or her own automobile except while travelling on company business, public and private sector companies in India are generous in providing exclusive cars to their officers.) Hence our recommendation, that the tax should fall on the assets owned by all public and private sector companies. The wealth tax paid should not be allowed to be claimed as expense for income tax purposes. It is for the shareholders to decide whether part or whole of the tax is to be recovered from the individuals using them partly at least for personal purposes.

STATEMENT 3

Statement of Net wealth as on 31st March, 199_.
(To form part of the return of income)

			Amount (in Rs.)	Amount (in Rs.)
I.	**Immovable Property**			
	(a)	Land including agricultural land	----------------------	
	(b)	House Property, including cost of improvement and extension	----------------------	
		Total of 'I'		------------------
II.	**Movable Property**			
	(a)	Balance in capital account in Proprietary business or Partnership firms	----------------------	
	(b)	Balance with banks and post offices	----------------------	
	(c)	Other deposits, loans and advances	----------------------	
	(d)	Shares, securities, savings certificates, Units, etc.	----------------------	
	(e)	Bullion and Jewellery	----------------------	
	(f)	Vehicles	---------- ------------	
	(g)	Cash-in-hand	----------------------	
	(h)	Other assets, if any	----------------------	
		Total of 'II'		---------------------
III.	**Liabilities**			
	(a)	Loans	--------------------	
	(b)	Sundry creditors	---------------------	
		Total of 'III'	---------------------	
IV.	**Net Wealth** ('I' plus 'II' minus 'III')			-------------------

Note: All assets should be valued at cost.

8

RESTRUCTURING IMPORT TARIFF

Introduction

8.1 The need for reforming tariff rates in India has been emphasised in the Report of the Alexander Committee and in the Long Term Fiscal Policy (LTFP) document (1985). It was noted that the prevailing tariff rates were high, which needed to be reduced and the tariff system was very complex, which should be simplified. The general recommendations regarding tariff reform were: (i) to have fewer rates (avoid multiplicity of rates), (ii) to have greater uniformity in tariff rates, (iii) to reduce the general level of tariff rates prevailing in India, and (iv) to shift over time from a system of import control based on quantitative restrictions to a system based on tariff. In the Long Term Fiscal Policy document, a five tier duty structure was proposed in which essential consumer goods such as foodgrains, edible oils and life saving drugs would attract zero or negligible duty, universal intermediates would be subject to a duty rate less than that for raw materials and other intermediate goods, which would in turn have a duty rate lower than that for capital goods, and the highest duty rate would apply to non-essential consumer goods, the imports of which were recommended to remain banned. It was also recommended that intermediate and capital goods for which quantitative control on imports would have to be maintained should be subjected to lower duty than the general rates applicable to those two categories.

8.2 In line with the LTFP some rationalisation of rates were made in respect of specific industries during the past few years, such as in the case of components of capital goods, drug intermediates and electronic goods. The multiplicity of rates of auxiliary duty was reduced. However, a comprehensive rationalisation of rates in the case of all goods covered by the tariff on the basis of LTFP, has not been attempted. Thus, the rates of protective tariff (basic plus auxiliary rates of customs duty) have been raised over time, rather than being lowered. In 1980-81, the import-weighted average rate of nominal tariff[51] (with quantifiable exemptions) was 38 per cent. In 1989-90, it rose to 87 per cent. The collection rate of duty increased in this period from about 20 per cent to about 44 per cent [The collection rate with countervailing duty (CVD) increased from 27 per cent to 52 per cent]. [52]

8.3 In the Budget for 1991-92 presented in July 1991, some changes were made in the tariff rate. Ad valorem rate of basic plus auxiliary duty was reduced to a maximum of 150 per cent (except alcoholic beverages and passenger baggage). Import duty for capital goods for general project and machinery was reduced by 5 percentage points from 85 per cent to 80 per cent. For components of such machinery, there was a

51. Nominal tariff rate is the general effective rate at the 6-digit level. Import weighted average rate is the average of the nominal tariff rate weighted for the value of imports in 1987-88. Collection rate of duty is the ratio of total customs revenue to total value of imports.

52. These and other such information presented later in this chapter are based on an on-going study on India's Tariff Structure at the National Institute of Public Finance and Policy, New Delhi.

similar 5 percentage points reduction in import duty. In December 1990, auxiliary duty rates had been raised. For some commodities the hike was by 20 percentage points. For such commodities, the auxiliary duty rate was reduced by 10 percentage points in the 1991-92 Budget. Further, for some commodities the auxiliary duty rate was rolled back to the pre-December 1990 level.

8.4 In spite of these changes, the tariff system continues to be highly dispersed and complex. The prevailing protective rates of customs duty (basic plus auxiliary) range from zero (for a number of commodities including petroleum products, fertilizers and newsprint) to over 400 per cent (for compound alcoholic preparations, undenatured ethyl alcohol, certain types of synthetic wastes, certain types of ball and roller bearings, and some other items). More than 10 per cent of imports are subject to duty rates of 120 per cent or higher, while nearly 40 per cent of imports are subject to zero or negligible rate of duty. As pointed out in Chapter 4, the existence of a large number of exemption notifications in respect of basic, auxiliary and additional customs duty makes the tariff system highly complex. One can find many examples where very similar products are subject to highly varying duty rates or where the same product attracts different duty rates depending on the use to which it is put.

8.5 Between 1980-81 and 1989-90, India's exchange rate depreciated substantially (Rupee-U.S. Dollar by 110 per cent, Rupee-Pound Sterling by 146 per cent, Rupee-Deutche Mark by 117 per cent, and Rupee-Yen by 216 per cent). The real effective exchange rate (taking into account composition of trade and the rates of inflation in India and her trading partners) depreciated by about 28 per cent in this period. This depreciation in the real effective exchange rate along with the marked increase in tariff rates during that period meant that the level of protection enjoyed by Indian industries went up substantially. It has been noted above that the import-weighted average rate of import duty increased from 38 per cent to 87 per cent between 1980-81 and 1989-90. For manufactured products, the increase in this period was from 38 per cent to 98 per cent. Thus, compared to the average level of nominal protection enjoyed by Indian manufacturing in 1980-81 (which was already high), the average level of nominal protection of Indian manufacturing in 1989-90 was higher by about 88 percentage points.[53]

8.6 The inability of the Government to reduce the general level of tariff rates, although this could have been done without exposing domestic industries to any serious import competition (in view of the depreciation of the exchange rate) seems to be attributable largely to the compulsions of the Government for raising revenue to meet its ever-increasing expenditure. This is reflected in the fact that the structure of tax revenue has been changing in favour of customs duties.

53. The increase in the level of protection may be over-estimated somewhat since tariff exemptions have been growing in importance over time. However, even on the basis of collection rates, it is found that the increase in nominal protection was by about 50 percentage points or more.

While customs duties contributed 25.5 per cent of total tax revenue of the Central Government in 1980-81, its share was about 35 per cent in 1989-90. The share in 1990-91 was 35.3 per cent, and in the Budget for 1991-92, customs duties account for nearly 40 per cent of total tax revenue.[54] Such high dependence on import duties is obviously not desirable, since any major reduction in imports (say, due to a foreign exchange crisis) can significantly decrease the revenues of the Government. Also, more than anything else, it is this high dependence on customs revenue that stands in the way of reduction of the tariff rates to reasonable levels, warranted by economic considerations.

8.7 In July 1991, the exchange rate was adjusted downward by about 20 per cent. Between December 1990 and September 1991, the Rupee-U.S. Dollar exchange rate depreciated by about 30 per cent.[55] The depreciation could have been utilized to make a significant reduction in the tariff rates. But, this was not done.[56] Instead, the downward adjustment of the exchange rate was allowed to increase Government's revenue from import duties. Considering the facts that recently there has been a substantial depreciation of exchange rate and that a sizeable part of imports have been put against EXIM scrips, on which there is a substantial premium (providing additional protection to domestic import competing industries), it seems that an appreciable reduction in tariff rates can be made (by, say, 30 per cent or so) without lowering the level of protection of Indian industry below what it was enjoying at the beginning of this year (1991). However, the main hurdle in carrying out such reform is that there will be a marked fall in government revenue. Thus, to reform tariffs, three things should be done: (a) an increasing proportion of revenue should be raised from domestic indirect taxes and from direct taxes, so that the dependence on customs duties can be reduced; (b) any major downward adjustment made in exchange rate in the coming years should be used primarily (or at least substantially) to lower the tariff rates, rather than for raising revenue for the Government; and (c) the growth of Government expenditure must be cut down substantially.

Theoretical Issues

8.8 In the theoretical literature on trade protection, a strong case is made for dismantling protective barriers and allowing foreign trade a more important role in the economy. Also, there is a good deal of empirical evidence which indicates that by reducing distortions created by tariffs and other trade barriers, a country can improve its growth performance.[57] Yet, even a well-motivated policy maker finds tariff reform a very difficult task because tariff reductions are strongly opposed by pressure groups affected by them. In such a situation, the immediate removal of all distortions becomes impossible, which implies that the policy-maker has necessarily to work in a second-best world attempt-

54. Analysis of Tax Systems of Developing Countries carried out by V. Tanzi for the year 1981, reveals that on an average import duties constitute about 25 per cent of total tax revenue in developing countries (V. Tanzi, "Quantitative Characteristics of the Tax Systems of Developing Countries", in R. M. Bird and O. Oldman [eds.], Taxation in Developing Countries, 4th edition, Baltimore, Johns Hopkins University Press, 1990). The ratio is higher at about 30 per cent for countries which have per capita income less than 850 U.S. dollars. The share is 24 per cent for countries with per capita income in the range 850 to 1699 U.S. Dollars and 13 per cent for developing countries with per capita income of 1700 U.S. dollars and more. It should also be noted that the share of import duties in total tax revenue is very low for industrial countries at about 2 per cent.

55. The rate of exchange between Rupee and Deutche Mark depreciated by about 23 per cent, while that between Rupee and Pound Sterling depreciated by about 24 per cent.

56. The implication of the changes made in the budget for 1991-92 is a revenue loss of Rs. 771 crore for a full year, which is only 2.8 per cent of the budgeted customs revenue of Rs. 27,357 crore for the year 1991-92. Apparently, these changes will not cause any appreciable fall in the average rate of import duty.

57. World Development Report, 1991 (World Bank), pp. 96-104

ing to reduce some distortions while others remain in place. As is known from the theory of second-best, such changes do not necessarily increase welfare. Moreover, the information required to identify and implement second-best policies is likely to be formidable. This difficulty has prompted a search for some simple piecemeal rules which are known to be welfare improving for a wide range of parameter values. Two rules which have received particular attention are (i) equi-proportionate reduction in all trade taxes (or the uniform reduction rule) and (ii) reduction of the highest trade tax first (or the harmonization rule).

8.9 In developing countries, customs duties can assist in achieving important policy objectives, including (i) protection of domestic industry, (ii) containing balance of payments deficit, and (iii) influencing the structure of imports so as to make foreign exchange available for essential and developmental needs. In addition, countervailing excise duties on imports can be used to raise revenue and to achieve the distributional objectives along with excise on domestically produced goods. On theoretical grounds, it may be argued that the taxation of local products and imports should be so coordinated as to yield desired revenue and meet distributional objectives without undue resource misallocation. This implies that (i) commodity tax revenue should be raised by taxes that differentiate between products according to their nature rather than their origin and (ii) differentiated sales taxes or excise taxes rather than customs duties should be used to achieve the distributional objectives.

8.10 An aspect of tariff reform which is often emphasized by pressure groups and politicians is the adjustment costs associated with reform. The adjustment costs arise because the removal of trade barriers reduces protection levels of certain sectors substantially, making it necessary for factors of production engaged in such sectors to move to other sectors of the economy. A common view is that the presence of such adjustment costs (which will be high if the level of industrialisation already achieved is high) justifies a "gradualist" approach in the reduction of protection, so that uncompetitive domestic industries are phased out over time rather than being eliminated in a single stroke. However, one major drawback of the gradualist approach is that the expected gains from the reform (say, improvement in efficiency) do not accrue quickly.

Recommended Programme of Tariff Reform

8.11 It is generally accepted that the existing system of import tariff requires substantial reform. Based on the available studies on India's import tariffs and the literature on the programmes of tariff reform in other countries, it seems to us that the main elements of the programme of reform of import tariff should be:

a. reduction of the general level of tariffs;
b. reduction of the spread or dispersion of tariff rates;
c. simplification of the tariff system;
d. rationalisation of tariff rates, along with the abolition of numerous exemptions and concessions; and
e. Abolition of the practice of making changes in effective rates through notifications.

8.12 Since a large and well diversified industrial base has already been established in the country, the process of reform has to be a gradual one so as to reduce the costs of adjustment. However, the reform process should not be too long either. Significant changes in tariff rates should be made in the next few years and most of the reform should be completed in the next six or seven years, say, by 1998-99. Actually, since there has been a substantial increase in the nominal rate of protection (mostly unintended) in recent years, the earlier phases of reduction in tariff rates should not impose any hardship or costs of adjustment on domestic industry.

Lowering the Average Rate

8.13 At present, the simple average of nominal tariff rates is about 125 per cent. The import weighted average rate of nominal tariffs is about 90 per cent. The collection rate of duty (excluding CVD) in 1990-91 was about 42 per cent which should be about 40 per cent for the year 1991-92, considering the changes introduced in this year's Budget. This difference between import-weighted average nominal tariff and the collection rate of duty is due to exemptions of various kinds including those for imports by exporters against advance licences. We are of the view that in the next four years, the general level of import tariff should be reduced by about 50 per cent, so that the import-weighted average rate of protective import duty comes down to about 45 per cent. In subsequent years, further reduction in duty rate should be attempted so that the average is brought down to about 25 per cent by 1998-99. Of the 50 per cent reduction in the average rate of nominal tariff to be achieved in the first phase of tariff reduction, 10 to 15 per cent reduction should be made in the next Budget for 1992-93 and the remaining part of tariff reduction should be carried out in the years 1993-94 to 1995-96. Since there has been recently a substantial downward adjustment in the exchange rate and a sizeable part of imported goods have been made importable against EXIM scrips (which carry a substantial premium), the proposed reduction in the import-weighted average import duty from 90 to 45 per cent should pose no serious problem to domestic producers in regard to competition from abroad.[58] In some industries, cost reduction would be necessary to meet import competition, but the extent of cost reduction required for this purpose would not be large and generally not beyond the capacity of domestic producers. In certain isolated cases, tariff reduction may render domestic industrial enterprises unviable. For such cases, appropriate steps will have to be taken for the restructuring of industries.

8.14 The reduction in the average rate of nominal tariff will cause customs revenue to go down; but as shown later, the reduction in the rate of growth of customs revenue will not be proportionate. If any substantial downward adjustment in exchange rate takes place in the next few years, it can be utilised for reducing tariff rates, and in that event the reduction in customs revenue will be much smaller. Additionally, the possibilities of enhancing revenue from other taxes have to be adequately explored and taken advantage of.

Reducing the Dispersion of Rates

8.15 There is at present considerable variation in tariff rates among different commodities. The tariff rates range from zero to over 400 per cent. While the average rate is progressively reduced, the spread or dispersion has also to be narrowed. To this end, it would be desirable to bring down the maximum rate to 80 per cent[59] in the next four years. The maximum rate should be reduced further progressively in subsequent years to reach about 50 per cent by 1998-99.

Simplifying the Tariff System

8.16 There is need to greatly simplify the tariff system. One step in this direction would be to combine the basic and auxiliary rates of customs duty into one protective duty.[60] It should be possible to do this in the next Budget. One argument against the immediate merger of basic and auxiliary customs duties is that India has of-

58. As noted earlier, between December, 1990 and September, 1991, there has been a nominal depreciation of the Rupee against the U.S. Dollar by about 30 per cent; the need to import through the EXIM route means further depreciation and a corresponding increase in protection. In general, the cost reduction needed with the lowering of duties, on an average by 50 per cent, would be within the justifiable range.

59. Some items such as baggage may be allowed to have a higher duty rate than this generally applicable maximum rate. Also, there should be provision for imposing temporary surcharges to guard against price fluctuations in international markets.

60. One can find many examples where two or more commodities are subject to the same level of protective customs duty, but the basic and auxiliary rates differ. To give one example, the effective duty rates for pig iron, ferro nickel and ferro molybdenum as on 14th December, 1990 were as follows: pig iron (basic 40 per cent, auxiliary 5 per cent); ferro nickel (basic nil, auxiliary 45 per cent); ferro molybdenum (basic 45 per cent, auxiliary nil). No useful purpose is being served by having two separate components of protective customs duty.

fered in the GATT negotiations, a 30 per cent cut in respect of only basic duties. This is not significant in view of the substantial reduction in protective customs duties (including both basic and auxiliary), recommended for the next few years.

8.17 In the case of certain specified goods imported from some countries, concessional duties at varying rates sometimes relatable to basic duties have been provided on a bilateral basis. There may not be a case for continuing the exemption in its present form after merger of the basic and auxiliary duties of customs. However, in case re-negotiation is considered necessary before making adjustment in the level of the concession, auxiliary duty may be continued only in those cases, till new levels of concession have been re-negotiated.

8.18 Another step towards simplification of the tariff system is to reduce the multiplicity of rates. Ideally, there should be only five or six rates applicable to different categories of commodities. At present, there are more than 20 different ad valorem rates of protective duty. In addition, many commodities are subject to duties at specific rates. As the maximum rate is lowered, the number of rates should automatically decline and it should therefore not be difficult to achieve in the coming years a rate structure of protective customs duties with only a small number of rates.

8.19 Where the rates are expressed on specific duty basis, or as specific cum ad valorem basis, the combined ad valorem incidence should be reviewed taking into account changes in the international prices.

8.20 There is also a case for reducing, and eventually removing, end-use exemptions which cause tariff rates for the same product to differ among uses. This would help in eliminating resource-use inefficiencies that use-specific variation in tariff rates lead to. Most of the end-use exemptions are given because the level of tariffs is high. As the general level of tariff rates is reduced, the end-use exemptions would become unnecessary and could be removed with a few possible exceptions, such as duty exemption for imports made by exporters against advance licences.

Rationalisation of Tariff Rates

8.21 Since revenue raising has been a major objective of the Indian tariff system, at least in the last ten years or so, tariff rates for many commodities have been pitched at very high levels without much regard for the economic principles that should govern import taxation. While there are economic grounds to have low duty on raw materials and intermediate goods, a large number of such items have been subjected to high rates of tariff. It is important therefore that, while the average rate and the maximum rate of tariff are lowered, appropriate changes be made in the duty rates on different categories of items so that adequate incentive is provided to manufacturing/processing activity and the incentive structure is made less distortionary.

8.22 In the Long Term Fiscal Policy document, a duty rate structure was suggested in which raw materials and intermediate goods would have a duty rate less than that for capital goods which in turn will have a duty rate less than that for non-essential consumer goods. This could be taken as the basic guiding principle in the rationalisation of the tariff rates. Another guiding principle in the rationalisation of tariff rates is that, there should not be any marked escalation in the tariff rate with the degree of processing.[61]

61. Marked escalation in tariff rate with the degree of processing is not desirable since it would discourage manufacturers to go in for backward integration. For example, the present rate structure of tariff for the electronics industry provides high protection for production of finished products from sub-assemblies compared to production of finished products from components, piece parts or raw materials. However, significant tariff escalation may in some cases be necessary for the first stage of the processing chain, if the raw material (say, a particular mineral) required for the product cannot be produced domestically and a very low rate of duty is imposed on the raw material for this reason.

Changing the System of Tariff Rate Determination

8.23 At present, changes in effective tariff rates are made through notifications issued by the Ministry of Finance. This system has the advantage that it can respond quickly to changes in international prices of imported goods. But, it is liable to misuse as considerable lobbying is done by various interested groups. We are of the view that this practice of making changes in effective duty rates of customs through notifications should be done away with. Lately, there has been some thinking in the Government that the Bureau of Industrial Costs and Prices be converted into a Tariff Commission. There is much merit in setting up a tariff commission for determining tariff rates, since it will make the system of tariff setting more transparent and open to public scrutiny. If any change in the statutory customs duty is to be made because of special circumstances such as a drastic change in the international price, say, by more than 30 per cent of imported goods, the change should be made only on the recommendation of the Tariff Commission. In addition, there should be a system of imposing temporary surcharges on imports to protect domestic industry from any drastic fall in the international prices.

8.24 It should be emphasized here that after the completion of the reform process, tariff rates should remain stable and not be subjected to frequent changes.

Recommendations for Implementation in the 1992-93 Budget

8.25 It was suggested in paragraph 8.13 that in the next four years the import-weighted average rate of nominal tariff should be reduced from about 90 per cent at present to about 45 per cent and the maximum tariff rate should be lowered to about 80 per cent. One question that arises here is how much of the proposed tariff reform can be undertaken in the next year, i.e., in the Budget for 1992-93. This will depend mainly on the amount of customs revenue loss the government will be able to bear next year, which will in turn depend on the scope of expenditure reduction and of raising additional revenue from direct taxes and domestic indirect taxes.

8.26 Some computations made by us (see Appendix II for details) indicate that if no changes are made in tariff rates, customs revenue in 1992-93 will be Rs. 28,993 crore (as against Rs.21,226 crore in 1990-91).[62] If 120 per cent is taken as the maximum protective tariff rate and duty rates of all items which are at present subject to higher rates of duty are reduced to 120 per cent (except passenger baggage for which the duty rate of 255 per cent is to continue and the high rates for alcoholic beverages), then the customs revenue for 1992-93 will be Rs.27,785 crore, implying a loss of revenue of Rs.1,208 crore.[63] The revenue loss will be greater if a lower peak rate is chosen. Thus, bringing down the maximum rate to 110 per cent will lead to a revenue loss of Rs.1,878 crore. With 100 per cent and 90 per cent maximum duty rates, the loss of revenue will be Rs. 2,696 crore and Rs.3,607 crore, respectively.

8.27 It should be pointed out here, that the figures given above represent gross loss of customs revenue; the net loss will be lower. A part of the estimated loss of customs revenue is on account of countervailing duty which is being set off at present against excise under Modvat. As against this component of customs revenue loss, relating to countervailing duty, there will be some gain from excise because the Modvat set-off will be reduced. Second, and more impor-

62. The projected revenue for 1992-93 is based on the collection during 1990-91 and the projected imports in 1992-93 based on the trends upto 1990-91. The Committee is aware that the realisation of customs revenue during this financial year upto November is only about Rs. 12,500 crore. On this basis, the revenue this year at the existing rates of duty will be of the order of Rs.21,000 crore and assuming a 20 per cent growth next year, the collections for customs duties in 1992-93 will be Rs.25,200 crore. In that event the revenue loss estimated consequent to the lowering of the peak level will be correspondingly less.

63. If customs revenue in 1992-93 is only Rs.25,200 crores, the revenue implication of the recommendation will be about Rs.1,050 crores.

tant, reduction in tariff rates will lead to higher imports (subject obviously to the availability of foreign exchange) and to a shift of the structure of imports in favour of commodities which are at present subject to high rates of duty. On both counts, the customs revenues should increase, partly offsetting the revenue loss due to the lowering of the peak duty rate.

8.28 If the loss of customs revenue has to be kept under Rs.2,000 crore, the maximum duty rate for the next year may be confined to 120 or 110 per cent. Choosing 120 per cent as the peak rate has the advantage that the net loss of customs revenue on account of lowering of the peak will be only about Rs.1,000 crore so that there would be scope for making other changes in the structure of tariff rates. Also, it should be noted that a large number of items (over 40 per cent) are at present subject to a protective tariff of 150 per cent or higher which implies that the lowering of the peak rate to 120 per cent will have a significant effect on the average rate of protective duty[64]

8.29 Lowering the peak rate is an important component of tariff reform. But it is somewhat mechanical in nature in that tariff rates are adjusted without paying attention to the nature of the commodities. It should, therefore, be supplemented by other changes in tariff rates, especially for the product categories for which the duty rates are too high and require substantial reduction.

8.30 Table 8.1 shows the realised (or collection) rates of customs duty (including CVD) for some major product groups for the years 1989-90 and 1990-91. It is seen from the table that the customs duty rates are relatively high for (1) organic chemicals; (2) dyes, colours, paints and varnishes; (3) plastics and articles thereof; (4) rubber and articles thereof; (5) man-made filaments and staple fibres; (6) iron and steel; (7) non-ferrous metals; (8) electrical machinery, and (9) transport equipment excluding aircraft. Although the average rate of duty for inorganic chemicals is only 36 per cent for 1990-91, this is due to low tariff on phosphoric acid and ammonia which are the raw materials for fertiliser. For other inorganic chemicals, the duty rate is on an average about 100 per cent, i.e., as high as the duty rate for organic chemicals. Some of the other items (not shown in the table) for which the collection rates of customs duty are high include (1) soaps, organic surface active agents and artificial waxes; (2) photographic and cinematographic goods, and (3) ball and roller bearings. Clearly, in all these cases, the rates of duty have to be brought down substantially, if the general level of tariff is to be reduced by 50 per cent in the next four years.

8.31 The lowering of the peak rate to 120 per cent next year will reduce the average rates of duty of the various product categories including those mentioned above. For some of the product categories, it may be desirable to reduce also the duty rates of items not affected by the lowering of the peak rate. Two such categories, in our view, are basic metals and basic industrial chemicals. Being basic goods, reduction of their prices will have far reaching, beneficial effects on the economy. A similar argument may also be advanced for machinery. For these three categories, it is recommended that a tariff reduction by ten percentage points be made for those items which are at present subject to a rate of duty in the range of 80 to 120 per cent. The loss of revenue due to this change in tariff rates is estimated to be about Rs. 745 crore for 1992-93 (see Appendix III). Thus, lowering the peak duty rate to 120 per cent and reduction of tariff by 10 percentage points in respect of items of basic metals, basic industrial chemicals and machinery which are at present subject to a rate of duty in the range of 80 to 120 per cent will together involve a revenue loss of Rs. 1,953 crore.

8.32 For reasons indicated earlier, this estimate gives the gross loss of revenue; the net loss will probably be in the range of Rs. 1500-1700 crore. We are suggesting later in the report that there

64. The simple average of nominal tariff rate will decline by about 10 per cent, while the import-weighted average of nominal tariff rate will decline by about 7 per cent.

Table 8.1
Realised Rates of Customs Duty, 1989-90 and 1990-91

		1990-91			1989-90
S.No	Description	Value of imports (Rs. in Crore)	Customs revenue (Rs. Crore)	Realised tariff rates (Per cent)	Realised tariff rates (Per cent)
1	Petroleum & petroleum products	10819.65	4055.00	37.48	41.93
2	Inorganic chemicals	871.80	315.00	36.13	30.52
3	Organic chemicals	1600.07	1550.00	96.87	94.00
4	Pharmaceutical products	35.02	9.00	25.70	5.41
5	Dyes, colours, prints & varnishes	167.69	180.00	107.34	89.95
6	Plastic & articles thereof	1096.11	1400.00	127.72	98.41
7	Rubber & articles thereof	225.93	315.00	139.42	80.80
8	Pulp, paper, paperboard & articles thereof	633.74	207.65	32.77	26.04
9	Man-made filaments & staple fibres	N.A.	430.50	N.A	134.18
10.	Iron & Steel	2006.58	1815.00	90.45	65.63
11	Non-ferrous metals	1108.67	863.95	77.93	62.67
12	Machinery excluding machine tools	3840.15	1840.00	47.91	58.90
13	Machine tools, parts & accessories	483.83	195.00	40.30	53.85
14	Electrical machinery	1740.74	1550.00	89.04	83.44
15	Transport equipment excluding air-craft	638.32	520.00	81.46	78.63
16	Project imports	2341.52	1325.00	56.59	60.74

Note : Customs revenue includes countervailing duty.

Source (i) Foreign Trade Statistics of India, DGCI & S
(ii) Receipt Budget, Government of India.

must be a minimum tariff rate on all imports equivalent to 10 per cent of value. This will result in some gain in revenue. In 1992-93, this can be applied to a number of commodities such as coking coal, HSD, ammonia and medical electronics. All in all, the net loss of customs revenue could be contained within Rs.1,500 crore.

Effective Rate of Protection

8.33 The effect the proposed tariff changes for the next year would have on the effective rates of protection (ERP) of Indian industries has been examined using detailed data on tariff rates for 1989-90 (See Appendix IV). The results of the exercise indicate that both the average ERP and the extent of inter-industry variation in ERP will significantly decline. There will be substantial reduction in ERP for sectors which are at present enjoying very high rates of effective protection. On the other hand, a number of industries producing capital goods for which the ERP is relatively low at present will gain from the tariff changes in terms of the level of effective protection enjoyed by them because the average rate of protection on their inputs will go down.

Tariff Reform in the Years 1993-94 to 1995-96

8.34 The tariff changes proposed for the next year (lowering of the peak rate and the reduction of duty rates on selected items of basic chemicals, basic metals and machinery) would reduce the import-weighted average tariff rate by about 10 per cent. The remaining part of the proposed 50 per cent reduction in the average tariff rate has to be made in the years 1993-94 to 1995-96. It was suggested above that in the next four years, the maximum rate of tariff should be brought down to 80 per cent. This lowering of peak rate would cause the average tariff rate to come down by about 16 per cent. Thus, duty rates of many items have to be reduced well below the peak rate if the proposed reduction in the average tariff rate by 50 per cent is to be achieved (still the average tariff rate will be as high as 45 per cent).

8.35 The tariff changes proposed for the next year are basically aimed at getting rid of some very high rates of duty and making basic industrial chemicals, basic metals and machinery less costly so that the user industries benefit. Even after these changes are made, many commodities (nearly 50 per cent of the items) will be subject to a rate of protective customs duty of 100 per cent or more which is quite high in relation to the levels of tariff rates prevailing in most other developing countries. It should be noted further that a large part of capital goods imports and a number of important raw materials and intermediate goods are at present subject to a rate of duty in the range of 40 to 70 per cent. The tariff changes proposed for the next year will leave the duty rates of such items unchanged. Appropriate changes in the duty rates of those items will have to be made in the years 1993-94 to 1995-96. Substantial reduction in duty rates would be necessary also for items for which the rate of duty is at present 80 per cent or higher. As the maximum rate is lowered, the duty rates for such items will come down. But, in many cases, further reduction will be necessary so that their duty rates come down to a level lower than the maximum rate.

8.36 It would be useful to provide here some idea about the structure of tariff rates that should emerge by 1995-96. This will help in formulating a plan regarding tariff changes to be made during the years 1993-94 to 1995-96 (i.e., deciding for which groups of commodities the duty rates should be reduced and by how much). Since in a period of four years it should be possible to make major changes in tariff rates,[65] the tariff structure emerging by 1995-96 should, as far as possible, be in accordance with the recommendations made in the LTFP document. Other points discussed earlier in connection with tariff rationalisation will also have to be borne in mind while changing the rates of tariff.

8.37 Table 8.2 shows simple and import-weighted average tariff rates for six broad groups of products for the year 1989-90. The product groups are: (1) agricultural products; (2) coal, crude oil and natural gas; (3) other mineral products; (4) manufactured consumer goods; (5) manufactured intermediate goods, and (6) capital goods. To what extent the average tariff rates of these groups should be reduced by 1995-96 is indicated in the last column of the table, which gives a set of proposed average tariff rates for the six groups for that year.

8.38 The import weighted average tariff rate for agricultural products was 46 per cent in 1989-90. The collection rate of duty was only about 19 per cent. Three major items of imports are cereals, pulses and rubber. The duty rate for cereals is zero, and those for pulses are low. But, the duty rates for cash crops are generally high (in many cases exceeding 100 per cent) and this is reflected in the fact that the simple average of tariff rates for agricultural products is high at 99 per cent. The implication of reducing the import weighted average rate of tariff to 20 per cent is that the duty rates on cash crops have to be reduced substantially. This would be consistent with the recommendations in the LTFP document that the duty rate for raw materials should be low relative to intermediate and capital goods.

8.39 The same logic applies in the case of 'other mineral products' group. However, the import-weighted average for this group is already low and only a marginal reduction has, there-

65. The revenue implications are discussed later.

fore, been recommended. It should be noted in this connection that the duty rate on sulphur is low and it is a dominant item in this product group. As a result, there is a big difference between the simple average and the import-weighted average of tariff rates. Evidently, there are many mineral products subject to a high rate of duty. The duty rates on such items will have to be lowered substantially[66]

portant consideration here is the cost of domestic crude oil production. Major petroleum products such as HSD and kerosene are not subject to any protective customs duty. But the import of such items is canalised and the prices of such items are regulated by the Government. Clearly, a detailed study of the petroleum sector has to be undertaken (examining in particular the implications of lowering the duty on crude oil and imposing a duty on major petroleum products) for making suitable recommendations for customs duty on crude oil and petroleum products.[67] We have not undertaken such a study. Nevertheless, we are of the view that when duty rates on all raw materials are proposed to be brought down to a low level (say 20 per cent or so) the duty rate on crude oil, an important raw material for petroleum refining, should not be maintained at 70 per cent or so. It is therefore proposed that the duty rate on crude

TABLE 8.2

Average Tariff Rates for Broad Commodity Groups

(Percent)

Group	Weight (import based)	1989-90		1995-96
		Simple average	Import Weighted average	Import Weighted
Agricultural products	0.03	99	46	20
Coal, crude oil, and natural gas	0.16	82	54	34
Other mineral products	0.03	98	20	15
Manufactured products	0.78	123	98	49
Of which -				
Consumer goods	0.07	138	89	60
Intermediate goods	0.47	125	103	45
Capital goods	0.24	94	91	55
Aggregate	1.00	121	87	45

8.40 The product group 'coal, crude oil and natural gas' is dominated by crude oil. The protective import duty rate on crude oil was Rs.1,060 per tonne (approximately 52 per cent ad valorem) in 1989-90. The duty rate at present is Rs. 1500 per tonne and going by the price of crude oil prevailing in international markets, this comes to over 70 per cent ad valorem. The rate of duty to be charged on crude oil is linked to the pricing policy for the petroleum sector. An im-

66. In 1989-90, the import duty rates on mica was 115 per cent, on lime stone 115 per cent, on iron ore nearly 100 per cent, on bauxite, manganese ore and copper ore 85 per cent.

67. Since naphtha competes with natural gas in many uses, rationalisation of tariff rates for the oil sector will require also appropriate changes in the pricing policy of natural gas.

oil should be reduced to about 35 per cent by 1995-96.

8.41 The nominal tariff rate on coal is 90 per cent, but the collection rate is very low. Most coal imports (coking coal) are done for the steel industry for which a concessional rate of duty of 5 per cent applies. In a study on tariff structure for the iron and steel industry carried out by the BICP, it has been recommended that the duty rate for coking coal should be raised to 25 per cent. Based on this recommendation, we feel that the duty rate for coal can be set at 20 or 25 per cent in the next few years.[68] Thus, for the sector 'coal, crude oil and natural gas' an import-weighted average tariff of about 34 per cent would be applied by 1995-96.

8.42 The import-weighted average rate of tariff for consumer goods was 89 per cent in 1989-90. It is proposed that this average be brought down to 60 per cent by 1995-96. For the majority of consumer goods the duty rate may be set at 70 per cent or higher, while for the essential items the duty rates may be set at 10 or 20 per cent.

8.43 The import-weighted average tariff rate for capital goods was 91 per cent in 1989-90. It would be in the range of 80 to 85 per cent at present. It is proposed that the average duty rate for capital goods should be reduced to 55 per cent by 1995-96. (As has been indicated in paragraph 8.55, this could be achieved even earlier.)

8.44 The import-weighted average tariff rate for intermediate goods was 103 per cent in 1989-90. This should be brought down to 45 per cent by 1995-96, i.e., a decline in the average tariff rate by 56 per cent. A wide range of commodities are included in this group. It may be desirable to have a duty rate less than 45 per cent for some raw materials (e.g., steel). On the other hand, for intermediate goods, which are not important inputs in capital goods production, the duty rate may be set at higher than 45 per cent. In determining the duty rates for various intermediate goods, the duty rates for consumer and capital goods have to be taken into account and it has also to be ensured that there is adequate incentive for domestic manufacturers to go in for backward integration (which requires that the difference in tariff rates at successive stages of value addition chain should not be too large)

Revenue Implications of Tariff Changes in the Years 1992-93 to 1995-96

8.45 The reduction in tariff rates proposed to be made in the next four years would result in a significant loss of customs revenue in relation to what it would be in the absence of any tariff changes. Though the average rate of nominal tariff is proposed to be reduced by 50 per cent, the growth of customs revenue will not be affected proportionately since there are many end-use duty exemptions which should be done away with.[69] Two other factors that would partly offset the revenue loss arising from tariff reduction are: (1) lowering of duty rates would cause imports to go up and the structure of imports to change in favour of goods which are at present subject to high import duty, and (2) reduction in the costs of imported inputs will encourage domestic industries and this will lead to increases in non-tariff revenue of the Government. Apart from these factors, if there is some fall in the exchange value of the rupee in the course of a shift to a convertible currency or otherwise, there would be a rise in the value of imports which would partly compensate for the cut in tariff rates.

8.46 There will be no short-fall in customs revenue, even with a 50 per cent reduction in the

---

68. In 1990-91, imports of coal and coke amounted to Rs.780 crore. Assuming a similar figure for 1992-93, an increase in the concessional duty rate from 5 to 25 per cent will yield an additional revenue of Rs. 150 to 200 crore.

69. There are two reasons why the reduction in the growth rate of customs revenue will be less than proportionate. First, since there are end-use duty exemptions, a reduction in the general effective duty rates will not reduce customs revenue proportionately. Secondly, the removal of end-use duty exemptions which has been recommended will partly offset the effect of tariff reduction on customs revenue.

average tariff rate, if imports grow very fast. Between 1980-81 and 1990-91, India's imports expressed in U.S. dollars grew at the rate of 9.1 per cent per annum. With the liberalisation of economic policies, particularly trade policies, one would expect the growth rates of exports and imports to go up. It seems to us, however, that the acceleration in import growth in the next few years is unlikely to be so much as to neutralise the effect of the proposed tariff reduction on customs revenue. This leaves the Government with three options: (a) making up customs revenue loss by raising additional revenue from direct taxes and domestic indirect taxes, (b) curtailing the growth of government expenditure, and (c) going in for further depreciation of the exchange rate. Needless to say, the Government may choose a combination of these three measures, with greater reliance on one or two of them.

Tariff Reform in the Years 1996-97 to 1998-99.

8.47 By 1995-96, the average tariff rate should be brought down to about 50 per cent and the peak rate to about 80 per cent. In the years 1996-97 to 1998-99, tariff rates should be reduced further to bring down the average rate to around 25 per cent and the maximum rate to 50 per cent by 1998-99. The broad structure of tariff rates in terms of the average rates of tariff for the six major commodity groups should be similar to that recommended for 1995-96 (Table 8.2).

8.48 There is at present a ban on imports of non-essential consumer goods (though domestic production is allowed). Such a ban may have to be continued for some time. However, if the foreign exchange position improves substantially by 1998-99, then some imports of non-essential consumer goods may be allowed at the peak duty rate of 50 per cent (excluding CVD).[70] This will eliminate the distortions that a ban on imports of such goods gives rise to.

8.49 By 1998-99, all end-use exemptions should be removed with a few possible exceptions. Since the general level of tariff rates will be brought down substantially, the end-use exemptions will become unnecessary. However, duty exemptions on imports made by exporters against advance licences can be continued.

8.50 By 1998-99, a minimum rate of import tariff, say 10 per cent, should become generally applicable. Almost all commodities which are at present subject to nil or negligible import tariff should attract by 1998-99, a rate of protective customs duty equal to or higher than the minimum rate. This would not, however, apply to imported inputs in exports for which complete duty exemptions will have to be provided.

8.51 At present, complete exemption from customs duties is given to imports of fertilizers and some of the inputs used for production of fertilizer in the country. Further, concessional duty rates apply to some intermediate inputs and to capital goods used in fertilizer production. The duty rate on fertilizer project imports is 15 per cent as against the rate of 80 per cent applicable to general project imports. The imposition of a minimum import duty and the abolition of end-use exemptions would imply an increase in the cost of imported fertilizers as well as the cost of domestic fertilizers (unless there is substantial efficiency improvement and cost reduction). We are of the view that in the interest of improving resource-use efficiency the increases in costs of imported and domestically produced fertilizers should be passed on to farmers and ultimately as higher prices for agricultural produce, rather than being absorbed as increased fertilizer subsidy.

Other Issues

8.52 A number of cases in which the customs duty structure is anomalous has been brought to the notice of the Committee. One of them is the case of polystyrene on which the duty rate is 55 per cent, while the raw material viz., ethyl ben-

70. If imports of some non-essential consumer goods are allowed at the peak duty rate, then the duty rate for baggage should be substantially reduced to a level not much higher than the peak rate plus the corresponding CVD.

zene attracts a duty of 90 per cent. Another case is that of medical electronics, where the finished product imported under certain conditions attract zero duty whereas the components required for indigenous manufacture are charged at 65 to 85 per cent duty rates. Such anomalies in duty structure exist also for some of the capital goods, for example, hydraulic extrusion press, industrial valves and certain types of machine tools. There are possibly many other cases in which the customs duty structure is anomalous. It is needless to say that all such cases have to be looked into and necessary corrections in duty rates made. In making the corrections, the broad structure of duty rates suggested for 1995-96 should be kept in view.

8.53 One important recommendation made above is that by 1998-99 a minimum rate of import tariff, say 10 per cent, should become generally applicable. A beginning should be made in this direction in the next year. The list of commodities for which the duty rate has to be raised to the minimum rate or higher includes newsprint, ammonia, petroleum products (e.g., kerosene and HSD), medical electronics and coking coal. (It may be difficult to impose immediately an import duty of 10 per cent or so on fertilizers. But this has to be done ultimately in six or seven years' time.) We recommend that a 10 per cent import duty be levied on all the above commodities in the next year.

8.54 Items whose imports are permitted only under EXIM scrips enjoy an additional protection compared to items importable under OGL or through other licences. This can be a source of distortion, especially if the rates of premium on EXIM scrips are high. Thus, if the imports of a final product are permitted only under EXIM scrips, while the imports of its components are placed under OGL, the ERP of the final product will be much higher than what the customs duty rates indicate. It is important, therefore, that trade policy be well coordinated with tariff policy.

8.55 A large part of the capital goods imports are at present not subject to any countervailing duty. For such items, a part of the protective customs duty (equivalent of the excise duty on corresponding domestic products) can be converted to countervailing duty. This would reduce the protective customs duty for such capital goods and would not involve any loss of revenue. The next step would be to extend the Modvat scheme in a slightly modified form to capital goods. The Modvat credit for excise duty or CVD on capital goods would be allowed to be utilized over a period of five years against the excise duty on finished goods. This would lower the cost of capital goods to the user industries with consequent benefits in terms of lower costs of production. The spreading of the utilisation of credit over five years has the advantages that the immediate loss of revenue will be small. In any case, part of the loss in revenue through Modvat credit will be recouped through higher income tax resulting from lower depreciation. We propose to evolve such a scheme and shall deal with this matter in all its details in the final report.

8.56 Several recommendations were made above regarding the changes to be made in tariff rates. Some of the recommendations were quite general, while the more specific ones related to broad groups of commodities. It would have been useful to provide also specific recommendations for various commodities. This is not done in this report, but will be done in the subsequent report for important groups of commodities such as iron and steel, non-ferrous metals, chemicals and plastics. The final report would also attempt to pinpoint the major anomalies in the existing import tariff structure which need to be removed at the earliest.

9

TAXATION OF DOMESTICALLY PRODUCED GOODS AND SERVICES

Introduction

9.1 In this Chapter, we deal with the reform of the system of Union excises, consider possible extension of indirect taxation by the Central Government and finally examine the possibilities of evolving a rational and harmonised system of indirect taxes levied by the Centre and the States. For obvious reasons, the major part of the Chapter deals with the reforms of Union excises.

9.2 The constant refrain of this report is that the tax system should be broad-based, simple and should have moderate rates. This principle applies as much to indirect taxes as to direct taxes; the indirect tax system must cover as many transactions as possible and should be broadly neutral in relation to production and consumption; departures from neutrality must be deliberate and for achieving a few major objectives. Hence the taxes levied must have only a few rates and very few exemptions. The basic indirect tax at the Central level, which should be broadly neutral, should in course of time cover commodities as well as services. This means that we should move towards a value added tax (VAT) covering services and commodities. In addition, there must be, as pointed out earlier, selective excises on specified products - mainly commodities of luxury or non-essential consumption and goods whose use must be discouraged for purposes of conservation and/or protection of the environment. To make the VAT system simple and easily administrable, it should be levied at two or three rates, say, at 10, 15 or 20 per cent. The selective excise duties on non-essential consumption could be levied at 30, 40 or 50 per cent. This means that the maximum rate on a commodity will not exceed 50 per cent with a few exceptions like cigarettes.

9.3 It would be ideal if there were one comprehensive VAT replacing the present system of Central excise, the State sales taxes and other indirect taxes except the State levy on alcoholic liquor and the State entertainment tax. The proceeds of the tax could be shared between the Centre and the States.

9.4 With a comprehensive base and limited exemptions, the rates of tax could be fairly moderate as indicated above and, therefore, there will be less incentive for evasion than at present. The changes in the indirect tax system at the Central level that we are recommending here should be consistent with, and represent, a further move towards the ultimate goal of a comprehensive value added tax.

9.5 In this report, we concentrate on recommendations for immediate action which would simplify the excise-cum-Modvat system, expand its base, increase its income and price elasticity and prepare the ground for a full-fledged VAT system at the Central level. We also recommend a beginning with the taxation of services. Apart from the concrete recommendations in the above two areas, we shall also indicate the broad directions for further reform to be completed within the next 5-7 years, simultaneously with the progress of import tariff reform.

Widening the Tax Base

9.6 There is a need to widen the tax base and extend the coverage of excise duties. With a system of Modvat, there should be as few areas of exemption as possible. In fact, in a scheme of value added tax, exempting a final product means exemption only in respect of value added at the final stage since the credit of the duty paid on the inputs is not available as set off. Thus the exempted product actually gets subjected to the duties paid on various inputs. Sometimes exemptions to the inputs based on end-use are given. Thus because tractors of engine capacity upto 1800cc are exempt from duty, separate exemptions for tyres and tubes and other motor vehicle parts cleared for use in such tractors have been given. Such end-use based exemptions complicate and distort the tariff structure; they also cause difficulties for administration. Even in such cases, it may not be possible to relieve the product of the burden of the levy of excise duties on all the inputs; for example, a manufacturer of tractor tyres would not be able to get Modvat credit on the inputs going into the tyres. There is a case for imposing duties on many items currently outside the excise net. Some of these items have been identified and are indicated below:

1. Spices packed in unit containers and bearing a brand name.
2. Preparations of meat, fish, etc. packed in unit containers and bearing a brand name.
3. Homoeopathic, Unani, Ayurvedic and Biochemic medicines.
4. Exposed cinematograph films (feature films).
5. Articles of plastics.
6. Exempted varieties of tractors.
7. Power tillers.
8. Ready-made garments.
9. Head gear.
10. Glass envelopes for use in bulbs, etc.
11. Glass yarn and fabrics.
12. Glass inners for vacuum flask.
13. Peizo-electric quartz.
14. Sponge iron or steel; iron or steel powders.
15. Pressure cookers and parts.
16. Pumpsets and parts.
17. Water coolers; gas compressors used for water coolers and parts thereof.
18. Bicycles and other cycles (including delivery cycles) not motorised.
19. Cinematograph projectors.
20. Vacuum flask.
21. Electric bulbs.
22. Sewing machines.
23. Products of coir, cashew oil mill and solvent extraction industry exempted at present under Notification No.115/75.
24. Tractors of engine capacity not exceeding 1800 cc.
25. Electrically operated two-wheeled and three-wheeled motor vehicles.

In addition to the aforesaid items, suggestions for bringing some other items like, Black & White TV sets, converted types of paper, corrugated paper made out of imported paper, kraft paper and paper board used for packing of horticultural products, printed cartons made from specified varieties of paper, tyres and tubes for bicycles, cycle rickshaws and powered cycle rickshaws, tyres for tractors of engine capacity not exceeding 1800 cc, tyres for power tillers and animal drawn vehicle (A.D.V.) tyres are made in Paragraph 9.29.

9.7 On all these items excepting Black & White TV sets, a duty of 10 per cent ad valorem should be levied. In the case of those items where the industry is decentralised, e.g., Ayurvedic medicines, articles of plastics, ready-made garments, to start with, all units could be brought under the Simplified Assessment Procedure Scheme suggested in paragraph 9.16. This arrangement could operate for a specified period, say, 5 years. Thereafter, these commodities should also be brought under the normal procedure. Wherever end-use based exemptions have been given for the inputs going into these products, these exemptions should be withdrawn and the same rate of 10 per cent should be imposed on the inputs. If it is not possible to withdraw all such exemptions immediately, this should be done gradually over a period of time when inputs and the finished products will bear duty with the benefit of Modvat credit for inputs.

The General Scheme of Excise Duty Exemption for Small Scale Industries

9.8 Duty concessions to the small-scale sector are a salient feature of the present excise duty regime. In the context of expanding commodity coverage, these concessions were conceived of both as an incentive for the small-scale sector and as an administrative measure to keep the excise net manageable. This concession is currently a positive tool of fiscal preference to Small Scale Industries (SSI) to enable them to withstand competition from the organised sector.

9.9 Several committees set up in the past including the Tariff Enquiry Commission, the Jha Committee and the Dandekar Committee have generally accepted the need for encouraging the small-scale sector which has the capacity to promote dispersal of industry, widen entrepreneurial base, provide employment and effectively utilise locally available labour and raw materials. The Industrial Policy Resolutions of the Government have also envisaged giving impetus and encouragement to this sector.

9.10 There are about a dozen schemes providing excise duty concessions to the small-scale sector producing excisable goods. Different criteria have been adopted to regulate these duty concessions. These are - (i) exemptions based on value of clearance - the most common criterion; (ii) exemption based on the quantum of clearances (e.g., in the case of biris, matches and tread rubber), (iii) exemption to goods manufactured without the aid of power (e.g., in the case of pigments, colour and soap); and (iv) exemption to Khadi & Village Industries.

9.11 The most important exemption scheme for the SSI is the general scheme under notification No.175/86-CE dated 1.3.1986, as amended. This scheme is applicable to over 80 per cent of the excisable goods specified in the tariff.

9.12 Prior to 1978, individual commodities had separate exemption for SSI based on different criteria. These were replaced in 1978 by a uniform criterion of eligibility related to the aggregate value of clearances from a manufacturing unit or by a particular manufacturer from one or more units in the preceding year. The exemption limit was also based on the value of clearances. Initially Rs.15 lakh and Rs.5 lakh were the eligibility limit and the full exemption limit, respectively. Thus a small manufacturer was eligible to avail himself of full duty exemption upto Rs.5 lakh, if his preceding year's clearances did not exceed Rs.15 lakh. Today the eligibility limit is Rs.200 lakh, while the full duty exemption is available for clearances upto Rs.20 lakh for units/manufacturer producing goods falling under only one chapter in the Central Excise Tariff and Rs.30 lakh where goods falling under more than one chapter are produced and cleared. A concessional rate of normal duty minus 10 per cent ad valorem or 5 per cent ad valorem whichever is higher, is applicable to subsequent clearances upto Rs.75 lakh. For clearances beyond Rs.75 lakh, the normal rate of duty is leviable.

9.13 The other salient features of the general exemptions scheme for the SSI sector are given below:

a. Higher notional credit

i. In order to facilitate the marketing of excisable goods manufactured in the SSI under the Modvat regime, the exemption scheme provides for optional payment of duty at the concessional rate of normal duty reduced by 10 per cent ad valorem subject to a minimum rate of 5 per cent ad valorem even for clearances within the full exemption limit, i.e., Rs.20 lakh or Rs.30 lakh as the case may be, with the special dispensation that the user industry can avail of Modvat credit at a notional rate which is higher than the actual incidence of duty as indicated above. The incremental rate was 10 per cent ad valorem initially and this was reduced to 5 per cent ad valorem in 1988. The notional higher credit is available for clearances upto the exemption limit, i.e., Rs.75 lakh. This special dispensation, which is nothing but a direct subsidy from the revenue account, was built into the exemption scheme contemporaneously with the introduction of the Modvat scheme, to ensure that goods produced in the SSI continue to enjoy the advantage of a relatively lower duty component net of Modvat, vis-a-vis, the same goods produced in the organised sector.

ii. The revenue loss on account of the notional higher credit is estimated at Rs.200 crore annually.

iii. It may be mentioned in this context that goods falling under Tariff Item 68 of the erstwhile Central Excise Tariff were eligible for proforma credit facilities under Notification No.201/79-CE dated 1.3.79 which were broadly similar to Modvat facilities. The concept of notional credit for the purpose of reducing the excise duty component net of proforma credit in respect of SSI producing such goods was not envisaged any time before the introduction of the Modvat regime in 1986. There was no demand from the SSI for this kind of subsidy in the form of higher notional credit.

b. Branded goods

Goods manufactured by small-scale units under the brand name of a manufacturer or trader who is not eligible for excise duty exemption scheme for the small-scale sector, do not qualify for the duty exemption under this scheme. In other words, branded goods produced in the SSI attract the normal duty applicable to the organised sector. However, the duty exemption is available if goods are manufactured under the brand name of any manufacturer in the small-scale sector.

9.14 The results of surveys conducted by the Tax Research Unit of the Department of Revenue in 1984 and 1989 indicate that the number of duty paying units has increased almost fourfold. There has, therefore, been tremendous increase in the assessment work, control and procedural work relating to Modvat and a corresponding increase in the administrative expenditure. It is also seen that only about 500 units have benefited in 1989 from the extended full exemption limit for clearances of goods (i.e., Rs.30 lakh) falling under more than one chapter, as against a total number of about 40,000 units availing of the general scheme of exemption for the small scale units. The net revenue contribution from this sector has remained at a low level, while there has been significant growth in the span of excise control over the units in the SSI after the introduction of the Modvat scheme. This has meant outgo from the exchequer in two ways - firstly as subsidy in the form of higher notional credit, and secondly by way of increased administrative expenses due to a larger number of units opting to come within excise control. The fact that such a large number of units have opted to come within the excise control indicates that excise control per se is not a strong disincentive for the growth of the small-scale sector.

9.15 There have been complaints about misuse of SSI exemption schemes in two ways: (a) misuse of higher notional credit facility by getting fake gate passes issued with the connivance of the officials and by issuing endorsed/duplicate gate passes; (b) avoiding duty incidence on branded goods through purchase of the rights to use well known brands by small-scale units and getting the branded goods manufactured by a chain of small-scale units who are sister concerns of the units purchasing the brand name.

Simplified Assessment Procedure [SAP]

9.16 In the light of these findings, the Committee would like to recommend an alternative simplified scheme of excise concession for the small-scale sector, which may be called Simplified Assessment Procedure [SAP]. The salient features of this scheme are:

a. Eligibility criterion

Only those units whose turnover in the preceding financial year did not exceed Rs.30 lakh will be eligible to follow this procedure. For new units, the jurisdictional Assistant Collector of Central Excise shall assess the estimated turnover during the current financial year on the basis of investment in plant and machinery, nature and value of the goods manufactured, etc. and if in his estimate the turnover is not likely to exceed Rs.30 lakh, allow the unit to avail of this simplified procedure,.

b. Rate of duty

The goods manufactured by these units shall be assessed to a flat rate of 2 per cent on the turnover. As no duty paying documents will be issued, Modvat credit shall not be available. This concessional rate shall be available for turnover upto Rs.25 lakh only. Subsequent clearances will be under normal excise control and will be subjected to the existing concessional rates of duty, i.e., normal duty minus 10 per cent ad valorem, subject to a minimum of 5 per cent ad valorem. Modvat credit of the duty actually paid shall be available in respect of those clearances.

c. **Procedural relaxations**

i. No excise licence would be required for such assessees. The assessee shall give declarations indicating his name, address, commodities to be manufactured, its value, preceding year's turnover and estimated turnover during the current year.

ii. Excepting for new units, prior approval of the Department will not be necessary for manufacturing and clearing the goods.

iii. Duty shall be paid quarterly through TR-6 or simplified proforma on the lines of the challan for payment of sales tax or through Personal Ledger Account (PLA).

iv. The requirements of the filing of price lists and classification lists and the clearance of goods on gate passes will be waived. Records maintained for sales tax/income tax purposes shall be accepted for the purpose of verification of production figures and turnover in lieu of statutory Central excise records. The returns filed by the assessees shall be accepted without question with a provision for random audit.

v. Investigation, enquiry or audit in these units shall be only with the approval of the Assistant Collector of Central Excise.

9.17 The Committee expects that in view of the simplicity of the procedure with all the relaxations, most of the eligible units will opt for this procedure. To start with, the simplified assessment procedure may be introduced for goods covered under the general scheme. The desirability of extending this procedure to other small-scale units could be examined in the light of the experience gained while administering this procedure in respect of goods covered under the general SSI Scheme.

Proposed Duty Structure

9.18 The duty structure for the small scale units will thus be as follows:

Slab	Proposed Duty
Rs.lakh	
0-15	Nil
15-25	2 per cent of the turnover for units operating under SAP; for others
25-75	Duty at normal rates minus 10 per cent ad valorem subject to a minimum duty rate of 5 per cent ad valorem.
75-200	Duty at normal rates

a. The exemption limit and eligibility limit for the general scheme of exemption may remain at the present level of value of clearance upto of Rs.75 lakh and Rs.200 lakh, respectively. The eligibility limit for SAP will be a turnover of Rs.30 lakh.

b. The extended exemption limit for units producing goods falling under more than one chapter should be withdrawn.

c. Since the subsidy in the form of higher notional credit is proposed to be withdrawn, the provision for the option to pay duty, right from the first clearances, will no longer be relevant.

Withdrawal of the Notional Credit

9.19 The Committee would recommend the withdrawal of the facility of notional higher credit to the user industry. It is noted that a large cross-section of SSI units including those which were manufacturing goods under Tariff Item 68 of the erstwhile tariff did not have the benefit of any such credit and the Committee does not find any reason why small-scale units producing goods covered under the General Small Scale Exemption Scheme should be supported by such a subsidy. In any case there is no such special dispensation for SSI units producing excisable goods not covered under the General Small Scale Exemption Scheme. Thus from the point of view of equity also, the withdrawal of the notional higher credit is desirable.

Branded Goods

9.20 The present distinction in regard to availability of the concession between brand name of trader or organised sector and that of small-scale sector should be removed. All goods manufactured under the brand name of any person other than the manufacturer should be charged to normal duty. Corresponding amendments regarding branded goods may be made in the special schemes of exemption for the small-scale sector producing cosmetics and toilet preparations, air conditioners and refrigerators.

Review of Exemption Notifications

9.21 The excise duty structure in operation, as in the case of customs duty, is contained not only in the Tariff but also in a large number of exemption notifications. The Committee recommends that all such notifications should be subjected to a close scrutiny with a view to ascertaining whether these can be withdrawn. Where the notifications prescribe effective rates of excise duty without any condition, such rates can be incorporated in the tariff itself after adjusting them in line with the rate structure proposed in paragraph 9.2. As already mentioned in paragraph 9.7, end-use based exemptions should be withdrawn, and duty should be levied on both inputs and final products with the facility of Modvat credit.

9.22 The Committee recommends that the power of granting exemption from excise duties should be withdrawn, as has been recommended in the case of customs duties. However, Government may retain the power of adjusting the rates of duty under very exceptional circumstances.

Replacement of Specific Duties by Ad Valorem Duty Rates

9.23 At present the excise duty is levied on ad valorem basis on some commodities and at specific rates on other commodities. There are also commodities on which the rates of excise duty are ad valorem cum specific. In the case of commodities like petroleum products and loose tea, specific rates were fixed for administrative reasons, as ad valorem rates were considered difficult to administer. On the other hand, in respect of commodities like tyres, paper, cement, glass, television sets and refrigerators, ad valorem rates prevailed initially and were replaced by specific rates or ad valorem-cum-specific rates over the years. This deliberate shift from ad valorem to specific rates for many commodities was effected consequent to the large number of disputes in valuation leading to protracted litigation in Courts. Such valuation disputes, the majority of them being those relating to abatement of post manufacturing expenses, created a lot of uncertainty in assessment and it is with a view to putting an end to such uncertainties and reducing disputes in assessments, that specific rates were fixed in the place of ad valorem rates for many commodities. As a result of this gradual shift to more and more specific rates over the years, the share of revenue from specific rated items has increased from a level of about 46 per cent of the total revenue in 1981-82 to 65 per cent in 1986-87 and has currently reached a level of about 70 per cent.

9.24 Specific rates no doubt have the advantage of ease of administration in that problems relating to valuation are eliminated leading to a certain measure of stability and certainty in assessments. In fact, many Trade Associations have represented to this Committee, the retention of specific rates and to desist from switching over to ad valorem rates. In a system of commodity taxation, ad valorem duties are preferable to specific duties as the former are related to the values of different products, a costlier item of a particular commodity paying more duty than a cheaper item. Ad valorem duties are essential to ensure controlled incidence and make easier the administration of a value added tax. These lead to elasticity of revenue with respect to national income and ensure buoyancy in revenue on account of increase in prices. It might be argued that even in a system of specific duties, one could achieve progressivity by fixing different specific rates for categories of a commodity with higher rates for costlier varieties determined on the basis of some well-recognised criteria. But this is not always easy. Having too many specific rates for one class of goods would lead to classification disputes. In the process of solving valuation disputes, one may end up in having to solve classification disputes. This may also induce a manufacturer to deliberately misdeclare a product with the intention of evading duty. For example, in a system of specific duties on fabrics with cotton fabrics carrying a lower rate than man-made fabrics, a manufacturer of man-made fabrics may deliberately describe the fabrics as cotton fabrics in the documents and pay the lesser rate applicable to cotton fabrics.

9.25 In regard to elasticity, it could be argued that by periodically revising the specific rates one could ensure higher collection on account of higher prices. But revising the specific rate is not always easily done. It may require elaborate studies of price variations and hence, there would always be a time lag between the price increase and the rate revision. Also, any adjustment of specific rates purely with reference to price factors could be viewed by the trade and industry as a fresh dose of taxation. This would not be the case with ad valorem rates. Therefore, often it may not be considered opportune to revise the specific rates on a commodity despite clear justifications for doing it. As a result of all these constraints, in fact most specific duty rates have not been changed for long periods, and as a result there has been considerable loss of revenue, far higher than what was sought to be gained by attempts to check suspected under-valuation.

9.26 Non-revision of specific rates besides having revenue implications also leads to other distortions. For example, on a commodity subject to a specific rate, the inputs required for manufacturing the same may be carrying ad valorem rates. On account of non-revision of the specific rates on the finished goods, Modvat credit of the duty paid on the inputs may go on increasing with increase in prices of the inputs, but without any corresponding increase on the duty on the finished goods. Over a period, this would result in the incidence on the finished goods getting lowered giving unintended benefits to some sectors. In fact, such unintended distortions creep in because in a system of specific duties one is never certain at any point of time about the actual incidence in ad valorem terms of the duty on a commodity. As a result, a rational fiscal structure is difficult to achieve in a system of specific duties, particularly when there is a comprehensive excise and Modvat system covering a wide range of commodities.

9.27 The relative merits and demerits of ad valorem and specific duties have been examined in the past by the Indirect Taxation Enquiry Committee (1977) and the Technical Study Group on Central Excise Tariff (1985). The Indirect Taxation Enquiry Committee noted the shift taking place during those years from specific to ad valorem duties and recommended that there should be further extension of the ad valorem basis except where there were serious difficulties in doing so. It was stated that ad valorem duties are preferable to specific duties to avoid frequent revisions of rates for meeting revenue needs which tend to create distortions and irrationalities.[71] The Technical Study Group on Central Excise Tariff (1985) on the other hand while recommending that the effort, in general, should be to have ad valorem levies, suggested that where ad valorem levies pose serious administrative problems, there need be no hesitation in adopting specific rates or better still to have specific-cum-ad valorem levies. The Group also recommended that there should be a conscious attempt to fix the rate category of products subject to such duties and then adjust the duty from time to time to remain in conformity with the relevant rate category.[72]

9.28 The Committee is of the view that the advantages of having ad valorem duties far outweigh the administrative benefits derived by switching over to specific duties. In a system of comprehensive taxation with a wide coverage of Modvat, it would be necessary to have by and large only ad valorem duties in order to ensure a rational system of taxation. However, there could perhaps be some justification for retaining specific duties on a few commodities on administrative considera-

71. Paragraph 8.2 of the Interim Report and paragraphs 8.14 and 8.15 of the Report of the Committee.

72. Paragraph 3.19 of part I of the Report of the Technical Study Group.

tions. The answer to valuation problems perhaps, lies in simplifying the law and rules relating to valuation instead of switching to specific duties. In the later part of this Chapter,[73] we deal with this matter and make some specific recommendations for amending the law relating to valuation.

9.29 Keeping in view the above considerations, an attempt has been made to suggest ad valorem rates in lieu of the current specific rates in respect of many items. Simultaneously, rationalisation of the existing rates has also been suggested with a view to reducing multiplicity of rates. Three broad categories, namely, petroleum products, tobacco products and textiles have been kept out of this exercise. These commodity groups are also outside the Modvat scheme at present. Ideally, goods of the same class should carry the same ad valorem rate. But revenue considerations prevent this from being done in many cases at present. Over a period of time, a uniform ad valorem rate for goods of the same class should be evolved in a phased manner. The Committee proposes to examine the duty structure on some of the important groups of commodities in the final report. For the time being, the Committee would recommend the following changes in the duty rates on some of the items. While recommending these rates, the Committee has kept in view the duty slots in which the entire tariff is required to be structured in the long run as referred to earlier in this Chapter.[74] However, it has become necessary to suggest some departure in view of immediate revenue implications.

a. Chapter 15[75]

As against a basic duty of Rs.1,900 per tonne in the case of vegetable product, an ad valorem rate of 10 per cent is suggested. In due course this rate can also be made applicable to refined oils which at present are fully exempted from duty.

b. Chapter 17

The duty on levy sugar is Rs.38 per quintal. Of this Rs.17 per quintal is by way of basic excise duty and Rs.21 per quintal by way of additional duty in lieu of sales tax, the proceeds of which go entirely to the States. On free sale sugar, the rate is Rs.71 per quintal - Rs.34 per quintal being basic excise duty and Rs.37 per quintal being additional excise duty. A uniform rate of 10 per cent ad valorem (basic duty plus additional duty) could be considered for both levy sugar and free sale sugar. The additional duty component could be so adjusted that the share of the States is not reduced from the present levels.

c. Chapter 21

On Pan Masala, the present rate structure is as follows:

i. Rs.30 per kg on Pan Masala not containing tobacco and cf which the value does not exceed Rs.75 per kg.

ii. Rs.60 per kg on Pan Masala not containing tobacco and of which the value exceeds Rs.75 per kg.

iii. 40 per cent ad valorem on Pan Masala containing tobacco.

A uniform ad valorem rate of 40 per cent could be fixed on all types of Pan Masala whether containing tobacco or not.

d. Chapter 25

i. The duty on cement is specific for the varieties of cement like grey cement yielding the major part of the revenue from this item. Cement prices have increased substantially in recent times and, in ad valorem terms, the duty incidence has fallen considerably over the years. The present ad valorem incidence of basic duty on grey cement is about 15 per cent.

73. Paragraphs 9.33 to 9.46.

74. Paragraph 9.2.

75. Chapter means Chapter in the Schedule to the Central Excise Tariff Act, 1985.

On the other hand, the duty rate is as high as 40 per cent ad valorem on other varieties of cement including white cement. Special concessional rate of 10 per cent ad valorem is prevailing for aluminous cement, high alumina refractory cement and cement clinkers. There is a need for rationalising these duty rates and prescribing a uniform ad valorem rate for all varieties of cement. A costlier variety would automatically pay a higher quantum of duty. It is proposed that an ad valorem rate of duty of 20 per cent be prescribed for the following:

(a) Cement clinkers of sub-heading 2502.10.

(b) All varieties of cement like grey cement covered by sub-heading No.2502.20.

(c) Aluminous cement of sub-heading 2502.30.

(d) High alumina refractory cement of sub-heading 2502.50.

ii. Ideally this rate of 20 per cent should also apply for white cement, etc. currently subject to a rate of 40 per cent. But a sudden reduction from 40 per cent to 20 per cent would give a windfall benefit to the manufacturers of such cement who may not reduce the prices to consumers but absorb the duty reduction as profits. Therefore, it is suggested that the duty be fixed at 30 per cent but eventually the duty could be brought to the same level as for other varieties. Thus, for the present the duty on all cement of sub-heading 2502.90 could be fixed at 30 per cent ad valorem.

iii. At present a special scheme of duty concession for mini cement plants is in operation. Such plants pay a concessional rate of Rs.90 per tonne in terms of notification No.24/1991 dated 25th July 1991. This scheme may continue with the only change that the concessional rate of duty be fixed at 10 per cent ad valorem instead of the specific rate prevailing at present.

e. Chapter 28

i. In respect of some cases, namely, chlorine, oxygen, carbon-dioxide and ammonia, specific rates of duties have been fixed. A uniform ad valorem rate of 15 per cent, which is the normal rate of duty for all inorganic chemicals of Chapter 28, could be fixed for all these gases falling under Heading Nos. 28.01, 28.04, 28.11 and 28.14.

ii. On caustic soda falling within heading 28.15, specific rates have been prescribed for different forms of caustic soda. A uniform rate of 15 per cent could be fixed for all forms of caustic soda.

f. Chapter 29

The present specific rate on acetylene of sub-heading No.2901.10 could be replaced by an ad valorem rate of 15 per cent, the general level of duty on other organic chemicals of Chapter 29.

g. Chapter 40

The duty on tyres and tubes is specific for almost all varieties with a few exceptions. The rates vary depending on parameters like size, type, whether made of rayon or nylon, etc. Some tyres, e.g., tyres used on bicycles and cycle rickshaws and tyres for exempted varieties of tractors and certain types of tyres designed for use in animal drawn vehicles, do not pay any duty. Tyre is a major revenue yielding commodity. The bulk of the revenue from tyres comes from tyres used on buses and trucks. While fixing ad valorem rates in lieu of the present specific rates, these factors have to be kept in mind. For the present, a uniform rate of 35 per cent ad valorem could be considered for all tyres and tubes with a few exceptions. In the latter part of the report, suggestions are made for imposing duty on bicycles, tractors, etc., that currently do not pay duty. Simultaneously, the current nil rates of duty for bicycle tyres, tractor tyres, etc., may be withdrawn. These varieties of tyres on which fresh duty would be imposed in that event need not, however, carry the high rate of 35 per cent but a lower rate of say 10 per cent. The lower rate would be justified on two counts. First, the final product, namely, bicycles or tractors would be carrying only low rates of duty. Secondly, while tyres used as original equipment would get the benefit of Modvat, there would be an impact of this duty on the prices of spare tyres.

h. The following rate structure is suggested for tyres and tubes:

   i. tyres for bicycles, cycle rickshaws and powered cycle rickshaws - 10 per cent;

   ii. tyres for tractors of engine capacity not exceeding 1800 cc - 10 per cent;

   iii. tyres for power tillers - 10 per cent ;

   iv. certain sizes of animal drawn vehicle (A.D.V) tyres which are at present fully exempted - 10 per cent ;

   v. all other tyres - 35 per cent ;

   vi. different ad valorem rates prevailing for aero, power tiller and gun carriage tyres in terms of Notification No. 150/90 dated 5.10.1990, Notification No. 44/91 dated 25.7.1991 and under sub-heading No.4011.99 respectively may be done away with and instead, the rate of 35 per cent may be made applicable to them also. The tyres meant for use on vehicles and equipment for use off the road, covered by sub-heading No.4011.91 may also carry the same rate of 35 per cent ; and

   vii. the duty on tubes could be at the same level as for the corresponding tyres.

i. Chapter 48

The bulk of the revenue from paper and paper products of this chapter comes from items carrying specific-cum-ad valorem rates. The specific components vary widely. Apart from these specific rates, there are varying ad valorem rates for those varieties of paper and paper products for which specific rates have not been fixed. A number of items are fully exempted from duty. There is a need for switching over to a fewer ad valorem rates, and doing away with many of the exemptions. While rationalising the rates, revenue considerations should no doubt be kept in mind but at the same time the need for keeping the duty on a commodity like paper at a reasonable level should not be lost sight of. The Committee would recommend a three tier duty structure of 10 per cent, 15 per cent, and 20 per cent for paper and paper products. Full exemption already available may have to be retained for some items. The following rate structure is suggested:

   i. paper made by employing sundrying process and falling under sub-headings 4805.11 and 4807.91 currently carrying a rate of 10 per cent may continue to have the same rate.

   ii. all items currently carrying 15 per cent may remain at that level. The concessional rate of 12 per cent to goods covered by Notification 135/89 dated 12.5.1989 may be raised to 15 per cent.

   iii. all items currently carrying various levels of specific or specific-cum-ad valorem duties may have a uniform rate of 20 per cent ad valorem.

   iv. the rate of 20 per cent may also be made applicable to all items currently carrying ad valorem rates at a level of 20 per cent or higher. This will apply to floor coverings of paper (48.15), carbon paper, self copying paper, etc.

   v. the following full exemptions should be withdrawn and the minimum rate of 10 per cent ad valorem should be levied:

   (a) exemption to corrugated paper made out of imported paper [Notification No.99/73 dated 24.3.1973].

   (b) exemption to converted types of paper [Notification No.49/87 dated 1.3.1987].

   (c) exemption to various products including registers, file covers, etc. [Notification No.43/86 dated 10.2.1986].

   (d) exemption to kraft paper and board used for packing of horticultural products [Notification No.2/87 dated 1.1.1987].

   (e) exemption to printed cartons made from specified varieties of paper [Notification No.59/88 dated 1.3.1988].

   vi. the other full exemptions to newsprint, hand made paper, paper from bagasse, etc. may continue.

vii. at present, there is a scheme of concessional rate for paper and paper board made out of unconventional raw materials. The rate is 10 per cent plus Rs.550 per tonne for large paper mills. For small paper mills there are varying rates of specific duty for different slabs of production. The general concessional rate under Notification 139/86 could be kept at 15 per cent ad valorem (i.e., 5 percentage points less than the general rate of 20 per cent ad valorem for paper and paper board). The concessional rate for small paper mills under Notification 138/86 could be kept at 10 per cent ad valorem. This rate should apply for all slabs of production subject to the existing overall eligibility limit of 33,000 tonnes.

j. Chapter 70

Varying specific rates have been fixed for glass products of headings 70.02, 70.03, 70.04 and 70.06. These rates may be replaced by a uniform ad valorem rate of 40 per cent which is the present rate for glass bottles. The rate is high for a product like glass but may have to be maintained for the present for revenue considerations. There is, however, a case for reducing this level in the long run to, say, 20 per cent.

k. Chapters 72 to 81

These chapters cover base metals and articles of base metals. In the case of iron and steel, the duty is specific for the metal and some of the articles of the metal. In the case of some of the non-ferrous metals, namely, copper, aluminium, lead and zinc, the rates are mostly specific or specific-cum-ad valorem for a number of items. In the case of nickel, tin and other base metals, the rate is 15 per cent ad valorem. Where the duty rates are specific, the rates are not high except in the case of aluminium. Metals constitute a basic input for the engineering, capital goods and construction industry. As such, it would not be desirable to levy a very high rate of duty on metals. The present specific rates on ferrous and non-ferrous metals could be replaced by a uniform ad valorem rate of 10 per cent with the exception of aluminium, where the rates may be kept at higher levels in view of revenue considerations. However, the specific rates could be replaced by suitable ad valorem rates. In the case of metals like nickel, tin and other base metals where the current rate is 15 per cent ad valorem, the rate for the primary metal could be reduced to the level of 10 per cent on par with the rate recommended for ferrous and non-ferrous metals. As the revenue from these metals is comparatively insignificant, the changes recommended would not involve any large loss of revenue. With this rationalisation, all metals, with the exception of aluminium would carry a rate of 10 per cent ad valorem. It is expected that this rationalisation would be broadly revenue neutral considering that a significant portion of revenue from metals is given as Modvat credit to downstream products.

l. Chapter 84

i. For airconditioners, varying specific rates have been fixed depending upon the capacity. A concessional rate applies in respect of window airconditioners and package type airconditioners of specified sizes when supplied for use in government hospitals. All these rates could be merged into a uniform ad valorem rate of 100 per cent. In the case of compressors for airconditioners, a uniform ad valorem rate of 40 per cent could be prescribed. This is the general level of duty applicable to parts of airconditioners.

ii. In the case of refrigerators, varying specific rates depending upon the capacity have been prescribed. A uniform ad valorem rate of 40 per cent is recommended for these items.

iii. For manual typewriters, varying specific rates depending on the carriage size have been prescribed and for typewriters other than manual, the rate is 20 per cent ad valorem. In lieu of the specific rates on manual typewriters, an ad valorem rate of 20 per cent could be considered.

m. Chapter 85

i. On fluorescent lighting tubes of heading 85.39, a specific rate of Rs.2.00 per tube has been fixed. Several other types of lamps and bulbs of the same heading carry rates of 10, 15, 30 and 35 per cent. Besides vacuum and gas filled bulbs have been fully exempted from duty. All these rates have been prescribed in terms of Notification No.67/83 dated 1.3.1983. There is a case for rationalisation of these duty rates. A uniform ad valorem rate of 15 per cent could be prescribed for all the products of heading 85.39.

ii. In the case of television sets and television picture tubes, the present specific rates and full exemption for black and white TV sets could be replaced by ad valorem rates as indicated below:

Black & white TV sets and picture tubes:	20 per cent
Colour TV sets and picture tubes :	30 per cent

iii. On video cassette recorders and video cassette players, a rate of 40 per cent should be fixed. In the case of combination sets of televisions with clock, radio, etc. a rate of 20 per cent for combination sets of black and white TV sets and 30 per cent for colour TV sets could be considered.

9.30 In the foregoing paragraph, the excise duty structure of some major commodities (other than petroleum, tobacco and textile groups) presently carrying specific duties has been examined. On some other major items like matches, tea, coffee, video and audio tapes there may be a need to continue with a specific duty structure for administrative reasons. There are some other items not very significant from revenue point, e.g., molasses or potassium chlorate, where too there may be a case for retaining specific rates. In the case of molasses, the duty collected is given as a money credit when alcohol produced out of molasses is used in the manufacture of industrial alcohol. The money credit scheme may be simpler to operate when the precise incidence of duty on molasses is known. On matches, because of the decentralised nature of the industry, ad valorem duties may be difficult to administer and so specific rates may continue. Matches are also outside Modvat scheme. The duty on Potassium Chlorate, the principal raw material for matches could also continue to be specific.

9.31 All the existing specific rates of excise duty may be comprehensively reviewed by the Government and shifted to ad valorem duties considered as far as possible. Wherever specific rates are retained, there should be a system of revising the rates every year to take into account price increases as represented by the relevant sectoral wholesale price index. While fixing ad valorem rates, goods falling within the same class should as far as possible be made to bear the same rate.

9.32 There are some commodities where specific rates may be retained but where the rates could be revised immediately so as to net some additional revenue. Such cases are discussed below:

a. The duties on coffee and tea which are specific have remained practically unchanged for a number of years. While for administrative reasons, there may be a case for retaining the specific rates, the present rates which are very low in ad valorem terms may be doubled. Even with the doubling of rates, the ad valorem incidence would be lower than the incidence in ad valorem terms when the specific rate was last revised and there would be sizable revenue gain. For the future, some mechanism for revising the specific rate with the increase in prices for example, by linking the rates with the coffee or tea price index could be considered. This would obviate the need for steeply increasing the rates after long intervals.

b. On marbles, duty was first imposed in 1985 and the specific rates have remained practically at the same level since then. There is a case for revising the rate upwards to bring the rate upto the rate obtaining in ad valorem terms when the specific rate was last revised.

Valuation of Excisable Goods

9.33 In the context of the Committee's recommendation that there should be a deliberate shift wherever possible to ad valorem duties from specific duties, the question of valuation of excisable goods which is a major function of excise taxation, assumes added importance. Under the existing scheme of valuation of central excise the assessable value is the normal price at which goods are ordinarily sold and where the normal price is not ascertainable, the nearest ascertainable equivalent thereof determined in the manner prescribed in the Central Excise (Valuation) Rules, 1975.

9.34 Even though statutory provisions and the valuation rules are elaborately worded for determining the assessable value in various situations, the actual interpretation of the legal provisions relating to valuation have given rise to a number of disputes between the assessee and the department. After a long history of litigation, which need not be gone into, the Supreme Court in the case of Bombay Tyre International (1983 ELT 1986) held that it is not the bare manufacturing cost and manufacturing profit which constitute the basis for determining the assessable value. The Court further clarified that all the expenses incurred on account of several factors which have contributed to the value of goods up to the date of sale , which apparently would be the date of delivery, are liable to be included in the assessable value. This would include expenses incurred by the assessee up to the date of delivery on account of storage charges, outward handling charges, interest on inventories, advertisement expenses, after sale service charges, etc. In the case of sales through the depots at places outside the factory gate, the expenses incurred by the assessee up to the date of delivery under the aforesaid heads cannot be deducted. Abatement is permissible, however, on account of the cost of transportation from the factory gate to the place where it is sold including the cost of insurance and freight.

9.35 Despite the Supreme Court's judgement in the Bombay Tyre International case, the disputes still persist as to the admissibility or non-admissibility of deduction of many items of expenditure incurred by the assessee from the price for determining the assessable value. As of now, a large number of cases involving about Rs.2,000 crore are pending in the Supreme Court and High Courts. It is in these circumstances, that the Government had considered worthwhile to switch over to specific duties so as to safeguard revenue and minimise assessment disputes.

9.36 Determination of assessable value involves submission of price-lists by the assessee and their examination and scrutiny by the departmental officers. Different forms of price-lists are to be filed depending upon considerations whether the goods are sold at the factory gate or supplied to the customers on contract basis or sold to related persons, etc. The price-lists filed by the assessees throughout the year are so large in number that their examination and scrutiny consume a significant part of the officers' time in the ranges and the divisions.

9.37 Given this scenario, the existing mode of valuation calls for a close review. Needless to say that the mode of valuation should be such as to reduce the disputes considerably by having a measure which provides certainty to the extent possible and is simple enough to be understood and administered.

9.38 It is pertinent to note that the Supreme Court has held that the levy of a tax is defined by its nature while the measure of tax may be assessed by its own standard. While it is true that the standard adopted as a measure of the levy may indicate the nature of the tax, it does not necessarily determine it. A broader based standard of reference may be adopted for the purpose of determining the measure of the levy. Any standard which maintains the nexus with the essential character of the levy could be regarded as a valid measure of the levy.

9.39 The present concept of value for purpose of assessment of Central excise duty is a notional value. There have been suggestions that it is worthwhile to move away from the notional concept and to adopt the actual transaction price for purpose of assessment, thereby, reducing the disputes arising out of deriving a notional price from the actual price. The Technical Study Group, 1985, had favoured this approach towards valuation and recommended that the existing system of filing of prices should be abolished and excise duty should be collected on the basis of invoice price. It appears that this recommendation did not find favour with the department.

9.40 It is clear that as the Modvat or the value added tax system gets extended and becomes the main plank for raising revenue from domestically produced goods and services, it would be necessary to move over to a system of assessment on the basis of invoice value. However, for this to be possible and easily administrable it would be desirable to fulfil two conditions. First, there should be extension of value added tax from the manufacturing to the wholesale stage; this would considerably reduce attempts at under-valuation of products. Second, it would be necessary to give up the traditional method of administering excises on the basis of clearance of goods from the factory and move over to a system of assessment on the basis of periodic returns to be submitted by manufacturers. These are important changes and their feasibility would have to be studied in greater detail. The Committee does not, therefore, recommend a changeover to the system of assessment on the basis of invoice value at present. However, it is recommended that a beginning may be made, by way of experiment, with the use of invoice value for assessment of excise in respect of selected commodities which is largely eligible for Modvat in the sense that they are mostly sold to taxable manufacturers. Meanwhile, the question of extending the collection of Modvat to the wholesale stage must be taken up for active consideration. For political reasons, it would be necessary to hold consultation with the States on this matter; however, it would appear to us that there would be no bar under the Constitution to the application of the Central VAT at the wholesale stage.

9.41 While it is true that over a period of time a number of points relating to the determination of the "normal" price have got settled through the decisions of the Supreme Court, there are still a number of cases regarding valuation pending in the courts and it cannot be stated that the present legal position is quite clear. In view of this, the Committee would like to recommend some other methods of measurement of value.

9.42 There is evasion of duties where manufacturers manage to create an artificial market at a lower price at the factory gate but actually sell most of the goods from the depots at much higher prices. As the law stands at present, once the wholesale price at the factory gate gets approved as the assessable value, all the goods including those sold from the depots, pay duty on the basis of that value. While perception in regard to the quantum of evasion by such methods varies, this is a matter for which a solution has to be found. The Committee is of the view that in such cases where only a portion of the produce is sold at the factory gate and the balance from the depot, it could be provided in the law that the assessment of the goods removed from the factory to the depots would be made on the basis of the price at which the goods are sold from the depots giving necessary abatement for the freight from the factory gate to the depots. This would mean that an exception to the concept of normal price will have to be made in the case of goods sold from the depots.

9.43 Under the Standards of Weights & Measures Act, 1976 and the rules made thereunder, notified items are to bear the retail sale price, i.e., the maximum price at which the commodity in package form may be sold to the ultimate consumer. The maximum price has been defined to include all taxes, freight, transport charges, etc.[76] In the case of goods covered by these rules, the maximum retail price can be taken as a basis for devising the measure for levy of excise duty. The rate can be applied on a value worked out after giving an abatement for various taxes and other items which are not to be included in the assessable value. Such abatement by its very nature cannot be very exact and would vary from commodity to commodity. The Committee would recommend that the quantum of abatement could be worked out in a fair manner in consultation with the manufacturers' associations. In the light of the persistent demand of the trade for a specific duty, the Committee feels that there would be co-operation forthcoming from the manufacturers in this matter. There may still be some manufacturers who may question the fixation of the quantum of

76. Rule 2(r) of Standards of Weights and Measures (Package Commodities) Rules, 1977.

abatement and drag the matter to the Courts. It will be in order if an option is provided to such manufacturers to pay the duty at the tariff rate and the scheme operated through an exemption notification on the pattern of the assessment of drugs covered by the Price Control Order.

9.44 In terms of Section 3 of the Central Excises & Salt Act, the Central Government may fix tariff values for the purpose of levying excise duty and once such tariff value is fixed, the provisions of section 4 of the Act in regard to valuation would not apply. Fixation of tariff value has the advantage of introducing an element of certainty in the quantum of excise duty payable and does away with the requirements of filing of price list, approval of assessable value, etc. In respect of certain commodities where the price variations among the different varieties of the commodity being produced by different manufacturers are not significant, tariff value could be fixed for the purpose of assessment. The Committee is aware of the decision of some courts holding that tariff value cannot be fixed on the basis of weighted average. It is seen that these judgements are mostly based on the pronouncement in the Voltas case that the assessable value cannot exceed the manufacturing cost and the manufacturing profit of the product. As has already been mentioned earlier in the report, the Supreme Court in Bombay Tyre International case has clearly held that it is not the bare manufacturing cost and manufacturing profit which constitute the basis for determining the assessable value. In the light of this development, there would perhaps be a case for reviving the system of fixing tariff values. The Committee would recommend that this may be considered in the case of a few commodities like sugar and cement. Here again, the Committee would recommend that there should be consultation with the manufacturers' associations.

9.45 The Committee would recommend, that, there should be a Directorate of Valuation which would be entrusted with the responsibility of closely monitoring the movement of prices of goods produced by individual manufacturers especially in those cases where the revenue implications are large. The responsibility of having consultations with the manufacturers' associations in regard to fixation of the quantum of abatement from the retail price, the work of fixation of tariff value, etc., can be entrusted to this Directorate. On the basis of studies of this Directorate, the Government could take a decision in regard to addition to or deletion from the list of commodities which are assessed to duty on the basis of tariff value or retail price.

9.46 The Committee recognises that valuation in Central excise for assessment purposes is a complicated legal issue and no foolproof method can be suggested. The Committee can only urge that the method followed should be simple and fair so that by and large the manufacturers are not provoked to take up the issues to the Courts and at the same time, the unscrupulous elements do not make this as a gateway for evasion. As pointed out earlier, ultimately the department will have to adopt invoice value for assessment and carry out the needed changes in procedures.

Taxation of Services

9.47 We have throughout the report emphasised the need for broadening the base of the tax system, which would make possible a lowering of rates. In respect of indirect taxes, such broadening has to take the form of covering (a) almost all commodities other than raw produce of agriculture, (b) many, if not most, services and (c) all stages of production or transactions. This is accomplished under an ideal system of VAT. In our present context, the major steps to be taken are to extend the coverage of commodities under excise, on which we have already made recommendations, and to make a beginning with the taxation of services.

9.48 From the economic point of view, there is little difference between the taxation of commodities and that of services. In both cases, the principle of value added taxation can be applied to tax the final users. As an economy develops the services sector expands relatively to the commodities sectors. Multifarious services are produced for the benefit of the consumers as well as producers. Exclusion of services from indirect taxation tends to create distortions just as the exclusion of major commodity groups. There is no question, therefore, that services must be brought under taxation. As pointed out earlier, the substantial broadening of the base through the taxation of services would enable the lowering of rates of commodity taxation. A general value added tax levied even at 10 per cent covering imports and domestically pro . ced commodities and services plus a selective excise at a limited number of higher rates on a few commodities should be able to fetch sufficient revenues.

9.49 It is extremely important, however, that we do not commit the same kinds of mistakes as we have committed in respect of commodities. We must ensure that there will be a unified and rational system of taxation of services applicable to the whole country. This means that the services tax must be part of a value added tax in course of time and should be levied at the Central level. A cascading type of services tax should be avoided at all costs. We envisage that as the Union excise on commodities gets gradually transformed into a value added tax at the manufacturing level, the services tax will get woven into that system and therefore tax could be levied also on services that enter into the productive processes.

9.50 Towards the end of our discussion of the reform of the Union excises earlier in this chapter we had indicated the manner in which the Modvat system should be gradually converted into a comprehensive value added tax at the manufacturing stage. Once this is done it would be possible to introduce a fairly comprehensive system of taxation of services also on the basis of the value added principle so that the entire system of indirect taxation at the Central level would be devoid of cascading and would cause no distortion in costs or in the allocation of resources.

9.51 The power to levy a tax on services in general is not mentioned either in the Union List or in the State List in the VII Schedule of the Constitution. However, by virtue of Entry 97 in the Union List which gives power to the Centre for levy and collection of "any tax not mentioned in either of those Lists" (that is, the State List or the Concurrent List), it is clear that the Union Legislature is competent to levy indirect tax on services.

9.52 For the time being only a few selected services should be subjected to tax; and the services to be selected for the purpose must be those which do not enter into productive processes in any substantial way. We recommend that a tax be levied on the following services:

a. Advertising services;

b. Services of stock brokers;

c. Service of automobile insurance;

d. Service of insurance of residential property, personal effects and jewellery; and

e. Residential telephone services.

9.53 In all the cases above except for telephone services, the tax should be levied at 10 per cent of the value of the transaction, i.e., the value of the turnover in the case of advertising and brokerage services and the value of the insurance policy in the case of insurance services. The same basis could be applied also to the taxation of the residential telephone services. However, in order to limit the incidence and because of the difficulty of separating out business and non-business telephone calls made from residences, it is recommended that an annual telephone service tax on every residential telephone connection of Rs.1,000 be levied on those in whose names telephones are installed in residential premises. For purposes of this tax, connections in places other than the non-residential premises of public limited companies, non-profit organisations and government offices will be treated as residential telephones.

9.54 The telephone department should be asked to collect the tax along with the telephone charges in four equal instalments. It is common in India for employers to provide their senior employees with one or more telephone connections in their residences. Although they are meant to be used for official purposes, they are also generally being used for calls on personal account often without any restriction as to the number of calls. Such telephone connections should also be made subject to the telephone service tax. However, in case such connections are in the name of the employer - the Government, public sector company, private sector company or non-profit organisation, as the case may be - the tax will be collected from the employer. It is for the employer to recover the whole or part of the tax from the employee concerned.

Central Sales Tax and the Proposed Consignment Tax

9.55 In Chapter 4, we had shown that the levy of a consignment tax as demanded by the States along side the existing Central sales tax, both being levied at a maximum rate of 4 per cent, while not enabling the States as a whole to raise more revenues to a significant extent, would be in general inimical to the interests of the backward or less industrialised States and, what is more important, would lead to inefficient allocation of resources and consequent loss of welfare. This is because a tax at 4 per cent of the value of inter-State sales, together with a consignment tax, in addition to the tax embedded in the costs through the taxation of inputs in the producing States, acts as a strong barrier to inter-regional trade within the borders of the country and fragments the common market. Such fragmentation goes contrary to the attempts now being made to integrate the Indian economy with the world economy. Since large regional common markets and free trade zones are being formed in the world, the economies inherent in a large economy with free movement of goods and services must be fully exploited by us in order to compete successfully with industries in the regional blocs.

9.56 At the same time, it is felt that a past commitment to enact a law imposing a consignment tax must be honoured by the Central Government. We would urge that the fulfilment of that commitment should be without prejudice to the maintenance of a common market within the borders of the country.

9.57 We would recommend that the Centre should work out a package of measures with the States that would represent a just compromise of the interests of the individual States and those of the Union as a whole. The enactment of the law imposing the consignment tax should be one of the measures.

9.58 The harmful effects of the inter-State sales tax-cum-consignment tax can be avoided or minimised in two different ways. The first and the more satisfactory arrangement would be as follows: (a) The inter-State or Central sales tax or the consignment tax imposed by the exporting State will be given credit by the importing State against the sales tax payable to it by "the importer". (b) The exporting State will credit the inter-State sales tax and consignment tax collections to a Central pool. (c) Thus all collections of these two taxes will be deposited in the Central pool and will be then shared among the States on the basis of an agreed formula. The formula should be so devised as to give even treatment to the producing and consuming States. (d) The rate of inter-State sales and consignment taxes would be two per cent.

9.59 The main argument for imposing an inter-State sales tax is that its absence would open up a loophole for evasion of local sales tax. As we have explained earlier, it is erroneous to think that the inter-State sales tax would enable the States as a whole to collect more revenue than what they could have done without it. Hence the rate of the tax is not significant except for the re-distribution of revenues as between net exporting and net importing States. This being so, a second best arrangement could be that the consignment tax would be imposed at one per cent after the ceiling rate of the Central sales tax has been reduced to one per cent without provision for set off in the first alternative. Even such a low-rated tax as that would contribute a barrier to trade and would give rise to cascading, but one could perhaps live with that situation because the harm done would not to be too serious.

9.60 The Constitution has assigned the subject of inter-State trade and commerce to the Central Government precisely because such trade is to be safeguarded and regulated in the national interest. Strictly speaking, even in a truly federal country inter-State trade should be kept free of any tax that could act as a barrier. If the Central Government is to impose a tax at all, on inter-State trade, it should be ensured that the manner of levy would be such as not to affect the integrity of the common market. The two alternatives we have suggested above will satisfy this criterion.

9.61 As of now, the States have been delegated the power to levy Central sales tax with a ceiling rate of four per cent. If the importing States are to give credit to the tax paid to the exporting States, the States might agree to a reduction in the rate to two per cent. Only if the States are willing to accept one of the two alternatives, should the Central Government enact a law imposing a consignment tax.[77]

9.62 Indeed it would be in the national interest and in the interests of individual States, if the Central Government and the State Governments work out a package which would meet to a large extent their respective demands and interests.

9.63 The Centre should agree -

a. to impose a consignment tax on conditions mentioned above;

b. to give back to the States the power to levy sales tax on sugar, textiles and tobacco; and

c. to share a given percentage of its gross tax revenues with the States. (That percentage should be equal to the present ratio of tax devolution to gross Central revenues and that percentage should be fixed and not be alterable by the Finance Commission.) This would mean that the States would automatically share in the expanding revenues from the taxes on services.

9.64 In return the States should -

a. accept either the system of giving credit to the inter-State sales/consignment tax paid against local sales tax payable by the importer/ manufacturer and of sharing the total proceeds; or a reduction in the rate of inter-State sales tax to one per cent;

b. agree to the elimination of the cascading effect of sales tax on inputs, by giving a set-off to tax paid on inputs against the sales tax payable on output by taxable manufacturers irrespective of whether the sale is intra-State or inter-State; and

c. undertake to abolish the tax on entry of goods into a municipal area in the form of octroi and replace it by a surcharge on sales tax or by an entry tax. This may be done over a period of five years or so. Since the power to levy the sales tax on textiles, sugar and tobacco would have reverted to the States, the surcharge on sales tax can fall on all goods normally subject to tax.

9.65 If this compromise package of tax changes is accepted by the Centre and the States, we would have succeeded in establishing a rational and equitable system of domestic indirect taxes feasible under the existing provisions of the Constitution. The only amendment to the Constitution needed would be to the provisions relating to the sharing of Central taxes. What is equally important, the changes would benefit the backward States as well as trade and commerce without in any way adversely affecting the capacity of the State Governments as a whole to raise revenues. In point of fact, the reversion of the power to levy the sales tax on three important commodities and the right to share in the buoyancy of all Central taxes would considerably augment their revenues.

Lines of Future Reform

9.66 The recommendations that we have made in regard to excises and the tax on services are intended to be implemented in the next financial year. In the second report, we shall indicate the manner in which, by stages, the Modvat scheme can be extended to cover most of purchased inputs including all machinery and tools. After that has been accomplished, steps could be taken to bring the taxes on services into the scheme of the value added tax and a much larger number of services can be brought under the tax. As the scheme is fully extended, the rate structure can be further simplified and all of the revenue needed can be collected through the levy of, at the most, two moderate rates of taxes such as 10 and 15 per cent apart from the selective excises. Any reform of tax structure has to be accompanied by a reform of tax administration, if complete benefits are to be derived from the tax reforms. We shall be including in the final report some suggestions regarding improvement of tax administration.

77. The commitment made by an earlier Government at the Centre was only to impose the consignment tax. With the new resolve to rationalise industrial, trade and fiscal policies, it is legitimate to reformulate the conditions of the levy.

10

ISSUES RELATING TO TAX ADMINISTRATION AND PROCEDURE

10.1 In the course of our work, we have received several suggestions from Trade and Industry and from various professional organisations. We have also had the benefit of discussing some of the problems and major issues with certain leading tax lawyers, accountants and Merchants' Chambers. Many suggestions deal with specific aspects of the Tax Laws and their administration. We propose dealing with most of them in our final report.

10.2 Certain important administrative and policy issues, however, deserve brief mention in this interim report because of the urgent need for initiating suitable action in regard to them. First and foremost among them is the need to tone up the administration. No amount of tax reform, rationalisation or simplification can substantially improve tax compliance, unless there is a substantial improvement in public perception regarding the efficiency, technical competence, integrity and ability of the tax authorities to relentlessly pursue and punish tax evaders, without political or other interference. For this, the morale of the work force should improve. The Government should recognise the paramount importance of the Revenue departments and should spare no efforts in improving their conditions of service, technical skills and work environment.

10.3 Taking into account the vital role that the Revenue department should play, in garnering adequate resources for ensuring the security of the country as well as substantial economic growth with social justice, the Committee is firmly of the view that the salary scales and promotional prospects of officers and staff in the Revenue department should at least be comparable with the best that Government offers to its employees. We propose to deal with this in greater detail in our final report. Adequate provision of residential accommodation, particularly for young officers in metropolitan towns and elsewhere should be made, so as to prevent staff and officers from becoming dependent on people who are only too eager to help, with a view to taking advantage of them later. Office space is also said to be woefully inadequate and poorly maintained. Library facilities for constant updating of knowledge and skills should be available at all offices.

10.4 Some leading Tax Consultants stressed the need for providing adequate facilities for taxpayers and their representatives, when they are asked to appear before various tax authorities. It is of utmost importance that the various tax authorities realise the need for courtesy and proper consideration while dealing with taxpayers and their representatives. It is equally important to observe punctuality and promptness in dealing with persons who have responded to notices, etc.

10.5 We would like to stress the need for generation of adequate information or intelligence about taxpayers' transactions, their sources of income, wealth, etc. This collection of information from internal and external sources and its matching can be done only if the work in this regard is computerised. We are told that in the income tax department, till now, use of the computer has mainly been for the purpose of assessments, processing of challans, allotment of PAN numbers, etc.

10.6 Much progress has, therefore, to be made in this regard, as early as possible. If the department does not have adequate expertise in this regard, it would be useful to consult some external agency (if necessary, even foreign agency) with adequate expertise and experience in this regard. In the absence of such computerised information matching, the dishonest assessee will go on evading taxes with impunity and will enjoy almost total immunity from detection. The very large number of search and seizure actions conducted annually is itself the prime cause for their limited effectiveness in detecting substantial tax evasion. Their 'shock' or surprise element is lost, unless they are done only in a very small number of cases and are then relentlessly pursued to their logical conclusion. No search would be justified unless it results in detection of substantial income/gift/wealth concealment or excise and customs duty evasion and the case leads to successful prosecution of the persons guilty of such tax evasion. Searches and seizures constitute a serious invasion on the right to privacy and freedom of the taxpayer and should, therefore, be resorted to with utmost circumspection and only on the basis of definite and reliable information.

10.7 The Committee notes with great concern, the widely prevalent practice of making excessive and unjustified additions, while making assessments. What is worse, the Revenue departments contest and appeal against relief correctly given in appeal, in a very routine manner, with apparently inadequate application of mind. Arbitrary and unreasonable targets for collection and the fear of "Revenue audit objections", it is said, have aggravated the situation. We would recommend that urgent steps should be taken to correct this situation. Maintaining the credibility of the department, which is considerably eroded by evidence of such unreasonable actions, is vital for building up taxpayers' confidence and compliance. These observations are as much true of Customs and Excise department as they are of Income tax department.

10.8 The new procedure adopted by the Income tax department with effect from assessment year 1989-90, whereby, to quote the Central Board of Direct Taxes, "the requirement of passing an assessment order in all cases, where returns of income are filed, has been dispensed with, and the issue of an acknowledgment slip to the assessee will be the end of the matter, if he has correctly paid the tax and interest, if any due on the basis of the return," has, according to several representatives, resulted in near chaotic conditions. It would have been all right if this new procedure were confined to "accepted returns", as was hitherto the case, under Section 23(1) of the 1922 Act and Section 143(1) of the Income-tax Act 1961, before its amendment in 1987. However, the provisions to Section 143(1)(a) read with the first proviso thereto now enable the assessing officer to make several adjustments including addition in regard to any loss carried forward, deduction, allowance, or relief claimed in the returns, which the assessing officer considers as prima facie inadmissible. The plethora of instructions issued by the Central Board of Direct Taxes, including the two hundred and one page "booklet" of January 1990 entitled "Prima Facie Adjustments under Section 143(1)(a) of Income-tax Act, 1961", we were told, are enough to establish the not so "prima facie" nature of the adjustments that the assessing officer is expected to consider while processing a return under Section 143(1)(a).

10.9 All these "prima facie" additions are made without giving the assessee any opportunity to explain the basis of his return, accounts or documents or to clarify the doubts that the assessing officer might have had. But that is not all: sub-section (1A) of Section 143, provides for the levy of an "additional tax" of twenty per cent of the tax payable on the "excess amount" of tax as a result of the purely unilateral adjustment made by the assessing officer, without affording any opportunity to the taxpayer, as indicated above. The booklet referred to above says that "Under the law, every return has mandatorily to be first processed under Section 143(1) regardless of whether it is later to be subjected to a detailed scrutiny under Section 143(3) or not." The assessee who is aggrieved by these prima facie additions and the levy of an additional twenty per cent tax thereon can only apply to the assessing officer himself, to persuade him to accept that what he has done is a "mistake apparent from the record" and request him to rectify it. The Income Tax Department seeks to justify these somewhat unusual provisions of questionable validity on the ground that it does not have the resources required to scrutinise all tax returns and that, in the absence of such resources and the consequent need to "process" most returns in a summary manner, such provisions are essential to deter taxpayers from claiming totally unwarranted deductions, allowances, reliefs, etc. We cannot accept that such arbitrariness as is being apparently exercised in the name of processing of returns under Section 143(1)(a) should be allowed, merely because the Department cannot handle the volume of work more satisfactorily. The sanitized nomenclature "additional tax" cannot really hide the real nature of the levy, which is penal in nature. Can such a penal levy be imposed without affording an opportunity to the taxpayer in this regard? If, later, it is seen that the addition, if any, can be sustained only on the basis of considerable argument and is not of a prima facie nature, can the additional tax still be justified when assessment is eventually completed under Section 143(3)? These are matters that the Central Board of Direct Taxes should examine in depth. In the meantime, much of the hardship can be mitigated if an appeal is provided against any adjustment under Section 143(1)(a), as it is, against an assessment. The Government has obviously realised the need for taking some corrective action. This is evident from the provision, through the Finance (No.2) Act, 1991, for revision applications before the Commissioner, against adjustments under Section 143(1)(a). However, such administrative remedy, which shuts out the appeal procedure, it has been submitted, is largely illusory. Hence, the need for ensuring that adequate justice is done, by allowing appeals against action under Section 143(1)(a), as early as possible, without awaiting the outcome of the thorough examination or study of the entire issue.

10.10 There are a few points relating to indirect tax administration and procedures which we would like to comment on. The present system of control in the Central Excise Department has evolved over a period of time starting from the year 1944 when the excise laws were codified. The basic structure of administration is what was formulated for the tobacco excise. No doubt, a number of Committees have gone into particular aspects of the administration but the efforts have only been in improving those areas without substantially disturbing the basic structure. A major change in the excise procedures was brought about in 1968-69 with the introduction of Self Removal Procedure. Since then, there have been developments in a number of areas relevant to tax administration. The more important among these developments are:

a. availability of a detailed tariff based on an internationally accepted classification code;

b. application of Modvat to the majority of commodities;

c. reduction in the volume of work in some areas involved consequent to a large number of issues getting settled over a period of time by the decisions of the Courts and Tribunal;

d. availability of modern facilities of communication, computation and information retrieval;

e. improvement in the quality of officers of the rank of Inspectors because of selection through a competitive examination; and

f. increase in the number of senior officers including those of the rank of Collectors in a Collectorate.

10.11. Over the years, the emphasis has been on continuous decentralisation in view of the complication and increase in the volume of the work. The time has now come for a total review of the system. The aim should be to evolve a simpler but effective method of administering the tax laws involving :

a. unambiguous laws;

b. simplified procedures;

c. simpler forms;

d. increased use of computers for monitoring; and

e. effective tax dispute resolution machinery.

10.12. Keeping all these factors in view, the feasibility of upgrading the level of decision making in regard to classification has to be seriously thought of. It is pertinent to note that the Technical Study Group had recommended constitution of a Central Classification Authority, whose rulings in classification disputes should be binding and final and of all India application. This Committee, however, is not in favour of setting up of a separate body distinct from the Board.

10.13. In indirect taxes, what is of paramount importance is uniformity of treatment. The assessing officers are supposed to be quasi-judicial authorities, not bound by any direction from their superiors. However, the assessment procedures have become extremely cumbersome and combining with the audit-phobia, the officers tend to take highly revenue-biased decisions. This is reflected in the large number of appeals pending before the Tribunal and in the Courts. It is doubtful whether the manufacturing fraternity would prefer such autonomy on the part of the officers to a certainty arising from a direction from a single authority in the light of their experience of the quasi-judicial functioning of the assessing officers. While the decisions of the assessing officers should not be capricious, there cannot be any objection, legal or otherwise, in providing in law that the officers would be bound by the directions of the Board, which will be appealable to the Supreme Court or a high-powered Tribunal. [There is already a proposal to set up a high powered Customs and Excise Revenue Appellate Tribunal which would be a Tribunal under Article 323B of the Constitution.] Such appeals will be few and far between for this reason that the decisions of the Board, unlike those of the assessing officers, will have all India applicability.

10.14. It is estimated that the total number of items being manufactured in the country requiring classification for excise duty will not exceed 50,000. A project to set up a computer network linking all the Collectorates of Central Excise is being implemented. It should not be difficult with the help of this network to codify and publish the classification currently in vogue in different Collectorates in regard to all these items. This would at once bring out aberrations in classification in different Collectorates and these can be sorted out by the Central Board of Excise and Customs. A Tariff Guide should be issued giving the classification of all commodities currently manufactured in the country and the classification given therein which would be in line with the existing established practice should be followed by all the assessing officers in the field. The number of items newly manufactured in the country which may require fresh classification decision in an year is not likely to be very large. It could be of the order of 100 per year, which would mean less than 10 per month, a level of work which the Board itself can conveniently handle. Thus, the additions to the Tariff Guide should be made on the basis of the decisions of the Board. This arrangement, which should be brought about simultaneously with the setting up of the computer network among all the Collectorates, would bring about a settled position in regard to classification component of assessment decisions. It is expected that the classification disputes will almost be wiped out and the number of cases and appeals relating thereto, which could be a few thousands today, will be reduced to a very small number.

10.15. The same procedure in regard to classification can be applied in the Customs Department also.

10.16. Simultaneously, there has to be a change in the procedures, forms and reports taking into account the modern facilities of communication available with the Department.

10.17 The Committee would urge that the pace of implementation of the computerisation project in the Customs and Excise Departments should be accelerated.

10.18. There may also be a review of the levels of decision making in various matters relating to assessment. Such a revision should be in the context of the number and quality of officers of different levels available to the Department. Administrative accountability will have to be fixed on Collectors to ensure that tax laws and tax rates are correctly applied. Any loss in revenue and any illegal collection of revenue arising out of negligence or deliberate design should be seriously dealt with.

10.19. The Principal Collectors will have to be involved in the process of decision making at the policy level. These officers should function as an active link between the policy making level and the implementation level.

10.20. These are some thoughts on administrative reforms in regard to collection of customs & central excise duties. While the major change in regard to classification can be brought about as soon as the computer link is available, improvement in the detailed working procedures, forms, returns, system of monitoring of revenue collection and other related matters can be brought about only after further detailed study. It is, therefore, suggested that a Task Force consisting of selected officers may be entrusted with this work. A similar review would be necessary in the case of Income Tax Department also.

11

CONCLUDING OBSERVATIONS

11.1 We wish to inaugurate a new era in the development of tax policy, structure and administration. This requires a transformation not only of the tax structure but also of attitudes and habits of thoughts and action. In response to the major changes which the government, we hope, would carry through on the basis of our recommendations towards moderation, rationalization and simplification, the tax paying public in general should change its attitude towards its tax obligations in the direction of much greater compliance. The Government and the tax department (along with their advisers) must begin to look at the tax system as an important determinant of economic efficiency and a factor that has serious implications for the citizens' welfare: it cannot and should not be tampered with lightly or from year to year in the quest of multiple objectives or for increases in revenue far in excess of what can come out of the growth of the economy. Equally importantly, the attitude and outlook of the tax administrators should undergo a thorough-going reorientation: they must be trained to look at and keep in view the broader aspect of taxation, particularly its impact on the economy and the welfare of the people. The Government's objective is not to take money out of the people regardless of what harm may be done to the economy and welfare in the process. Therefore, if a tax provision is such as to cause harassment or to create adverse effects on productive activity, the tax officers must bring that to the notice of the Government. Also, the tax administration must strive to build a collaborative and not adversarial relationship with the tax paying public; while the tax evaders must be dealt with strictly in accordance with the law, the ordinary taxpayer should receive ample help in fulfilling his tax obligations.

11.2 It cannot be gainsaid however that the change in attitude regarding compliance with tax laws cannot come about merely through exhortation. A credible structure of sanctions against non-compliance is crucial to the establishment of an equitable system of taxation. Dissatisfaction with the existing system has as much to do with the failure of the system to bring tax offenders to book as with the wasteful use of the funds raised by the government through taxes. Measures for strengthening tax administration will engage our attention in the final report. The success of reform would depend much on Government's will in strengthening tax enforcement and bringing the tax department under effective control.

11.3 Along with the need for changes in attitudes, there is also a need for a change in perception. The irrational and unnecessarily complicated tax structure and the deficiencies in procedures and laws leading to an excess of expenditure of time and effort on disputes are as much an impediment to growth of the economy as any other component of the earlier policy regime. Thus, it has to be understood that radically transforming the tax structure and improving tax administration is an integral part of the structural reform of the economy as a whole which is being attempted by the Government.

11.4 As we have emphasized, a meaningful fiscal policy geared to the long-term objectives of fast growth and desired distribution requires a rational and stable tax structure. This means that the concept and device of annual ARM must be given up. One should, of course, make constant effort at resource mobilization (RM) for desirable public expenditure through better enforcement of taxes and pruning non-essential public expenditure.

However, the annual budget exercise out of which numerous alterations - changes in rates, new levies, concessions and deductions - emerge must be given up. It follows that the annual practice of each Ministry forwarding suggestions for tax concessions in its own sector must also cease.

11.5 Just as it is imperative to abolish the licence and permit raj, so also, it is necessary to do away with the notification raj. (The Committee has, however, noted that the number of customs and excise notifications issued this year is substantially lower than the number issued during the earlier years). Once we have introduced a rational structure and moderate rates there will be no need or justification for end-use exemptions and sectoral concessions. As far as excises or Modvat is concerned, the issue of notifications can be totally done away with. Any odd or rare change in definition or moving a commodity from one rate category to another should be done through a change in the statute at the time of the annual budget. In any case, ultimately, there would be only three rates of Modvat - 10, 15 and 20 per cent - and three higher rates on luxury products - 30, 40 and 50 per cent. Industries, producers and consumers must adjust themselves to these rates. That is the whole meaning of purposive taxation. Thus in the case of excises, the rates to be applied must be statutory rates in almost all cases. In the case of import duties, the need for issuing notification would arise only under two circumstances: one is a sudden and large change in the international price of a commodity, and the other is the attempt by outside partners to dump some commodities into the Indian market. In such situations a quick response would be needed, and there may be no other way but to resort to notifications to reduce or increase the rates. But we would recommend that the notifications should be issued only on the recommendation of the Tariff Commission, which is to be set up, and that the surcharge or reduction which involves a departure from the statutory rate must be temporary, that is, only for a specified period of six months or so, after which the change would lapse, unless Parliament extends it.

11.6 With the reduction in the tariff rates, all end-use or producer-specific exemptions can be done away with. Here again, once a rational structure of duty rates has been established, the producers must make their production decisions on the basis of those rates; and not the other way round.

11.7 Taking all our recommendations on reform, including reform of the tariff, we strongly believe that if implemented they would lead to the establishment of a rational, equitable and fairly simple system of taxation conducive to the healthy growth of the economy and consequential rise in revenues. If the reformed direct tax system is properly implemented, the ratio of direct taxes to GDP should start rising. However, the share of direct taxes in total revenues should not by itself be taken as the test of progressivity of the tax system or to indicate the relative burden cast on the richer sections of society. The total burden on those sections would include not only the burden of the progressive income tax but also that of the net wealth tax on unproductive assets, the tax on expenditure, foreign travel and air travel. They will also bear most of the burden of the tax on services which we have recommended. In addition, of course, the higher rates of taxes on luxury goods will also be mostly paid by them. In judging the progressivity of the system which we have recommended, the incidence of all these taxes must be borne in mind.

11.8 It is also to be remembered that in every economic system, there are some implicit taxes apart from the explicit ones levied by the Government. The imposition of ceiling rates of interest is an example of such an implicit tax. Implicit taxation arises also when there is high protection of particular goods or commodities. While implicit taxation can affect all sections of society, it appears that the richer sections bear a proportionately larger share of that burden. Subsidies are negative taxes and hence the distribution of the burden of the tax system can be affected, sometimes significantly, by the benefits flowing from subsidies. There are some subsidies such as those relating to higher education which go relatively more to the benefit of the richer sections of society. Generally, attention is concentrated on making the tax system progressive in order to bring about re-distribution. It is clear that the distribution of subsidies is also equally important. In our country today, it is important to examine carefully the existing distribution of the benefits flowing from subsidies and to remove or curtail those which unduly benefit the better off sections of society. As far as explicit taxes are concerned, it is our belief that the structure that we have recommended would result in the optimum degree of progressivity keeping incentive and compliance and administrative aspects in view.

11.9 There is a final and important aspect which we must touch upon. We have stressed the desirability of having an indirect tax system that would be basically neutral. However, we have also argued that for achieving some important social objectives, the tax system could and should be used to influence the choices of consumers and producers in the desired directions. Discouragement of the consumption of harmful commodities, conserving scarce resources and protecting environment were cited as examples. Market-driven decisions do not take into account what are called "externalities" which arise in several cases. The externality takes the form of conferring a benefit or imposing cost and hardship on people other than those undertaking an activity or using a commodity. An important instance of externality is pollution or destruction of natural resources which has assumed alarming proportions in industrialized and industrializing economies. Pollution by the consumption of petroleum products and that caused by several types of industries imposes heavy costs on the community but those who benefit from the activities causing the pollution are not being asked to pay for any measure that need to be taken to eliminate or control it. Policy makers in several countries are coming round to the view that taxation would have to play an important role in checking pollution and ensuring that those who cause it, or benefit from activities causing it should be made to pay for the costs of nullifying the effects of pollution and of taking compensatory action. Thus a new area of "taxation of pollution" is opening up in which research is to be conducted to devise proper methods of dealing with diverse cases of polluting activities. In the case of corporations and businesses in general, there might have to be a shift from income taxation to taxation of pollution. It is imperative that the Government should encourage and support studies in this area with a view to evolving a suitable pattern of tax instruments to deal with this problem.

12

SUMMARY OF RECOMMENDATIONS

Guiding Principles of Tax Reform

12.1 The guiding principles underlying the tax reforms proposed by the Committee are as follows:

a. The tax system and its burden must be acceptable to the citizens i.e., the potential taxpayers.

b. Given our past experience and the present totality of circumstances affecting the tax system and its operation, it is better to have moderate rates with broader bases.

c. While the tax structure should be progressive, it should not be such as to induce the generation of unaccounted income and wealth.

d. The tax system must be rational from the economic point of view. For this purpose, the structure once established must remain stable unless and until the economic conditions undergo a radical transformation. Ad hoc changes from year to year will undermine rationality and reintroduce complications.

e. The tax system and law should be as simple as possible: it should have the strictly limited objectives of raising revenues for the government in a fair and efficient manner, achieving redistribution and discouraging some industries and the use or consumption of some products as well as granting a reasonable degree of protection to domestic industries. A simple system will have only a limited number of rates and exemptions or deductions and give the least possible discretionary power to the tax officials for interpreting the law.

f. Methods of tax administration should be modernised and tax enforcement should be visibly improved.

g. The tax reforms suggested should be fully, or at least nearly, revenue neutral in their totality; however, the system should become more income elastic.

Income Tax

12.2. Ideally, a single rate income tax would be the simplest both for compliance and administrative reasons. However, for the present, the following tax rate schedule for different taxable entities is recommended:

a. in the case of individuals, the exemption limit should be fixed at Rs.28,000. The marginal rates of tax (inclusive of surcharge, if any) should be :

   i. 20 per cent for total income in the range of Rs.28,000 to Rs.50,000;

   ii. 27.5 per cent for total income in the range of Rs.50,000 to Rs.2,00,000; and

   iii. 40 per cent for total income exceeding Rs.2,00,000.

b. in the case of a Hindu undivided family, the existing distinction between a "specified HUF" and a "non-specified HUF" should continue. The rate schedule for non-specified HUFs should be the same as recommended in the case of individuals. For specified HUFs, the exemption limit should continue at Rs.12,000. The marginal rates of tax (including surcharge, if any) should be 27.5 per cent for total income in the range of Rs.12,000 to Rs.1,00,000 and 40 per cent for total income exceeding Rs.1,00,000.

c. in the case of local authorities, tax should be levied at a flat rate of 30 per cent.

d. in the case of domestic companies, the tax rate (inclusive of surcharge) should, in the course of the next three years (i.e., by assessment year 1995-96), be reduced to the same level as the maximum marginal rate of tax (inclusive of surcharge) in the case of individuals i.e.40 per cent. Further, the existing distinction between companies in which the public are substantially interested and companies in which the public are not substantially interested for the purposes of tax rate, should also be abolished within the next three years.

When the new scheme of taxation of partnership firms, AOP and BOI recommended in this report comes into operation, there will be no need for prescribing a separate tax schedule for registered firms.

[Paragraph 6.18 & 6.19]

12.3 Complete integration of the incomes of both the spouses or, for that matter, all adult members in the family is not feasible or necessary. However, the existing safeguards in the income tax law for aggregation of incomes in the case of splitting of assets should continue, with the modifications that all incomes of a minor, other than wage income, should be aggregated with the total income of -

i. the parent having the higher income, where the total income of one parent or of both the parents happens to fall below the exemption limit for individuals;

ii. any one of the parents at the option of the parents where the income of both the parents exceeds the exemption limit; and

iii. if over time the income of the parent, with whom the income of the minor was aggregated earlier, goes below the exemption limit, the parent having the higher income.

iv. the income of the minor arising from assets transferred to him or her by any one including his grandparents should be aggregated with the income of the parent as recommended above.

[Paragraph 6.38]

12.4 The following tax concessions now available under the Income-tax Act should be abolished:

a. exemption under Section 10(15)(iic) in respect of interest on notified Relief Bonds;

b. exemption under Section 10(15)(iv)(h) in respect of interest received from any public sector company in respect of notified bonds or debentures;

c. exemption under Section 10(15)(iv)(i) in respect of interest received from Government on deposits in notified scheme out of moneys due on account of retirement;

d. deduction under Section 80-L in respect of income from specified sources.

[Paragraph 6.44]

12.5 The tax rebate allowed under section 88 for investment in provident fund, NSCs, etc. should continue to be allowed at the entry point rate of tax but only for investment upto a reduced maximum level of Rs. 10,000/-. Further, the tax concession should be restricted to contributions to provident fund, life insurance policies and repayment of loans taken for purchase or construction of a residential house property.

[Paragraph 6.46]

12.6 The tax concession under Section 80-CCA for any investment in the Jeevan Dhara or Jeevan Akshay annuity plans of the Life Insurance Corporation of India should be withdrawn. The tax concession under Section 80-CCB for investment in equity linked saving scheme should be abolished.

[Paragraph 6.47]

12.7 The existing ceiling of Rs.40,000 for deposits in the National Savings Scheme under Section 80-CCA should be increased to Rs.50,000.

[Paragraph 6.48]

12.8 The provisions of Sections 35-AC, 35-CCA, 35-CCB and 80-GGA should be amalgamated with Section 80-G. The 100 per cent deduction at present allowable under Sections 35-AC, 35-CCA, 35-CCB and 80-GGA should be restricted to 50 per cent as in the case of deduction for other donations under Section 80-G. Further, deductions should be allowed only in respect of donations to an approved association/institution and not for expenditure incurred on an in-house programme.

[Paragraph 6.52]

12.9 The tax incentives under Sections 80-HH, 80-HHA, 80-I, 80-IA, 80-JJ, 80-QQ and 80-QQA should be abolished with immediate effect, with the result, the taxpayers would not henceforth be eligible for the tax benefits they have been enjoying under the above-mentioned provisions.

[Paragraph 6.54]

12.10 The provisions such as Sections 80-HHC, 80-HHE, etc., need to be kept under review.

[Paragraph 6.55]

12.11 The rules for perquisite valuation of concessional rent accommodation or rent-free accommodation should be modified so as to remove the present distinction in perquisite valuation between employees of the Government, companies in the private sector and public sector and other autonomous bodies. The perquisite value of both the rent-free accommodation and concessional rent accommodation should be taken to be equal to twenty per cent of the salary or the expenditure incurred by the employer in providing housing, whichever is lower. This rule should be made applicable to all employees irrespective of whether the employee is in the private sector or in the public sector or in the Government. However, where the expenditure incurred by the employer in providing housing is fully recovered from the employee, the perquisite value should be taken to be nil. Further, the perquisite value should be taken to be nil in all cases where the annual income under the head 'Salary' (excluding non-monetary benefits or amenities) does not exceed Rs.36,000.

[Paragraph 6.71]

12.12 The provision of clause (13A) of Section 10 of the I.T.Act providing for exemption of house-rent-allowance as per rule 2A should be abolished.

[Paragraph 6.71]

12.13 All taxpayers, whether enjoying a rent-free accommodation or concessional rent accommodation or in receipt of house rent allowance or receiving no such benefit on account of being self-employed should be entitled to relief under Section 80GG of the Income-tax Act for rent paid. For the purposes of computing relief under Section 80GG, 'rent paid' should mean the rent actually paid as increased by the amount of HRA that would otherwise have been admissible to the taxpayer. The existing provisions of Section 80GG of the I.T. Act should be modified to provide for deduction in respect of rent paid in excess of ten per cent of salary upto a maximum of twenty per cent. The limit of Rs.1,000 under Section 80GG of the I.T. Act should be removed. Further, since the income from a let-out property is taxable and the income from a self-occupied property is deemed to be nil, the benefit under this provision should not be available in any case where the taxpayer or his spouse or minor child or the Hindu undivided family of which he is the Karta has a self-occupied property anywhere in India.

[Paragraph 6.71]

12.14 Where the expenditure incurred by the employer in providing housing to its employee is in excess of twenty per cent of the salary of the employee, such excess which remains uncaptured in the tax assessment of the employees, should be subjected to a separate fringe benefit tax in the hands of the employer at the flat rate of 30 per cent. The tax so paid by the employer, however, should not be allowed as a deduction in the computation of profits of the employer. The expenditure incurred by the employer in providing housing to its employees should be the rent which a similar accommodation would realise in the same locality or actual rent paid if accommodation is hired by the employer or the municipal valuation in respect of the accommodation, whichever is higher.

[Paragraph 6.71]

12.15 At least, 80 per cent of the leave travel allowance, home travel allowance, travel allowance on retirement, passage money and such other payments should be subjected to tax.

[Paragraph 6.73]

12.16 The allowances paid to legislators should be fully subjected to tax.

[Paragraph 6.74]

12.17 The exemption in respect of allowances covered under sub-clause (ii) of clause (14) of

Section 10 of the Income-tax Act should not exceed 10 per cent of salary.

[Paragraph 6.75]

12.18 All loans given to employees should be deemed to have been given at the rate of 12 per cent and any concession implicit in the interest actually charged should be treated as a fringe benefit and taxed accordingly. However, where the concessional interest loan is utilized for construction of a house property or any other income generating asset, the perquisite value of the concessional interest loan should also be allowed as a deduction in the computation of income from such house property or any other income generating asset.

[Paragraph 6.77]

12.19 The value of all other perquisites as contained in Rule 3 of the Income-tax Rules should be revised upward to take account of inflation since the values were last fixed or revised.

[Paragraph 6.78]

12.20 For purposes of computation of capital gains arising on the transfer of a capital asset -

i. A long-term capital asset be defined to mean a capital asset transferred after one year from the end of the financial year in which the asset is acquired. To compute long-term capital gains, all long-term capital assets should be deemed to have been acquired on the last day of the financial year in question and transferred on the first day of the financial year in which the transfer takes place.

ii. The cost of all assets acquired prior to a cut-off date be converted into the value of the asset on the cut-off date. For the present, the existing cut-off date of 1.4.1974 should continue.

iii. The value of the asset should be indexed for inflation for the subsequent period of holding in a manner described below.

iv. The cost of acquisition of an asset or the value of the asset, as the case may be, should be increased by a cost-inflation index (CII), which should be equal to 75 per cent of the consumer price index for urban non-manual employees (CPI), for the entire period of holding or for the period reckoned from the specified cut-off date, respectively. Similarly, the cost of any improvement undertaken to the asset should also be inflation indexed using the CII.

v. In the case of non-corporate taxpayers, long-term capital gains duly indexed will be subject to tax at the marginal rate applicable to the assessee in the concerned year subject to a maximum of 27.5 per cent. If income other than capital gains is below the general exemption limit the tax on long term capital gains will be applied to the excess of the sum of other income and long term capital gains over the exemption level. In the case of corporate assessees the indexed long term capital gains will be subject to a flat rate of 40 per cent. When the rate of tax on corporate profits is reduced to 40 per cent, as per our recommendations, the rate of tax on long-term capital gains for the corporate assessees should be fixed at 30 per cent.

vi. In the case of firms, the income from capital gains should be apportioned among the partners in the ratio of their share in the partnership. This income should be treated as capital gains in the hands of the partner.

vii. The roll-over provisions should be retained but the special exemptions granted under Sections 53 and 54E of the Income-tax Act should be withdrawn. Roll-over relief should, however, be granted uniformly in each roll-over section of the Income-tax Act in the following manner:

a. The gain should be computed after adjusting the cost of acquisition and improvement by the cost inflation index as recommended earlier.

b. The fraction of the capital gain that is allowed "roll-over" relief should be equal to the proportion formed by the cost of the newly purchased asset (new asset) to the net sale consideration from the sale of existing asset (old asset). In the case of a new asset, capital gain should be reckoned as the sale price less the inflation adjusted cost of the old asset. The inflation adjusted cost of the old asset should, however, be calculated for the entire period of holding of the new asset and the old asset. Where the old asset is acquired prior to the cut-off date, the cost of acquisition and the period of holding of the old asset should be reckoned to be respectively, the value of the old asset on the cut-off date and the period from the cut-off date.

viii. The existing Capital Gains Accounts Scheme should be replaced by a simple scheme along the lines of a money-multiplier scheme promoted by some banks in the country.

ix. The existing method for computing the period for re-investment, with reference to the date of transfer should be replaced by a method whereby the period is computed with reference to the financial year in which the asset is transferred. Accordingly, the period specified for re-investment should be either within the financial year immediately preceding or within two succeeding financial years immediately after the financial year in which the original asset is transferred.

x. There is no necessity to make any further change in the existing scheme of allowing set-off of capital losses only against capital gains.

xi. Capital loss should be computed after adjustment of the cost of the asset by the cost inflation index. Provisions relating to scaling down of long-term capital losses may, consequently, be deleted.

xii. The existing provisions relating to tax treatment of capital gains from depreciable assets used for business or profession does not merit any change.

[Paragraphs 6.87 to 6.99]

12.21. The existing provisions seeking to restrict the deductibility of certain expenses in business be reviewed and limits prescribed be revised. The restriction on the deductibility of certain expenses have been rationalised.

[Paragraph 6.100]

12.22. The deductions of Rs.3,600 in respect of each residential unit forming part of a building for a period of five years from the date of completion of such a building at present allowable under second proviso to sub-section (1) of Section 23 of the Income-tax Act should be withdrawn. Further, since the proposed lower rates of personal income tax will benefit also tax payers having income from house property, the deduction for construction of new residential units should be withdrawn from the Assessment Year 1993-94 for all taxpayers even in respect of residential units in a building completed prior to the implementation of this recommendation.

[Paragraph 6.103]

12.23. An amount equal to 1/5th of the "annual value" of the property should be allowed as a statutory standard deduction for the aggregate expense on repair of the house property and collection of rent.

[Paragraph 6.105]

12.24. The number of years in which the interest on borrowed capital relating to pre-completion period that is allowed as a deduction in the computation of "income from house property" should be reduced from five to three.

[Paragraph 6.106]

12.25. In the case of partnership firms,-

a. The scheme of registration of firms for income tax purposes should be abolished. All firms should be treated alike for income tax.

b. The existing separate tax on the income of the firm should be abolished. The firm should be required to calculate capital gains and its income other than capital gains separately. The income other than capital gains should be apportioned amongst the partners in the ratio of their share in the profits of the firm, for taxation in their hands at the appropriate income tax rates. In computing the income of the firm, it should be allowed, as against the present practice, to claim as a deduction any payment of interest, salary, bonus, commission or remuneration to any of its partners.

c. Where new partners are admitted to the benefits of a partnership at any time during the accounting year after the end of the first three months, the share of the new partners in the profits of the firm should be ignored and profits should be apportioned amongst the old partners in the revised ratio of their shares in the manner indicated in Chapter 6. However, this should only be in respect of the financial year in which the new partners have been admitted. This however will not apply when a firm is reconstituted on the death of a partner.

d. Where a firm has any income from capital gains, it will be eligible to claim "roll-over" relief wherever permissible. Any capital gain (after allowing for the "roll-over" relief) or loss incurred by the firm should be apportioned amongst the partners in the ratio of their share in the profits of the firm. However, the partners should not be allowed any "roll-over" relief in respect of such share in the capital gains. The relief for "bunching" of gains should be allowed to be claimed by the partners in their personal assessments.

e. All association of persons and bodies of individuals should be taxed in the same manner as firms.

f. Where the shares of partners in a firm or of members in the AOP or BOI are not specified, they should be presumed to be equal amongst them and no partner or member should be allowed to claim differently at anytime in the future in respect of profits of the year for which such presumption is made.

g. The firm or AOP or BOI should not be allowed any credit for the tax deducted at source from payments received by it. However, it should be allowed to apportion the same amongst its partners in the ratio of their share in its profits.

h. The firm should be required to pay advance tax on behalf of partners in respect of the income of the partner from the firm and income from all other sources along the same lines as the facility available under sub-sections (2), (2B) and (3) of Section 192, to both the employer and the employee, in respect of deduction of tax at source. The advance-tax paid by the firm on behalf of the partners should be deposited with the Central Government through a single challan. The firm should after the end of the previous year be required to submit separate annual statements regarding advance-tax paid on behalf of the partners.

i. Every firm should be required to issue a certificate to every partner indicating the amount of interest, salary, bonus, commission or remuneration paid by it, the share of the partner in the profits of the firm, the share of the partners in the tax deducted at source on payments received by the firm and the advance-tax paid by the firm in respect of income of the partners.

j. Notwithstanding the fact that there would be no tax liability on the part of the firms, AOPs and BOIs, they should be required to file their returns of income irrespective of their level of income. Where the firm files the return of income voluntarily but after the due date, they should be required to pay one-half per cent of the computed income of the firm subject to a minimum of Rs.200, as a late fee for every month of default. If the return is filed in response to a notice issued after the end of the assessment year and the firm has not deposited the deducted tax at source, in the appropriate manner, from payments made to the partners, the firm should be assessed to tax at the maximum marginal rate of tax for individuals and also be required to pay late fee as indicated above. In such a case, distribution of income in the partners' hands would not arise.

k. In a case where the returned income of the firm is increased as a result of additions or disallowances, the difference between the assessed income and the income declared should be taxed at the maximum marginal rate in the hands of the firm but exempt from any additional tax liability in the hands of the partners. However, in a case where loss is returned and where the additions made result in a reduction in the loss or in the computation of a positive income, the income or loss computed should be apportioned amongst the partners and consequential rectifications should be carried out in their tax assessments.

l. The problem of "benamidar" partners should be tackled only by sustained investigation under the Benami (Prohibition) Act, 1988 without causing undue distortion in the tax structure. Where it is established that a partner in a firm is the benamidar of any other partner of the firm or is an undisclosed benamidar of an outsider and any one or more of the other partners new or had reasons to believe that it was so, the whole of the income of the firm (including any payment income to the partners) should be taxed at the maximum marginal rate.

[Paragraphs 6.113 to 6.115]

12.26. In the case of co-operative societies,-

a. The deduction, presently available to cooperative societies under Section 80-P, in respect of whole of their profits from business, should be restricted only to 20 per cent of their profits. However, all other deductions under Section 80-P should be abolished.

b. The income exemption limit for cooperative societies should be fixed at Rs.25,000.

c. The total income of the cooperative society, in excess of the exemption limit, should be subjected to tax at the flat rate of 30 per cent.

[Paragraph 6.118]

12.27. For inducing traders and manufacturers operating on a small scale but enjoying taxable income to make some contribution to income tax, two simple schemes based on the presumptive approach are recommended. The first variant which we call the scheme of presumptive taxation envisages a very simple system under which one is required only to pay a lump-sum tax in lieu of income tax. This scheme will apply only to traders and manufacturers having a total business turnover of between Rs.3 lakh and 5 lakh. Under the other scheme the net income of the taxpayer will be estimated as a specified percentage of the gross turnover in business (the percentages depending on the type of business activity). This, we call, the estimated income scheme (EIS). The specifications of the two schemes are outlined below:

i. **Presumptive tax scheme**

Under this scheme, traders and manufacturers deriving income from business should be allowed an option to pay tax in a lump-sum of Rs.1,000/- without filing any return if their total turnover in business happens to fall between Rs.3 lakhs and Rs.5 lakhs as estimated by themselves.

It is possible that even such small traders/producers have income from other sources like brokerage from commission agency, interest, dividend, property, etc. The facility of this scheme should not be denied to them so long as income from these sources remains modest. For brokerage income, this limit may be fixed at Rs.25,000. But tax at the rate of 20 per cent may be realised from such income without going through the process of aggregating such income with income from other heads. When the trader/producer has income from other sources, again the scheme would still be open to the trader or producer if the receipts from such other sources do not exceed Rs.10,000. Here 'receipts from other sources' would include interest, dividend, property, salary, etc. However, in such cases the taxpayer should not be permitted to claim any refund of tax deducted at source on such receipts.

Taxpayers opting for this scheme should not, however, be allowed any deduction on account of savings incentives or any other provision of the Income-tax Act. As mentioned earlier, no return need be filed by persons opting for this scheme. Nor should they be required to make any advance payment of tax in instalments. It should suffice, if they pay the tax in one lump-sum any time before the 15th of March during the accounting year.

ii. **Estimated income scheme (EIS)**

Persons having business turnover of more than Rs.5 lakhs or brokerage or commission receipts exceeding Rs.25,000 or receipts from other sources above Rs.10,000 should come under the alternative scheme, namely, the Estimated Income Scheme (EIS). Under this scheme, net income from business will be presumed to be equal to -

a. eight per cent of the turnover from trading or manufacturing operations;

b. fifty per cent of the receipts from brokerage or commission;

c. ten per cent of receipts from contracts relating to construction of roads, bridges, buildings, other public works and transporting. This is in line with the scheme of estimating income taxation for contractors as outlined in sub-section 'c' below.

d. eighty per cent of receipts from other sources, being in the nature of interest, dividend, rent, export incentive schemes or any other receipt of similar nature.

'Receipts from other sources' for this purpose will not include any receipt falling under the head 'salaries' or 'income from house property' or 'profits and gains from business or profession'. The income estimated in the aforesaid manner will be aggregated with income from profession and income under the heads like 'salaries' and 'house property', if any, to determine the gross total income. Taxpayers opting for the scheme will be eligible for deductions allowed for savings and specified activities as may be available under the Income-tax Act from time to time. The total income so computed should be subjected to tax at the appropriate rates. Unlike in the case of PTS, tax due under the EIS should be paid in advance in three instalments and the provisions in the Income-tax Act relating to the payment of advance tax should apply. The EIS should, however, be restricted to persons whose turnover and/or receipts do not exceed Rs.25 lakh.

Further, a simple statement should be furnished by taxpayers coming under these schemes to the nearest income tax office. The challan and statement forms should be made available freely in all bank offices or branches, market committees, office of trade associations, etc.

For the first three years, the statements of turnover may be accepted without any question, unless there is strong evidence to the contrary.

Every attempt should be made to estimate the ratios separately for each separate activity and for different locations as has been done in Israel for the "takshivs". Once these ratios are set up they should be given wide publicity (subject to periodic revisions), so that they can be used for self-assessment by taxpayers having income from business on their own and also by tax officers as a check against gross understatement. In other words, these ratios can be used as benchmarks or guidelines for estimating business incomes where verifiable accounts are not maintained. Incomes computed on the basis of the ratios should be accepted without any question. Any variation above or below the norms so set up beyond say 10 per cent should be subjected to scrutiny and approval by the next higher official.

In order that the presumptive income approach suggested above for small enterprises does not come under any legal attack, it would be necessary to make the presumptions rebuttable.

[Paragraph 6.130 to 6.138]

12.28. In the case of contractors, 10 per cent of contract receipts from all contracts relating to construction of roads, bridges, buildings, other public works and transporting, should be presumed to be the income in such cases and the same should be formalised in law.

[Paragraph 6.139]

12.29. Efforts should be made to introduce the estimated income system on the basis of physical indices. A beginning may be made by prescribing that each truck with an inter-State permit could be presumed to yield an income of Rs 4,000 per month. Similarly each truck with a State permit could be presumed to yield an income of Rs 3,000 per month.

[Paragraph 6.140]

Taxation of Wealth

12.30. The tax on wealth should be abolished in respect of all items of wealth other than those which can be regarded as unproductive forms of wealth or other items whose possession and use could legitimately be discouraged in the social interest.

[Paragraph 7.4]

12.31. The new scheme of net wealth tax should be as follows:

a. An annual tax on the aggregate capital value, in excess of the specified exemption level, of the following items of wealth will be levied in the hands of individuals, Hindu undivided families, and all companies.

b. The items on which wealth tax would be levied are: residential houses, motor cars (other than those used in the business of running them on hire), bullions and jewellery, (other than those used as stock-in-trade), yachts and boats and planes (other than those used for commercial purposes) and urban land.

c. Residential houses should include all farm houses within 25 kilometers from the local limits of any municipality or cantonment board.

d. For the purpose, the valuation of the above items for wealth tax purposes would be according to the procedures now being adopted under the Wealth Tax Act. However, the rules regarding valuation of residential property would be required to be re-examined, as there is a general feeling that these rules are a little too liberal. Simultaneously, efforts should be made to suitably adjust the rates of stamp duty on transfers of property and the level of municipal property tax. The objective should be that the total burden of all these taxes on property income should be reasonable.

e. Any liability specifically incurred for acquiring the assets which are liable to wealth tax and charged against them will be deductible from the computed value of the assets before the tax is applied.

f. The first Rs 15 lakh of the net value of the taxable items of wealth will bear nil tax. Any excess of net value over that level will bear tax at one per cent of value.

g. The existing provisions in the Wealth Tax Act will apply to taxable items of wealth transferred to members of one's family without adequate consideration. However, in line with our recommendation in respect of income of minor children, we recommend that the net value of the taxable items of wealth in the hands of any minor child should be aggregated with the net value of such assets in the hands of the parent whose taxable assets have a higher value if one or both of them are not liable to pay wealth tax and with the net value of the taxable assets of either parent if both of them are liable to pay the wealth tax.

h. Although only items of wealth mentioned in (b) above will be subjected to wealth tax, all income tax payers whose gross total income exceeds Rs.1 lakh should be required to file a net wealth statement in the form indicated in Annexure to this Chapter. For this purpose, all assets should be valued at cost. The statement should form an integral part of the return of income. The statement should not give details of individual items of wealth, but only values of specified categories of wealth, e.g., equity shares and debentures, bank deposits and money invested in partnerships or in own business.

[Paragraph 7.5]

12.32. Net wealth tax should also be levied on the specified assets owned by all public and private sector companies. The wealth tax paid should not be allowed to be claimed as expense for income tax purposes. [Paragraph 7.7]

Restructuring Import Tariff

12.33 The main elements of the programme of reform of import tariff should be:

a. Reduction of the general level of tariffs;

b. Reduction of the spread or dispersion of tariff rates;

c. Simplification of the tariff system;

d. Rationalisation of tariff rates, along with the abolition of numerous exemptions and concessions; and

e. Abolition of the practice of making changes in effective rates through notifications.

[Paragraph 8.11]

12.34 In the next four years, the general level of import tariff should be reduced by about 50 per cent, so that the import-weighted average rate of protective import duty comes down to about 45 per cent. In subsequent years, further reduction in duty rate should be attempted so that the average is brought down to about 25 per cent by 1998-99. Of the 50 per cent reduction in the average rate of nominal tariff to be achieved in the first phase of tariff reduction, 10 to 15 per cent reduction should be made in the next Budget for 1992-93 and the remaining part of tariff reduction should be carried out in the years 1993-94 to 1995-96.

[Paragraph 8.13]

12.35 There is need to greatly simplify the tariff system. One step in this direction would be to combine the basic and auxiliary rates of customs duty into one protective rate.

[Paragraph 8.16]

12.36 Another step towards simplification of the tariff system is to reduce the multiplicity of rates. It should not be difficult to achieve in the coming years a rate structure of protective customs duties with only a small number of rates.

[Paragraph 8.18]

12.37 Where the rates are expressed on specific duty basis, or as specific cum ad valorem basis, the combined ad valorem incidence should be reviewed taking into account changes in the international prices.

[Paragraph 8.19]

12.38 There is also a case for reducing, and eventually removing end-use exemptions which cause tariff rates for the same product to differ among uses, with a few possible exceptions.

[Paragraph 8.20]

12.39 The practice of making changes in effective duty rates of customs through notifications should be done away with. If any change in the statutory customs is to be made because of special circumstances such as a drastic change in the international price of imported goods, the change should be made only on the recommendation of the Tariff Commission, into which the BICP is proposed to be converted.

[Paragraph 8.23]

12.40 If the loss of customs revenue has to be kept under Rs.2,000 crore, the maximum duty rate may be confined to 120 or 110 per cent. Choosing 120 per cent as the peak rate in the Budget for 1992-93 has the advantage that the net loss of customs revenue on account of lowering of the peak will be only about Rs.1,000 crore, so that there would be scope for making other changes in the structure of the tariff rates.

[Paragraph 8.28]

12.41 A tariff reduction by ten percentage points be made for those items of basic metals, basic industrial chemicals and machinery, which are at present subject to a rate of duty in the range of 80 to 120 per cent.

[Paragraph 8.31]

12.42 Even after these changes are made, many commodities (nearly 50 per cent of the items) will be subject to a rate of protective customs duty of 100 per cent or more which is quite high in relation to the levels of tariff rates prevailing in most other developing countries. It should be noted further that a large part of capital goods imports and a number of important raw materials and intermediate goods are at present subject to a rate of duty in the range of 40 to 70 per cent. The tariff changes proposed for the next year will leave the duty rates of such items unchanged. Appropriate changes in the duty rates of those items will have to be made in the years 1993-94 to 1995-96. Substantial reduction in duty rates would be necessary also for items for which the rate of duty is at present 80 per cent or higher.

[Paragraph 8.35]

12.43 The average duty rate for capital goods should be reduced to 55 per cent by 1995-96. (As has been indicated in paragraph 8.55, this could be achieved even earlier).

[Paragraph 8.43]

12.44 The import-weighted average tariff rate for intermediate goods should be brought down to 45 per cent by 1995-96.

[Paragraph 8.44]

12.45 By 1995-96, the average tariff rate should be brought down to about 50 per cent and the peak rate to about 80 per cent. In the years 1996-97 to 1998-99, tariff rates should be reduced further to bring down the average rate to around 25 per cent and the maximum rate to 50 per cent by 1998-99.

[Paragraph 8.47]

12.46 By 1998-99, all end-use exemptions should be removed with a few exceptions.

[Paragraph 8.49]

12.47 There are several anomalies in the duty structure and all such cases should be looked into and necessary corrections in duty rates made. In making the corrections, the broad structure of duty rates suggested for 1995-96 should be kept in view.

[Paragraph 8.52]

12.48 By 1998-99, a minimum rate of import tariff, say 10 per cent, should become generally applicable. A beginning should be made in this direction in the next year.

[Paragraph 8.53]

Taxation of Domestically Produced Goods and Services

12.49 The indirect tax at the Central level should be broadly neutral in relation to production and consumption and should, in course of time, cover commodities and services. This means we should move towards VAT covering services and commodities. To make the VAT scheme simple and easily administrable, it should be levied at two or three rates, say, at 10, 15 or 20 per cent. The selective excise duty on non-essential consumption could be levied at 30, 40 or 50 per cent (This means that the maximum rate on a commodity will not exceed 50 per cent with a few exceptions like cigarettes).

[Paragraph 9.2]

12.50 There is a need to widen the tax base and extend the coverage of excise duties. The Committee has identified a number of commodities which could be brought under the excise net. Except Black & White T.V. sets which should bear duty at the rate of 20 per cent ad valorem, other commodities should be subjected to the minimum duty rate of 10 per cent ad valorem.

[Paragraphs 9.6 & 9.29]

12.51 In respect of Ayurvedic and other indigenous systems of medicine, articles of plastics and ready-made garments which are recommended to be brought under excise net, the Simplified Assessment Procedure (SAP) scheme should be made applicable.

[Paragraph 9.7]

12.52 All end use based exemptions for inputs should be withdrawn and the minimum duty rate of 10 per cent ad valorem should be levied on such inputs. If it is not possible to withdraw all such exemptions immediately, this should be done gradually over a period of time when inputs and finished products will bear duty with the benefit of Modvat credit for inputs.

[Paragraph 9.7]

12.53 A new scheme, Simplified Assessment Procedure (SAP), should be introduced for goods covered under the general scheme of excise duty concession in respect of those small scale units whose turnover in the preceding year did not exceed Rs.30 lakh.

12.54 The proposed duty structure for small scale sector is as follows:

Slab Rs.lakh	**Proposed Duty**
0-15	NIL
15-25	Two per cent of the turnover for units operating under SAP; for others, duty at normal rates minus 10 per cent ad valorem subject to minimum duty of 5 per cent ad valorem.
25-75	Duty at normal rate minus 10 per cent ad valorem subject to a minimum duty rate of 5 per cent ad valorem.
75-200	Duty at normal rate.

12.55 The following procedural relaxations should be allowed for units operating under SAP:

i. No excise licence would be required for such assessees.

ii. Duty shall be paid quarterly.

iii. The requirements of the filing of price lists and classification lists and of clearance of goods on gate passes will be waived. Records maintained for sales tax/income tax purposes shall be accepted for the purpose of verification of production figures and turnover in lieu of statutory Central excise records. The returns filed by the assessees shall be accepted without question with a provision for random audit.

iv. Investigation, enquiry or audit in these units shall be only with the approval of the Assistant

Collector of Central Excise.

12.56 Since no duty paying documents will be issued for goods cleared under SAP, Modvat credit shall not be available.

12.57 The desirability of extending this scheme to other small scale units should be examined in the light of the experience gained while administering this procedure in respect of goods covered under the general scheme.

[Paragraph 9.17]

12.58 The subsidy in the form of notional higher credit available to industries using inputs covered under the general scheme should be withdrawn.

[Paragraph 9.19]

12.59 The present distinction in regard to the availability of concession, between brand name of trader or organised sector and that of the small-scale sector should be removed. All goods manufactured under the brand name of any person other than the manufacturer should be charged to normal duty. Corresponding amendments regarding branded goods may be made in the special schemes of exemption for the small-scale sector producing cosmetics and toilet preparations, air conditioners and refrigerators.

[Paragraph 9.20]

12.60 All exemption notifications should be subjected to a close scrutiny with a view to ascertaining whether these can be withdrawn. Where notifications prescribe effective rates of duty without any condition, such rates can be incorporated in the tariff after adjusting them in line with the rate structure proposed in Paragraph 9.2.

[Paragraph 9.21]

12.61 The power of granting exemptions from excise duty should be withdrawn. However, Government may retain the power of adjusting the rates of duty under very exceptional circumstances.

[Paragraph 9.22]

12.62 In a system of commodity taxation ad valorem duties are preferable to specific duties, particularly under Modvat regime. Switching over to ad valorem rates in respect of a number of commodities is, therefore, recommended. Simultaneously, rationalisation of the existing rates has also been suggested with a view to reducing multiplicity of rates. The ad valorem rates suggested for various items broadly conform to the duty slots in which the tariff is required to be structured in the long run. For administrative considerations, however, some commodities like petroleum products, tobacco products and textiles, coffee, tea, marble, etc., may continue to have specific rates.

[Paragraph 9.29]

12.63 Where specific rates are retained, there should be a system of revising the rates every year to take into account price increases as represented by the relevant sectoral wholesale price index. While fixing ad valorem rates, goods falling within the same class should as far as possible be made to bear the same rate.

[Paragraph 9.31]

12.64 In certain cases like coffee, tea and marble, the specific rates should be revised immediately since these rates have remained practically unchanged for a number of years while prices have gone up considerably.

[Paragraph 9.32]

12.65 As the Modvat or the value added tax system gets extended and becomes the main plank for raising revenue from domestically produced goods and services, it would be necessary to move over to a system of assessment on the basis of invoice value. However, for this to be possible and easily administrable it would be desirable to fulfil two conditions. First, there should be extension of value added tax from the manufacturing to the wholesale stage; this would considerably reduce attempts at under-valuation of products. Second, it would be necessary to give up the traditional method of administering excises on the basis of clearance of goods from the factory and move over to a system of assessment on the basis of periodic returns to be submitted by manufacturers. These are important changes and their feasibility would have to be studied in greater detail. The Committee does not, therefore, recommend a changeover to the system of assessment on the basis of invoice value at present. However, it is recommended that a beginning may be made, by way of experiment, with the use of invoice value for assessment of excise in respect of selected commodities which are largely eligible for Modvat in the sense that they are mostly sold to taxable manufacturers. Meanwhile, the question of extending the collection of Modvat to the wholesale stage must be taken up for active consideration.

[Paragraph 9.40]

12.66 The Committee recommends introduction of following methods of measurement of value:

i. Where only a portion of the total produce is sold at the factory gate and the balance from the depots, it could be provided in the law that the assessment of the goods removed from the factory to the depots shall be made on the basis of the price at which the goods are sold from the depots after giving necessary abatement for the freight from the factory gate to the depots.

[Paragraph 9.42]

ii. In case of goods covered under Standards of Weights and Measures (Package Commodities) Rules, 1977 the maximum retail price can be taken as a basis for devising the measure for levy of excise duty. The rate can be applied on a value worked out after giving an abatement for various taxes and other items which are not to be included in the assessable value. Such abatement by its very nature cannot be very exact and would vary from commodity to commodity. The quantum of abatement could be worked out in a fair manner in consultation with the manufacturers' associations.

[Paragraph 9.43]

iii. There would be a case for reviving the system of fixing tariff values. The Committee recommends that tariff values could be fixed for a few commodities like sugar and cement in consultation with the manufacturers' associations.

[Paragraph 9.44]

12.67 A Directorate of Valuation should be created which will be responsible for closely monitoring the movement of prices of goods produced by individual manufacturers especially in those cases where the revenue implications are large. The responsibility of having consultations with the manufacturers' associations in regard to fixation of the quantum of abatement from the retail price, the work of fixation of tariff value, etc., should also be entrusted to this Directorate. On the basis of studies of this Directorate, Government could take a decision in regard to addition to or deletion from the list of commodities which are assessed to duty on the basis of tariff value or retail price.

[Paragraph 9.45]

12.68 The valuation method should be simple and fair so that by and large manufacturers are not provoked to take up the issues to the Courts and at the same time the unscrupulous elements do not make this as a gateway for evasion. Ultimately, the department will have to adopt invoice value for assessment and carry out the needed changes in procedures.

[Paragraph 9.46]

12.69 The Committee envisages that as the Union excise on commodities gets gradually transformed into a value added tax at the manufacturing level the services tax will get woven into that system and, therefore, tax could be levied also on services that enter into the productive processes.

[Paragraph 9.49]

12.70 The Committee recommends that a tax be levied for the present on the following services:

a. Advertising services,

b. Services of stock brokers,

c. Services of automobile insurance,

d. Services of insurance of residential property, personal effects and jewellery and

e. Residential telephone services.

12.71 In all the cases above except for telephone services, the tax should be levied at 10 per cent of the value of the transaction. In the case of telephone services, an annual telephone service tax on every residential telephone connection of Rs.1,000 shall be levied.

[Paragraphs 9.52 & 9.53]

12.72 The centre should work out a package of measures with the States that would represent a just compromise of the interests of the individual States and those of the Union as a whole. The enactment of the law imposing the consignment tax should be one of the measures.

[Paragraph 9.57]

12.73 The harmful effects of the inter-State sales tax-cum-consignment tax can be avoided or minimised in two different ways. The first and the more satisfactory arrangement would be as follows: (a) The inter-State or Central sales tax or the consignment tax imposed by the exporting State will be given credit by the importing State against the sales tax payable to it by the "importer". (b) The exporting State will credit the inter-State sales tax and consignment tax collections to a Central pool. (c) Thus all collections of these two taxes will be deposited in the Central pool and will be then shared among the States on the basis of an agreed formula. The formula should be so devised as to give even treatment to the producing and consuming States. (d) The rate of inter-State sales and consignment taxes would be two per cent. The second best arrangement could be that the consignment tax would be imposed at one per cent after the ceiling rate of the Central sales tax has been reduced to one per cent.

[Paragraphs 9.58 & 9.59]

Issues Relating Tax Administration and Procedure

12.74 Appeals should be provided against any adjustment made under Section 143(1)(a) of the Income-tax Act, 1961.

[Paragraph 10.9]

12.75 A Tariff Guide should be issued giving the classification of all commodities currently manufactured in the country and the classification given therein which would be in line with the established practice should be followed by all the assessing officers in the field. The additions to the Tariff Guide should be made on the basis of the decisions of the Board. This arrangement should be brought about simultaneously with the setting up of the computer network among all the Collectorates.

[Paragraph 10.14]

12.76 The Committee would urge that the pace of implementation of the computerisation project in the Customs and Excise Department should be accelerated.

[Paragraph 10.17]

APPENDIX I

The Intertemporal and Intersource Horizontal Equity of the Indian Income Tax: A Comparison of Tax Treatment in Selected Assessment Years[78]

Introduction

The purpose of the analysis undertaken in this Appendix is to compare the tax treatment of persons having equal incomes derived from different sources under the Indian income tax in selected years. The years chosen are assessment years 1968-69, 1978-79, 1988-89 and 1991-92. Sources of income covered are salaries (inclusive of fringe benefits); income from house property (including imputed income from self-occupation); income from business or profession; capital gains; and income from investments.

Strategy of Analysis

Equality between two individuals is taken to hold when they realise identical annual incomes from all sources[79] (to be measured in 1990-91 rupees). Tax treatment of equals in different years will be examined for various income levels as follows. Pre-tax incomes will be converted, in turn, to 1967-68, 1977-78 and 1987-88 rupees and the tax liability and after-tax income of taxpayers having different sources and levels of income will be computed with reference to the tax provisions prevailing in the relevant year.

Analysis of these figures will be carried out to examine: (a) variations in effective tax rates across income earners depending on their source of income; (b) changes in the impact of savings concessions; (c) changes in the effect of provisions relating to costs of earning income; (d) changes in the relative discrimination between different types of otherwise equal taxpayers across years; (e) the overall change in horizontal equity with respect to a specific index; (f) trends in the progressivity of the income tax.

The Price Index: No appropriate price index appears to be available for intertemporal comparisons of income. The major problems with available indices are the neglect of asset prices and the cost of such things as housing. Given the predominantly urban base of the Indian income tax, the Consumer Price Index for Urban Non Manual Employees (CPIUNME: Base Year 1960) brought out by the Labour Bureau, Ministry of Labour, Government of India will be used. To examine the sensitivity of results to the chosen price index, computations for a few cases are also done with a separate rental index for housing services, based on data from the New Delhi Municipal Corporation.

78. A background paper which includes a full discussion of limitations of the study, detailed charts on the specific assumptions made in the various cases considered and additional computational tables is available from the National Institute of Public Finance and Policy, New Delhi.

79. For a discussion of conceptual and data difficulties and measurement problems leading to departure of the concept used here from comprehensive income concept used in the literature, see the background paper.

Treatment of Deductions: Deduction availing behaviour affects the income tax liability of a person. Given the changes in deduction provisions under the income tax, with changed economic environment and tastes, it may be presumed that deductions will typically not be taken to the same extent by persons who have the same comprehensive income at constant prices in different years. Since there are useful insights to be gained both by examining equals across years taking the actual deductions as given in official statistics and by holding constant, the level of savings and other characteristics which influence tax liability across years for hypothetical taxpayers, exercises are carried out both on the basis of data available in the All India Income Tax Statistics and for a selection of model or hypothetical taxpayers.

Two separate computations are done for salary earners in the exercise with hypothetical taxpayers. In one computation, it is assumed that 10 per cent of the individual's income or an amount equal to the tax deductible ceiling, whichever is less, consists of tax deductible interest or dividends. In the other computation, it is assumed that the individual takes full advantage of tax deductible investments subject to adequate income being available. In each case the difference in effective tax rates due to savings concessions is examined for each income level and year.

Treatment of Costs of Earning Income: Comprehensive income should be taken net of any costs of earning income. Various provisions under the Income-tax Act, 1961, specify the extent to which different costs of earning income may be deducted from the 'total incomings' from different sources during a financial year. It will be assumed here that cost allowances under the Income-tax Act reflect actual cost of earning income in the base year (1968-69).

Distortions in Published Income Tax Statistics: In the intertemporal comparison requiring the use of published data, the All India Income Tax Statistics (AIITS) will be used. The "Gross Income" concept used in these statistics excludes, inter alia, income exempt from tax under Section 10 of the Income-tax Act and thus, falls short of the comprehensive income concept even if other, conceptual, limitations are ignored. The implication of this is that persons in different gross income ranges in the statistics will actually include some persons with higher comprehensive incomes. This will bias gross income figures in a downward direction. Secondly, figures reported in the AIITS reflect assessed income prior to 1984-85 and returned income thereafter. Comparisons across these periods will thus be biased though the extent of bias is unlikely to be large.

Summary of Methodology Used

a. The effective tax rate (ETR) in a year is defined as the ratio of taxes payable to comprehensive or gross income.

b. The impact of savings is computed by comparing effective tax rates with those obtained when the tax saving at the appropriate marginal tax rate(s) due to deductions is added to the numerator of the ETR. This is done for each ETR computed.

c. Kakwani's index of tax progressivity is used to compare changes in progressivity of the tax over time for the exercise based on published data. This index is simply the difference between the Gini index of taxes paid and the Gini index of post-tax income.

d. Assessment of horizontal equity: For each income level and each year the coefficient of variation of effective tax rates is computed across different types of hypothetical taxpayers. Horizontal equity is assessed in terms of both the coefficient of variation and an index of horizontal inequity of the effective tax rates across different types of taxpayers at each income level and in each year. The index of horizontal inequity at the kth income level or income class in year t is given by

$$H_{tk} = \Sigma_i \; \Sigma_{j>1} \; \frac{(ETR_{tik} - ETR_{tjk})^2}{(ETR_{tik} + ETR_{tjk})/2)^2}$$

In the equation, ETR_i or ETR_j represent the effective tax rates of the ith or jth type of taxpayer (the type defined by income sources, saving behaviour and owner-occupied or rented housing) in the kth income class in year t. An aggregate measure of the extent of horizontal inequity in year t is given by

$$H_t = \sum_K H_{tk}$$

Only values of the Index relative to various base years are reported since, in view of the limited data on cost of earning income, the absolute value of the Index will be influenced by data limitations.

Findings from the Intertemporal Comparison Based on the All India Income Tax Statistics

Effective tax rates before and after deductions under Chapter VIA of the Income-tax Act, for selected years during the period ending in 1988-89, are given in Table I.1. Tax relief resulting from savings deductions as a percentage of gross income is reported in Table I.2. Substantial variation in the effective tax rates is observed across the years examined. Middle income taxpayers were hardest hit by changes in the tax structure. For the very rich (with income of Rs 5 lakh[80] or more) the effective tax rates (both before and after deductions) increased in the year 1974-75 as compared to the base year and declined thereafter. For persons in the income range Rs 25,000 to Rs 30,000, effective tax rates increased over the years except for the last year (1988-89). For persons in the income range of Rs 50,000 to Rs 1 lakh, however, effective tax rates increased throughout the period despite the substantial tax relief due to the deductions taken by this class of taxpayers. Thus even when the tax burden on high or low income taxpayers fell, the tax burden on middle income taxpayers rose. However, it should be mentioned that the tax burden on the high income taxpayers was unduly high in the earlier years.

While the progressivity of the tax increased marginally over 1968-69 in the year 1974-75, this was followed by a substantial decline in later years. The decline in tax progressivity in the year 1978-79 is attributable to a rise in effective tax rates of low and middle income taxpayers and a decline in effective tax rates of high income taxpayers. The further decline in 1988-89 is attributable mainly to the decline in effective tax rates of the high income taxpayers. Reductions in marginal tax rates of high income taxpayers had thus led to the erosion of tax progressivity in the years 1978-79 and 1988-89.

Turning to the average level of effective tax rates, this has increased over the years. This is despite the decline in the proportion of taxpayers in the upper income ranges and the decline in their shares of income and tax in these years (Tables I.3 and I.4). The rise in average effective tax rate is attributable to increase in marginal tax rates at the lower end of the income scale.

Savings deductions under Chapter VIA of the Income-tax Act, 1961 were most liberal, on average, in 1988-89 and, as compared to earlier years, they favour lower income groups much more than upper income groups (Table I.2).

Findings of the Intertemporal Comparison based on Model Taxpayers

A synopsis of findings from computation done for model taxpayers are presented in Tables I.6 to I.13. Average tax rates are in Table I.5.

Tax schedules : Table I.5 shows:

i. Average tax rates were higher for incomes below Rs 3 lakh and lower above this income level in the latter two years studied as compared to the earlier two years.

ii. The tax structure was more progressive in the earlier two years according to the coefficient of variation reported in the last row of the table.

80. Unless stated explicity, all monetary amounts are in 1990-91 rupees.

Equal Treatment of Equals : Table I.6 presents aggregate indices of horizontal inequity between different types of taxpayers in each year, treating 1968-69 as the base year. As can be seen, tax provisions differentiated most between taxpayers in assessment year 1978-79. Discriminatory tax treatment of different types of taxpayers declined between the years 1978-79 and 1991-92 resulting in the same level of discrimination in 1991-92 as in 1968-69.

Table I.7 presents computed indices of horizontal inequity for taxpayers with comprehensive incomes of Rs 50,000, Rs 2 lakh and Rs 10 lakh. These disaggregated computations show that horizontal equity violations are most severe at lower income levels and least severe at around Rs 2 lakh of income. Low effective tax rates of manufacturers and investors account for most of the horizontal inequity in tax treatment of the taxpayers.

Tax Progressivity : Due to the rental subsidy on government housing for government servants, which sharply reduces taxes at low income levels, progressivity is highest for this type of taxpayer along with other salary earners who receive house rent allowance and take advantage of savings deductions to the maximum extent possible.[81] Taxes were least progressive for taxpayers having salary income but no fringe benefits and taxpayers having income from house property only, given that, in both cases, tax deductible investments were not taken into account. It may be mentioned that, for all taxpayers studied, progressivity was eroded by allowances.

Turning to a yearwise comparison of tax progressivity, the tax system was most progressive for non-savers in 1968-69, followed by 1978-79, 1988-89 and finally, 1991-92. It is interesting to note that the basic tax schedule has the same progressivity pattern across the four years except that the ranking of 1988-89 and 1991-92 are interchanged. It is thus seen that tax concessions available to upper income groups in 1991-92 led to an erosion of progressivity both absolutely and relatively as compared to 1988-89. For savers, the increased level of tax incentives available in recent years led to a progressivity ranking (highest to lowest) of 1968-69, 1991-92, 1988-89 and finally 1978-79.

Levels of Effective Tax Rates : Effective tax rates for non-savers were highest on average in 1991-92. More or less similar patterns are to be found at income levels of Rs 50,000 and Rs 2 lakh. However, for those with incomes of Rs 10 lakh taxes were substantially lower in the two recent years as compared to the two earlier years. In 1991-92, average effective rates ranged between 17.45 per cent and 29.18 per cent (Table I.6). For savers, however, the highest average effective rates prevailed in 1978-79.

Savings Concessions and Horizontal Equity Violations between Savers and Non-savers : Savings concessions have been found to be most liberal for the middle range of income groups studied in all years (Table I.8).

First turn to tax deductible interest income (under Section 80-L). For a person who has upto 10 per cent of income (subject to the applicable ceiling) from this source, the maximum tax relief is available at incomes between Rs 1 lakh and Rs 2 lakhs. Upto incomes of Rs 50,000 relief due to deductions was greatest in 1988-89 while above this income level 1991-92 had the maximum tax relief.

Next consider tax deductible and rebateable investments. If advantage is taken of these concessions to the maximum possible extent (subject to available income and applicable ceilings), these led to substantial reductions in tax rates especially in 1988-89 and 1991-92 (Table I.8). In fact in these two years, persons with income upto Rs 1 lakh could avoid taxes altogether. It is also of interest that even persons having income of Rs 3 lakh could reduce their effective tax rate by over 10 percentage points in 1991-92. On average, savers could reduce their effective tax rates by about 10 percentage points in 1991-92.

81. Within of course, available income and ceilings on tax deduction saving.

Comparing across years, it is clear that savings concessions available to equals differed widely in different years. More interesting is the fact that horizontal discrimination between savers and non-savers has risen sharply since 1978-79. Thus, in 1991-92, while discrimination within groups of savers and non-savers taken separately was relatively low, discrimination between the two groups was marked.

Discrimination between owner-occupiers and renters of housing.: Perhaps the greatest source of violation of horizontal equity is the lenient taxation, or more recently, non taxation of the imputed rent to owner occupied housing. Table 9 shows that horizontal equity violations have been increasing sharply as the taxation of imputed rent has stopped. It is important to note that it has been so despite our assumption that income of a taxpayer from a owner occupied house was only 20 per cent of his gross income.

Sensitivity Analysis with Respect to the Rental Price Index : In performing computations with the separate rental price index, which attempts to capture the fast growth as compared to the CPIUNME in the rental cost of housing, the already advantageous position of owner occupiers gets further accentuated leading to even greater discrimination between equals.[82]

Fringe Benefits for Salary Earners :[83] A frequent criticism heard of the present tax system is that fringe benefits are lightly taxed due to valuation problems making them a source of much horizontal inequity.[84] This is clearly brought out in Table 10 where, in all years, salary earners receiving liberal fringe benefits paid less taxes than other salary earners. In 1991-92 effective tax rates were lower on average by about 10 percentage points for those receiving fringe benefits. In fact those with incomes upto Rs 50,000 could save their entire tax liability in 1991-92. Furthermore, it has been seen that taxation of fringe benefits has been getting progressively more liberal over the years except for a marginal reversal of the trend in 1991-92 - due primarily to an enhanced surcharge - for persons with incomes upto Rs 2 lakh. When coupled with savings deductions and rebates, effective tax rates get further diluted. Income taxes need have been paid in 1991-92 only by those having incomes of about Rs 2 lakh.

Three types of fringe benefits may be specially mentioned since they lead to further violations of horizontal equity.

The first is the exemption for carriage of goods and passengers for employees of transport undertakings (under Income Tax Rule 3(f)). Consider the case of an airline employee who, on top of the usual fringe benefits, takes two trips with her family (consisting of a husband and two teenaged children) to Europe and the United States. If, in addition, she has taken full advantage of tax deductible saving and just ends up with no tax liability then it can be inferred that her comprehensive income is Rs 3 lakh per year. A complete picture is in Table I.11.

Next consider the case of an employee who gets "reimbursed" for "entertainment expenditure" not actually incurred by her. This is a practice followed in some private sector organisations despite it being a contravention of law. From Table I.11 it may also be seen, given that a monthly reimbursal of Rs.1,000 to Rs.2,000 is not uncommon, that no taxes will be payable upto a comprehensive income of Rs.2 lakh.

The third benefit is the rental subsidy on government accommodation given to government of-

---

82. The key assumption made in order to define persons who are equal for this analysis is that the value of owner-occupied housing or the rent paid, as the case may be equals 20 per cent of the gross income in 1968-69 and that the same type and quality of housing was available in other years without a drop in income, at constant prices, availabel for other purposes to these individuals. To the extent that 20 per cent is conservative, equity violation indices presented here estimates of the reality.

83. For an earlier evaluation of taxation of fringe benefits in India see Jetha (1990).

84. See, for example, Nayak and Peerzade (1989).

ficers. As can be seen from Table I.12, the value of this subsidy, can amount to as much as Rs.1.86 lakh according to our estimates. Clearly, this level of income ought not to escape tax. The subsidy has been growing from year to year. It is also worth pointing out that the extent of tax free subsidy has been deliberately underestimated in our computations in order to get a reliable upper bound for effective tax rates despite data limitations present.

Horizontal equity in different years - An overall assessment: Table I.13 brings together the computed indices of horizontal equity violations from Tables I.6, I.8, I.9 and I.10. As is clear, the relatively low level of discrimination between income sources in 1991-92 gets increasingly eroded when discrimination within a given source is examined. So much so, that, when the horizontal inequity index over all types of taxpayers - savers and nonsavers, government and private sector salary earners, owner occupiers and renters and so on - is examined, it shows that horizontal equity violations in 1991-92 were, on an average, next only to the level in 1968-69 (Table I.13, last row).[85]

Other items : One other item which may be mentioned in this context is accelerated depreciation. This also leads to under-taxation of those able to benefit from it relative to persons with the same comprehensive income who cannot take advantage of it as is shown by the computed effective rates for manufacturers in this study.

85. It may be noted that the index is not additive: thus it is not possible to add up indices for within and between group indices to get the aggregate index.

References

Bagchi, A. and Pawan K. Aggarwal (1983), "Reform of Statistical Information System in the Income Tax Department", Report Submitted to the Economic Administration Reforms Commission, Mimeographed, National Institute of Public Finance and Policy, New Delhi.

Kakwani, Nanak (1977), "Measurement of Tax Progressivity: An International Comparison", Economic Journal, Vol. 87, pp.71-80.

Nayak, Pulin B. and Syed Afzal Peerzade (1989), "Towards a Fringe Benefits Tax", Current Policy Issues Paper No. 2/89, National Institute of Public Finance and Policy, New Delhi.

Jetha, Nizar (with contributions from K. Srinivasan) (1990), "Direct Taxation in India: Selected Issues", Mimeographed, Country Operations Division, Indian Department, The World Bank, Washington, D.C.

TABLE I.1
Average and Effective Income Tax Rates in the Case of Individuals in Selected Assessment Years

(Per cent)

Average real gross income (90-91 Rs.)	1968-69	1974-75	1978-79	1988-89
	A. Average tax rates			
25,000	1.39	3.58	4.62	2.67
30,000	2.46	4.17	5.45	5.15
40,000	4.27	5.56	7.12	10.12
50,000	5.78	7.25	8.79	15.08
75,000	8.76	12.83	13.96	20.78
100,000	12.16	18.10	19.89	26.22
200,000	26.29	36.46	33.02	37.62
500,000	45.93	60.76	54.38	46.19
1,000,000	57.30	72.90	63.99	49.17
Average	15.23	14.74	16.48	21.78
	B. Effective tax rates			
25,000	0.88	3.20	4.29	0.00
30,000	1.84	3.79	5.05	1.76
40,000	3.56	5.09	6.57	5.42
50,000	5.08	6.58	8.10	9.08
75,000	8.15	11.92	13.22	14.72
100,000	10.88	17.00	18.91	20.22
200,000	21.54	34.58	31.63	31.89
500,000	38.42	58.62	53.16	43.01
1,000,000	49.64	70.97	63.26	45.99
Average	13.00	13.89	15.69	16.27
Kakwani's index of tax progressivity (%)	20.44	20.95	17.82	16.41

Source : Computed from All India Income Tax Statistics Data (AIITS),various issues. Directorate of Income Tax, Govt. of India.

TABLE I.2
Tax Relief Due To Deductions as a Percentage of Gross Income in Selected Years

(Percentage points)

Average real gross income (90-91 Rs)	1968-69	1974-75	1978-79	1988-89
	A. Tax relief due to deductions			
25,000	0.51	0.38	0.33	2.74
30,000	0.62	0.38	0.40	3.39
40,000	0.72	0.47	0.55	4.69
50,000	0.70	0.67	0.69	6.00
75,000	0.61	0.91	0.74	6.06
100,000	1.28	1.10	0.98	6.01
200,000	4.75	1.87	1.40	5.73
500,000	7.51	2.14	1.22	3.17
1,000,000	7.65	1.93	0.73	3.18
Average	2.23	0.85	0.79	5.51

Source : Computed from AIITS .

TABLE I.3
Distribution of Individuals and Their Shares of Gross Income

Range of income assessed in 70-71 prices Rs' 000	Assessments				Gross income			
	1967-68	1973-74	1977-78	1987-88	1967-68	1973-74	1977-78	1987-88
up to 10	63.57	73.35	67.31	58.20	34.57	48.56	45.23	37.37
10 to 20	25.22	20.99	25.44	29.76	28.01	29.21	31.76	33.78
20 to 30	5.86	3.36	4.93	9.26	11.92	8.80	11.01	16.61
30 to 50	3.53	1.68	1.58	1.78	11.17	6.58	5.63	5.54
50 to 100	1.42	0.46	0.55	0.82	7.91	3.23	3.18	4.36
100 to 200	0.29	0.12	0.15	0.15	3.16	1.50	1.53	1.50
Over 200	0.11	0.03	0.04	0.03	3.26	2.12	1.66	0.84
ALL	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00

Source : Computed from AIITS .

TABLE I.4
Shares of Individuals in Assessed Income and Tax Payable

Range of income assessed in 70-71 prices Rs' 000	Assessed/Returned income				Tax payable			
	1967-68	1973-74	1977-78	1987-88	1967-68	1973-74	1977-78	1987-88
up to 10	34.96	48.27	44.84	36.64	7.55	15.74	18.98	15.31
10 to 20	28.37	29.14	31.71	33.23	16.79	23.12	27.01	33.56
20 to 30	11.86	8.91	11.11	16.87	12.53	14.23	17.27	23.26
30 to 50	10.95	6.66	5.73	5.82	18.47	16.01	12.94	10.74
50 to 100	7.65	3.27	3.25	4.80	19.73	11.39	10.11	10.60
100 to 200	3.03	1.53	1.56	1.67	10.99	6.86	5.72	4.07
Over 200	3.18	2.23	1.78	0.97	13.94	12.67	7.97	2.46
ALL	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00

Source: Computed from AIITS .

सत्यमेव जयते

TABLE I.5
Effective Income Tax Rates before Deductions in Selected Assessment Years

(Percentage points)

Gross income in 90-91 prices (Rupees)	Effective tax rates on gross income			
	AY 68-69	AY 78-79	AY 88-89	AY 91-92
20000	0.00	0.00	0.00	0.00
25000	0.76	0.00	1.92	2.40
30000	2.11	0.61	5.77	5.33
40000	4.33	4.77	11.57	11.50
50000	5.67	7.72	15.25	15.20
75000	8.99	14.09	23.35	23.47
100000	14.09	20.71	28.31	30.91
200000	32.79	36.54	39.63	43.46
300000	46.58	45.60	44.42	47.64
400000	55.18	51.45	46.82	49.73
500000	61.64	54.96	48.25	50.98
1000000	74.70	61.98	51.13	53.49
Coefficient of variation of effective tax rates	1.0197	0.9149	0.6997	0.7102

Source : Computed

TABLE I.6

Effective Income Tax Rates before Deductions for Different Groups of Taxpayers: Average across Income Groups (All Income Levels)

(Per cent)

Group of taxpayers	Assessment year			
	1968-69	1978-79	1988-89	1991-92
Doctors/Traders	21.91	20.35	22.19	23.80
Manufacturers	16.40	14.14	16.33	17.45
Landlords	27.13	26.24	26.94	28.92
Investors	20.42	20.79	18.88	21.01
Salary earners	27.90	27.37	27.52	29.18
Horizontal inequity index	100.00	142.53	106.44	100.15

Note : Figures are averages over the following income levels (in 1990-91 rupees): 25,000; 30,000; 40,000; 50,000; 75,000; 1 lakh; 2 lakh; 5 lakh; and 10 lakh.

TABLE I.7
Effective Income Tax Rates for Different Types of Taxpayers with Different Gross Income Levels in 1990-91 Rupees

(Per cent)

Group of taxpayers	Assessment year			
	1968-69	1978-79	1988-89	1991-92
With Gross Income Level of Rs.50,000				
Doctors/Traders	4.19	4.36	10.54	10.49
Manufacturers	2.70	1.46	5.84	5.79
Landlords	4.96	6.28	12.48	13.04
Investors	2.87	0.82	0.77	2.80
Salary earners	5.67	8.09	12.23	12.66
Horizontal inequity index	100.00	605.38	643.19	331.06
With Gross Income Level of Rs.2 lakh				
Doctors/Traders	24.03	26.86	31.15	34.66
Manufacturers	16.29	17.87	22.69	25.89
Landlords	31.74	35.54	38.39	42.45
Investors	20.40	27.18	27.81	32.26
Salary earners	32.79	36.74	39.09	43.13
Horizontal inequity index	100.00	94.84	60.47	52.00
With Gross Income Level of Rs.10 lakh				
Doctors/Traders	62.88	50.36	42.64	44.69
Manufacturers	51.06	38.75	34.18	35.92
Landlords	74.41	61.74	50.88	53.29
Investors	63.51	56.15	44.01	46.32
Salary earners	74.70	62.03	51.02	53.43
Horizontal inequity index	100.00	154.49	110.35	108.60

Source: Computed.

TABLE I.8
Effect of Savings Concessions on Effective Income Tax Rates

(Percentage points)

Gross income in 1990-91 prices (Rupees)	Decrease in effective tax rates with 10% tax deductible investment income				Maximum decrease in effective tax possible with tax deductible investments			
	Assessment year				Assessment Year			
	1968-69	1978-79	1988-89	1991-92	1968-69	1978-79	1988-89	1991-92
25000	0.15	0.00	0.00	0.00	0.15	0.00	0.00	0.00
30000	0.55	0.00	1.00	0.93	0.94	0.00	1.00	0.93
40000	0.82	2.15	2.34	1.93	3.11	3.17	5.40	4.41
50000	0.66	2.28	3.12	3.81	4.44	4.47	8.89	9.33
75000	0.66	3.59	3.81	5.08	6.52	5.48	15.75	18.02
100000	0.78	3.65	4.80	4.98	8.84	6.84	22.65	25.41
200000	0.88	2.50	3.85	4.04	12.44	8.94	16.47	21.50
500000	0.47	1.20	1.54	1.62	7.56	4.39	6.95	8.60
1000000	0.24	0.60	0.77	0.81	3.78	2.20	3.48	4.30
Average Index of inequity between savers and non-savers					100.00	55.87	247.19	742.61

Note : Amount of tax deductible investment is limited both by availability of current income and by applicable ceilings.

TABLE I.9
Effect of Owner Occupied Housing on Effective Income Tax Rates

(Percentage points)

Gross income in 90-91 prices (Rupees)	Decrease in effective tax rates due to owner occupation of Housing			
	Assessment year			
	1968-69	1978-79	1988-89	1991-92
25000	0.14	0.00	0.00	0.00
30000	0.14	0.00	1.00	0.93
40000	0.27	0.65	5.40	4.04
50000	0.27	0.55	5.64	5.53
75000	0.30	0.43	4.94	5.85
100000	0.24	0.38	6.61	8.28
200000	1.49	2.88	6.53	6.37
500000	7.13	6.36	5.50	5.54
1000000	8.82	7.32	5.15	5.25
	Average index of inequity between renters and owner occupiers			
	100.00	171.29	13341.88	12220.58
Gross income in 90-91 prices (Rupees)	Decrease in effective tax rates due to owner occupation: Sensitivity analysis with an alternative rental index			
25000	0.14	0.00	1.91	2.2
30000	0.14	0.00	5.1	4.7
40000	0.27	0.76	9.56	9
50000	0.27	0.68	9.79	10.54
75000	0.30	1.65	12.5	15.03
100000	0.24	3.74	12.85	16.28
200000	1.49	6.58	14.63	15.86
500000	7.13	8.41	13.77	15.18
1000000	8.82	8.34	13.48	14.95
	Average index of inequity between renters and owner occupiers			
	100.00	1504.91	26976.62	29490.36

TABLE I.10
Effect of Fringe Benefits on Effective Income Tax Rates

(Percentage points)

Gross Income in 90-91 Prices (Rupees)	Decrease in effective tax rates of salary earners due to fringe benefits — Assessment year			
	1968-69	1978-79	1988-89	1991-92
25000	0.76	0.00	1.92	2.40
30000	2.11	0.61	5.77	5.33
40000	3.83	4.77	11.57	11.50
50000	4.07	6.60	12.78	15.20
75000	5.62	9.52	15.80	21.91
100000	9.33	13.55	17.49	25.43
200000	20.05	17.43	18.57	24.82
500000	24.23	18.13	15.79	19.36
1000000	22.27	16.13	14.87	17.53
Average index of inequity between salary earners receiving and not receiving fringe benefits				
	100.00	477.01	919.68	3348.71

Source: Computed.

TABLE I.11
Impact of Concessions under Income Tax Rule 3(f)* and "Reimbursement of Entertainment Expenses" in AY 1991-92

Gross income in 90-91 prices	Rule 3(f): No. of free airline tickets required for zero tax liability		"Reimbursement of entertainment": monthly amount for zero tax liability	
	without tax deductible investment	with tax deductible investments	without tax deductible investments	with tax deductible investments
(Rupees)	(Nos.)	(Nos.)	(Rupees)	(Rupees)
25000	Nil	Nil	Nil	Nil
30000	Nil	Nil	Nil	Nil
40000	Nil	Nil	Nil	Nil
50000	Nil	Nil	Nil	Nil
75000	0.43	Nil	Nil	Nil
100000	1.24	Nil	784	Nil
200000	4.69	0.5	2069	836
300000	8.43	7.96	14035	8017
400000	12.15	8.54	20246	14228
500000	15.87	12.26	26458	20440
1000000	34.51	30.9	57514	51497

Note : * Carriage of goods and passengers for employees of transport undertakings. Computations are based on the Model taxpayer where airfare is taken at Rs 20,000 which is roughly the median cost of a round trip economy class ticket to Europe and the United States.

TABLE I.12

Combined Effect of Fringe Benefits, Rental Subsidy and Saving Deductions on Effective Income Tax Rates of Government Servants

(Per cent)

Assessment year	Gross income in current prices (Rupees)	Ratio of fringe benefits to gross income	Ratio of rental subsidy to gross income	Ratio of savings deduction to gross income	Effective tax rate before fringes & deductions	Effective tax rate after fringes & deductions	Ratio of fringe benefits to ETR before all concessions	Ratio of ETR after fringes & subsidy to ETR before all concessions	Ratio of ... to ETR before all concessions
1968-69	4641	24.44	15.50	0.00	0.76	0.00	0.00	0.00	0.00
	5569	24.44	15.50	0.00	2.11	0.00	0.00	0.00	0.00
	7425	24.44	15.50	6.18	4.33	0.00	28.37	3.05	0.00
	9282	24.44	15.50	16.96	5.67	0.00	45.23	15.14	0.01
	13923	24.44	15.50	31.33	8.99	0.00	48.26	29.30	0.00
	18563	24.44	15.50	33.11	14.09	0.30	44.09	25.94	2.11
	37127	24.44	15.50	21.55	32.79	3.54	47.64	27.43	10.80
	92817	24.44	15.50	8.62	61.64	20.55	60.94	40.57	33.34
	185635	23.45	15.50	4.31	74.70	36.74	68.39	50.18	49.18
1978-79	8640	22.06	17.06	0.00	0.00	0.00	NA	NA	NA
	10368	22.46	17.06	0.00	0.61	0.00	0.00	0.00	0.00
	13823	22.95	17.06	0.00	4.77	0.00	0.00	0.00	0.00
	17279	23.25	17.06	1.82	7.72	0.00	27.88	0.00	0.00
	25919	23.65	17.06	17.60	14.09	0.54	41.42	17.89	3.81
	34558	23.84	17.06	17.59	20.71	2.17	43.08	21.59	10.47
	69117	24.14	17.06	15.82	36.54	7.18	53.28	31.93	19.64
	172792	23.54	17.06	6.33	54.96	22.85	65.06	43.98	41.59
	345584	22.00	17.06	3.16	61.98	32.85	71.64	52.68	53.00
1988-89	19498	41.19	18.07	0.00	1.92	0.00	0.00	0.00	0.00
	23397	38.40	18.07	0.00	5.77	0.00	0.00	0.00	0.00
	31196	34.91	18.07	0.00	11.57	0.00	0.00	0.00	0.00
	38995	32.81	18.07	6.58	15.25	0.00	13.14	0.00	0.00
	58493	30.02	18.07	23.55	23.35	0.00	35.58	12.45	0.00
	77990	27.04	18.07	33.62	28.31	0.00	46.81	23.84	0.00
	155980	21.77	18.07	32.18	39.63	4.98	63.12	41.02	12.57
	389950	16.65	18.07	12.87	48.25	22.75	77.06	56.84	47.15

Cont'd...

TABLE I.13
Indices of Horizontal Inequity by Sources of Violation of Equity

	Assessment year			
	1968-69	1978-79	1988-89	1991-92
(a) Between Income Sources				
	100.00	142.53	106.44	100.15
(b) Between Savers and Non-savers				
	100.00	55.87	247.19	742.61
(c) Between Owner Occupiers and Renters				
	100.00	171.29	13341.88	12220.58
	(100.00)	(1504.91)	(26976.62)	(29490.36)
(d) Between Salary Earners Receiving Fringe Benefits and those not Receiving them				
	100.00	477.01	919.68	3348.71

Note: Figures in parentheses are for the sensitivity analysis with the alternative rental cost index.

APPENDIX II

Projection of Customs Revenue for 1992-93 and Estimation of Revenue Loss Due to Lowering of Maximum Duty Rate

For estimating customs revenue, non-POL imports have been projected for 1992-93 (Table II.1). To convert import value from US dollar to Rupees, the exchange rate for 1992-93 has been taken as Rs. 26.7 per US dollar. This is 9 per cent higher than the average exchange rate (expected) for the year 1991-92 of Rs. 24.5 per US dollar. A 9 per cent depreciation of the exchange rate in 1992-93 over 1991-92 has been assumed since we find that in the period 1980-81 to 1990-91, the exchange rate of the Rupee to the US dollar has been depreciating at the average annual rate of about 9 per cent.

For non-POL items, customs revenue for 1992-93 has been estimated considering the growth of import value and taking the elasticity of customs revenue to import value as 0.8. For POL imports, it is assumed that the import of crude will be of the order of 26.5 m tonnes. Our projection of customs revenue for 1992-93 is Rs.28,993 crore (Table II.2). The projected customs revenue for 1992-93 is 36.5 per cent higher than the customs revenue for 1990-91. The distribution of customs revenue according to rates of protective customs duty for the year 1990-91 is shown in Table II.3. To obtain such distribution for 1992-93, the distribution for 1990-91 has been blown up proportionately (Table II.4), considering the increase in total customs revenue between 1990-91 and 1992-93 (Table II.2). It has been assumed that the share of countervailing duty in total customs duty is 15 per cent (the ratio was 16 per cent in 1985-86 and 15 per cent in 1987-88; such break-up is not available for recent years).

The results of the simulation exercise are presented in Tables II.4 and II.5. The loss of customs revenue on account of lowering of the maximum rate to 120 per cent, 110 per cent, 100 per cent and 90 per cent are found to be Rs.1,208 crore, Rs.1,878 crore, Rs.2,696 crore and Rs.3,607 crore, respectively. In making these computations, it has been assumed that the duty rate for passenger baggage will not be lowered. The same assumption may be made for alcoholic beverages. But this will have very little effect on the estimates of revenue loss.

In making these computations, the effect of tariff reduction on the total volume of imports and on the structure of imports has not been taken into account. One would expect that, as the peak duty rate is lowered, the import volume will go up and the structure of imports will shift in favour of goods which are now subject to high import duty. This will partly offset the revenue loss from the lowering of the peak duty rate. Therefore, the net loss of revenue should be lower than the figures given in Table II.5.

We are aware that making projections of import value for a year following abnormal developments in the economy is a difficult and hazardous task. Apart from that, we have neither the information nor the time needed to make fairly accurate projections. We have undertaken the exercise only to obtain a rough order of magnitude of the probable loss in customs revenue due to duty reduction.

TABLE II.1
India's Non-POL Imports

(billion U.S. dollars)

Year	Non-POL imports
1980-81	9.21
1981-82	9.39
1982-83	8.97
1983-84	10.64
1984-85	9.86
1985-86	11.99
1986-87	13.53
1987-88	14.04
1988-89	16.49
1989-90	17.50
1990-91	18.03
1992-93 (projected)	21.17

Note: The projection of non-POL imports for 1992-93 is based on estimated trend line fitted to data for the period 1980-81 to 1990-91.

TABLE II.2
Customs Revenue Projections

(Rs crore)

	1990-91	1992-93
Non-POL imports	32351	56514
Customs revenue		
POL	3700	4500
Non-POL	17526	24493
Total	21226	28993

Note: Customs revenue projections for POL imports for 1992-93 are based on the assumption that import of crude will be of the order of 26.5 million tonnes.
For non-POL imports, the elasticity of customs revenue with respect to import value has been taken as 0.8. Exchange rate is taken as Rs 24.5 per US dollar for 1991-92 and Rs 26.7 per US dollar for 1992-93.

TABLE II.3
Customs Revenue by Rate Categories: 1990-91

Duty rate (B+A) per cent	Customs revenue (B+A) Rs crore	% share
400	14.11	0.08
350	1.33	0.01
255	483.32	2.71
250	156.31	0.88
240	7.42	0.04
180	0.92	0.01
170	27.64	0.16
160	12.57	0.07
155	0.08	0.00
150	3199.85	17.96
140	4.48	0.03
135	3.74	0.02
130	42.12	0.24
120	2285.60	12.83
110	571.91	3.21
105	844.05	4.74
100	116.74	0.66
95	104.99	0.59
90	1972.42	11.07
85	286.40	1.61
80	2446.26	13.73
77	115.01	0.65
75	9.53	0.05
70	634.32	3.56
65	648.50	3.64
60	570.94	3.20
55	117.04	0.66

Cont'd.....

TABLE II.3 *(Cont'd.)*

Duty rate (B + A) per cent	Customs revenue (B + A) Rs crore	% share
50	2154.26	12.09
45	4.39	0.02
40	78.45	0.44
35	347.33	1.95
30	378.20	2.12
25	7.57	0.04
20	27.45	0.15
15	101.30	0.57
10	15.00	0.08
3	26.13	0.15
Total (B + A)	17817.70	100.00
Total (B + A + CVD)	20962.00	
Gross revenue	21225.77	

Note : B: Basic duty A: Auxiliary duty CVD: Countervailing duty.

TABLE II.4
Simulation of Customs Revenue, 1992-93

Duty rate (B + A) per cent	Customs revenue (B + A), Rs Crore				
	Tariff un-changed	Max. 120%	Max. 110 %	Max. 100%	Max 90 %
400	19.27	5.78	5.30	4.82	4.34
350	1.82	0.62	0.57	0.52	0.47
255	660.18	660.18	660.18	660.18	660.18
250	213.51	102.49	93.95	85.41	76.87
240	10.14	5.07	4.65	4.22	3.80
180	1.25	0.84	0.77	0.70	0.63
170	37.76	26.65	24.43	22.21	19.99
160	17.17	12.88	11.81	10.73	9.66
155	0.12	0.09	0.08	0.07	0.07
150	4370.78	3496.63	3205.24	2913.86	2622.47
140	6.12	5.24	4.81	4.37	3.93
135	5.11	4.54	4.16	3.78	3.41
130	57.53	53.10	48.68	44.25	39.83
120	3121.98	3121.98	2861.82	2601.65	2341.49
110	781.19	781.19	781.19	710.17	639.16
105	1152.91	1152.91	1152.91	1098.01	988.21
100	159.46	159.46	159.46	159.46	143.51
95	143.41	143.41	143.41	143.41	135.86
90	2694.20	2694.20	2694.20	2694.20	2694.20
85	391.20	391.20	391.20	391.20	391.20
80	3341.43	3341.43	3341.43	3341.43	3341.43
77	157.10	157.10	157.10	157.10	157.10
75	13.02	13.02	13.02	13.02	13.02
70	866.44	866.44	866.44	866.44	866.44
65	885.80	8785.80	885.80	885.80	885.80
60	779.87	779.87	779.87	779.87	779.87
55	159.87	159.87	159.87	159.87	159.87
50	2942.58	2942.58	2942.58	2942.58	2942.58
45	6.00	6.00	6.00	6.00	6.00
40	107.16	107.16	107.16	107.16	107.16
35	474.43	474.43	474.43	4743.43	474.43
30	516.59	516.59	516.59	516.59	516.59
25	10.34	10.34	10.34	10.34	10.34
20	37.49	37.49	37.49	37.49	37.49
15	138.37	138.37	138.37	138.37	138.37
10	20.49	20.49	20.49	20.49	20.49
3	35.69	35.69	35.69	35.69	35.69
Total (B + A)	24337.80	23311.15	22741.49	22045. 1	21271.94
Total (B + A + CVD)	28632.70	27424.88	26754.69	25936.36	25025.81
Gross revenue	28993.00	27785.18	27114.99	26296.66	25386.11

Note : It is assumed that the duty rate for baggage (255%) will not be lowered.

TABLE II.5
Loss of Customs Revenue due to Lowering of Duty Rates

		(Rs crore)
Customs revenue (including CVD) in 1990-91 (Rs crore)		21,226
Customs revenue (including CVD) projected for 1992-93		
(i)	without tariff charge	
(ii)	max. 120 per cent	27,785
	revenue loss	1,208
(iii)	max. 110 per cent	27,115
	revenue loss	1,878
(iv)	max. 100 per cent	26,297
	revenue loss	2,696
(v)	max. 90 per cent	25,386
	revenue loss	3,607

APPENDIX III

Revenue Implications of Lowering Duty Rates on Selected Items of Basic Metals, Basic Industrial Chemicals and Machinery

In Table III.1, an estimate of loss of customs revenue is presented for a 10 percentage point reduction in the rates of duty on basic metals, basic industrial chemicals and machinery items which are at present subject to a rate of duty in the range of 80 per cent to 120 per cent. The duty rates shown in the Table are as on 25th July, 1991, while the customs revenue figures (excluding CVD) are for 1990-91. Using some data on product-wise customs revenue collection for 1987-88, the ratio of countervailing duty to total customs duty has been computed. This ratio works out to 12 per cent for basic metals, 8 per cent for machinery and 14 per cent for basic chemicals. These ratios have been used to compute total customs revenue including CVD.

Our computations show that a ten percentage point reduction in the duty rate for the selected items would have led to a revenue loss of Rs. 533 crore in 1990-91. Considering the growth of customs revenue from non-POL imports between 1990-91 and 1992-93, the loss of customs revenue for 1992-93 resulting from a 10 percentage point reduction in the duty rate on the selected items has been estimated at Rs. 745 crore.

As in the case of peak rate reduction, the net revenue loss should be much lower than Rs. 745 crore because (1) a part of the loss relates to countervailing duty and (2) tariff reduction may cause higher imports or shift of import structure in favour of items subject now to high duty rates. Another point to be noted in this connection is that the duty rates shown in the Table are general effective rates. In many cases, the effective duty may be lower depending on the end-use. Thus, lowering of duty rates may not reduce customs revenue proportionately. Since we assume a proportional relationship between duty rate and revenue, the loss of revenue is over-estimated.

TABLE III.1

Customs Duty Rates and Revenue - Simulation Results for Items Subject to Duty Rate in the Range of 80 to 120 Per Cent (Rates as on July 25, 1991, Revenue for 1990-91)

	Duty rate (%)	Revenue (B+A) Rs. cr.	Proposed rates (%)	Revenue Rs. cr.
Basic Metals				
1 Alloy steel	120	200	110	183.3
2 Lead ingot	120	30	110	27.5
3 Cold rolled steel sheets	110	350	100	318.2
4 Articles of other base metal	110	35	100	31.8
5 Hot rolled sheets	105	300	95	271.4
6 Ferro alloys	105	6	95	5.4
7 Bars, rods, shapes, etc	105	25		
8 Nickel & articles	105	30	95	27.1
9 Aluminium & articles	105	50	95	45.2
10 Tin & articles	105	25	95	22.6
11 Steel wire	95	5	85	4.5
12 Tungston powder	90	20	80	17.8
13 Nickel waste & scrap	85	10	75	8.8
14 Steel sheets of thickness over 5mm	80	4	70	3.5
15 Copper waste & scrap	80	105	70	91.9
Total revenue (B+A)		1195.0		1081.8
Total with CVD		1358.0		1229.3
- Revenue loss				128.7
Machinery				
1 Certain types of tools	110	35	100	31.8
2 Optical fibres and cables	110	11	100	10.0
3 Thermostat monostat hydraulic and pneumatic instruments	110	40	100	36.4
4 Telecom and broadcast equipment	105	20	95	18.1
5 Thermionic valves, tubes diods & ICs	90	177	80	157.3
6 Tractors	90	22	80	19.6
7 Computers	85	43	75	37.9
8 Capital goods - licensible	80	1020	70	892.5

Cont'd...

		Duty rate (%)	Revenue (B + A) Rs. cr.	Proposed rates (%)	Revenue Rs. cr.
9	Project imports - general	80	510	70	446.2
	Total revenue (B + A)		1878.0		1649.9
	Total with CVD		2041.3		1793.3
	Revenue loss				248.0
Basic Chemicals					
1	Specified organic chemicals (Ch 29)	120	1100	110	1008.3
2	Specified inorganic chemicals (Ch 28)	120	160	110	146.7
3	Sulpha drugs (bulk)	110	4.5	100	4.1
4	Paraxylene	85	35	75	30.9
5	Caprolactum	80	200	70	175.0
	Total revenue (B + A)		1499.5		1365.0
	Total with CVD		1743.6		1587.2
	- Revenue loss				156.4

APPENDIX IV

Effect of Tariff Change on Effective Rates of Protection

If the peak rate is lowered to 120 per cent and a ten percentage point reduction is made in duty rates on items of basic metals, basic chemicals and machinery which are at present subject to a rate of duty in the range of 80 to 120, per cent, then the nominal rates of protection (accorded by the tariff system) to different industries will come down and this will lead to changes in the effective rates of protection. Using data on tariff rates at 6-digit level HS product classification for 1989-90, we have made an attempt to assess the effect of the above-mentioned tariff changes on the effective rates of protection (ERP) of different industries. The estimation of ERP has been done with the help of an input-output table (for 1983-84) using the following formula

$$ERP_i = \frac{t_i - \Sigma a_{ij} t_j}{1 - \Sigma a_{ij}}$$

where ERP_i is the effective rate of protection of sector i, t_i is the average rate of tariff (nominal protection) of sector i, and a_{ij}'s are the input-output coefficients. For mica, the nominal rate of protection has been computed on the basis of export tax. For cotton, tobacco and iron ore, implicit tariff rates have been computed comparing domestic and international prices. For sugarcane, the nominal rate of protection has been assumed to be the same as that for sugar.

Table IV.1 shows the nominal and effective rates of protection of various manufacturing industries. Two sets of estimates are presented. For one set of estimates we have taken for each sector a simple average of tariff rates of items belonging to that sector; for the other set we have taken an import-weighted average of tariff rates. The table gives estimates of nominal and effective rates of protection for both the actual tariff rates and the simulated tariff rates incorporating the tariff changes mentioned above.

It is seen from the table that ERP estimates based on simple averages of tariff rates range from 71 per cent to 340 per cent, and those based on import-weighted averages range from 145 per cent to 484 per cent. The sectors for which ERP is high include edible oils other than vanaspati; beverages; tobacco products; cotton textiles; paints, varnishes and lacquers; iron and steel casting and forging; and iron and steel foundries. The sectors for which ERP is low include sugar, fertilizers[86], tractors and other agricultural implements, non-electrical industrial machinery, ships and boats, and bicycles. The average ERP is 125 per cent in the first set of estimates and 115 per cent in the second set.

It is also seen from the Table that the tariff changes recommended above would result in a significant reduction in nominal rates of protection for most manufacturing industries. The average ERP falls by about 20 percentage points. There is a significant fall in the extent of inter-industry variation of ERP

86. Though ERP for fertiliser is negative, this sector is adequately protected through quantitative restrictions on trade and government's control on fertiliser prices. The protection arising from non-tariff meausres is not taken into account in our estimates.

as may be seen by comparing the standard deviations. It is interesting to note that the sectors for which ERP is low gain from the tariff changes in regard to the level of effective protection enjoyed by them.

In Table IV.2, the average rates of nominal and effective protection are given for four major industrial groups, namely, agro-based, chemicals, metals and machinery, and for the entire manufacturing sector. It is seen that tariff changes cause the average ERP to decline for all the four major groups. The decline is relatively larger for agro-based industries and relatively smaller for machinery.

TABLE IV.1

Nominal and Effective Rates of Protection based on Simple Averages and Import-Weighted Averages of Tariff Rates in 1989-90 and Simulated Tariff Rates

(Per cent)

	Commodity	GVA	Simple Average NRP	Simple Average ERP	Simple Average Simulated NRP	Simple Average Simulated ERP	Import-Weighted Averages NRP	Import-Weighted Averages ERP	Import-Weighted Averages Simulated NRP	Import-Weighted Averages Simulated ERP
33	Sugar	0.53	104	43.58	101	73.83	100	37.09	100	74.44
34	Khandsari, boora	0.11	104	60.85	101	82.22	100	62.30	100	89.11
35	Hydrogenated oil (vanaspati)	0.10	138	155.29	113	131.12	166	296.17	119	186.97
36	Edible oils other than vanaspati	0.20	141	340.35	108	136.98	116	187.85	88	39.27
37	Tea and coffee processing	0.35	145	151.51	120	123.81	145	156.99	120	129.05
38	Miscellaneous food products	0.75	133	209.95	114	164.96	88	95.68	81	84.36
39	Beverages	0.22	232	315.71	115	126.85	321	484.40	117	144.98
40	Tobacco products	0.86	145	200.23	120	167.02	145	203.77	120	170.69
41	Khadi, cotton textiles in handlooms	1.50	129	129.53	114	114.51	145	146.88	120	121.84
42	Cotton textiles	2.22	129	186.28	114	166.86	145	215.07	120	180.74
43	Woollen textiles	0.16	107	109.32	98	101.66	85	82.29	84	89.00
44	Silk textiles	0.33	110	122.69	104	116.84	100	118.85	99	120.65
45	Art silk, synthetic fibre textiles	0.67	156	166.23	120	123.97	189	213.76	118	124.97
46	Jute, Hemp, Mesta Textiles	0.27	129	154.93	114	131.80	142	182.89	119	144.61
47	Carpet weaving	0.30	139	144.16	118	120.93	139	144.26	118	122.05
48	Ready made garments & made up textile goods	2.24	145	148.65	120	122.12	145	147.41	120	123.08
49	Miscellaneous textile products	0.54	141	151.28	118	123.13	110	102.82	99	97.46
50	Furniture & fixtures-wooden	0.17	145	161.28	120	129.95	145	170.98	120	140.36

Cont'd ...

TABLE IV.1 *(Cont'd.)*

	Commodity	GVA	Simple Average NRP	Simple Average ERP	Simple Average Simulated NRP	Simple Average Simulated ERP	Import-Weighted Averages NRP	Import-Weighted Averages ERP	Import-Weighted Averages Simulated NRP	Import-Weighted Averages Simulated ERP
51	Wood and wood products except furniture	0.56	107	147.33	102	137.49	93	176.22	85	161.09
52	Paper, paper products & newsprint	0.38	122	128.78	105	109.03	76	73.85	71	71.26
53	Printing, publishing and allied activities	0.63	88	64.52	73	52.17	9	-40.35	8	-36.62
54	Leather footwear	0.35	145	156.00	120	125.94	145	171.62	120	137.73
55	Leather & leather products except footwear	0.12	124	158.62	110	137.93	84	104.88	80	102.40
56	Rubber products	0.55	141	155.50	118	125.51	141	157.54	117	126.97
57	Plastic products	0.20	152	159.50	118	121.52	192	215.54	119	125.63
58	Petroleum products	0.41	108	167.17	98	130.54	1	-145.14	1	-143.81
59	Coal tax products	0.05	76	65.22	76	66.63	43	11.49	43	12.6
60	Inorganic heavy chemicals	0.13	116	118.88	104	105.75	97	106.48	86	94.42
61	Organic heavy chemicals	0.30	115	116.09	103	104.38	123	160.11	101	130.76
62	Fertilizers	0.58	0	-71.11	0	-64.71	0	-40.59	0	-36.24
63	Pesticides	0.13	115	110.94	113	115.00	118	120.21	115	124.68
64	Paints, varnishes & lacquers	0.23	195	242.22	120	128.79	195	249.98	120	137.14
65	Drugs and medicines	0.68	107	98.52	107	107.06	105	102.58	105	112.26
66	Soaps, cosmetics & glycerine	0.32	151	177.97	119	132.48	143	177.69	117	141.08
67	Synthetic fibres, resin	0.33	132	139.14	107	108.94	126	141.89	104	115.84
68	Other chemicals	0.54	125	142.98	113	130.74	124	147.66	115	142.25
69	Structural clay products	0.35	127	137.42	114	121.47	107	129.72	107	130.39
70	Cement	0.49	131	139.87	115	120.37	108	112.03	106	113.21

Cont'd

TABLE IV.1 *(Cont'd.)*

	Commodity	GVA	Simple Average				Import-Weighted Averages			
					Simulated				Simulated	
			NRP	ERP	NRP	ERP	NRP	ERP	NRP	ERP
71	Other non-metallic mineral products	0.95	129	133.68	111	113.40	85	85.93	84	88.07
72	Iron & steel and ferro alloys	1.46	118	122.53	95	95.08	134	158.79	112	130.57
73	Iron and steel casting and forging	0.04	145	193.03	120	158.20	145	199.97	120	162.16
74	Iron and steel foundries	0.53	159	179.12	107	111.25	154	172.13	103	105.16
75	Non-ferrous basic metals (including alloys)	0.21	118	129.23	103	110.20	109	130.90	97	114.61
76	Hand tools, hardware	0.34	115	101.82	100	98.88	76	45.33	70	54.91
77	Miscellaneous metal products	0.84	134	130.34	113	119.56	119	108.92	101	101.27
78	Tractors and other agricultural implements	0.21	77	36.50	69	43.65	68	25.77	62	34.58
79	Industrial machinery for food & textile ind.	0.25	81	51.06	72	54.55	82	58.48	73	60.88
80	Industrial machinery (except food & textile)	0.19	81	58.16	71	57.76	82	62.82	73	61.84
81	Machine tools	0.25	78	51.14	72	55.86	63	29.42	59	36.89
82	Office computing and accounting machinery	0.03	103	91.98	93	88.06	64	42.14	60	46.51
83	Other non-electrical machinery	0.94	95	73.62	81	68.25	100	83.44	83	72.64
84	Electrical industrial machinery	0.47	86	54.31	77	57.52	83	52.26	73	53.52
85	Electrical cables, wires	0.18	145	155.26	120	129.05	145	160.93	120	133.60
86	Batteries	0.15	145	156.58	120	127.12	145	163.52	120	133.42
87	Electrical appliances	0.39	110	102.91	97	93.82	92	85.42	80	75.68

Cont'd ...

TABLE IV.1 (Cont'd.)

	Commodity	Simple Average					Import-Weighted Averages			
					Simulated				Simulated	
		GVA	NRP	ERP	NRP	ERP	NRP	ERP	NRP	ERP
88	Communication equipment	0.21	136	138.23	113	114.61	138	144.74	116	121.19
89	Other electrical machinery	0.03	79	41.41	76	54.82	84	55.18	80	66.89
90	Electronic equip ment including TV	0.17	117	121.69	100	102.34	122	131.10	104	109.47
91	Ships and boats	0.13	63	34.25	63	48.48	40	6.93	40	20.73
92	Rail equipment	0.38	82	62.40	82	73.52	81	65.48	81	76.04
93	Motor vehicles	0.82	104	88.43	89	78.39	64	22.55	61	31.85
94	Motor cycles and scooters	0.57	81	67.60	73	64.60	45	25.66	45	31.72
95	Bicycles, cycle-rikshaw	0.19	85	54.82	80	66.30	70	37.54	70	55.96
96	Other transport equipment	0.11	85	70.69	76	68.02	42	17.28	41	25.35
97	Watches and clocks	0.13	145	149.53	120	123.25	145	152.37	120	125.51
98	Miscellaneous manufacturing	1.51	114	112.61	101	100.94	86	77.08	83	78.87
	Minimum		0	-71	0	-65	0	-145	0	144
	Maximum		232	340	120	167	321	484	120	252
	Simple average		119	125	101	104	109	115	91	93
	Std. deviation		33	63	21	37	50	88	30	55
	Weighted average@		79	40	71	34	70	37	62	31

Note: Gross Value Added (GVA) of different sectors as percentage of total gross value added of the whole economy in 1983-84 (obtained from the input-output table) is shown in the table. The value-added weights have been used to compute weighted average of NRP and ERP shown at the bottom of the table. The manufacturing sector accounted for 30.54 per cent of total GVA of the economy in 1983-84.

Source : Calculations are based on
(i) Input-Output Transactions Table (1983-84), Central Statistical Organisation,
(ii) Customs Tariff Working Schedule as on 1.6.1989, Directorate of Publications, Customs and Central Excise, New Delhi

TABLE IV.2

Nominal and Effective Rates of Protection Based on Simple Averages and Import-Weighted Averages in 1989-90 and Simulated Tariff Rates According to Major Groups

(Per cent)

	Simple averages				Import-weighted averages			
			Simulated				Simulated	
Major Groups	NRP	ERP	NRP	ERP	NRP	ERP	NRP	ERP
Agro-based								
Mean	134	161	112	126	131	160	105	121
Standard deviation	26	65	7	22	49	91	16	37
Weighted average*	134	160	114	133	133	160	111	131
Chemicals								
Mean	117	120	98	96	115	131	96	108
Standard deviation	49	79	35	58	48	74	35	53
Weighted average*	105	101	91	84	104	114	89	98
Metals								
Mean							100	111
Standard deviation							16	32
Weighted average*							103	111
Machinery								
Mean							85	77
Standard deviation							22	34
Weighted average*							83	74
Manufacturing								
Mean							91	93
Standard deviation							30	55
Weighted average*							95	100

Note: * Value-added wei