CHAPTER 5

PUBLIC FINANCE

In this Chapter, I will learn

- GENERAL BUDGET
- RECEIPTS
- EXPENDITURES
- TYPES OF DEFICIT
- TYPES OF BUDGET
- TAX
- CLASSIFICATION OF TAXATION
- METHODS OF TAXATION ON GOODS
- TYPES OF TAXES
- FRBM ACT 2003
- TAX REGIMES OF CENTRE & STATE
- RELATED TERMS

Public Finance is one of the disciplines in economics that deals with resource mobilisation for and utilisation of the same to accomplish State activities at all levels viz., central, state and local governments.

This chapter covers general budget, types of deficit, types of budget, tax, additional terms related to tax, Fiscal Responsibility and Budget Management (FRBM) Act and tax regime of Centre and State.

GENERAL BUDGET

Budget is an annual financial statement. In case of central government Article 112 and in case of state government Article 202 of the Indian constitution requires the annual financial statement to be laid before the respective legislatures. The budget is a statement of accounts of Government.

Pranab Mukherjee observes:"The Union Budget cannot be a mere statement of Government accounts. It has to reflect the Government's vision and signal the policies to come in future."[1] So it is more than just a financial statement.

Railway budget was separated from General Budget in 1921 on the recommendation of "Acworth Committee". Aggregates of receipts and expenditure of the railways are incorporated in the General Budget. Demand for Grants relating to railway expenditure is presented to Parliament separately in advance of the general budget. Demand for Grants is a statement of estimates estimated expenditure to be made out of Consolidated Fund of India. It is required to be voted by Lok Sabha.

1 Budget speech 2010-11

General budget contains estimated receipts and expenditure for one year usually.

i. Actual figure of the previous year

ii. Budget and Revised figure for the current year

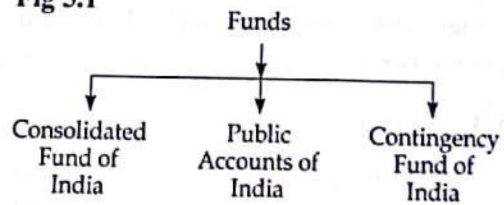
iii. Budget estimate for the upcoming year

Budget estimates are based on the previous two year estimates.

If it is the budget of 2009-10, the previous year is 2007-08 the current year is 2008-09 and the coming year is 2009-10. Here a confusion may arise regarding the years mentioned. You may raise the question how 2008-09 will become current year for 2009-10 budget. Please remember that the budget for 2009-10 is submitted at the end the fiscal year 2008-09. So it becomes the current year. Accordingly other years also come to be mentioned.

The estimated receipts and expenditures are essentially made into and out of following funds. They are shown in the figure 5.1.

Fig 5.1



1. Consolidated Fund of India

The Consolidated Fund has been defined in Article 266 (1) of the Constitution.

According to the same, all revenues received by the Government of India, all loans raised by that Government by the issue of treasury bills, loans or ways and means advances and all moneys received by that Government in repayment of loans shall form one consolidated fund to be entitled "The Consolidated Fund of India".[2]

All expenditure incurred by the Government including repayment of debt and loans given to States/UT Governments is spent out of this Fund.

2. Public Accounts of India

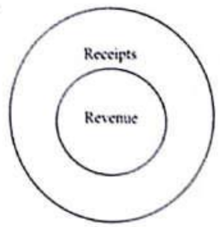
It is established under Article 266 (2) of the Constitution. All public money received other than those included in Consolidated Fund of India are held in Public Accounts of India. This account mainly consists of money raised through small saving schemes, provident fund schemes etc. Government is just custodian of these. It has to repay either on maturity date or whenever claimed by people. This kind of debt or obligation raised by government is called other liabilities. But it is to be noted that Public Accounts of India doesn't contain other liabilities only. There are some other receipts also.

3. Contingency Fund of India

It is created by Article 267 of the Constitution to meet unforeseen expenditure. It is held at the disposal of Honourable President of India. He/she can meet the expenditure and get the approval of parliament later.

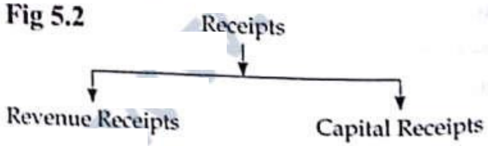
RECEIPTS

Before getting into the details of receipts it is necessary to see the difference between receipts and revenue. Revenue belongs to the receiver. It need not be repaid by the receiver. If we take an individual the salary received by him is his revenue. Receipts include revenue apart from others. For example loan received also included in receipts. The loan received needs to be repaid. The figure 5.2 explains this relationship.



As per Articles 112 and 202 of Indian constitution it is necessary to distinguish revenue expenditure from other expenditure. In addition to this classification Indian budget classifies receipts also alike.

Fig 5.2



A. Revenue Receipts

Revenue receipts are those receipts which need not to be paid again to the payee by government and income from government assets. These are necessarily one way transaction i.e no need to return the receipts and it is a onetime settlement. Revenue receipts are three types:

1. Tax Revenues
2. Non – tax Revenues
3. Other non-tax receipts

1. Tax Revenues

The revenue generated by levy and collection of taxes by central government is called tax revenue.

i. Union Excise Duties

It is the tax on production of commodities.

ii. Customs Duties

It is the tax on export and import of commodities from and to the country.

iii. Corporate Tax

It is levied on the company's profit income. There is no any separate tax called corporate tax. It is also income tax. But the contribution of tax from corporate to the income tax is large. So it is shown in separate head.

iv. Income Tax (Personal income tax)

It is a tax on the personal income of the individuals, Hindu Undivided Families (HUFs), partnership firm etc.

v. Service Tax

It is a tax on the services consumed by consumers.

vi. Taxes of Union Territories

In India, Union Territories [except Delhi and Puducherry] are under the direct administration of the Centre. So their tax income is lumped and taken into account in the central budget.

vii. Other Taxes and Duties

Tax income from other taxes like wealth taxes are lumped together under this category.

2. Non Tax Revenues

i. Interest Receipts

It is the interest income from the loans given by the central government to state governments and other government bodies.

ii. Dividends and Profits

Dividends are income from the shares held by governments in private enterprises and semi government enterprises. Profits are dividend income from the fully government owned enterprises.

3. Other Non-Tax Receipts

i. Fiscal Services

a) Currency, Coinage, Mint

These are profit from the circulation of currency and coins. The profit is the difference between the face value and cost incurred to produce it. For example consider that cost incurred to produce a five rupee coin is 50 paisa. Then profit to government is ₹ 4.50 from a five rupee coin.

b) Other Fiscal Services

These receipts mainly consist of amount paid by RBI towards international

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2 Control over Public Finance in India S.P.Ganguly, Second revised edition, 2006 p.39

obligations like subscriptions to international bodies and penalties charged by international financial bodies.

ii. Other General Services

Receipts from public services commission, central police etc are included in this category.

iii. Social services

Receipts from departments like education, sports, culture, health, information and publicity etc constitute this category.

iv. Economic services

Receipts of departments like Agriculture and allied activities, irrigation and flood control, energy, transport and communication come under this category.

v. Grants in Aid Contributions

These are receipts from foreign governments and multilateral bodies as gift to the government which need not be repaid. It also includes contribution in the form of material and equipment.

4. Non tax Receipts of Union Territories

Revenues that have been raised in the form of fees, fines etc. within the union territories and from sale of timber and forest produce in Andaman and Nicobar Islands are put under this category.

B. Capital Receipts

These receipts are essentially a two way transactions. It means once disbursed money will come in the form regular income or at the time disposal if any asset was created out of the disbursed money. These receipts can be raised either from already invested amount in the form of loan given /asset created by disposing it or on the assurance that it will be paid back in future if government has not invested already and has no claim over the source of this receipt. In short, they are:

a. Receipts due to disposal of permanent assets

b. Recovery of Loans given to others

c. Fresh loans raised by the government

Capital receipts can be classified into two categories as shown below.

1. Debt capital receipts
2. Non-debt capital receipts

1. Debt capital receipts

Among the above listed capital receipts fresh loans raised (borrowings) by the government along with other liabilities fall under this category. In short

I. Borrowing

II. Other liabilities

I. Borrowings

Borrowings or public debts are money raised on the security of consolidated fund of India and repayable out of it. The borrowings are of two types as under:

A. Internal borrowings

B. External borrowings

A. Internal Borrowings

Money borrowed within the country from

various sources and various instruments is called internal borrowing.

a. Market Loans (net)

Net market loans = Gross market loans - Repayment of old loans

Market loans are raised by issuing bonds (dated securities) to public and financial institutions. They have maturity of 12 months or more. They are generally interest bearing with fixed "coupon" (i.e., periodic interest payment). But after 1992-93 the fixed interest system has been changed and became flexible.

b. Treasury Bills Issued to RBI & Banks

Treasury bills are securities issued by Government treasury. They are of short term nature and in this regard they differ from market loans. They are non-interest bearing (zero interest / zero coupons). These kinds of bonds are called Zero coupon bonds. They are issued at a discount rate. It means security worth of ₹ 1,000 is issued against receipt of amount lower than ₹ 1000. The purchaser of security can redeem the full ₹ 1,000 at a particular date. This is called redeem at par (original value).

There are number of Treasury bills of differing maturity. Till 1991-92 there were only 91 days Treasury bills. It is also called as ad-hoc Treasury bill. It was discontinued from 1997-98. In its place ways and means advance came to be introduced. In 1998-99, 182 days Treasury bills were introduced. But it was replaced by 364 days Treasury bills. Again 182 days treasury bills were reintroduced. 14 days Treasury bills were introduced in 1999-2000.

c. Other Internal Debt

Debt raised to meet budget needs apart from the previous two methods are called other internal debt.

i. Funded Securities

Sometimes short term treasury bills are converted as market loans (long term loans) to defer the repayment. These are called funded securities. And these were made as non-marketable. Sometimes portion of these securities was made marketable. Non-marketable means it cannot be sold to any third party.

ii. Other Special Securities Issued to RBI

Bonds issued by the government to raise funds which were outside its annual borrowing programme like oil bonds, fertiliser bonds were classified as special securities. If these bonds were subscribed by RBI come to be accounted in this head.

iii. Ways and Means Advance

RBI acts as banker to the government. It keeps the bank account of Government. It receives and pays money on behalf of government. If the balance goes negative RBI lends short term interest bearing advance to government. It is called ways and means advance. It is like overdraft facility available to government from RBI, like over draft facility available to current account holders in commercial banks.

International Financial Institutions

These securities issued to international financial institutions like World Bank, Asian Development bank etc. Non-negotiable means they cannot be sold to others by security holders and can be

government is liable to repay. This money is kept in the Public Accounts of India and paid out of it whenever claimed. They are

A. Small Saving Scheme

B. Provident Funds

C. Other Accounts

funds are also included in this category.

These budget liabilities are taken into account while calculating deficits of the government budget if they are drawn from Public Accounts for the purpose of government expenditure.

b. Preferential allotment of shares of the CPSE to promoters as per SEBI (Issue of Capital and Disclosure Requirements) Regulations, 2009 so that Government shareholding does not go down below 51% in all cases where the CPSE is going to raise fresh equity to meet its Capex programme.

c. Recapitalization of public sector banks and public sector insurance companies.

d. Investment by Government in RRBs/ IIFCL/NABARD/Exim Bank;

e. Equity infusion in various Metro projects;

f. Investment in Bhartiya Nabhikiya Vidyut Nigam Limited and Uranium Corporation of India Ltd.;

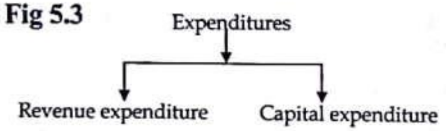
g. Investment in Indian Railways towards capital expenditure

The allocations out of the NIF will be decided in the Government Budget.[3]

EXPENDITURES

The public expenditure can be classified as shown in the figure.

Fig 5.3



A. Revenue Expenditure

Expenditure incurred to meet day to day and regular needs expenditure of government and that will not yield any revenue in future are termed as revenue expenditure. It is a one way payment. It means if government spends money it cannot recover it. These are

3 http://www.divest.nic.in/Nat_inves_fund.asp

1. Interest Payments

Interest paid on borrowing and other liabilities and discounts on treasury bills do constitute this category.

2. Defence, Police

Expenditure towards law and order come under this head. Though defence equipments are capital in nature considered as revenue expenditure. But all the defence equipments are not in revenue expenditure nature.

3. Subsidies

Subsidies on public distribution, fertilisers etc. are included in this category.

4. Grants to States & Union Territories

Grants given by Centre to states and union territories come under this head. Though these grants are spent under capital expenditure by receiving governments come under this head as stipulated by Article 34(c) of the Audit Code.

5. Pensions and Salaries

Pensions and salaries of central government departments, and those paid out of consolidated as charged expenditure come under this category. Charged expenditure means the expenditures that can be spent without vote (approval) of legislature.

6. Economic Services

Non capital Expenditure towards Agriculture, Industry, Power, Transport, Communication etc are included in this item.

7. Other General Services

Non capital Expenditure towards Organs of States, tax collection external affairs etc are included in this item.

8. Social Services

Non capital Expenditure towards Education, Health, Broad casting etc.,is included in this item.

9. Postal Deficit

Postal department is unable to meets its expenditure out of its own revenue. This short fall crosses ₹ 1,000 Crores. This is met by central government.

10. Expenditure on Union Territories without Legislatures

Expenditure towards administration and other expenditure on Union Territories without legislatures come under this item.

11. Grants to Foreign Governments

Grants given to foreign governments like Bhutan, Nepal, and some other developing countries towards their developmental expenditure and aid given during disaster, natural calamities to all foreign countries constitute this category.

B. Capital Expenditure

In general expenditures that create permanent assets and yield periodical income and loans given to state governments and local bodies are called capital expenditure. It is a two way payment. It means spent money can be recovered through periodical income and/ or by disposal of asset created.

In addition as per Article 34 of the Audit Code, the following considerations are relevant in arriving at a decision whether or not expenditure is of capital nature.[4]

(a) It is not essential that the concrete assets should be productive in character or that they should even be revenue producing. A productive asset may be considered as one which produces sufficient revenue to afford a surplus over all charges relevant to its functioning. It may on rare occasions be necessary and justifiable to treat as a capital scheme not commercially remunerative but involving large expenditure, say for construction of a new city.

(b) The purpose of commutation of recurring liabilities is their extinction or reduction. Although expenditure on this purpose may be genuinely capital expenditure, it is always necessary to examine from the point of view of economic financial administration whether such capital expenditure does not in fact merely replace one set of recurring payment by another, for example, where commutation by debit to capital of pension payment does not result in the substitution of equivalent payments of interest.

(c) It is inherent in the definition of capital expenditure that the assets produced should belong to the authority incurring the expenditure. Expenditure by Government

4 Control over Public Finance in India S.P.Ganguly, Second revised edition 2006 p.47

on grants-in-aid to local bodies or institutions for the purpose of constructing assets which will belong to these local bodies cannot legitimately be considered as capital expenditure.

(d) Expenditure on a temporary asset cannot ordinarily be considered as expenditure of a capital nature.

Plan and Non-Plan Expenditure*

Before the setting up of NITI Aayog, India was following planned development through 5 year planning. So in the plan, the expenditure came to be classified as plan and non-plan expenditure.

Plan Expenditure

Expenditures envisaged in 5 year plan documents are called as Plan Expenditure. It has both revenue and capital component like expenditure on Central Plan.

Non-Plan Expenditure

Expenditures not envisaged in the 5 year plan documents are called as Non Plan Expenditure. It also has both revenue and capital component of expenditure.

DEFICIT

Deficit means shortage. Here deficit means shortage of money for expenditure. The gap between the receipts and expenditure is called deficit. There are various types of deficits which are explained below. (In the case of equations, you just keep in mind the words in italics. The words in normal letters are to make its components in detail).

** Italics: This may not be relevant in the context of NITI Aayog. However, for the purpose of conceptual clarity the topic is given*

Budget Deficit

It is the difference between Total Expenditure and Total Receipts. Budget deficit is always zero. It doesn't have any meaning in central government budget. So

Budget Deficit = Total Expenditure – Total Receipts

= (Capital expenditure + Revenue expenditure) – (Capital Receipts + Revenue Receipts)

= (Capital expenditure + Revenue expenditure) – {(Borrowings and other liabilities + Receipts other than Borrowing) + (Revenue Receipts)}

Revenue Deficit

Revenue deficit is the difference between revenue expenditure and revenue receipts.

Revenue Deficit = (Revenue Expenditure – Revenue Receipts)

Or

= [Current Revenue Expenditure – Current Revenue Receipts]

Fiscal Deficit

Fiscal Deficit is the difference between Total Expenditure and Total Receipts except Borrowing and Other liabilities.

Fiscal Deficit = Total Expenditure – Total Receipts except Borrowing and Other liabilities

= Total Expenditure –[Capital Receipts other than Borrowings and other Liabilities + Revenue Receipts]

= Budget Deficit + [Borrowing from RBI + Public borrowing and other liabilities]

To be precise about fiscal deficit it is the amount of *Borrowing and other Liabilities.*

Primary Deficit

Primary Deficit is measured by subtracting the interest payments from fiscal deficit. It is a measure of current year's fiscal operation after excluding the liability of interest payment created due to borrowings under taken in the past.

Primary Deficit = Fiscal Deficit – Interest Payment

Monetised Deficit

Monetised deficit goes beyond the Government budgetary operations. This represents increase in the net RBI credit to the Union Government which is the sum of increases in the RBI's holding of Government debt plus any draw down by the Government of its cash balance with RBI. To say simply, the monetised deficit represents the expansion in money by the RBI.

Monetised Deficit = Borrowing from RBI + Draw down balance of government from RBI

TYPES OF BUDGET

There are different kinds of budget. These budgets have different principle to achieve best results. They are explained in the following passage.

Performance and Programme Budgeting

In this budget the chosen programmes/ projects are subjected to the tests of actual performance against their expected standards. So it involves stage wise plan and standard fixation to assess performance of programmes. It establishes a correlation between physical (output) & financial (input) aspects of each programme and activity.

It was introduced in India in 1968 for 4 ministries and in 1975 – 76 for all developmental departments.

Outcome Budget

It is the compilation of anticipated and intended outcomes of various ministries. Outcome is not just the physical output of financial input. Outcome means the benefits arise out of physical output from respective financial input. For example if 'n 'number dams constructed out of allocated money it is physical output. The rise in the productivity of fields getting irrigation facility form these dams and resultant increase in the income of farmers etc is Outcome. 1st outcome Budget was introduced in August 25, 2005.

Zero based Budget

In this budgeting all the schemes and programmes are not included in every year budget just for the reason being that they already exist. Under it every scheme should be reviewed critically and re-justified that why they have to be included in the coming budget. It involves a consideration that there is no existing schemes/programmes and the budget has to be started from scratch/ zero base. So it is called as Zero based Budget. Finance ministry has the plan to introduce it in future.

TAX

Tax is a compulsory levy payable by an economic unit to the government without any corresponding entitlement to receive a definite and direct quid pro quo from the government. Quid pro quo means something given or taken equivalent to another.

Broad Areas of tax

a. Tax on income and expenditure

Taxes imposed on Personal income, Corporate income, Sales tax and like come under this area.

b. Tax on commodities

Taxes like Excise duty, Custom duty fall under this category.

c. Tax on Property & Property Transaction

Taxes like wealth tax, Estate & Succession duties are classified under this category.

Tax Base

Tax base is the legal description of the object with reference to which the tax is payable. It may have time dimension like year, month.

E.g. Base of excise duty is production of commodities.

Base of income tax is income of individual.

Tax Buoyancy

It measures actual or observed change in Tax revenue relative to GDP.

Tax Buoyancy = Proportionate change in the tax revenue/Proportionate change in GDP

Tax Buoyancy = %ΔT/ %ΔGDP

Where,

ΔT = Change in Tax revenue

ΔGDP = Change in Gross Domestic Product

Here, the change in the tax can be for two reasons one is due toautomatic increase and another one is due to discretionary changes that is change in tax rate or coverage or both.

Change in tax rate will lead to change in tax revenue. Change in coverage means bringing new group of economic units (tax base) into or leaving existing groups out of taxation. The introduction of negative list in service tax is an example for this. The negative list system brought all the services into service tax net except services listed in the negative list.

Tax Elasticity

Proportionate change in tax revenue, without any discretionary change, relative to GDP is called tax elasticity. Tax revenue that is calculated after setting aside the change in tax revenue due to discretionary changes is called adjusted tax revenue.

Tax Elasticity = Proportionate change in Adjusted tax revenue/Proportionate change in GDP

Tax Elasticity = %ΔAT/%ΔGDP

Where,

ΔAT = Change in Adjusted Tax revenue

ΔGDP = Change in Gross Domestic Product

Example,

Total change in tax revenueis 20%. Out of this, change in tax revenue automatically is 10% and due to discretionary changes like change in tax rate is 10 %.

Change in GDP is 10 %. Then

Tax Buoyancy = 20/10 = 2

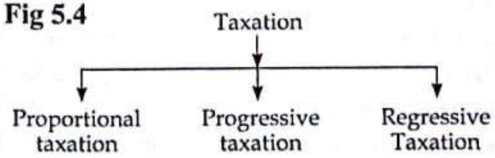
Tax Elasticity = 10/10 = 1

These measures help in forecasting the tax revenue and in deciding the policy regarding tax rate and coverage to achieve targeted tax revenue.

CLASSIFICATION OF TAXATION

The taxation can be classified mainly into three types as shown in the figure 5.4.

Fig 5.4



Proportional Taxation

Tax levied as a % of tax base irrespective of size of tax base, at a uniform rate is called as proportional tax. For example both who receive income/spend/purchase worth of ₹10,000 and ₹100,000 pay equal % of tax.

Table 5.1

Size of tax base	Tax rate	Tax amount
₹ 10,000	10%	₹ 1,000
₹ 100,000	10%	₹ 10,000

Here the % of tax rate remain the same but the absolute amount of tax increases with increase in size of tax base.

Progressive Taxation

If tax rate increase with the increase in size of tax base, it is called progressive tax. For example, those who receive income/spend/ purchase worth of ₹ 100,000 pay higher tax rate than those of ₹ 10,000.

Progressive taxation helps to ensure economic equality in the society.

Table 5.2

Size of tax base	Tax rate	Tax amount
₹ 10,000	10%	₹ 1,000
₹ 100,000	20%	₹ 20,000

Here the % of tax rate as well as the absolute amount of tax increases with increase in size of tax base.

Regressive Taxation

If tax rate decrease with the increase in the tax base it is called regressive tax. Here those who receive income/spend/purchase worth of ₹ 100,000 pay lesser tax rate than that of ₹ 10,000.

Table 5.3

Size of tax base	Tax rate	Tax amount
₹ 10,000	10%	₹ 1,000
₹ 100,000	5%	₹ 5,000

Here the % of tax rate decrease but the absolute amount of tax increases with increase in size of tax base but less than that of proportional and progressive taxation.

Impact of Tax

Impact of a tax is on its first point of contact with the tax payers. It is upon those who bear the first responsibility of paying it to the authorities. In case of Income Tax it is income recipient. In case of Sales Tax it is Seller.

Incidence of Tax

Incidence of a tax is on its final resting place, i.e. those economic units which finally bear the money burden of tax, and which are not able to pass it to others. In case of income tax, it is the income recipient who has to bear the money burden of paying tax. In case of Sales tax, tax is paid by seller but ultimately paid by consumer along with price. Here the seller acts as an intermediate between government and consumer by collecting tax along with price. While the seller can pass the tax burden to the consumer, the consumer cannot. So the seller is point of impact and consumer is point of incidence.

Effects of Tax

When a tax is imposed and collected, it elicits certain responses from tax payer which have influence on working hours, saving, investment etc. Such responses and their results are called Effects. For example, if heavy tax is imposed on spending, people will save more to avoid tax burden.

METHODS OF TAXATION ON GOODS

1. Ad valorem

If tax is levied as a % of the value of the goods regardless of number of units produced/sold/imported, then it is called ad valorem e.g. 10% on the value of car. Revenue increases with rise in price. Let us take an example. If price of the car is ₹ 2 lacs, the tax amount is ₹ 20000 and if the car price increase to ₹ 4 lacs the tax amount is ₹ 40000.

2. Specific duty

If tax is levied at a flat rate per unit of goods produced/sold/imported regardless of the value then it is called specific duty. E.g. ₹ 2 per 1kg of iron, ₹ 3 per 1mt of cloth. Revenue increases only with number of units not with value. Let us take the above example: the tax amount will not increase if car price increase from ₹ 2 lacs to ₹ 4 lacs if tax of ₹ 10000 per car is imposed. Tax revenue will increase only if car sales increase from one to two. The tax revenue will increase from ₹ 10000 to ₹ 20000.

In some cases, both type of tax is levied on the same good, e.g. ₹ 10,000 per car plus 10% on the value of car.

TYPES OF TAXES

There are two types of taxes namely

1. Direct Tax
2. Indirect tax

1. Direct Taxes

If the impact and incidence lies on same point it is called as direct tax. E.g. income tax levied on 'X' person paid by the same 'X' person.

Direct taxes are progressive in nature in India and all over the world and are highly elastic in nature.

Income Tax (Personal income tax)

It is a tax on the personal income of the individuals, Hindu Undivided Families (HUFs), partnership firm etc.

Corporate Tax

It is levied on the company's profit income. There is no any separate tax called corporate tax. It is also income tax. But the contribution of tax from corporate to the income tax is large. So it is shown in separate head.

Wealth tax

It is imposed on the accumulated wealth or property of every individual, Hindu undivided family. Wealth tax is chargeable in respect of the net wealth exceeding ₹30 lakh at 1%. It does not yield enough revenue to the government.

Securities Transaction Tax (STT)

It was introduced in 2004 – 05. It is a tax imposed on transactions of Securities in Stock Exchanges.

Commodities Transaction Tax

It is a tax on the sale of commodities in Commodity Exchanges. It was introduced in 2013-14.

Minimum Alternate Tax (MAT)

It is a tax imposed on companies, which escaped corporate tax net or pay very low tax by using the provisions of exemptions, deductions, incentives etc, which are called Zero tax companies. It was introduced in 1996 – 97. In case, total income of the company after availing all eligible deductions is less than 30% of the book profits, the company shall be charged to a minimum tax as a percentage of total income. This is to ensure that companies pay at least a minimum amount of tax.

The same kind of tax imposed on commercial establishment other than companies like partnership firm, limited liability partnership firm etc., is called **Alternate Minimum Tax.**

2. Indirect Tax

If impact is on one point and incidence on some other point, it is called indirect tax. E.g. excise duty – levied on producer, but ultimately paid by consumer along with price.

Irrespective of spending capacity and purchasing power of people usually all were charged equal % of tax. It is well known that ₹10 is a big amount for a person who earns ₹100 per day but it is not the case for a person who earns ₹1000 per day. In this case, if both were required to pay equal amount of tax of ₹10, it puts higher burden on the first person than second. So these taxes are considered as regressive in nature.

But by imposing higher rate of taxes on luxury goods and lower rate of taxes on essential goods the progressiveness of indirect taxes is ensured to some extent.

Excise Duties

It is the tax on production of commodities

Customs Duties

It is the tax on import and export of commodities.

ModVAT (Modified VAT)

L.K. Jha Committee recommended it in 1976. It is an excise duty. Introduced as MANVAT (Manufacturing VAT). Then it was changed as ModVAT in 1986-87). Here, the taxes levied on final goods, tax on inputs and intermediate goods were abolished. Different tax rates were levied on different goods. Then it was modified as CENVAT (Central VAT) in 2000 – 2001 with uniform rate on all goods covered under this tax scheme.

Sales Tax /VAT (Value Added Tax)

It is a tax on sale of commodities. It is a state level sales tax. The tax rate is imposed as a% of value added. Hence, it is called VAT. Here consider a cotton shirt production. First the cotton sold is taxed. It is bought by a spinning mill owner. He has to pay for cotton including sales tax on it. He processes it into yarn and sells it to a weaver. Again sales tax is imposed. Here, the price includes cost of the cotton + sales tax on cotton + value added by spinner. So the tax amount already paid also gets taxed. It continues till the end product. It inflates the price of the end product. This is called the cascading effect. To avoid this and to bring about uniformity in sales tax throughout the country, it has been converted into VAT (Value Added Tax).

VAT was introduced with effect from April 2005. It is a multi-level tax. Here the different processors were repaid for the tax paid by them on their respective inputs. It is called **input tax credit or tax credit**. In the above example the spinner is repaid the sales tax paid by him on cotton. So producer pay tax only on the value added by him. Tax on tax is avoided. Cascading effect is undermined. So price rise is avoided.

Special features of VAT

Totally 550 goods come under VAT.

Two basic rates 4% and 12.5%

1 % for gold and silver ornaments

Exemption to 46 items comprising of natural unprocessed products in unorganized sector

Small traders with turnover up to ₹ 10 lakh

exempted from the provision of VAT

Central Sales Tax

It is a tax on Sale of commodities in the interstate trade. It is imposed by the Union government but collected and retained by the state where the interstate trade commences.

It was 4%. It has to be phased out from April 1, 2007 by 1% every year and to be brought to zero by 2010. But it is still at 2 %.

Under the regime of GST Integrated GST (IGST) is proposed in place of CST.

Service Tax

It is a tax on the services provided. It was introduced in 1994-95. It is like sales tax. While sales tax is imposed on goods, it is imposed on services. Usually it is imposed on the service provider. For some service it is on the person who avail service. It is called "reverse charge". For some services it is imposed partially on service provider and partially on the person receiving the service. It is called "partial reverse charge or joint charge"

From 1st july of 2012 all the services are taxable barring the services listed in Negative List. Negative list is list of services which do not attract service tax.

GST (Goods and Service Tax)

It is a uniform tax on goods and services throughout the country. It is supposed to be implemented from 2010. It will have all features of VAT. In VAT, only goods are taxed but in GST both goods and services will be taxed on the basis of value addition method. If it comes, the taxes like excise duty and octroi will go away. There will be two GSTs namely State GST and Central GST.

If it is implemented the tax rate throughout India will be more or less same. So, it will give a feeling of India as single market. There will be no competition between states to reduce tax and attract investment. As multiple taxes go away, the cost to tax payer will come down. The price of goods and services will come down.

Octroi

It is a tax on the entry of goods into a local area for consumption, use, or sale. This is a check post based levy collected at entry points into urban local bodies.

FRBM ACT 2003

[Fiscal Responsibility and Budget Management Act]

FRBM Act was enacted in the year 2003 with the purpose of correcting the fiscal imbalances like high revenue and fiscal deficit. Apart from provisions of the act, FRBM rules also framed which fix targets of deficits among other things. Special features of the act and rules are as under.

Act

- Central Government to take appropriate measures to reduce the fiscal deficit and revenue deficit so as to eliminate revenue deficit by March 31, 2008 and thereafter build up adequate revenue surplus

• Rule to be made under this Act to specify the annual targets for reduction of fiscal deficit and revenue deficit, contingent liabilities and total liabilities

• The revenue deficit and fiscal deficit may exceed targets specified in the rules only on grounds of national security or national calamity or such other exceptional grounds as the central Government may specify

• The Central Government shall not borrow from the RBI except by way of advances to meet temporary excess of cash disbursements over cash receipts

• RBI not to subscribe to the primary issues of the Central Government securities from the year 2006 – 07

• Central Government has to take suitable measures to ensure greater transparency in its fiscal operations. As a part of it, Central Government has to lay in each financial year, before both houses of parliament, three statements with Budget. They are:

1. Macroeconomic Frame Work

It contains assessment regarding the GDP growth rate, fiscal balance of the Central Government and the external sector balance of the economy.

2. Fiscal Policy Strategy Statement

The Statement explains how the current policies are in conformity with sound fiscal management principles and gives the rationale for any major deviation in key fiscal measures.

3. Mid-Term Fiscal Policy Statement

The Mid-term Fiscal Policy Statement, sets out three-year rolling targets for four specific fiscal indicators in relation to GDP at market prices namely

(i) Revenue Deficit

(ii) Fiscal Deficit

(iii) Tax to GDP ratio and

(iv) Total out-standing Debt at the end of the year

The Statement includes the underlying assumptions, an assessment of sustainability relating to balance between revenue receipts and revenue expenditure and the use of capital receipts including market borrowings for generation of productive assets.

Rules

• Finance Minister to make a quarterly review of trends in receipts and expenditure in relation to the budget and place the review before both houses of parliament

• Reduction of revenue deficit by an amount equivalent of 0.5 per cent or more of the GDP at the end of each financial year, beginning with 2004 – 05 and to be brought to zero by 2008-09

• Reduction of fiscal deficit by an amount equivalent of 0.3% or more of the GDP at the end of each financial year, beginning with 2004 – 05, so that deficit is less than

3% by 2008 – 09.[5]

• No assumption of additional liabilities (including debt at current exchange rate) in excess of 9% of GDP for the financial year 2004 - 05 and progressive reduction of this limit by at least one percentage point of GDP in each subsequent year to 6% by 2007 – 08.

• No guarantees in excess of 0.5 per cent of GDP in any financial year, beginning with 2004 – 05.

• Four fiscal indicators namely (i) Revenue deficit as a percentage of GDP, (ii) Fiscal deficit as a percentage of GDP, (iii) Tax revenue as percentage of GDP and (iv) Total outstanding liabilities as percentage of GDP are to be projected in the medium term fiscal policy statement.

• For greater transparency in the budgetary process, rules mandate the Central Government to disclose changes, if any, in accounting standards, policies and practices that have a bearing on the fiscal indicators.

• The Government is also mandated to submit statements of receivables and guarantees and a statement of assets, at the time of presenting the annual financial statement, latest by Budget 2006 – 07.

• The rules prescribe the form for the quarterly review of the trends of receipts and expenditures. The rules mandate the Central Government to take appropriate corrective action in case of revenue and fiscal deficits exceeding 45 per cent of the budget estimates, or total non- debt receipts falling short of 40 per cent of the budget estimates, at the end of first half of the financial year.

5 The Government unveiled a revised fiscal consolidation map in October 2012. It targeted a fiscal deficit of 4.8 % for 2013-14 and through correction of 0.6 percentage point each year thereafter, a fiscal deficit of 3.0 percent of GDP by 2016-17.

TAX REGIMES OF CENTRE & STATE

The Indian Constitution makes clear division of fiscal powers between the Centre and State governments in the 7th schedule.

The list I of 7th Schedule – Centre

1. Tax on income, other than agriculture income
2. Corporate tax
3. Customs duties
4. Excise duties except on alcoholic liquors and narcotics not contained in medical or toilet preparations
5. Estate & Succession duties other than agricultural land
6. Taxes on Capital value of assets except agricultural land (Capital Gain Tax)
7. Rates of Stamp duties on financial documents
8. Taxes other than Stamp duties on transactions in stock exchanges and future markets

9. Taxes on Sales & Purchases of newspapers and on advertisements therein
10. Tax on railway freight and fares
11. Terminal taxes on goods or passengers carried by railways, sea or air
12. Taxes on the sale or purchase of goods in the course of interstate trade

List II - State

1. Land Revenue
2. Taxes on Sale and purchase of goods except news papers
3. Taxes on agricultural income
4. On land and buildings
5. Succession and estate duties on agricultural land
6. Excise duty on alcoholic liquors and narcotics but not including medicinal and toilet preparations
7. On the entry of goods into a local area
8. On the consumption and sale of electricity
9. On mineral rights (Subject to any limitations imposed by the parliament)
10. On vehicles, animals and boats
11. Stamp duties except those on financial documents
12. On goods and passengers carried by roads or inland water ways
13. On luxuries including entertainments betting and gambling
14. Tolls
15. On professions, trades, callings and employments
16. Capitation taxation
17. On advertisement other than those contained in newspapers
18. In the above division, more revenue yielding taxes are in the domain of the Centre. But the same constitution allocates more social and economic responsibility to states. To meet these responsibility states need more revenue. So the same constitution makes provisions to share the taxes of Centre between Centre and States.

Tax Sharing Mechanism

The Finance commission and Parliament are the two institutions for the tax sharing between Centre and states, and distribution of states' shares among different states. Now 80th and 88th amendments of the constitution govern this mechanism.

Before 80th amendment, only few taxes were sharable between Centre and States. The taxes like the corporate income tax were not sharable. The states demanded share in these taxes also. After taking into account this demand, the 10th finance commission recommended amendments in the constitution. The recommendation was accepted and the 80th amendment was made. As per 80th amendment, for

the first time, 11th finance commission recommended sharing of all taxes.

After 80th Amendment, 2000

Art 270

All taxes and duties referred in the Union list except

a. Taxes come under Art 268

b. Taxes come under Art 269

c. Surcharge and

d. Cess

became sharable between Centre and the States. The share is decided by Finance commission

Art 268

a. Stamp duties and

b. Excise duties on toilet and medicinal purpose

are the taxes coming under this Article.

These taxes are levied (imposed) by Union government but collected and appropriated by states.

Art 269

As per this article the power to impose and collect following taxes is with the centre and the revenue has to be shared among states.

a. Interstate sale & purchase and

b. Interstate consignment

Under Central Sales Tax Act 1956, this tax imposed by Central government but the tax is collected by states. For this each state framed rules. The tax is collected and appropriated by the state from where the trade originates. Interstate consignment means transportation of goods from manufacturer to franchise to be sold to ultimate consumers. The franchise sell commodity on commission basis. It means the sales do not take place between manufacturers and franchise. But as the goods are ultimately sold CST is imposed.

Art 252

This article has the provision for the enactment of law in state subjects by parliament on the request of legislatures of two or more states. Under this article, any tax coming under the states' domain can be handed over to Parliament regulation. It is called Rental arrangement. As of now, there is no any such arrangement.

After 88th Amendment, 2003

Art 268 (A)

Under this article, Service Tax was introduced. As per this article this tax can be levied by Union government only but can be collected and appropriated by centre and states as per the law made by the Parliament.

In this regard the Central government enacted Service Tax Act 1994. But this tax is imposed as well as collected by Central government only. But this tax is sharable between centre and states. The share from Service tax collection is determined separately apart from other taxes that are shared.

National Emergency & Tax Sharing

Above mentioned provisions are applicable only in the normal times. In case of national emergency, under Art 358 (b), Parliament can make law to impose tax and duties even though not in union list and under Art 354, President may change provisions of articles from 268 to 279 during emergency.

RELATED TERMS

Cess

It is a tax additionally levied as a percentage of existing tax amount for specific purpose. For example, educational cess of 3% is levied on all central taxes. Let us take service tax rate as 12%. Then 3% of 12% is equal to 0.36%. Therefore, total tax rate is 12.36%. The tax amount collected as cess should not be used for purposes other than the purposes for which it is meant for.

Surcharge

It is also like cess. A tax additionally levied as a percentage of existing tax amount, but without any specific purpose. It is levied if the size of the tax base exceeds a certain threshold limit. For example corporate income tax up to ₹ 1 Cr is 30% on domestic companies and surcharge is 10% if income exceeds ₹ 1 Cr.

Note : the tax rate given here is an example. It keeps changing.

Countervailing duty

To encourage export, countries give subsidy to exporters. So, the cost of production for exporters comes down. Hence, exporters are able to export to other countries at a cheaper rate. It largely affects producers of the importing country. To counterbalance (countervail) this, importing countries impose duty on imported goods to raise the price of subsidized product to offset its lower price. This is called countervailing duty.

Anti-Dumping Duty

Dumping means exporting goods to other country in large quantity at a cheaper rate. There are two types of dumping.

1. Price dumping

It means selling goods in foreign country at price lower than the price of home country.

2. Cost dumping

It means selling goods in foreign countries at a price lower than cost of production. It is mainly aimed at wiping out the domestic producers from the market. It is also called **Predatory Dumping.**

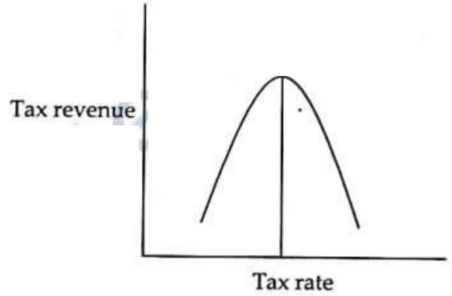
Duty Imposed on dumped goods is called Anti-Dumping Duty. Please remember that countervailing duty is to counter low cost and low price because of subsidy but anti-dumping duty is to counter voluntary low price to capture market.

Laffer curve

Laffer curve explains the relationship

between tax rate and tax revenue. It says that at lower as well as higher rate of tax, the tax revenue is low but tax revenue is high at optimal rate of tax. At lower rate, the tax collection is low. At higher rate of tax, there is high tax evasion and so there also the tax revenue is low. But, at optimal rate, there is no tax evasion and so the tax revenue reaches its maximum. The following figure 5.5 explains this.

Fig 5.5



Off-budget Liabilities

These liabilities arise not because of borrowing or use of the public money by government. These are money liable to be paid by the governments to various entities as a policy matter. For example, government has stake in keeping prices (inflation) at control. So, it does not allow the oil marketing enterprises (OMEs) to raise prices when the price of crude oil rises in the international market. In this regard, oil marketing companies incur some losses. To bear these losses in part, the Government issues bonds to OMEs. These bonds are interest bearing and have to be paid as money at the time of maturity. When these liabilities are not considered in calculation of deficits in the budget, though are equivalent to borrowed expenditure, come to be called as Off-budget liabilities.

Fiscal Slippage

If the actual fiscal deficit is more than what was expected it is called as fiscal slippage. For example in the budget, estimated fiscal deficit was 4.5% but the actual deficit at the end of the financial year is 7%, then it is called fiscal slippage.

Fiscal consolidation

Fiscal consolidation refers to long term permanent strategies to eliminate deficit by increasing the revenue and reducing the expenditure. The strategies dominated by revenue increasing method are preferred.