# General Knowledge Today



# Government Budgeting-1: Basic Concepts For Prelims

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**Prelims MCQ Topics**

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# Fiscal Policy

Fiscal policy refers to all the means which influence the income and expenditure of the Government. Since most of the government income comes from taxation and most of the government expenditure goes to public expenditure, these two viz. taxation and public expenditure are main fiscal policy instruments. Any government policy stance that influences the government taxation and government spending – would be termed as a fiscal policy.

Any changes in the level and composition of taxation and government spending can affect the economy because –

- This can bring a change in the aggregate demand and the level of economic activity
- This can bring a change in the pattern of resource allocation
- It can bring a change in the distribution of income.

A welfare government tries to reallocate income by designing tax systems that treat high-income and low-income households differently.

## Types of Fiscal Policies

There are three types of the Fiscal Policies viz. neutral, expansionary and contractionary.

### Neutral Fiscal Policy



A neutral fiscal policy means that total government spending is fully funded by the tax revenue. The government takes a neutral fiscal policy stance when the economy is in a state of equilibrium.

### Expansionary Fiscal Policy

An expansionary fiscal policy means that the government spending is more than tax revenue. Government needs to spend more than its revenue during the time of recessions. This is because recession occurs when there is a general slowdown in economic activity. Recessions generally occur when there is a widespread drop in **overall spending**. Recessions may be triggered by various events, such as

- financial crisis
- External trade shock,
- Adverse supply shock
- Bursting of an economic bubble.

*Governments usually respond to recessions by adopting expansionary fiscal policies*, such as increasing money supply, increasing government spending and decreasing taxation. When the tax is decreased, there is more money left with people, who can spend more.

### Contractionary fiscal policy

Contractionary fiscal policy occurs when government spending is lower than tax revenue. When the tax revenue of the government is more, the excess money can be used to pay the government debt.

## Difference between Fiscal Policy and Monetary Policy

**Fiscal policy** deals with the taxation and expenditure decisions of the government. On the other side, the **monetary policy** deals with the supply of money in the economy and the rate of interest. The Fiscal Policy and the monetary policy are the main policy approaches used by economic managers to steer the broad aspects of the economy. In India as well as almost all countries, the *government deals with fiscal policy while the central bank (RBI in India) is responsible for monetary policy.*

## Implications of Fiscal Policy on the Economy

Fiscal policy is composed of several parts such as taxation policy, expenditure policy, investment / disinvestment policies, debt and surplus management etc. Fiscal policy is an important constituent of the overall economic framework of a country and is therefore intimately linked with its general economic policy strategy. Moreover, fiscal policy has direct relation with the economic trends. The fiscal policy directly influences monetary policy. When the government receives more than it spends, it has a surplus. If the government spends more than it receives it runs a deficit.

# Government Receipts and Expenditures

The most basic thing in public finance is to know the difference between revenue and capital flows, be they receipts or expenditures. On this basis, there are four elementary concepts viz. Revenue Receipts, Revenue Expenditures, Capital Receipts and Capital Expenditures. On the basis of these four elementary concepts, the government budget can be divided into two parts viz. Revenue Budget and Capital Budget. While revenue budget deals with revenue receipts and expenditures; capital budget deals with capital receipts and expenditures. *Revenue budget is also known as Current Budget.*



## Revenue Budget

Revenue budget deals with revenue receipts and expenditures of the government.

### Revenue Receipts

The term "Revenue Receipt" is made up of two words revenue and receipts. Any income that *does not generate a liability is revenue*. For example, if the Government borrows money from World Bank, it will increase its liabilities (because this money has to be paid back)- so cannot be called revenue. However, if the government gets the same money has grant (donation), its revenue receipt because grants are not to be paid back.

Taxes are the most important revenues receipts of the governments. However, some revenue receipts are non-tax revenues such as grants. On this basis, revenue receipts are of two types viz. Tax Revenue and Non-tax revenue.

#### Tax Revenues

Tax revenues are either from direct taxes or indirect taxes. Direct tax generally means a tax paid directly to the government by the persons on whom it is imposed. Income Tax, Gift Tax, Wealth Tax and Property tax etc. are direct taxes. Indirect tax is a tax collected by an intermediary (such as a retail store) from the person who bears the ultimate economic burden of the tax (such as the consumer). Sales tax, Value Added Tax (VAT), Goods and Services tax (GST) or any other such tax is an indirect tax. Largest chunk of tax revenues of government of India currently comes from Corporation Tax, followed by Income Tax, followed by Union Excise duties, customs and thereafter service tax. The collection of service taxes is increasing over the last years. The amount collected under Direct Taxes (Corporate/ Income/ wealth) is larger than that under Indirect taxes.

### Non-Tax Revenue

Non Tax Revenue Receipts are those revenue receipts which are not generated by Taxing the public.

- Money which the Government earns as "Dividends and profits" from its profit making public enterprises (PSUs).
- Interest which the Government earns on the money lent by it to external or internal borrowers. Thus this revenue receipts may be in foreign currency as well as Indian Rupees.
- The money which the government receives out of its fiscal services such as stamp printing, currency printing, medal printing etc.



- Money which the Government earns from its "General Services" such as power distribution, irrigation, banking services, insurance, and community services etc. which make the part of the Government business.
- Money which the government accrues as fees, fines, penalties etc.
- Grants the Government of India receives from the external sources. In case of the state Governments, it may be the internal grant from the central Government.

In recent times, spectrum auctions have been one of the major sources of non-tax revenues for the government. We note here, that despite it looks that spectrum amount should be a capital receipt, it is shown as a non-tax revenue receipt in budget documents as one time spectrum charges levied on telecom players.

## Revenue Expenditure

While the Revenue Receipts are those incomes of the Government which don't create additional liability, the Revenue Expenditures are those expenditures which don't create any productive assets. The money in these expenditures goes either in running administration / operation of government or in welfare schemes which don't result in creation of assets. Specific examples are discussed below:

- The **interest paid by the Government of India** on all the internal and external loans does not produce any assets, so it is revenue expenditure.
- The **salaries and Pension paid by the Government to Government employees** is

needed to run the Government's business. It is revenue expenditure.

- The **subsidies forwarded by the government** to all sectors do not produce any productive asset, so it is revenue expenditure.
- The **defense expenditures** which are **needed for smooth operation** of the standing armed forces is a revenue expenditure. However, purchase of equipments produces assets, so that would be a Capital expenditure.
- The **postal expenditures** and deficits are Revenue expenditures.
- The money spent of **maintaining the law and order situation** of the country is also revenue expenditures.
- The money spent on **various social services** such as public health, education, poverty alleviation, scholarships, etc. all revenue expenditures.
- The **grants** given by the Government of India to states and other countries is Revenue expenditures.

## Revenue Deficit and Surplus

If total Revenue receipts are more than total revenue expenditure, it is called *revenue surplus*. If the total revenue receipts are less than total revenue expenditures, it is called *Revenue Deficit*.



## Implications of Revenue Deficit and Revenue Surplus on Economy

Revenue expenditures are a consumptive kind of expenditures and that is why the Governments try to minimize the Revenue deficit. The Revenue deficit does not add into the production of productive assets so, it is considered dangerous to have a large revenue deficit.

Revenue surplus is good because it would give the government some opportunity to use some of the surplus in those activities which might create some productive assets. But the revenue surplus is not appreciated for many other reasons. We can easily understand that if the Tax revenue of the Government is increased, it may give the Revenue surplus to the Government. But ultimately it would not be judicious to burden the public with large taxes. Further, large taxes would result in Tax evasion, corruption and problem of black money. So, the aim of the governments is to have a judicious tax structure, so that the balance is near Zero.

## Primary Deficit

The Revenue expenditures include the interest liabilities of the Government. If the interest liabilities are NOT included from the revenue deficit, it is called primary Deficit.

## How can government increase revenue receipts?

Since the grants are generally fixed, the most common way to increase revenue receipt is to raise taxation. Raising taxation also implies increasing Tax-GDP Ratio and this would include:

- Raising tax rates i.e. direct and / or indirect
- Lowering tax exception slabs
- Impose new taxes, cess or surcharges
- Improving profitability of PSU companies.
- Increasing government business.

**How can government curb the revenue deficit?**

The government can curb the revenue deficit either by increasing revenue receipts or by decreasing revenue expenditure. Revenue expenditure can but reduced by a cut in social expenditures and subsidies. Since both ways have their own economic and political ramifications, government could never achieve what it was supposed to achieve as per the FRBM act. The FRBM act had mandated the government to eliminate revenue deficit by March 2008 (it was later shifted to March 2009). It has never been achieved. The act also mandates the government to place the three separate documents along with Budget documents viz. Macro-Economic Framework Statement, Medium-Term Fiscal Policy Statement and Fiscal Policy Strategy Statement. These statements every time reiterate the government vow to achieve FRBM targets.

**Revenue Deficit in India's budget**



The term Revenue deficit and fiscal deficit are being used in the Government of India Budget since the fiscal year 1997-98. Please note that *since 1997-98, the Government budget has shown revenue deficit every year.*

## Effective Revenue Deficit

The definition of the revenue expenditure is that it must not create any productive asset. However, this creates a problem in accounts. There are several grants which the Union Government gives to the state / UTs and some of which do create some assets, which are not owned by union government but by state government. For example, under the MGNREGA programme, some capital assets such as roads, ponds etc. are created, thus the grants for such expenditure will not strictly fall in the revenue expenditure.

So, to do away with such anomaly, the government introduced the Effective Revenue Deficit concept from Union Budget 2010-11. From 2012-13 onwards the Effective Revenue Deficit is being brought in as a fiscal parameter.

## Definition and logic behind Effective Revenue Deficit

Effective Revenue Deficit is the difference between revenue deficit and grants for creation of capital assets. In other words, the Effective Revenue Deficit excludes those revenue expenditures which were done in the form of grants for creation of capital assets aka GoCA. Such grants include the grants given under:

- Pradhan Mantri Gram Sadak Yojana
- Accelerated Irrigation Benefit Programme
- Jawaharlal Nehru National Urban Renewal Mission
- MGNREGA etc.

The logic is clear; these expenses despite being shown in the accounts as Revenue Expenditures, are involved with asset creation and cannot be considered completely 'unproductive'.

### India's Effective Revenue Deficit?

According to the Interim Budget 2014-15 documents, the Effective revenue deficit is 2.2 % of the GDP and the government projects it to be 1.8% of GDP in fiscal year 2014-15.

| Effective Revenue Deficit | | | | |
|---|---|---|---|---|
| Year → | 2012-2013 | 2013-2014 | 2013-2014 | 2014-2015 |
| Effective Revenue Deficit | 250383 | 205182 | 249005 | 236342 |
| As % of GDP | -2.5 | -1.8 | -2.2 | -1.8 |
| Data in middle row: In Crores of Rupees | | | | |



# Capital Budget

Capital budget deals with the capital receipts and expenditures of the government.

## Capital Receipts

A receipt that results in either reduction in government assets (sale of share, disinvestment) or increase in some liability (government borrowings) is a capital receipt. These receipts are NOT a part of normal operations of government business. Capital Receipts include market loans, external loans, small savings, Government Provident Funds, Accretions to various Deposit Accounts, Depreciation and Reserve Funds of various departments like Railways.

The Capital receipts are of two types viz. Debt receipt and non-debt receipts. The debt receipts are those which government needs to repay along with interest. Non-debt receipts are those which come to the government by sale of some assets. Most of the capital receipts of the government are debt receipts and are shown as liabilities of the Government's balance sheet.

### Borrowings by the Government

The Government borrows from domestic as well as foreign sources. All borrowings are called capital debt receipts. However, interest paid on such borrowings is placed under Revenue expenditures.

It's worth note that Government of India is the largest borrower in India and the market borrowings are the largest source of capital receipts of the Government.

Government raises its market loans by selling dated government securities by Auction since 1992-93. These auctions are conducted by the Reserve Bank of India, as debt manager to the Central Government. These bonds are of either fixed interest rate (called Fixed Coupon Securities) or of floating interest rate (called Floating Rate Bonds (FRB)).

Apart from these, Government also issues short term money market instruments viz. 364/182/91 days Treasury Bills. These treasury bills offer short-term investment opportunity to financial institutions, banks, etc. Finally, government also issues Cash Management Bills, which are issued to meet the temporary cash flow mismatches of the Government. The Cash Management Bills are issues only when Government needs a short term cash. Thus, the maturities of the Cash Management Bills are always less than 91 days. The above borrowings are from the market.

Government also borrows from common people like all of us in the form of small saving schemes. At present, the active small saving schemes are as follows:

- Post Office Saving Account
- Post office fixed deposits of 1, 2, 3 & 5 years
- Post Office RDs (Recurring Deposits)



- Post Office Monthly Income Account
- Senior Citizens Saving Scheme
- National Saving Certificates
- Public Provident Fund (PPF)
- Sukanya Samriddhi Account
- Kisan Vikas Patra
- Monthly Income Scheme

The money of all of these goes to National Small Savings Fund. This fund is a part of Public Account of India and is active since 1.4.1999.All withdrawals are also taken out of this fund. What remains as balance in the fund is invested in the Central and State Government Securities. How should be these invested and in which securities, this is decided by the Government from time to time. At present, the term of Central and State Government Securities is 10 years, 9.5 per cent interest rate.

Then finally, government issues savings bonds for people to invest in them. There are two kinds of Bonds viz. Tax Saving and not Tax Saving. Obviously the interest rate in taxable bonds is higher.

## Miscellaneous Capital Receipts

Miscellaneous Capital Receipts refers to the money receipt by disinvestment of the public sector companies. This money comes from sale of government share / equity in public sector companies. In

2013-14, Government received around Rs. 40,000 crore in lieu of sale of its shares in Hindustan Copper, ITDC, MMTC, National Fertilizer, Neyveli Lignite, State Trading Corporation Ltd, Power Grid Corporation of India Ltd, NHPC Ltd, Indian Oil Corporation, Engineers India Ltd, BHEL, Hindustan Aeronautics Ltd. The money from this disinvestment earlier used to go to '**National Investment Fund**' (NIF). Currently, this fund is merged with the Public Account of India and these proceeds are maintained in the public Account as a separate head – NIF.

The Money from NIF is used for several purposes as decided by the Government. These include recapitalisation of Public Sector Banks', investment in Indian Railways, investment in other public sector units towards capital expenditure.

### Loan Recovery

The money which the Government of India had lent in the past to the states, to the PSUs and to the Union Territories, and to the parties and Governments abroad, when recovered back, are called Capital Receipts. Here, please note that Loan recovery is Capital Receipt but the interest received on these loans is revenue receipts.

## Capital Expenditures

Capital Expenditure is that expenditure which results in increasing of government asset (giving out loans) or reduce in some liability (paying back old loans). Following are the key examples of capital expenditures.

#### Loan disbursals

The loans given by the Government to the states, PSUs and other governments come under Capital Expenditures because such loans are assets of the government.

#### Loan Repayments

The loans that were borrowed in past but are now returned back are included in the capital expenditures; because they result in reduction of liability.

#### Expenditures resulting in asset creation

The government's budget expenditures on infrastructure, machinery, land, roads, bridges etc. and purchase of arms and equipments, modernization of the army etc. are also Capital Expenditures.

### Capital Deficit

In Public Finance or Economy, The term Capital Deficit is not used. Generally, we read about the *Capital crunch which refers to the expenditures needed by the Government for Capital Expenditures.*

## Fiscal Deficit

The term Revenue deficit and fiscal deficit are being used in the Government of India Budget since the fiscal year 1997-98. Fiscal deficit is the difference between total expenditure and total revenue receipts including recoveries of loans and other receipts.

Fiscal Deficit = Total Expenditure – (Revenue Receipts + Recoveries of Loans + Other Receipts)

or

Fiscal Deficit = (Revenue Expenditure + Capital Expenditure) – {(Tax Revenue + Non Tax Revenue) – + Recoveries of Loans + Other Receipts}

## Funding of Fiscal Deficit

The rising fiscal deficit has dominated all discussions on the budget in recent years. The biggest question is that if there is an excess of government's expenditure over its tax and non-tax revenues, where it will be funded from? The answer is that the excess of the government expenditure has to be met with borrowings from the public. To be exact, this borrowing is called fiscal deficit, which is usually expressed as a percentage of GDP.

This also means that a high fiscal deficit runs the risk of government cornering the bulk of the savings, leaving little for corporate and other borrowers (crowding out). Prolonged periods of high fiscal deficit run the risk of raising interest rates and inflation and depressing growth. A deficit of 3% of GDP is seen as sustainable.

- A deficit budget shows that the government proposes to spend more in the coming year than its receipts. A surplus Budget shows that Government will get more receipts and spend less.



- In a developing country like India, the Government always seeks to present a "deficit budget" because it intends to spend more (on development) than what its receives. This is because; the deficit budget symbolizes the concerns of the Government towards the development activities. In India a surplus budget was NEVER presented.

## Current Year Targeted Fiscal Deficit

For 2015-16, Indian Government has aimed to contain the fiscal deficit at **3.9 per cent** of the GDP and the revenue deficit at 2.8 per cent of the GDP in the current fiscal.

## Deficit Financing

The Government, when proposes a deficit budget is well aware of the fact that its total expenditures are going to be more than its receipts. So, it adopts the policies and process which can sustain the burden of the deficit. The process of supporting the budget deficit of the country is called **Deficit Financing**. There are several methods of Deficit Financing such as:

- Borrow from domestic or foreign sources
- Draw upon its foreign exchange reserves
- Print an equivalent amount of money.

Any of the above three activities would tend to influence other economic variables. The following observations must be noted in this context:

- In a general sense, **excessive printing of money** leads to inflation. This is because when government prints too much money, its purchasing power goes down and a situation of *too much money choosing too few goods*

- If the government **borrows too much from abroad**, it leads to a debt crisis. The money that has been borrowed from abroad comes on **sovereign guarantee and is called Sovereign Debt**. Governments usually borrow by issuing securities, government bonds and bills. However not all governments can borrow by these methods. The less creditworthy countries need to borrow directly from World Bank or other financial institutions. The debt may be short term or long term. Inability to service the debt may result in **Sovereign Default** which is another name of **Debt Crisis**.
- If the government **draws down on its foreign exchange reserves**, a **Balance of Payments** crisis may arise. Balance of payments (BoP) accounts are an accounting record of all monetary transactions between a country and the rest of the world. These transactions include *payments for the country's exports and imports of goods, services, financial capital, and financial transfers*. A BOP crisis, also called a currency crisis, occurs when a nation is unable to pay for essential imports and/or service its debt repayments. Typically, this is accompanied by  a rapid decline in the value of the affected nation's currency.
- **Excessive domestic borrowing** by the government may lead to higher real interest rates and the domestic private sector being unable to access funds resulting in the "crowding out" of private investment.

The above discussion makes it clear that it is not prudent for a government to run an unduly large deficit. But at the same time, for a developing country like India, it is also not prudent to have surpluses at the cost of long-term growth. This is because the need for infrastructure and social investments is substantial. So, the most developing country governments have the biggest challenge to meet infrastructure and social needs while managing the government's finances in a way that the deficit or the accumulating debt burden is not too great.

### Domestic Borrowing Versus External Borrowing

Government in India prefers external funding of the Deficit Budget because **External Borrowing** is cheaper in long term and comes in foreign exchange, which the Government can use to meet its fiscal deficit. The Government also prefers borrowing from the external sources because if it only resorts to the internal borrowing, there may be a problem of liquidity in the country. External grant comes as free, *but in recent years, external grant has been very low.*

### Why printing of currency is used as a last resort?

*Printing Currency is used by the Government as last resort in deficit financing*. The printing of currency has its own side effects such as increasing inflation and pressure on the Government for upward revision of the wages. *Further, printing currency does not meet the expenditures which are needed to be met with foreign currency only.*

# Internal Debt and External Debt

## Internal Debt

Internal debt is that part of the total debt that is owed to lenders within the country. It is the money the government borrows from its own citizens. *The government borrows by issuing the Government Bonds and T-Bills (Treasury Bills). It also includes the Market borrowings by the government.* The government bonds and T-Bills are traded in the market which is also known as **Gilt Market.** When government borrows from the domestic sources, the increase in inflation is less in comparison to simply printing the money.

## External Debt

External debt is owed to creditors outside the country. The outsider creditors can be foreign governments, International Financial Institutions such as World Bank, Asian Development Bank etc., corporate and foreign private households. External debt may be of several kinds such as multilateral, bilateral, IMF loans, Trade credits, External commercial borrowings etc. When the non-resident Indians park their funds in India, it is also a type of external debt and is called NRI deposits. If the external debt is denominated in Indian Rupee, it is called Rupee Debt.



**External Debt Sustainability**

Every country needs to meet its current and future external debt service obligations. If these obligations are met in full, without recourse to debt rescheduling or the accumulation of arrears and without compromising growth – then it would be called external debt sustainability. If not, then the condition would be called a debt burden. The external debt sustainability can be measured by several indicators such as Debt to GDP ratio; Foreign debt to exports ratio; Government debt to current fiscal revenue ratio etc.

### Sovereign Default

A failure or refusal of the government of a sovereign state to pay back its debt in full is called *Sovereign Default*. Sovereign Default may be accompanied by a formal declaration of a government not to pay (repudiation) or only partially pay its debts (due receivables), or the de facto cessation of due payments.

# Framework of India's Fiscal Administration

Indian constitution has divided the taxing powers as well as the spending powers (and responsibilities) between the Union and the state governments. The subjects on which Union or

State or both can levy taxes are defined in the 7th schedule of the constitution. Further, limited financial powers have been given to the local governments also as per 73rd and 74th amendments of the constitution and enshrined in Part IX and IX-A of the constitution.

Since the taxing abilities of the states are not necessarily commensurate with their spending responsibilities, some of the centre's revenues need to be assigned to the state governments. On what basis this assignment should be made and on what guidelines the government should act – the Constitution provides for the formation of a Finance Commission (FC) by President of India, every five years, or any such earlier period which the President deems necessary via Article 280. Based on the report of the Finance Commission, the central taxes are devolved to the state governments.

## Separation of Powers

The Union government is responsible for issues that usually concern the country as a whole, for example national defence, foreign policy, railways, national highways, shipping, airways, post and telegraphs, foreign trade and banking. The state governments are responsible for other items including, law and order, agriculture, fisheries, water supply and irrigation, and public health.

Some items for which responsibility vests in both the Centre and the states include forests, economic and social planning, education, trade unions and industrial disputes, price control and electricity.

Then, there is devolution of some powers to local governments at the city, town and village levels.

The taxing powers of the central government encompass taxes on income (except agricultural income), excise on goods produced (other than alcohol), customs duties, and inter-state sale of goods. The state governments are vested with the power to tax agricultural income, land and buildings, sale of goods (other than inter-state), and excise on alcohol. Local authorities such as Panchayat and Municipality also have power to levy some **minor** taxes.

The authority to levy a tax is comes from the Constitution which allocates the power to levy various taxes between the Centre and the State. An important restriction on this power is Article 265 of the Constitution which states that "*No tax shall be levied or collected except by the authority of law.*" This means that no tax can be levied if it is not backed by a legislation passed by either Parliament or the State Legislature.

## Sources of Revenue for Union Government

The sources of Revenue of the Union Government are as follows:

- Income (except tax on agricultural income), Corporation Tax & Service Tax
- Currency, Coinage, legal tender, Foreign Exchange
- Custom duties (except export duties)
- Excise on tobacco and other goods.

- Estate Duty (except on agricultural goods) (Kindly note that its mentioned in the constitution but Estate duty was abolished in India in 1985 by Rajiv Gandhi Government)
- Fees related to any matter in Union list except Court Fee
- Foreign Loans
- Lotteries by Union as well as State Governments.
- Post Office Savings bank, Posts, Telegraphs, Telephones, Wireless Broadcasting, other forms of communication
- Property of the Union
- Public Debt of the Union
- Railways
- Stamp duty on negotiable instruments such as Bills of Exchange, Cheques, Promissory notes etc.
- Reserve Bank of India
- Capital gains taxes, Taxes on capital value of assets except farm land
- Taxes other than stamp duties on transactions in stock exchanges and future markets
- Taxes on the sale and purchase of newspapers and advertisements published therein.
- Terminal Taxes on Goods and passengers, carried by Railways and sea or air.

## Sources of revenue for State Governments

The following are sources of revenue for State Governments.

- Taxes and duties related to agricultural lands
- Capitation Taxes
- Excise on liquors, opium etc.
- Fees on matters related to state list except court fee
- Land Revenue, Land and buildings related taxes
- Rates of Stamp duties in respect of documents other than those specified in the Union List
- Taxes on mineral rights subject to limitations imposed by the parliament related to mineral development
- Taxes on the consumption or sale of electricity
- Sales tax on goods (other than newspapers) for consumption and use within state.
- Taxes on advertisements except newspaper ads.
- Taxes on goods and passengers carried by road or on inland waterways
- Taxes on vehicles, animals and boats, professions, trades, callings, employments, luxuries, including the taxes on entertainments, amusements, betting and gambling.

- Toll Taxes.

## Certain Taxes levied as Concurrent Powers

Please note that the Union and the State Governments have the concurrent powers to fix the principles on which taxes on motor vehicles shall be levied and to impose stamp duties on non-judicial stamps. The property of the Union is exempted from State Taxation; and the property of the states is exempted from the Union Taxation. But the parliament of India can pass legislation for taxation by Union Government of any business activities / trade of the state which are not the ordinary functions of the state.

### Residuary Power of Taxation

Union Government has exclusive powers to impose taxes which are not specifically mentioned in the state or concurrent lists. Some taxes imposed using these powers include Gift tax, wealth tax and expenditure tax.

## State's power Regarding Sales Tax

The sales tax on consumer goods such as toothpastes, soaps, daily use items, electronic items etc. are *imposed, collected and appropriated by state governments.* However, newspapers and newspaper ads are exception to this. Further, there are four restrictions to this power of the state. These include:



- A state cannot impose sales tax if a good is produced there but is sold outside the state.
- A state cannot impose sales tax if the sale and purchase is taking place for items due for export.
- A state cannot impose tax on interstate trade and commerce of goods
- State cannot impose a tax on a good that has been declared of special importance by parliament.

## Other facts about levying and appropriation of Taxes

- Sales tax is imposed, levied, collected, appropriated by states as mentioned above
- Income tax, Corporation Tax, Service tax are levied and collected by Centre but are appropriated by both states and centres as per distribution formula recommended by Finance Commission. This formula is NOT binding upon the parliament.
- However states have no share in surcharges, cesses on these taxes.
- Stamp duties on negotiable instruments and excise duties on medicinal and toilet preparations that have use of alcohol and narcotics are levied by Centre. But these taxes don't make a part of consolidated fund of India. They are assigned to respective states only, which appropriate these taxes.
- Sales tax in case of Inter-state trade of goods (except newspapers) is levied and collected by the centre but such proceeds are assigned to states. (This is known as Central Sales Tax)

## Direct Taxes

Direct tax generally means a tax paid directly to the government by the persons on whom it is imposed. Income Tax, Gift Tax, Wealth Tax and Property tax etc. are direct taxes.

## Income Tax

There are two kinds of Income Taxes viz. Personal Income Tax and Corporation Tax.

### Personal Income Tax

Personal Income tax is levied on individuals and HUF (Hindu Undivided Families) by the Central Government. The levy of the Income tax follows the principle of "ability to pay" and is a progressive tax. This implies that *those who can pay more should pay more*; as the rate of tax increases as the taxable amount increases. On this basis, low income people have been exempted from the Income Tax with minimum exempt limit varying from year to year. Currently, the minimum taxable income with reference to Income Tax is Rs. 250,000. It was Rs. 40,000 in 1995-96 budget. The current income tax slabs are as follows:

| Type | Age | Income | Tax Rate |
|---|---|---|---|
| Male / Female Individual | <60 years | 2.5 Lakh or below | Nil |
| Male / Female Individual | <60 years | 2.5 Lakh to 5.0 Lakh | 10% on income above 2.5 lakh |
| Male / Female Individual | <60 years | 5 Lakh to 10 Lakh | 10% on income between 2.5 Lakh to 5 Lakh and 20% on income above 5 Lakh |
| Male / Female Individual | <60 years | Above 10 Lakh | 10% on income between 2.5 Lakh to 5 Lakh; 20% on income between 5-10 Lakh and 30% on income above 10 Lakh |
| Male / Female Individual | >60 years | 3 Lakh | NIL |
| Male / Female Individual | >60 years | 3 Lakh to 5.0 Lakh | 10% on income above 3 lakh |
| Male / Female Individual | >60 years | 5 Lakh to 10 Lakh | 10% on income between 3 Lakh to 5 Lakh and 20% on income above 5 Lakh |
| Male / Female Individual | >60 years | Above 10 Lakh | 10% on income between 3 Lakh to 5 Lakh; 20% on income between 5-10 Lakh and 30% on income above 10 Lakh |
| Male / Female Individual | >80 years | 5 Lakh or below | NIL |
| Male / Female Individual | >80 years | 5 Lakh to 10 Lakh | 20% on income above 5 Lakh |

| Type | Age | Income | Tax Rate |
|---|---|---|---|
| Male / Female Individual | >80 years | Above 10 Lakh | 20% on income between 5-10 Lakh and 30% on income above 10 Lakh |

Further, currently, there is a surcharge of 12% on the persons having taxable annual income exceeding Rs 1 crore. Taking this into account, the maximum marginal tax rate at present stands at around 34%.

**Corporate Income Tax**

Corporation Tax is levied on the net income of the companies. The rates of corporate taxes were very high once upon a time. They were reduced gradually since liberalization and it was pegged at around 35% in 2005-06. Still, India is ahead of many economies in terms of corporation tax.

Currently, basic tax rate for domestic companies is 30% and for foreign companies is 40%. A minimum alternate tax (MAT) is levied at 18.5 percent of the adjusted profits of companies where the tax payable is less than 18.5 percent of their book profits. After including surcharges, the current *effective corporate taxes* are 33.9% for domestic companies and 43.26% for foreign companies.

The effective rate of dividend distribution tax remains at almost 17%. Large dividend tax-paying companies include ONGC, Coal India, TCS, ITC, NTPC etc.



## Income Tax Department

Income Tax Department functions under the Department of Revenue in Ministry of Finance. It is responsible for administering following direct taxation acts passed by Parliament of India.

- Income Tax Act
- Wealth Tax Act (Abolished now)
- Gift Tax Act
- Expenditure Tax Act
- Interest Tax Act
- Various Finance Acts (Passed Every Year in Budget Session)

Income Tax Department is also responsible for enforcing Double Taxation Avoidance Agreements and deals with various aspects of international taxation such as Transfer Pricing.

## Central Board of Direct Taxes

The Central Board of Direct Taxes (CBDT) is a part of the Department of Revenue in the Ministry of Finance. CBDT provides essential inputs for policy and planning of direct taxes in India and is also responsible for administration of the direct tax laws through Income Tax Department. The CBDT is a statutory authority functioning under the Central Board of Revenue Act, 1963.It is India's official FATF (Financial Action Task Force) unit.

## Indirect Taxes

Indirect taxes include service tax, sales tax, custom, excise duties, VAT, MODVAT, CENVAT, proposed Goods & Services Act etc. Initially the indirect tax regime was too complicated and there was an ubiquitous problem of **tax on tax.** Post liberalization, there is a lot of change in the Indirect tax administration of the country and there was a dramatic change when the country shifted to VAT regime in 2000s.

### Custom Duties

Custom duties are imposed on both during import and export of goods. The custom duties imposed during export are generally called “export duties”. Since, export duties reduce the competitiveness of the Indian products in the international markets, the Government has abolished the export duties. The import duty is quite productive, particularly when it is levied on high value imports such as iron and steel etc.

The custom duties were very important in the decades of 50s and 60s and later their place was taken by the excise duties as more and more goods were produced domestically. From 1990-91 to till date the custom duties have fallen drastically due to trade liberalization also.

### Sales Tax



Sales tax is the tax which a purchaser pays when he / she purchases goods. The sales tax in most goods (except newspapers) for intra-state sales and consumption are within the powers of the states governments, which levy, collect and appropriate these taxes. This is the reason that some goods may be cheaper in a particular state as compared to another state. The sales tax on inter-state sale of goods is levied by Central Government and is payable to the state where the particular goods are sold. Today, sales tax regime has drastically changes and its place is now taken by VAT in most states.

### Value Added Tax (VAT)

Today, in many states, the Sales Tax has been abolished and replaced with the Value Added Tax (VAT). While Sales Tax is a single point tax levied on the price of the goods; VAT is a multipoint tax in which tax is levied at each stage of transaction in the production/ distribution chain. By value addition, we mean the increase in the value of goods / services at each stage in the value chain. The tax paid at earlier stage is called ‘Input tax credit (ITC)’ and this credit can be used against a tax at later stage.

#### Similarity between Sales Tax and VAT

Both Sales Tax and VAT are indirect taxes which are ultimately borne by the consumer. Both taxes come within the jurisdiction of the states and are levied, collected and appropriated by states. The state legislature needs to pass state level acts to provide legal backing to Sales Tax and VAT. The states where VAT acts have been enacted, the sales taxes have been abolished. The idea of replacing Sales Tax with VAT was to rationalize the taxes and bring the retail price of products to minimum possible level.

### Difference between Sales Tax and VAT

Sales tax is levied on the sale of goods/ service and thus is simple to calculate and accounting purpose. VAT is multistage tax, so involves complex accounting. This difference makes VAT evasion difficult because VAT evaded at one stage would be caught at next stage.

### MODVAT / CENVAT

MODVAT was introduced in 1986-87 to overcome the problem of cascading effect of Central Excise Duty. Currently, MODVAT has been replaced by CENVAT. In MODVAT, the manufacturer was able to obtain reimbursement of the excise duty and countervailing duties paid on the components against the duty payable on the final product. *For example, if the* excise duty of Rs. 1,000 was already paid on inputs or raw materials; and the final good attracted an excise duty of Rs. 10,000, then the manufacturer would pay only Rs. 9000 as MODVAT.

Thus, the key objective of MODVAT was to avoid repetitive payment of duties from raw material to the final product stage. The idea was that it would reduce the cost of the final product. However, it  was later found that in many consumer goods, the final price got increased due to MODVAT. Further, the tax evasion was possible by creation of false invoices.

In 2000-2001, MODVAT was replaced with the CENVAT. This system has only one basic excise duty of 16% that is applicable to almost all goods except some goods which attract special excise duties of 8%, 16% or 20%. The system is much simpler but still leaves scope for tax evasion.

## Service tax

Service tax was not in the constitution until 88th Amendment was passed. Via this amendment, article 268-A was added and also added a new entry in Union List viz. 92-C (taxes on services). Like Income tax and Corporate tax, Service tax is levied by the centre but collected and appropriated by both the centre and the states.

The Service tax was imposed in India initially from 1994-95 on electricity services, telephone services, brokerage etc. With every passing year, more and more services were brought into the ambit of the service tax. The first year collection of the Service Tax in 1994-95 was Rs. 407 Crore, which rose to Rs. 2610 Crore in 2001-02.

Currently, service tax is levied at the rate of 14% subject to minimum service value exceeds Rs. 10 Lakh in a year.

## Goods and Services Tax

The Goods and Services Tax (GST) is a value added tax to be implemented in near future. It will

replace all indirect taxes levied on goods and services by the Union and State governments. It is aimed at being comprehensive for most goods and services with little tax exemption.
( GST is discussed in Government Budgeting-2)

# Government Budgeting

Article 112 of the Indian Constitution, says that every year "the President of India shall cause to be laid before both the houses of the parliament" the "Annual Financial Statement". This is popularly known as Budget. "*cause to be laid*" here means that the person through whom President acts, is *Finance Minister of the country, who is known as the custodian of the nation's Finances.* The Budget gives the complete picture of the estimated receipts and expenditures of the Government of India for that year. This picture is actually based upon the budget figures of the previous years. There are three kinds of figures in this set. If we are studying the budget of 2015-16, then this set would be made up of actual of 2013-14, budget & revised estimates of 2014-15 and budget estimates of 2015-16.

## Budget Estimates

The Budgetary estimates are based upon the previous data. Similarly provisional estimates are also based upon the previous data. When these data are revised as per the current position, they are called "**Revised Estimates**". However, if the **Revised estimates** show the latest short term situation, then they are called "**Quick Estimates**". **Advance estimates** are a kind of "Quick Estimates" which are done ahead of the time.

The main Budget documents are presented to the parliament accordingly various articles of our constitution as follows:

- Annual Financial Statement (AFS) : As per Article 112
- Demand for Grants (DG) : As per Article 113
- Appropriation Bill: as per Article 114 (3)
- Finance Bill: As per article 110 (a)
- While presenting the Budget, the following are presented as mandated in Fiscal Responsibility and Budget Management Act 2003.
- Memorandum Explaining the Provisions in the Finance Bill,
- Macro-economic framework for the relevant financial year
- Fiscal Policy Strategy Statement for the financial year
- Medium Term Fiscal Policy Statement

## Discussion on Budget

On a day subsequent to the presentation of the Budget, the House takes up the General Discussion of the Budget which is called the *first stage followed by second stage i.e. discussion and voting on Demands for*

*Grants.*

During the General Discussion on the Budget, the house is at liberty to discuss the Budget as a whole or any question of principle. The scope of discussion at this stage is confined to the general examination of the Budget i.e. the proper distribution of the items of expenditure according to the importance of a particular subject or service, the policy of taxation as is expressed in the Budget and the speech of the Finance Minister.

### Standing Committee Reports

After the General Discussion on Budget in both the Houses is over and **Vote on Account** is passed, the House is adjourned for a specified period. The Demands for Grants of each Ministry/Department will be examined by the concerned Standing Committee having jurisdiction over it during the said recess period. The Committee gives separate report for each Ministry. The Demands for Grants are discussed / considered in the House in the light of the reports of the Standing Committee. The reports of the Standing Committees which are of persuasive value are nevertheless treated as considered advice given by the Committee.

The detailed discussions are followed by Guillotine. Guillotine refers to closure imposed on the debate. On the last of the allotted days at the appointed time, the Speaker puts every question necessary to dispose of all the outstanding matters in connection with the Demands for Grants. The Guillotine concludes the discussion on Demands for Grants.



## Appropriation Act and Finance Act

An Appropriation Act in India is an act of Parliament which allows the withdrawal of funds from Consolidated Fund of India or Consolidated Funds of States (in case of state budgets). Similarly, the Finance Act of Central Government gives effect to the taxation proposals in the beginning of every financial year. For taxation proposals at state levels, State Finance Acts are enacted every year.

### Appropriation Act

Constitution says that *no money shall be withdrawn from the consolidated fund of India except under the appropriation made by law*. Thus, the Appropriation Bill authorizes the amount which can be drawn out of the Consolidated Fund of India for meeting the expenditures. This bill is required to be passed for votable as well as non-votable expenditures and also any vote on account.

Further, kindly note that once the Lok Sabha has passed the Appropriation Bill, no amendments in its amounts can be proposed in either house of Parliament. Once the bill gets President's assent, it becomes Appropriation Act. The Appropriation Act authorises the government to withdraw funds from Consolidated Fund of India.

### Finance Act

The Constitution (Article 265) says that *no tax shall be levied or collected except by authority of law*. Consequently, a Finance Bill dealing with such law is introduced to authorize the government to raise funds through taxation. This bill must become an act within 75 days of introduction.

**Difference between Appropriation and Finance Bills / Acts**

- While Appropriation act legalizes the expenditure side of the budget, Finance act legalizes the income side (Taxes) of budget.
- While no amendments can be moved or passed in case of appropriation bill, amendments seeking to reject or reduce a tax can be moved in the case of finance bill.

## Vote on Account and Interim Budget

### Vote on Account

The Appropriation Bill and Finance Bill are presented in the month of February, and they take their own time to become act. In order to keep the Government functioning, the House is asked to vote usually **two months**' funds i.e. approximately 1/6th of the total estimated expenditure under various grants. This is called **Vote on Account**. Vote on Account is passed after general discussion on the Budget. Usually it is treated as a formal matter and is passed without discussion. Vote on account is as per provisions of Article 116 of the Constitution. This makes clear that Vote on Account __:



- Can be passed on occasions when government needs some money on its disposal to keep running the administration till appropriation act is passed.
- Related to only taking money out of Consolidated Fund of India and thus *limited to expenditure side*
- Normally related to expenditures of 2 months only that is equivalent to 1/6th of the total budget; but that is NOT a rule. In 2004-05, the NDA Government sought for a Vote on Account for Four Months. In fact, during election year or when it is anticipated that the main demands and appropriation bill will take longer time than two months; the vote-an-account may be for a period extending two months. Typically this period does not exceed six months, as that is the maximum gap possible between two sittings of the Parliament.
- *Not related to Taxation* matters or revenue side of budget
- Can be passed by all governments whether incumbent or regular or caretaker, however, Vote On Account becomes of special importance when the elections are underway and a caretaker government is in place.

### Interim Budget

While a vote-on-account deals only with the expenditure side of the government's budget, interim budget is a complete set of accounts, including both expenditure and receipts. When a government presents Vote on Account as a part of its Budget exercise; two appropriation bills viz. Appropriation (Vote on Account) Bill and Appropriation Bill of that year are passed. For example, the current (outgoing) Lok Sabha has passed Appropriation (Vote On Account) Bill, 2014 authorising the government for withdrawal of Rs 20,30,334 crore from the Consolidated Fund of India for expenses during the first four months of the new financial year 2014-15.

Interim Budgets also can be presented by all governments whether incumbent or regular or caretaker, however, Interim Budget becomes of special importance when the elections are underway and a caretaker government is in place. It can also be presented when a new Government has recently sworn in.

## The Votable and Non-Votable Expenditures

The budget shows the estimated receipts and expenditure of the upcoming Financial Year. After the budget is presented to the house (parliament), the government needs its approval to draw even one rupee from the Consolidated Fund of India. This approval comes by voting, which means that the Budget proposals must be passed by the Parliament. However, there are some charges which essentially have to be paid by the Government and for those charges no voting takes place. Thus, the expenditure embodied in the Budget Documents is of two types:

- The sums required for charged expenditures. These are non-votable.
- The sums required for other expenditures as mentioned in the Budget Documents. These are votable.

**Charged Expenditures or Non-Votable Charges**

Non-votable charges are called Charged Expenditures; and no voting takes place for the amount involved in these expenditures for their withdrawal from Consolidated Fund of India. This means that they have to be paid in any case, whether the budget is passed or not passed. Following are the charged expenditures:

- Salary and Allowances of the President, Speaker / Deputy speaker of Lok Sabha, Chairman/ Deputy chairman of Rajya Sabha, Salaries and Allowances of Supreme Court judges, Pensions of Supreme Court as well as High Court Judges, Salaries and Allowances of CAG, Lok Pal
- Debt charges of Government of India.

The above expenditures cannot be voted because; these payments are deemed to be guaranteed by the state. Although voting does not take place on such charges, discussion can take place in any house of the parliament. The demand for grant for these charges is also made on recommendation of the president. (Article 113)

Here we should not that retainer of Attorney General or Solicitor General is NOT a charged expenditure upon Consolidated Fund of India. They are paid a fee which comes from the budgetary allocations of Department of Legal Affairs, which itself though comes from consolidated fund but is a votable charge. Further, while salary of High Court Judges is charged from Consolidated Fund of States, their pension comes from Consolidated Fund of India.

**Votable / Voted Expenditures**

The Votable part is actual Budget. The expenditures in the Budget are in the forms of **Demand for Grants**. There Budget also presents ways and means – how the government would be recovering the expenditures. Generally, the demands for Grants of each and every ministry are made separately in the Budget documents and each demand for grant has the provisions under its different heads.

## Cut Motions

After the budget is presented in Parliament and discussions over it are completed, the members get an opportunity to move cut motions to reduce the amount of demand. The members from particular parties or coalitions may bring their own cut motions. The members generally give notice of the Cut Motions for the reduction of the votable heads of expenditure of the Demands for Grants immediately after the Finance Minister or the Railway Minister as the case may be, has presented the Budget in the House.

Every Cut Motion to a demand for Grant represents *disapproval* of some aspect or other of the Budget or the economic policy of the Government. Accordingly Cut Motion is of three kinds:

### Policy Cut

This type of cut motion aims that the amount of the demand be reduced to Re. 1. It represents the complete disapproval of policy underlying the Demand. This is because the motion aims to reduce the demand for grant to Re. 1 only, which almost finishes the demand for grant of a ministry.

### Economy Cut

This type of cut motion aims that the amount of demand be reduced to certain other amount and it represents that the demand for grants should be altered.

### Token Cut

This Cut Motion aims that the amount of the Demand be reduced by Rs. 100" in order to *ventilate a specific grievance,* which is within the sphere of responsibility of the Government of India. Actually, Token cut is symbolic and is humiliating for the Government. To be precise, *all cut motions are humiliating for the ruling party or coalition. The Cut motions provide the members maximum opportunity to examine every part of the budget and criticize the Government.*

### Implications of Cut Motions

The Cut Motions are mostly defeated due to Number strength of the ruling party or coalition. As the cut motion is a veto power given to the member of the Lok Sabha to oppose a demand in the financial bill discussed by the government, it is seen as an effective tool to test the strength of the government. If a cut motion is adopted by the House and the government does not have the numbers, it is obliged to resign. The cut motion can be admitted to the house only if it is related to only one demand and not many. No cut motion can be moved on charged expenditures. The cut motions are important because they facilitate the constructive discussion on each demand and uphold the principle of democratic government, by giving the members power to veto the demands.

## Plan and Non Plan Expenditures

All the expenditures that are incurred on the public exchequer of the country are kept in two categories viz. Plan and Non Plan. The expenditures which are done by the Government of India in the name of Planning are Plan expenditures. All other expenses are Non-plan expenditures. Generally (not always), the plan expenditure produces some tangible assets related to economic development. This is not a rule, but this is one reason that plan expenditures are also called *Developmental expenditures*. In fact till 1997-98, the budget used to show development and non-development expenditures. Now they are called planned and non-planned expenditures as per recommendations of *Sukhmay Chakraborty Committee*. The important heads among the expenditure parts are enumerated below:

### Non-Plan Revenue Expenditure

Important Non-Plan Revenue Expenditures are as follows:

- Interest payments on the loans taken by Government of India
- Expenditure incurred on Defence Services (except Defence Equipment which is a capital expenditure)
- Subsidies
- Grants to the states and UTs, including those from calamity fund
- Pensions, Social services such as healthcare, education, social security etc.
- Police
- Economic services by the government such as Agriculture, Industry, Power, Science & Technology
- Grants to foreign Governments

### Non-Plan Capital Expenditure

Important Non-Plan Capital expenditures are as follows:

- Defence Equipments and modernization
- Loans to Public sector companies

- Loans to states and union territories

One of the most important headings under the non plan revenue expenditures is "Interest payments on the loans taken by Government of India". The Budget 2014-15 makes a provision of payment of Rs. 4.27 Lakh Crore as interest payment on public debt. This amount includes the internal debt / external debt and other liabilities.

## Plan Expenditures

The plan components relate to items dealing with long-term socio-economic goals as determined by the ongoing plan process. They often relate to specific schemes and projects. Furthermore, they are usually routed through central ministries to state governments for achieving certain desired objectives. These funds are generally in addition to the assignment of central taxes as determined by the Finance Commissions. In some cases, the state governments also contribute their own funds to the schemes.

# General Knowledge Today



# Government Budgeting-2: Taxation System

Integrated IAS General Studies:2016-17

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# Model Questions

**Prelims MCQ Topics**

James Wilson, Rule of Lapse, Participatory Budgeting, Gender Budgeting, Zero Based Budgeting, Incremental budgeting, Taxes mentioned in Arthashashtra, Progressive and Regressive Taxes, Elasticity in Taxes, Sin Tax, Difference between Direct and Indirect Taxes, tax avoidance, tax evasion and tax planning, locations of major Tax Havens, Thin Capitalization, Base Erosion and Profit Sharing (BEPS), Letterbox Entity, GAAR, Tax Information Network, eSahyog, Constitution (122nd Amendment) Bill, 2014 provisions and GST Council.

1. Trace the evolution of Budget In India since East India Company rule.
2. "Budget serves as a public policy document expressed in money and is an embodiment of implied policy objective in monetary terms." With this reference assess the role played by budget in economy.
3. "Budget transparency and accountability are two of the eight basic indicators of good governance as propounded by United Nations." With this reference, critically discuss the principles followed in budgterary process in India.

4. Elaborate the various stages of preparation of budget in India before it is presented in the parliament.
5. "Open and participatory budget making is imperative for good governance; yet by international standards India fares badly on this count." Discuss critically.
6. Assess the efforts by state and union towards Gender Budgeting while throwing light on its benefits.
7. Differentiate between Zero Based Budgeting and Incremental Budgeting. Why they are not adopted now? Examine.
8. What do you understand by "Kosha Moolo Danda"? Discuss in the light of Kautiliya's tax administration.
9. "There are many similarities between the current day tax system and the Kautilya's system of Tax administration". Explain.
10. What do you understand by progressiveness and regressiveness in the taxes? Make a comparison of direct and indirect taxes on this basis.
11. Critically compare the Direct and Indirect Taxes.
12. What do you understand by tax avoidance, tax evasion and tax planning? Objectively discuss various methods involved in the same.

13. Base Erosion and Profit Sharing (BEPS) has emerged as one of the most important challenges for the governments across the world today. Critically examine in the light of G20- OECD's BEPS Action Plan and the recently released BEPS Package.
14. "The basic issue with GAAR provisions is the trust deficit between the corporate entities and government." Discuss in the light of recent developments.
15. Outline the Direct & Indirect Tax Reforms in India in recent times.
16. Discuss the composition and functions of the GST Council as proposed in the Constitution (122nd Amendment) Bill, 2014.

# Government Budget: Select Topics

## Evolution of Budget

Etymologically, the term budget is related to Latin *bulga* , which refers to a 'leather bag. The term comes from a Gaulish source connected to the Irish bolg, which means a bag. It got associated with finance in mid 18th century following up a pamphlet titled "The Budget Opened" sarcastically attacking the tax plans of Great Britain's first prime Minister Sir Robert Walpole. However, the term budget was first used in 1760 for statement of the actual results of receipts and expenditure in the preceding fiscal year presented in House of Commons by UK's Chancellor of Exchequer. The term budget was used in current context only after mid 19th century. 20th century was a stimulating era for budgeting. It was only after 1950s that budget was more rationally used for public planning and policy. The development of the theoretical framework of budgeting during 20th century has been shaped by the political, social and administrative players and circumstances.

During the 20th century, while the Budget and Accounting Act 1921 systematized the budgeting in USA, the Parliament Act 1911 excluded the Lords in UK to refuse money bills, thus depriving House of Lords of its power of veto over financial legislation. Since then, the elected House of Commons has supreme powers regarding budget decisions in UK and same was followed in India where Lok Sabha has such powers.



### Key Points: Evolution of Indian Budget

A rough budget of East India Company was prepared in 1790. After the end of East India's Company's rule, India's first budget was presented on February 18, 1860 by James Wilson, a Finance Member of the India Council. The Finance Member's work was to advise the Viceroy on financial matters.

After the Morley-Minto Reforms of 1909, the Finance Member had to present his estimates to the Central Legislature in first quarter of every year. The Finance Member's presentation was followed by discussions on Budget proposals. During discussions, the members of the legislature could propose alterations in tax provisions, loans and grants to local government. The Finance Member was able to accept or reject these proposals but he needed to justify why he accepted some proposals and why rejected others.

Initially, the Railway budget was part of the general budget. On the basis of recommendations Acworth Committee, the Rail Budget was separated in 1924. That system follows till date. Recently, the Bibek Debroy committee has recommended to abolish the separate Railway Budget in a period of five years. The first budget of Independent and united India was presented by John Mathai in 1949-50. This budget also included the financial statements for former Princely States. The decision of forming a planning commission was declared in this budget.

## Functions Of a Government Budget

The key functions of a government budget are discussed below:

### Public Policy Document

The budget serves as a public policy document expressed in money and is an embodiment of implied policy objective in monetary terms.

### Redistribution of Wealth

The most important function of budget is redistribution of wealth. However, that needs proper integration of revenue and expenditure side.

### Instrument of Economic Development

Budget serves as an instrument of economic development, which embodies a work programme for administration and government. It's a source of information for all stakeholders.

### Instrument of budgetary control

Budget also serves as an instrument of financial control by legislative over executive. It also serves as instrument of accountability and financial control. Further, it is a management tool for achieving efficiency, productivity, improvements and for determining the degree to which policy goals have been accomplished.



### Instrument of accountability

Budget is an instrument to make elected legislators accountable to people. It also upholds the economic, social and cultural rights of the people.

## Principles of Budgeting

There are a few principles followed in budget preparation exercise. These are as follows:

### Principle of Annuality

This implies that a budget is prepared every year on annual basis. One year is considered ideal period for budget because it's an optimum period for which the legislature can afford to give financial authority to the executive. Further, executive also needs this much time to implement the budget proposals effectively. Further, a year corresponds with the customary measures of human estimates. Annuality in budget formation is a widespread phenomena. In some countries of OECD, yearly budgets are now framed within a multi-year framework.

### Rule of Lapse

Principle of Annuality also implies that the money left unspent in a year must also lapse to the public treasury and government should not be able to spend it unless it is re-sanctioned in next year's budget. This is called Rule of Lapse and is useful as an effective tool of financial control.

### Fiscal Discipline

Budget should be balanced and should be able to display congruence between the income and expenditure. This is known as Fiscal Discipline and it adheres to the Keynesian School of Thought. Fiscal discipline helps to eliminate fiscal deficits and offset fiscal surplus.

#### Inclusiveness

Budget should be comprehensive and inclusive of diverse budget estimates. An inclusive budget includes all government revenue and expenditures and helps evaluating the much required trade-offs between different policy options.

#### Accuracy

Budget figures are essentially predictions of the amount of money to be generated in the forthcoming year and its expenditure. The Finance Ministry is accountable for its formulation with the help of the data and material from the various departments. These estimates need to be accurate and precise. The preciseness is dependent real and credible input data, information and unbiased information.

#### Transparency and Accountability

Budget transparency and accountability are two of the eight basic indicators of good governance as propounded by United Nations. Budget transparency implies that government gives out all data regarding budget. These two traits of budget also involve ethics on the part of the Government. For the sake of clarity and transparency, the revenue and capital portion of the budget are kept separate.

## Budget Preparation Process



The preparation of budget in India involves the several stages before its presentation to the house. The fiscal year of the Union and State Governments is from April to March. The preparatory work on budget documents starts around 6-8 months before the commencement to of the fiscal year. The first initiative is taken by the finance ministry which sends *circulars* along with some *skeleton forms* to different ministries and departments asking them to start preparing in advance for the coming fiscal year. It also sends various instructions and guidelines in the Budget Circular, releases via Department of Economic Affairs, Budget Division.

The ministries and departments pass on these printed forms to the disbursing officers. Disbursing Officers are the heads of the local offices such as Deputy Commissioners of the districts, for preparing their own estimates. The forms are filled with items of income and estimated expenditures with actual figures of last year, sanctioned budget of current year, revised estimates of current year and proposed estimates of next year.

This makes it clear that in our country, *process of budget preparation is bottom up process,* that starts at the lowest level in departments and moves upwards to the level of the Head of the Department. The head of the department works as Controlling Officer for budgetary transactions. This is as per the below flowchart:


In the second stage, the estimates sent by the disbursing officers are scrutinized by Head of Departments (Controlling Officers). They have the option to either accept the estimates as they are or revise it. These revised estimates are then sent to the Budget Department of the Ministry of Finance by mid November. The Estimates Committee considers these estimates and after its approval sends them to the Finance Ministry. They are further scrutinized by the finance ministry. This scrutiny by Finance Ministry is of different nature. For example, it would correlate the estimates with the state of economy and see if the revenues are available. It also would correlate them with new schemes to be announced soon. Simple questions are kept in mind while scrutinizing the estimates for example:

- If the proposed expenditures are really necessary?
- How without this expenditure was done till now? How this expenditure would make difference?
- Is such expenditure done elsewhere?
- From where the funds would come?



The Finance ministry justifies and passes the demands of several Administrative Ministries and fixed a net figure for each Ministry. We note here that the decision of the finance ministry is final in determining the provision. Many a times, there might be differences between ministries over inclusion or exclusion of some schemes. Such disputes are sorted out by finance ministry at ministerial level and such disputes might also be sent to Union Cabinet or Prime Minister, whose decision in this context is final.

Once the budget estimates on the expenditure side are done; the Finance Ministry prepared the estimates of revenue side with the help of Central Board of Direct Taxes and Central Board of Excise and Customs (a.k.a. Central Board of Indirect Taxes).

Finally, a consolidated statement is prepared which is now considered by the cabinet. Cabinet approval of the budget is done by January. The Finance minister in consultation with the Prime Minister now prepares a Financial Policy, which is essentially kept secret.

## Participatory Budgeting

According to the International Budget Project (IBP), participatory budgeting is the process by which citizens *deliberate and negotiate over the distribution of public resources.* Participatory budgeting creates opportunities for engaging, educating and empowering citizens, which can equip and advance a more vibrant civil society.

Union Budget affects almost every sector of the economy and the policies driving the budget and implementation of the budget proposals are of direct relevance to the entire population. However, neither the budget process nor the budget policies come under substantial public scrutiny. The entire exercise of budget-making remains shrouded in complete secrecy till the budget is presented in the parliament. Only then, the general public gets relief from the vague guesswork of media. While budget presentation in the Parliament and subsequently its legalisation are quite transparent, the process of budget preparation by the Government is rather closed.

The interest and participation of the civil society in Budget making process has increased in recent times. In countries such as US, South Africa, New Zealand, the UK, the governments provide extensive information to their citizens on budget, while in India, only limited information is available to the public as well as parliament.

## Status of public participation in Budget making in India

The process of the budget preparation starts in the month of September every year. The Budget Division of the Ministry of Finance collects estimates of expenditure of the next fiscal year and after a scrutiny of these estimates, the Ministry of Finance finalized these estimates. Prior to finalization, the finance ministry holds discussions with concerned ministries and departments. The finance minister has authority to make changes in consultation with the Prime Minister. The Budget is briefed to President and also Cabinet shortly before it is presented in the parliament. During the process of budget making, various lobby groups, representing the interests of industrialists, traders and exporters are able to express their interests. However, *there is no visible lobbying with the Finance Ministers for the poor and marginalized sections of the population.* Thus, general public and civil society organizations have been traditionally excluded from the budget making process in India. Thus, open and participatory budget making is imperative for good governance; yet by international standards India fares badly on this count.

### Reasons for low participation

One of the major obstructions in public involvement in the budget process is the inability of majority of people to understand budget terminology and budget-related debates. Given the technicalities associated with budgets, even the highly educated people could be budget-illiterates, and unable to grasp the arguments put forward in the debates over budget policies. Majority of the population in India gets to know about the Union Budget when it is covered in the media, i.e., during the immediate interval of budget presentation in the Parliament.

### Arguments for Participatory Budgeting

There are several arguments making a case of active public participation in budget process in India. These are discussed as below:

- The budget embodies the socio-political and economic policy priorities and fiscal targets of the government. Since the government cannot spend or raise public money without the authorisation of Parliament which in principle amounts to people's sanction; *the people have a right to know how the public resources are being raised and spent.*
- Openness or transparency is an indispensable principle of public finance management and it is a prerequisite for answerability. However, one can argue that the people have exercised their vote in the elections and elected representatives do the work of creating budget. However, participation of the informed citizens in crucial budget process is warranted ***in between the elections***
- It has been further argued that informed citizens make a very small fraction of the large population of India. However, looking at the nil participation of the public in the budget making process, civil society must be given an opportunity to raise issues relating to the vulnerable sections of the population.



### Initiatives towards public awareness

A few civil society organisations in India at the national and state levels have been focusing on budget work with a pro-people perspective. Some of them have come up with very significant and innovative work in their areas. Developing Initiatives for Social and Human Action (DISHA) is perhaps the pioneer organisation in India working on budget analysis with perspectives for marginalised sections of people. There are other organisations like the Public Affairs Centre, Centre for Budget and Policy Studies, Samarthan Centre for Budget Studies, Centre for Budget and Governance Accountability (NCAS programme), Social Watch Tamil Nadu, and Budget Analysis Rajasthan Centre, which work on budget analysis mainly with the viewpoint of the social sector and other sectoral issues. Most of their work is centred on post-budget analysis of allocation for the social sector and its implications. Budget groups' low involvement in shaping or influencing budget decision-making is said to be because of the closed budget formulation process of the government.

## Gender Budgeting

A gender budget is **not** a separate budget for women. Instead, the gender budgets are an attempt to assess government priorities as they are reflected through the budget and examine how they impact women and men.

Gender budgets look at what the impact of the spending is on men and women and whether or not budgets respond to the needs of both women and men adequately.

"Women's budgets", "gender budgets", "gender-sensitive budgets", and "gender responsive budgets" are all terms that are used to describe initiatives that have used gender as lens from which to analyse budgets at national, regional, and civic levels.

## Gender Responsive Budget

A Gender-Responsive Budget is a budget that acknowledges the gender patterns in society and allocates the money to implement policies and programs that will change these patterns in a way that moves towards a more gender equal society. Gender budget initiatives are exercises that aim to move the country in the direction of a gender-responsive budget.

## Need of a Gender Budget

Gender Budget Initiatives are attempts to disaggregate the government's mainstream budget according to its impacts on women and men. It refers to the process of conceiving, planning, approving, executing, monitoring, analysing and auditing budgets in a gender-sensitive way. The gender budgeting exercise would potentially assist and lead to the following empowering measures:

- Addressing gap between policy commitment and allocation for women by emphasizing on adequate resource allocation.



- Putting pressure and focus on gender sensitive programme formulation and implementation.
- Mainstreaming gender concerns in public expenditure and policy.
- By being a tool for effective policy implementation where one can check if the allocations are in line with slated gender sensitive policy commitments and are having the desired impact.

Gender budget is helpful in

- Improving women's economic equality.
- Improving effectiveness, efficiency, accountability, and transparency of government budgets.
- Revealing discrepancies between what a governments says it is doing and the actual impact of government policies.
- Offering a practical way for the governments to implement their obligations under international human rights agreements such as the Convention on the Elimination of All Forms of Discrimination against Women (CEDAW).

## Gender Budgeting Around the World

- The concept of gender budgeting is a nineties' trend that has been introduced *mostly in Commonwealth countries.*
- Australia was the first country to implement a women's budget in 1984. Federal, state and territorial governments in Australia examined the impact of budgets on women and girls for 12 years until a change of government in 1996.

- South Africa's Women's Budget Initiative was initiated in 1995 and involves NGOs, parliamentarians, and a wide range of researchers and advisors. Gender budget initiatives in Tanzania(1997) and Uganda(1999) examine the impacts of structural adjustment programs in these countries and specifically focus on education and health.
- Many of the earlier gender budget initiatives focused primarily on the expenditure side rather than the revenue side of government budgets. Since 1995 there have been gender budget initiatives in more than 60 countries around the world.

### How Gender Budgeting helped the Governments around the world?

- In Australia, Gender Budgeting significant increase in spending in areas of importance to women. There was also a five-fold increase in child care places for working women.
- In Philippines, there was made a specific requirement that every government agency allocate at least five per cent of its budget to gender and development initiatives.
- UK "***From the wallet to the purse***". In United Kingdom, the government announced that from 2003 onwards the new Child Tax Credit would be paid to the main carer — usually a woman — rather than to the main earner — usually a man. The group supporting this used the slogan "From the wallet to the purse"(men carry wallets while women carry purses) to argue that giving money to women was more efficient and in-line with government policy on reducing child poverty.



- In South Korea, a gender budget initiative demonstrated that most of the beneficiaries of training and education programs were leaders or women from women's organizations.
- Gender Budgeting Statement (GBS)
- The Gender Budgeting Statement (GBS) which *comprises the gender specific demands for grants,* has emerged as an important advocacy tool which reflects on the flow of funds for women and encourages debate and discussions on Gender Budgeting.

### Gender Budgeting in India

The first Gender Budget Statement appeared in the Union Budget 2005-06 and included 10 demands for grants. However, in recent budgets the number of demands of grants have been as high as 36. Ten states in India have also introduced gender budgeting but the lack of a standardised nomenclature for the various schemes has made it difficult to replicate or assess them.

## Zero Based Budgeting

Zero-based budgeting is a method of budgeting in which all expenses for each new period must be justified. Under zero-based budgeting, no reference was made or considered of previous years. The budget request has to be evaluated thoroughly with its commencement from the zero-base. The concept was advocated in 1924 by British budget authority Edward Hilton Young. He advocated complete justification of every item requested in a budget. The ZBB concept became more popular only in 1970s.

In India, the principle of ZBB was initiated in the Department of Science and Technology in 1983. In 1986, the Indian government adopted ZBB as a technique for determining expenditure budget. The government made it mandatory for all ministries to review their programmes and activities and prepare their expenditure estimations based on ZBB concept. In seventh five-year plan, the ZBB system was promoted. However, later not much progress happened in this area.

Though ZBB is a good technique of budgeting, it was not implemented successfully because ZBB does not fit into organisations with long range objectives. Proper attention, Commitment form management and trained personnel can better implement the ZBB process. (You may read about ZBB here)

## Incremental budgeting

Incremental budgeting is a way of budgeting where the future allocations are based on current allocations. The new budget is prepared by increasing or decreasing the current budget by certain amounts or percentages. The increased amounts are arrived through a fairly simple calculation and the scope for political conflicts is minimised because everyone is treated as same.

The Theory of Budgetary Incrementalism was formulated by Aaron Wildavsky in the 1960's. It has dominated the mainstream of American budgeting for decades. The theory of budgetary incrementalism assumed that budget process is driven by the 'department heads' and they are annually revised by having an increment. The revised budget heads were examined by the legislature. The theory of Budgetary Incrementalism survived till 1984 because of several problems. Though incremental budgeting is the basis for some baseline decisions, there are some drawbacks also. Incremental budgeting focuses on aggregate trends and fails to analyse revenue and expenditure changes. Although there are many criticisms of incremental budgeting, it is being followed in many countries.

# Issues: Taxation and Fiscal Policy

## Kautilya's Taxation: "Kosha Moolo Danda"

*Kosha Moolo Danda*, which means " revenue is the backbone (of administration)" is sourced from Kautilya's Arthshastra Part 8, Chapter 1. This implies that a nation's status relies upon its fiscal power. He expressed that the Government's power had source of treasury. This verse is used in the logo of Income Tax Department of India in Devanagari script.

## Taxation as discussed by Kautilya

Arthashashtra was the first authoritative text on Public Finance, Public Administration and the Fiscal Laws in this country. In Arthashashtra, Kautilya has mentioned various types of taxes and duties such as those imposed on agricultural produce, trade, octroi, tolls and custom duties. Some of the important taxes were as follows:

- Custom Duty (*Sulka*), which consisted of import duty (*praveshya*), export duty (*nishkramya*) and gate tolls / octroi (*dwarabahirikadeya*).
- Transaction tax (*vyaji*), which included *manavyaji* (transaction tax for Crown goods)
- Share of Production (*Bhaga*) which included 1/6th share called (*Shadbhaga*)
- Tax in cash called (*Kara*)
- Taxes in Kind (*Pratikara*), which included Labour (*vishti*), for military (*Ayudhiya*)
- Counterveiling duties (*Vaidharana*)
- Road Cess (*Vartani*)
- Monopoly Tax (*Parigha*)
- Royalty (*Prakriya*)
- Taxes paid in kind by villages (*Pindakara*)
- Army Maintenance Tax (*Senabhaktham*)
- Surcharges (*Parsvam*)



The *basic premise of Kautilya's taxation doctrine was that public should not be exploited by imposing tax more than their competence to pay*. People should be willing to pay so that the receipts can be effectively used to build social and physical infrastructure.

## Kautilya's System of Tax Administration and Present Day Tax System

There are many similarities between the current day tax system and the Kautilya's system of Tax administration prevalent more than two thousand years ago. For example, Kautilya had specifically laid down the terms for taxation, without any scope for arbitrariness. Further, he fixed a time table for payment of taxes and also what share of the produce or product value is to be paid as tax. Further, the stance of Kautilya on a kind of progressive taxation and ability to pay principle are followed in modern day practice also. Further, the personnel responsible for collection of the tax needed to keep proper record of the entire collection as done today. There were additional taxes for emergency situation (such as tax on liquor levied during war or emergencies).

# Merits and Demerits of Direct Taxes

There are different types of direct taxes such as Income Tax, Corporate Tax, Inheritance Tax, Property Tax, Wealth Tax (abolished now in India), Capital Gains Tax etc.

## Merits

The key merits of the direct taxes are as follows:

**Progressive Tax**

The direct taxes follow the principle of 'ability to pay' because they are levied on the basis of individual's income and wealth. Since ability to pay can be measured, the direct taxes are imposed at progressive rate whereby richer persons pay higher taxes in comparison to the poor persons.

**Reduction in Inequality**

Due to their progressive nature, the direct taxes help in reduction of the inequalities because the revenues collected from the rich man can be used for the good of poor man.

**Economical in collection**

In comparison to indirect taxes, the direct taxes are easy to collect because a tax payer makes his own payments.

**Elasticity**

Direct taxes can be manipulated / altered as per requirements of the government, change in the income of the people and economic status of the nation as a whole.

**Taxpayer Consciousness**

The taxpayers are conscious of their payments and are aware or make efforts to be aware where their money is being spent. It develops a national and civic consciousness among themselves. The role of RTI in recent years has become much more important in recent times towards increased awareness among tax payers.



## Demerits

There are several demerits of the direct taxes. Since the burden of tax payment is on individuals, it is most disliked tax. It is generally paid as large amount and sometimes involves too much personal information, direct tax gets unpopular. Further, tax burden of one person cannot be transferred to another person; so direct tax does not differentiate between ways of earning. One might be working hard while another might be earning without hard labour; but direct tax liability of both are similar so sounds unjust.  Further, since there is no scientific principle of defining the degree of progression, the direct taxes are fixed arbitrarily. Since, large number of taxpayers make self declaration, the honest tax payers end up paying more than those who involve in tax evasion by falsifying the accounts.

# Merits and Demerits of Indirect Taxes

Indirect taxes are levied on the production or consumption of goods and services or on transaction, including imports and exports. In case of indirect taxes, it is said that the person who is hit does not bleed; someone else bleeds. Still, there are key merits of Indirect taxes as follows:

### Elasticity

Akin to direct taxes, the indirect taxes are elastic because they can be adjusted to the changing economic environment. Further, the burden of the tax is on to the consumers of goods and services, so any change in the rates increases the revenue of the government in bulk. For example, the recent change in service tax rates from 12.5% to 14% has increased government revenue to great extent.

### Broad-based

Indirect taxes are charged on a large number of goods and services so they are broad based. Due to wider coverage and broad base, the governments end up collecting more revenues as the taxes cover almost every goods.

### Progressive

To some extent, the indirect taxes can be made progressive, for example imposing such taxes on items of luxury while exempting the essential commodities.

### Leveller

Indirect taxes spare none. Rich or poor, all have to pay indirect taxes. This makes the lower income groups share the burden of the government while not paying the direct taxes.

### Low Tax evasion

Since the indirect taxes are collected on sundry items and are a part of the price of commodities; these taxes are not evadable generally. However, they can be evaded by falsifying accounts or smuggling activities.



### Sin Tax to promote social welfare

Sin Tax refers to a tax levied on all products and consumer goods known as vices or unhealthy for social growth and consumption of which may cause negative externalities. Sin Tax is thus a subtle way to discourage people from participating in such activities without implementing as complete ban on them. The tax forms a huge source of revenue to the government.

### Easy to Pay

The indirect taxes are paid in small amounts while purchasing the goods and services and due to this, it's easier to pay them.

### Environment Protection

This is relatively new concept. The governments would use indirect taxes to modify the behaviour of the individuals to achieve goals related to environment protection. For example, increased taxation on goods produced via polluting industries can modify the demand. Similarly, increase cost of fossil fuel may promote public transport.

## Demerits

There are several demerits of the indirect taxes. Firstly, the cost of collection is very high. The government needs to establish network throughout the territory to enable indirect tax collection. Secondly, since the taxes are on expenditure, they affect only the consumers, the revenue generation is uncertain and is subject to price elasticity of demand / supply of the goods. Thirdly, indirect taxes need to be paid by all whether rich or poor, they are termed regressive, though they can be artificially made progressive to some extent. Fourthly, since the indirect prices are paid concealed in the price, they don't bring on civic awareness among the taxpayers in contrast to the direct taxes. Fifthly, since indirect taxes inflate the price of the goods, they lead to inflation. To reduce inflationary pressure, government reduces indirect taxes from time to time on concerned commodities. Sixthly, being regressive in nature, the indirect taxes impose heavier burden on poorer sections of society.

## Comparative Analysis of Direct and Indirect Taxes

There are several parameters on which the direct and indirect taxes can be compared. *Firstly,* direct taxes are progressive and they help to reduce inequalities but indirect taxes are regressive and they widen the gap of inequalities. Thus, direct taxes result in more equitable distribution of income and wealth, though it might not be always true. Secondly, direct taxes are narrow based so their collection is easier; but indirect taxes are broad based, so administration costs to collect them is comparatively higher. Thirdly, in comparison to direct taxes, the indirect taxes affect the purchasing power of the people more. In other words, direct taxes only remove the enhanced purchasing power of the tax payers. On the other hand, the indirect taxes affect poor people more brutally. Fourthly, in terms of the economic growth, indirect taxes are more growth oriented in comparison to direct taxes. Direct taxes are progressive and they reduce savings and investments. When saving and investments are discouraged, economic growth is more likely to be affected. In contrast, the indirect taxes discourage consumption and increase savings. The sin taxes for example discourage consumption of inconspicuous items and promote health, which has indirect effect on economic growth.



## Tax Avoidance and Evasion

There are three different concepts viz. tax avoidance, tax evasion and tax planning. Tax Avoidance means an attempt to reduce tax liability through legal means, i.e. to regulate one's financial affairs in such a way that one pays the minimum tax imposed by the law. This can be understood with a simple example. Tax Evasion and Tax avoidance are two different things. While Avoidance is legal management to avoid tax, tax evasion is illegal means to reduce tax liabilities, i.e. falsification of books, suppression of income, overstatement of deductions, etc.

Similarly, Tax planning is an accepted practice, whereby the taxpayer uses provisions of law to minimize his tax liability.

### Methods of Tax avoidances

#### Tax Havens

This implies to route profits through subsidiaries located in tax havens. Tax havens refers to the countries or territories where either very low tax is levied on certain items or not taken at all. Switzerland, Luxembourg, Isle of Man, British Overseas Territory, Bermuda, British Virgin Islands, Cayman Islands, Puerto Rico etc. are some of the popular tax havens around the world.

#### Treaty Shopping

Treaty shopping refers to taking undue advantage of a tax treaty between two countries by a resident of a third country.

#### Round Tripping

India Round Tripping, money is routed back into the country by local investors through tax havens like Mauritius. In this, money from home country goes out through illegal channels and invested back in the same country via a second country with whom India has a tax treaty. For example, it was suspected that many Indians used round tripping method and invested the money back in India via Mauritius. Such problem is countered by including relevant clauses and rules in the taxation law. For example in India, the domestic companies routing their investments through Mauritius need to pay capital gains tax.

#### Transfer Pricing



Transfer Price is the price of the goods and services sold between related entities such as – parent company and daughter (subsidiary) company. The companies artificially keep pricing of goods and services between related entities to avoid taxation via so called Base Erosion and Profit Sharing (BEPS).

#### Thin Capitalization

Thin capitalization is when most part of company's capital is made of debt instead of equity. When most of the capital is debt, the company has solvency risk. For tax avoidance purpose some companies indulge in artificial thin capitalization if there are tax benefits on receiving debt or loan. To counter this menace, governments need to introduce rules to disallow interest payments beyond certain limits.

### Methods of Tax Evasion

Tax evasion involves illegal and unfair ways to get away without paying. Evasion of tax takes place when the people report dishonest tax. Falsifying the accounts, smuggling, false invoicing etc. are common methods of tax evasion.

## Treaty Shopping

Treaty shopping is considered to be a means of tax avoidance. The bilateral tax treaties are done to reciprocate the benefits between the residents of two countries but when someone from a third country invests in any of them just for the sake of avoiding tax and derives the benefits of low taxation, this is termed as treaty shopping. Countries use anti-treaty-shopping provisions such as Limitation of Benefit (LOB) clause and/or beneficial ownership provisions to counter the treaty shopping. For example, India included such LOB clause in relation to bilateral tax treaty with Singapore.

### Limitation Of Benefit (LOB)

Limitation Of Benefit (LOB) refers to the rules that are put in place to counter the menace of treaty-shopping/ Such rules restrict availing of the treaty benefits by a conduit (compromised) entity formed for the purposes of treaty-shopping {*they call it a letterbox entity*}. It also restricts entities who attempt to claim double non-taxation; for example, LOB clause under India-Singapore tax treaty.

## Transfer Pricing

Transfer Price is the price of the goods and services sold between related entities such as – parent company and daughter (subsidiary) company; or between branches of same entity. The fixing of price of goods and services between parent-subsidiary is called Transfer Pricing.

### Tax Avoidance Using Transfer Pricing

Transfer pricing itself is not a means of tax avoidance if transfer price matches what the seller entity would charge to an unrelated customer (called customer at arm's length). However, since lowering or  increasing the prices between parent-daughter entities don't affect the whole organization, the companies artificially increase or decrease the transfer price to avoid corporate tax. This processing of using unusual transfer pricing to avoid tax is called *Base Erosion and Profit Sharing (BEPS).*

**Transfer Pricing Case Study**

In 2009-10, TCS (Tata Consultancy Services) ad shown a net profit per employee of Rs 4.3 lakh. At the same time, Capgemini, a foreign IT firm with operations in India, recorded a net profit per employee of Rs 1.5 lakh. Thus, Capgemini showed a net profit per employee one third of TCS. Despite of similar business, similar in contract pricing and similar in salaries and other expenses, why the foreign IT firms reporting profitability numbers that are a fraction of their Indian peers? *Moreover, the same difference went* on the same lines on other scales such as revenue per employee, operating profit margin, net profit margin. This was **due to the menace of Transfer pricing** as per experts.

### How it is done?

The subsidiaries of the foreign companies in India use transfer pricing to allocate most expenses / loss to India and most profits to their high-tax home country thus produce low taxable income or excessive loss on transactions. The Transfer Pricing has been under tough scrutiny by the authorities in India, which look for a better share in the tax from the companies. However, sometimes the companies claim and insist that they have done transfer pricing correctly. Due to this, Transfer pricing has been a key issue for both multinational corporations and tax authorities for a long time. Most of the countries in the western world have their own rules regarding the transfer pricing. Indian Government also has took some proactive measures to resolve the disputes arising due to the transfer pricing.

### Government Efforts in this Direction

The Government had introduced Transfer Pricing Regulations (TPR) through the Finance Act, 2001 on the basis of OECD guidelines. Currently, the transfer pricing rules are part of section 92 and 92F of the Income Tax Act. Basic premise of these rules is that the related party transactions should involve an arm's length principle and the pricing should be such as if it would have been charged from an independent buyer. The rules postulate several methods of defining an arm's length price such as Comparable uncontrolled price (CUP) method; Resale price method (RPM); Cost plus method (CPM); Profit split method (PSM); Transactional net margin method (TNMM) etc.

To handle the dispute in calculation of tax liabilities, government established a Dispute Resolution Panel (DRP) under Income Tax Act via the Finance Act 2009.



**Dispute Resolution Panels**

DRPs had been constituted at Delhi, Mumbai, Ahmedabad, Kolkata, Chennai, Hyderabad, Bengaluru and Pune. DRP consists of three commissioners or directors of income tax appointed by the Central Board of Direct Taxes (CBDT). Any foreign company, or any domestic company with transfer pricing issues, in whose case the income-tax assessing officer proposes to make any variation in the income or loss returned, may apply within a month of receiving the draft assessment order before the DRP for appropriate remedy by way of direction to the assessing officer.

Further, via the Finance Act 2012, the government extended these rules to domestic related party transactions exceeding Rs. 5 Crore also.

## G20- OECD's BEPS Action Plan

Base Erosion and Profit Sharing (BEPS) has emerged as one of the most important challenges for the governments across the world today. The globalization, privatization and liberalization has resulted into free movement of capital and labour, shift of manufacturing base from high cost to low cost locations, gradual removal of the trade barriers and rise of digital economy. LPG has boosted trade and foreign investments in many countries thereby supporting growth, employment generation, innovation and removal of poverty. LPG has led to flourishing of multinational corporations with their presence in many countries.

As early as 1920s, it was recognized that the interaction of the foreign companies with domestic tax system in host country might lead to double taxation which might result in adverse impacts on the growth and global prosperity.

To eliminate double taxation countries started entering into Double Tax Avoiding Treaties. The bilateral tax treaties are effective in preventing double taxation, but they often fail to prevent double non-taxation that results from interactions among more than two countries. This led to an increased number of *sophisticated tax planners* around the world. These professionals would *identify and exploit the loopholes in the tax treaties* thereby allowing the MNCs to do aggressive treaty shopping and go for Base Erosion and Profit Shifting (BEPS) to reduce their tax burden. This has harmed governments because they need to cope with less revenue and incur heavy cost to ensure tax compliance. This is a critical issue around the world.

## What is BEPS?

Base Erosion and Profit Shifting (BEPS) refers to those instances where gaps between different tax rules leads to tax avoidance causing harm to the government. It refers to all those artificial arrangements where:



- Due to gaps in application of the bilateral tax treaties, cross border activities may go untaxed in any of the two countries.
- No or low tax is paid by shifting profits to low tax jurisdictions and shifting losses and high expenditures to high tax jurisdictions.

Further, the spread of the digital economy has also posed challenges for international taxation.

Over the years, the MNCs have artificially reduced their corporate tax outgo by shifting to lower tax jurisdictions. As per OECD estimates, the base erosion and profit shifting has resulted in a loss of $100-240 billion every year to countries which is around 4-10% of global corporate income tax revenue.

## OECD Action Plan on BEPS

Originally, OECD had started the BEPS project in response to the 2008 financial crisis in order to create sustainable economic growth. It was formally launched in 2012 by the G-20 Finance Ministers who in turn called on OECD to develop an action plan to address BEPS issues in a co-ordinated and comprehensive manner and develop an action plan with inter alia, following points:

- There is a need to effectively prevent the double non-taxation and low taxation by checking the artificial arrangements to reduce tax liability.
- Countries should adopt new consensus-based anti-abuse provisions and new international

standards to ensure the coherence of corporate income taxation at international level to complement the existing standards.

- Rise of digital economy has furthered the problem.

In 2013, the OECD came up with an action plan to address the Base Erosion and Profit Shifting menace. This action plan has 15 actions points. In summary, the 15 OECD action points seek to develop a more coherent international system to address the problems of digital economy taxation, treaty abuse, transfer pricing, aggressive tax planning and disputes related to such problems. The document says that countries should build consensus on how to effectively address the tax compliance of digital products and services and effective collection of VAT/GST with respect to cross border supply of digital products and services. It talks about neutralising the effects of hybrid mismatch arrangements and strengthening the CFC (controlled foreign company) rules. It aims to improve transparency both for business and governments by introducing commonly agreed minimum standards for tax administration across countries.

**Hybrid mismatch arrangements**

Hybrid entity refers to the companies which might be treated differently in two tax jurisdictions. A hybrid instrument is one which is treated differently in two tax jurisdiction i.e. debt in one and equity in other. The tax planners exploit the asymmetries between different tax jurisdictions through the use of a hybrid entity or a hybrid instrument. The OECD action plan calls for developing model treaty provisions regarding domestic rule to neutralize the effect of hybrid mismatch arrangements.

**The BEPS Timeline**

**June 2012**

- G20 Summit launches BEPS Project

**February 2013**

- OECD publishes BEPs background report
- Public comments and stakeholder discussions continue on a parallel track since June 2013 over issues like transfer pricing, treaty abuse, permanent establishment status, taxing the digital economy

**July 2013**

- OECD Action plan delivered to G20

**September 2013**

- G20 leader's declaration at St Petersburg endorsing the project, making it a joint project between OECD and G20

**September 2014**



- OECD presents G20 leaders with draft proposals to tackle tax evasion
- Push for greater role of developing countries to curb corporate tax avoidance

**October 2014**

- OECD issues revised calender for stakeholder consultation

**February 2015**

- OECD gets the mandate to launch negotiations on a multilateral instrument, an implementation package for country-by-country reporting, among others

**October 2015**

- G20 Finance Ministers discuss OECD/G20 final BEPS reports

## Current Status

The G20-OECD led project on base erosion and profit sharing (BEPS) is currently taking a firm shape. It aims to fulfil the 15 points of the G20-OECD on the multifarious aspects of international tax policy by December 2015. On October 5, 2015, OECD has released a Base Erosion and Profit Shifting (BEPS) package containing final reports on 15 identified focus areas. This report includes recommendations for significant changes in the key elements of international tax architecture. In

2016, OECD is expected to come out with a multilateral convention to prevent the treaty abuses.

### India's Stance on multilateral / Bilateral Tax Regime

India has also responded positively to the G20-OECD led BEPS project. For a developing country like India, any such regime which effectively addresses the treaty shopping would result in more tax revenues. Further, India is also in the process of making tax treaties sustainable with its bilateral partners such as Mauritius. India also has become a signatory of the Multilateral Competent Authority Agreement on Automatic Exchange of Financial Account Information on 3rd June, 2015. These new global standards on automatic exchange of information, known as Common Reporting Standards (CRS), once implemented, will facilitate automatic exchange of taxpayers' information between treaty partner countries for speedy dispute resolution and reducing instance of base erosion through use of dubious structures/financing instruments in cross-border transactions.

Further, India has also signed the Inter-Government Agreement (IGA) on Foreign Account Tax Compliance Act (FATCA) with United States.

### India and BEPS

It was **recently reported** that the Budget 2016-17 might take some recommendations from the BEPS measures and make domestic anti-abuse provisions such as rules to block thin capitalization, Controlled Foreign Corporation (CFC) Regulations etc.



## General Anti Avoidance Rules (GAAR)

General Anti-Avoidance Rules (GAAR) are general rules that target any transaction of business arrangement that is done for aggressive tax planning, tax avoidance or tax evasion. GAAR were introduced in Australia in 1981, Canada in 1988, South Africa in 2006 and China in 2008.

### GAAR in India

In India, GAAR is still at proposed stage and current government has deferred implementation till April 2016.

### Key Proposals in GAAR

The objective of GAAR is to check tax avoidance by giving additional powers to the Income Tax Department. The department will have powers to deny tax benefit if a transaction was carried out exclusively for the purpose of avoiding tax. It will be able to go deeper into ownership structures, beneficial ownerships, voting rights, transactions, etc. and lift the corporate veil if there is any artificial arrangement made just for the sake of avoiding taxation. The key proposals are as follows:

#### Minimum threshold for invoking GAAR

As per the proposals, GAAR can be invoked only if artificial arrangements have been done to avoid tax value of at least Rs. 3 Crore in a particular assessment year.

#### Applicability of GAAR to foreign institutional investors (FIIs)

GAAR provisions are not applicable to those SEBI-registered Foreign Institutional Investors (FIIs) which do not take any benefit under Double Taxation Avoidance Agreements (DTAA) entered by India with other countries. GAAR would also not apply to investment made by FIIs by way of offshore derivative instruments

**'Grandfathering' of investments**

This implies that the GAAR provisions will not apply in case of income from transfer of investments made before August 30, 2010

**Consequence of impermissible arrangement in a transaction**

Applicability of GAAR will be restricted to only that part of the arrangement which is regarded as an 'impermissible avoidance arrangement' by tax authorities, and not to the entire transaction

## Powers of Income Tax Commissioner

The Income Tax Commissioner will be empowered to declare an arrangement as an Impermissible Avoidance Arrangement (IAA) if:

- The whole, a step or a part of the arrangement has been entered with the objective of obtaining tax benefit, and
- The arrangement creates rights and an obligation not normally created in arm's length  transactions or results in direct or indirect misuse or abuse of the provisions of the code or lack commercial substance in whole or part, or is not bonafide.

This is so far reaching in nature that almost each and every transaction, which results in saving tax could be regarded as an IAA.

This means that GAAR enables tax authorities to declare any arrangement entered into by a taxpayer as an IAA. If it is so declared, then the tax authorities can disregard, combine or re-characterize any step of such arrangement or the entire arrangement, disregard any accommodating party involved in such arrangement, treat the transaction as if it had not been entered into or carried out, reallocate any income or expenditure, look through any arrangement by disregarding any corporate structure, re-characterize debt as equity or vice-versa and so on.

In effect, for tax purposes, any transaction can be treated in a manner different from the manner in which it is carried out if it is regarded as an IAA.

## Key concerns of Industry

The industry in one voice raised several concerns. The basic issue here is the trust deficit between the investors / corporate and the income tax department. The real fear was that overarching powers to the Income Tax department would create an environment of deterrence and would make doing business further difficult in India.

To draw the final guidelines, to bring tax clarity and to address the concerns of foreign investors in relation to GAAR, the UPA government in 2012 had set up the **Parthasarathy Shome panel**. This panel made the following important recommendations:

- The implementation of GAAR shall be deferred by three years.
- GAAR should be made applicable only if the monetary threshold of tax benefit is Rs.3 crore and more.
- GAAR should not be invoked to examine the genuineness of the residency FII from Mauritius.
- GAAR should apply "only in cases of abusive, contrived and artificial arrangements".
- Short-term capital gains tax should be abolished and transaction tax should be increased.

### Current Status

The UPA Government in 2013 had deferred GAAR for two years accepting recommendations of the Shome Panel. In the budget for 2015-16, FMM Jaitley proposed postponing the implementation of GAAR by two more years. There are several questions that remain unanswered as follows:

- There are already some Special Anti-Avoidance Rules (SAARs) in the Income Tax Act. Will GAAR apply when these rules exist.
- What are the cases which would fall within and outside purview of GAAR; government should clarify this.
- Remove retrospective taxation.
- Government should create a special cadre of GAAR-trained tax administrators



The above extension is likely to be the last extension.

### Conclusion

Tax avoidance is an international concern and comes heavy on the Government exchequer. Several countries have already codified GAAR laws or are in the process of doing so. India is no different and must codify the laws that check misuse of the tax treaties and legal loopholes to avoid taxes. While the carefully drafted GAAR rules should not deter the genuine investors, GAAR must be in place to show the world that India is not a tax haven.

## Tax Reforms

Prior to the liberalization of Economy, India's tax regime was marred with numerous problems. In terms of direct taxes, there was a high degree of progressiveness in 1960s and 1970s that led to adverse effect on tax collection efficiency. Further, there were large number of exemptions eroded the already narrow tax base in the country. Then, the poor enforcement of direct taxes led to tax evasion at vogue. In terms of corporation tax, there were numerous discriminations between different kinds of the companies that discouraged the investments. Further, double taxation of dividends was also common in those days. In terms of Indirect taxes, the high rates of custom / excise duties were prevalent. There was no VAT, there was no service sector within the purview of tax.

The efforts to reform India's tax system began in mid 1980s when the government announced a Long Term Fiscal Policy 1985. This policy recognized that the fiscal position of the country is going downhill and there was a need to make changes in the taxation system. In that decade, a technical group to review and rationalize the central excise duties was established and this led to introduction of Modified System of Value-Added Tax (MODVAT) in 1986. To rationalize the custom duties, the harmonized system (HS) of the classification of goods was introduced.

**Raja Chelliah Committee**

The Government appointed a Tax Reforms Committee under Prof Raja Chelliah to lay out agenda for reforming India's tax system. This TRC came up with three reports in 1991, 1992 and 1993 with several measures, which can be summarized in these points:

1. Reforming the personal taxation system by reducing the marginal tax rates.
2. Reduction in the corporate tax rates.
3. Reducing the cost of imported inputs
4. by lowering the customs duties.
5. Reduction in the number of Customs tariff rates and its rationalization.
6. Simplifying the excise duties and its integration with a Value-Added Tax (VAT) system.
7. Bringing the services sector in the tax net within a VAT system.
8. Broadening of the tax base.
9. Building a tax information and computerization.
10. Improving the quality of tax administration.



The tax reforms that began with the Chelliah Committee recommendations are still going on. Later on, government appointed the Vijay Kelkar Committee in 2002 which further provided direction to the tax reforms in the country. Below is the crisp summary of tax changes made in India since 1991. The DTC and GST have been so far biggest reforms initiated by the Government in direct and indirect tax regime respectively. However, while DTC has lapsed and the government had decided to not to pursue it further, GST remains entangled into India's murky politics.

## Direct Tax Reforms

Impetus to direct tax reforms in India, came with the recommendations of the Task Force on Direct & Indirect Taxes under the chairmanship of Vijay Kelkar in 2002. The main recommendations of this task force related to the direct taxes related to increasing the income tax exemption limit, rationalization of exemptions, abolition of long term capital gains tax, abolition of wealth tax etc. Its key recommendations were as follows:

## Administration of Direct Tax

- The taxpayer services should be extended both in quality and quantity and taxpayers should get easy access through internet and email.
- PAN (Permanent Account Number) should be expanded and it should cover all citizens.
- Block assessment of search and seizure cases should be abolished.
- To clear the backlog, the department should outsource the data entry work.
- All returns and issue of refunds should be completed in a four month period. Dispatch of refunds should be outsourced.
- Government should establish a Tax Information Network to modernize, simplify and rationalize tax collection, particular TDS and TCS.
- Abolish the requirement of Tax Clearance Certificate on leaving the country.
- Empower CBDT with appropriate administrative and financial powers.

## Personal income tax

- Increase in exemption limit to Rs.1 lakh for the general categories of taxpayers and further exemption for senior citizens and widows.



- Rationalize income tax slabs, eliminate surcharge on personal income tax.
- Incentivise home loans by providing interest subsidy on home loans @2%.
- Increase deduction under Section 80CCC for contribution to pension funds.

## Corporation Tax

- Reduce the Corporate tax to 30% for domestic companies and 35% for foreign companies.
- The listed companies should be exempted from tax on dividends and capital gains.
- Increase rate of depreciation for plant and machinery.
- Abolish Minimum Alternate Tax.

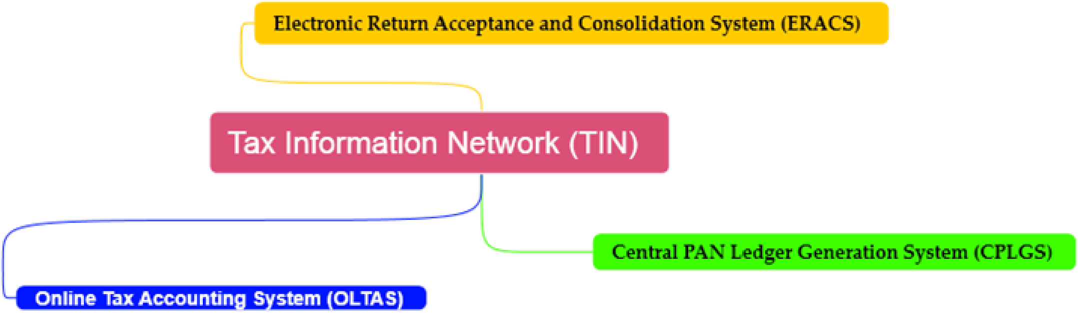
## Wealth Tax

- Abolition of wealth tax.

The above recommendations were made 13 years ago. Today, we see that many of them have been implemented. The current status of various tax reforms done in these years is as follows:

## Tax Information Network (TIN)

On behalf of the Income Tax Department, the National Securities Depository Limited (NSDL) established Tax Information Network (TIN). This is a source of the countrywide tax related data. The basic idea behind establishing TIN was to modernise collection, processing, monitoring and accounting of direct taxes using information technology. TIN has three subsystems viz. ERACS, OLTAS and CPLGS.




**Electronic Return Acceptance and Consolidation System (ERACS)**

ERACS consists of a system for interface with the taxpayers (TIN Facilitation Centres that is TIN-FC) and an internet supported system for upload of electronic returns of Tax Deduction at Source (TDS) and Tax Collection at Source (TCS) and Annual Information Return (AIR) to the central system of TIN.

**Online Tax Accounting System (OLTAS)**

OLTAS is used for upload to the central system the details of tax deposited in numerous tax collecting branches across the country every day.



**Central PAN Ledger Generation System (CPLGS)**

It is the central system that merges the details of TDS/TCS and advance tax into the PAN.

## e-TDS & e-TCS

TDS refers to Tax Deduction at Source. The third parties deduct tax at source and then deposits it at pre-determined bank branches. Since 2004–2005, it has been made mandatory to file TDS returns electronically for both the operators, the Government as well as corporate sector. Further, the Income Tax Act, 1961 states that when tax is collected at source by the seller from the buyer, it is named TCS (Tax Collected at Source). Under the scheme named 'Electronic Filing of Returns of Tax Collected at Source Scheme, 2005', the corporate and Government deductors have to pay electronically or physically to NSDL.

## eSahyog initiative : Paperless Assessments

Information Technology has made the life of tax payers easy as they don't need physically go to banks to deposit bank challans and present the case and documents to assessing officers. To make further simple, the CBDT recently came up with a proposal paperless income tax assessment over emails. This would save the taxpayer to pay a visit to IT office, particularly in case of small amounts. Pilot projects in this direction have been launched in Mumbai, Delhi, Chennai, Bengaluru and Ahmedabad.

## Sevottam: Efficient grievance redressal

To bring new life to the sluggish grievance redressal system, the department is using 'Sevottam' platform that connects all income tax offices in the country. The idea is to address the queries and grievances in real time.

## Faster refunds

The IT department is working towards processing and sending tax refunds within 10 working days. The initiative to verify Income Tax Return (ITR) by Aadhaar or bank database has been taken.

## Pre-filled ITR forms

Despite of online forms, many people still use offline downloaded forms for tax purpose. The Department is now taking an initiative to offer pre-filled forms which automatically populated with user / taxpayer data and are downloaded with most information filled already.

## PAN camps

To increase coverage of the PAN, the government has been conducting PAN camps across India. There is also a proposals to launch Income Tax Business Application-Permanent Account Number (ITBA-PAN) portal, through which anyone can apply for PAN online and get it within 48 hours.

## Income Tax Rates

The personal income tax rates have been rationalized, however, currently the minimum taxable income is Rs. 2.50 Lakh.

## Corporate Tax Rates

Despite of the demand to bring down the corporation tax rate to 25%, the current effective tax rate is around 34% and 42% for Indian and foreign companies. Further, Indian companies still need to pay 12% Dividend Distribution Tax, which is regressive.

## Wealth Tax

Wealth Tax in India was introduced in 1957 and was levied @1% on Individuals, HUF's and Companies if the Net Wealth of such person / entity exceeds Rs. 30 Lakhs. This tax is now abolished from April 1, 2015. The loss of the revenue is to be compensated with additional surcharge on super rich tax payer earning more than Rs. 1 crore.

## Direct Taxes Code

Direct Taxes Code (DTC), which was first released in 2009, sought to replace the existing Income Tax Act 1961 and Wealth Tax Act 1957 through a single legislation, with consolidation and improvements in the way taxes are collected in India. It sought to consolidate all direct taxes. The current NDA Government has put it in cold storage and will not pursue it. As per finance minister, most of its proposals have already been incorporated in the Income Tax Act, there is not merit in pursuing it.

## Indirect Tax Reforms

First Indirect Tax Reform occurred in India when the Modified Value Added Tax (MODVAT) was introduced for selected commodities in 1986 to replace the Central Excise Duty. It was gradually extended to all commodities through Central Value Added Tax (CENVAT). The states also followed the suit and enacted the VAT acts to replace the sales tax with Value Added Tax. Following are the key indirect tax reforms done.

### Reduction in Custom Duties

In 1990, the custom duty on non-agricultural products was around 128%. It was brought down gradually. Currently, the average custom duties are 11-12%, however, they range from 0 to 150%.

### Central Excise

Central Excise duties were first replaced with MODVAT and now CENVAT is applicable. The number of different types of duties was cut down.

### Service Tax

Service tax was first introduced on some limited services in 1994-95 at 7%. The rate was gradually increased and so was the number of taxable services. Currently, we pay 14% service tax on around 100 services.

### Direct Tax Code and Goods and Services Tax



The Goods and Services Tax (GST) is so far the biggest tax reform in the country. It is currently entangled into the murky politics in parliament.

# Goods and Services Tax

Goods and Services Tax is a comprehensive indirect tax which is to be levied on the manufacture, sale and consumption of goods and services at a national level. This is so far the biggest tax reform in the country. France was the first country to introduce GST system in 1954. More than 140 countries have implemented the GST. Most of the countries have a unified GST system. Brazil and Canada follow a dual system where GST is levied by both the Union and the State governments.

## Background

Genesis of the GST occurred during the previous NDA Government under Atal Bihari Vajpayee Government when it set up the Asim Dasgupta committee to design a model for GST. The UPA Government took the matter further and announced in 2006 that this tax would be introduced from April 1, 2010. However, so far it has not been introduced. It is now proposed to be introduced from April 1, 2016.

## Rationale

The indirect taxes such as excise duty, sales tax, service tax, octroi, customs duty etc. are currently imposed on goods and services and are levied by both centre and states. There are multiple incidences on taxes and cascading impact on the cost of finished goods. For example, prior to MODVAT and VAT reforms, the excise duty was imposed on both inputs used and output produced as well as each intermediate product. This led to multiple taxation incidents and that would have a cascading effect on the prices of the goods. The Sales tax was also incident upon for multiple times in the entire distribution chain.

VAT regime solved this problem to a great extent but several problems still remain. Many central and state taxes and few sectors such as real estate, oil/gas sector remained out of VAT. Further, each state levied VAT differently making it a very complex matter.

The problem is compounded in the interstate transport and trade of the goods. Currently, different forms are needed to be kept in different states during the entire logistics operations. The first problem is getting these forms as they are maintained in serial numbers. Second problem is of these forms to be presented as each of the check posts, if the trucker is not able to do so, the truck is detained. The checking of these documents itself is cumbersome so we can see long lines on the check posts. The result is a drastic increase in the transit time from the source to destination. It is said that in India, the transit time is 50% higher than other countries. The direct implication of this is the decrease in the return on investment per truck.



Many of these problems are addressed by the Goods and Services Tax.

## Need for Constitutional Amendment

Article 264 & 293 are related to the financial relations between the Union and the State Governments. Since, the state Governments have their interests in GST, the implementation of GST cannot take place without amendment of the Indian Constitution. For this purpose, Constitution (122nd Amendment) Bill, 2014 is currently pending in the parliament. The bill was passed in Lok Sabha on May 06, 2015 and currently needs to be passed in Rajya Sabha where ruling coalition is in minority.

### Proposed New Articles in Constitution

#### Article 246A

This articles provides that both parliament and state legislatures shall have concurrent powers to make laws with respect to goods and services tax (GST). The Parliament will retain exclusive power to legislate on inter-state trade or commerce.

#### Article 269A

In case of the inter-state trade, the tax will be levied and collected by the Government of India and shared between the Union and States as per recommendation of the GST Council.

#### Article 279A

This article provides for constitution of a GST council by president within sixty days from this act coming into force.

**Proposed important amendments in existing articles**

- The residuary power of legislation of Parliament vi article 248 wll be made subject to article 246A.
- Article 249 will be changed so that if 2/3rd majority resolution is passed by Rajya Sabha, the Parliament will have powers to make necessary laws with respect to GST in national interest.
- Article 250 would be amended so that parliament will have powers to make laws related to GST during emergency period.
- Article 268 would be amended so that excise duty on medicinal and toilet preparation will be omitted from the state list and will be subsumed in GST.
- Article 268A will be repealed / modified so that service tax is subsumed in GST.
- Article 269 would empower the parliament to make GST related laws for inter-state trade / commerce.

## Scope of GST

- GST is one tax applicable to both goods or services. There will be no service tax once GST is implemented. There will be no cesses either in indirect taxes. Exports are zero-rated.



- Alcoholic liquor for human consumption is exempted. Further, GST will not be applicable to crude oil, high speed diesel, petrol, natural gas, aviation turbine fuel as of now. When the GST will apply to these items- is to be decided by GST council later on.
- Tobacco and tobacco products will be subject to GST. The centre may also impose excise duty on tobacco.

## Levy of GST

- The power to make laws on taxation of goods and services would be vested in both Parliament and state legislatures. Further, a law made by Parliament on GST will *not override a state law* on GST.
- In case of inter-state trade / commerce, an Integrated GST (IGST) will be levied and collected by the Central Government.
- Parliament will by law prescribe how the IGST will be shared between centre and states on recommendation of GST council.
- The central government will also imposed 1% tax on supply of goods in case of inter-state trade or commerce. This tax is to be collected by centre and to be assigned to state from where the supply of good originated. This tax is to be levied for 2 years or for a longer period as recommended by GST council.

## GST Council

GST Council will be a constitutional body established by president of India. It's composition will be as follows:

- Chairman – Union Finance Minister
- Minister of State (Finance)
- Finance Minister as member from each state
- The meetings of the GST Council can proceed with a quorum of 50 percent and decisions will be taken with a at least three-fourth weighted majority voting for a resolution. All decisions of the GST Council will be made by three-fourth majority of the votes cast; the centre shall have one-third of the votes cast, and the states together shall have two-third of the votes cast.

### Functions of GST Council

The functions of the GST council would be to make recommendation on

- What taxes, cesses, and surcharges to be subsumed under the GST?
- What goods and services are subject to, or exempted from GST?
- The threshold limit of turnover for application of GST

- Rates of GST
- Model GST laws, principles of levy, apportionment of IGST and principles related to place of supply
- Special provisions with respect to the eight north eastern states, Himachal Pradesh, Jammu and Kashmir, and Uttarakhand
- Other related matters

## Compensation to states

The proposed bill says that the parliament would enact law for compensation to states for revenue losses arising out of the implementation of GST. This will be done on the basis of recommendations of the GST Council. Such compensation could be for a maximum of five years.

# General Knowledge Today



# Government Budgeting-3: GST, Fiscal Policy, FRBM, Investments

**Integrated IAS General Studies:2016-17**

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# Contents

## Model Questions

**Prelims Topics for MCQs**

Special Majority, Fiscal Policy versus Monetary Policy, Components of Fiscal Policy, Constitution articles related to India's Fiscal Policy, FRBM documents that need to be placed with budget, Financial Investment and Real Investment, Induced and Autonomous Investment, Impact of monetary and fiscal policies on Investments, Types of Growth Models.

### Mains Model Questions

1. To what extent the proposed Goods & Services Tax has potential to alleviate the tax-on-tax problem? Substantiate your answer.
2. Discuss the concerns of the states with respect to the Goods and Services Tax. To what extent, these concerns have been addressed in the current GST model as proposed in Constitution 122nd amendment Bill.
3. The demand for an independent GST Dispute Settlement Authority seems to be more logical in comparison to GST Council. Analyze.



4. The proposed 1% additional levy on supply of goods under GST will contradicts the actual purpose of GST introduction. Comment.
5. Explain the concept destination-based taxation? How the GST proposes to implement the destination-based taxation system and what are the implications of it?
6. "The success of a GST system is largely dependent on the width of its coverage." Comment.
7. Critically examine the potential implications for small sector business and consumers.
8. Discuss the impact of the GST implementation on inflationand GDP with special reference to the Make in India campaign?
9. Discuss the key elements of fiscal policy of the government.
10. "The overarching framework for India's fiscal policy is provided by the constitution." Amplify.
11. "It appears that the FRBM act and the rules framed for fiscal discipline was an exercise in futility.". Discuss suggesting steps towards fiscal dicipline with reference to FRBM Act 2003.
12. Differentiate between Induced and Autonomous Investments. Why governments try to boost the autonomous investment?
13. Objectively differentiate between Demand-led, Investment-led and Consumption-led Economic Growth models. Which model suits to Indian Economy. Discuss.

14. Why the Investment led growth is not considered to be sustainable? Examine citing examples.
15. Discuss various factors that influence the Foreign Investment Decisions.

In this document, we continue our discussion on GST from Government Budgeting-2 document.

# Analysis: Key Issues with GST

GST will come into effect by enactment of constitution 122nd amendment bill. This bill is the current and slightly modified version of Constitution 115th amendment bill, which was proposed by the UPA Government in 2011 but failed to get it passed. The 122nd amendment bill was cleared in Lok Sabha on May 6, 2015 but is currently stalled in Rajya Sabha where ruling dispensation is in minority.

To become a law, the bill needs to be passed by *special majority in* both Houses, and ratified by 50% of states. Special majority is the majority of the total membership of that House and by a majority of not less than two-thirds of the members of the House "present and voting".

## GST and its impact on cascading effect of taxes

There are three important elements of GST:



- First, it is a unified tax taking the form of a dual GST to be levied concurrently by both levels of governments and would comprise of a Central GST and a State GST. It would combine the taxes such as excise, sales and services. It is going to replace 17 taxes and it is argued that it would lead to ease of doing business.
- Second, GST is essentially a Value Added Tax. This implies that it would be calculated on value addition and not only the value of the goods or service.
- Third, GST has to remove the cascading effect of the tax-on-tax problem and profit on tax problem. It is argued that this would lead to a fall in prices.

There is no doubt that GST would be simplifying the indirect tax regime however, it appears overhyped. Even under GST, there are going to be three taxes viz. *CGST to be collected by Centre, SGST to be collected by States and the IGST to be collected by centre on inter-state sales of the goods.* Thus, it appears that the CGST, SGST and IGST are nothing but new names for existing Central Excise/Service Tax, VAT and CST.

This apart, it is likely that *alcohol, tobacco and petroleum products* would be left out of purview of GST mainly because of pressure from states. Further, electricity and real estate is also being left out of the GST net and thus they would be taxed separately. In summary, the cascading effect of some taxes is going to stay and not to be alleviated completely.

## Issue of Revenue Neutral Rate (RNR)

Because GST removes the problem of tax on tax and cascading effect of various taxes; and because GST is a value added tax, it is expected that tax collection would fall when it comes into effect. This implies that government tax revenue will come down when India moves to the GST regime. If the government wishes to collect the same amount of tax as in earlier tax regime, it needs to raise tax rate to make adjustments. This increased tax rate has been called the Revenue Neutral Rate (RNR).

What should be the revenue neutral rate? This has been a contentious issue. The government had set up several committees to arrive at such rate. The initial panels (including 13FC) recommended that RNR should be slightly above 12%. However, states called this rate too low and objected because they would be bearing the brunt of low tax revenue collection.

Subsequently, a Delhi based think tank National Institute of Public Finance and Policy (NIPFP) was asked to compute the RNR. This think tank proposed a 26.68% RNR (12.77% CGST and 13.91% SGST). This rate is practically very high because globally, the average GST or VAT rate is around 16%. Thus, this number was neither politically not practically satisfactory. Currently, the deliberations are on to identify the most appropriate number which can be around 23 to 25%. The Congress party had asked the Rajya Sabha select committee for capping the GST rate at 18 per cent.



A possible implication of high RNR is inflation, which reduces the demand in economy and will affect rate of growth. The government cannot give up RNR because if it does so, its revenue would fall and states would suffer. This is the main worry of the states. We note here that the Centre has been proposing to compensate the states for their revenue losses but then, it will increase deficit of the centre.

In June 2015, a panel headed by Chief Economic Adviser Arvind Subramanian, was set up to prescribe a RNR which strikes a balance so that the rate is not too high for industry and simultaneously high enough, so that states do not suffer any revenue loss. The committee will also suggest the impact of GST rollout on inflation. The Committee is expected to submit its report in December this year.

### Concerns of the States

The state governments have the following issues:

- A lower GST rate might mar their existing revenues and they may need to look up to the centre for compensation.
- They are not ready with the information technology systems and the administrative infrastructure.

Various state Governments have sought assurances that their existing revenues will be protected, fearing that if the uniform tax rate is lower than their existing rates, it will hit their tax kitty. The centre believes that dual GST will lead to better revenue collection for States.

## IT Infrastructure for the GST: GSTN

A robust IT infrastructure is prerequisite to successful implementation of GST. The current status is as follows:

- For central taxes, the IT infrastructure is managed by the NIC and all the returns are filed through the ACES site.
- For states, the tax infrastructure is managed by the tax departments of respective states. *There is a huge inequality in the IT infrastructure among the states.*

In the proposed GST, government would be consolidating the returns to be filed and a new infrastructure has to be created from scratch. For this, a new entity *Goods and Service Tax Network (GSTN)* in the form of a *non-government private limited company* was created in March 2013.

In September 2015, Infosys had bagged Rs. 1380 Crore contract from central government to build the technology infrastructure for Goods and Services Tax Network (GSTN). Infosys will work as managed service provider (MSP) for GSTN and the contract is for five years.

The GSTN company would provide IT infrastructure and services to the Central and State governments, tax payers and other stakeholders for implementation of the Goods and Services Tax (GST).

## The Issues around GST Council

The GST bill seeks to set up a GST Council. The GST Council aims to develop a harmonized national market of goods and services. According the GST Bill, the President must constitute a GST Council within sixty days of this Act coming into force. The composition of the GST Council includes:

- The Union Finance Minister (as Chairman),
- The Union Minister of State in charge of Revenue or Finance, and
- The Minister in charge of Finance or Taxation or any other Minister, nominated by each state government.

The decisions of the GST Council will be made by three-fourth majority of the votes cast. The centre shall have one-third of the votes cast, and the states together shall have two-third of the votes cast.

The GST Council will make recommendations on:

- taxes, cesses, and surcharges to be subsumed under the GST;
- goods and services which may be subject to, or exempt from GST;
- the threshold limit of turnover for application of GST;

- rates of GST;
- model GST laws, principles of levy, apportionment of IGST and principles related to place of supply;
- special provisions with respect to the eight north eastern states, Himachal Pradesh, Jammu and Kashmir, and Uttarakhand; and
- other related matters.

The GST Council may decide the system of resolving disputes arising out of its recommendations. The GST Council will also decide when the GST would be levied on petroleum crude, natural gas, high speed diesel, aviation turbine fuel and motor spirit (petrol).

The Congress Party has opposed the composition of the council which gives the one-third weightage to the central government. It is demanding for the one-fourth of representation to the Central government. The Congress Party has also proposed for an independent dispute settlement mechanism.

## GST and Issue of Dispute Resolution

The current GST bill seeks to entrust the power of dispute resolution to the GST Council, comprising the Centre and states, instead of an independent body like *GST Dispute Settlement Authority* as proposed in UPA government draft. A dispute redressal mechanism is needed as issues are bound to come up between states, or the Centre and states, or even with local bodies. *The proposed GST Council as the dispute resolution body is criticised on the ground that how can it resolve the disputes arising out of its own recommendations.*

The GST Council provides veto power to centre along with state governments. The GST Council will give the Centre one-third voting power and the states two-thirds. Any decision will need three-fourth of the votes. Thus, neither the states together nor the Centre alone can change the GST. However, the dispute resolution body cannot work on this principle. Because any dispute resolution mechanism would need a judicial member. The authority was supposed to have a former Supreme Court judge or chief justice of a high court as its chairman. In GST Council each state, whether big such as Uttar Pradesh or Madhya Pradesh or small such as Uttarakhand or Chhattisgarh, will have the same voting percentage with it. The weak states may sometimes become orphan as they cannot woo the stronger states to support them.

Any dispute resolution mechanism whether it is independent or other way should resolve the issues in an amicable manner by giving due say to each of the parties to the dispute.

## Issue of GST being a Destination based Tax

Indirect taxes can be either origin based or destination based. Origin based tax (also known as production tax) is levied where goods or services are produced. Destination based tax (consumption tax) are levied where goods and services are consumed. In destination-based taxation, exports are allowed with zero taxes whereas imports are taxed on par with the domestic production.

In case of the inter-state trade of goods and services, there may be two undesirable instances of *double taxation* or *tax avoidance* due to origin and destination based taxes. Firstly, some goods might be taxed in both the states of origin and destination, leading to double taxation. Secondly, the goods might skip tax in both the states thus leading to tax evasion. The first instance of double taxation in India is so high that importing goods from abroad is cheaper than importing it from other state.

The 13th finance commission had recommended that GST may be *either origin based or destination based.* If it is destination based, revenue should belong to the states where the goods are finally consumed and not to the State where the goods are produced. If its origin based tax, should accrue to state, where the goods or services are produced and not to the State where they are consumed. As per current proposals, the GST will be a destination-based tax. This implies that all SGST collected will generally accrue to the State where the consumer of the goods or services sold resides. This simply means that the producing state gets nothing if produced goods are sold outside that state.

There are several implications of this, discussed as below:

- Firstly, destination based GST would be very much beneficial for the states which consume more goods / services than they produce. The more they consume the more revenue they get from inter-state trade but such benefits that *come via increased consumption* are not good for overall economy of the state.
- Secondly, the destination based tax may not be very encouraging for the states which produce these goods because nothing will accrue to them.
- Thirdly, to discourage consumption, some states might put restriction on inter-state movement of goods. Such move might adversely affect the economy.

The move from origin based to destination based indirect tax regime would lead to drop in revenues of some states. This was the reason that some states such as Gujarat have opposed GST, which is a destination based tax. The central government has promised to compensate such states for a period of five years.

There are counter arguments to the revenue loss concept of producer states. The increased exports will increase the income of the producer state and the increased income may increase the consumption and thereby the revenue of the state will improve.

## GST and the concept of "Supply of Goods"

Under GST, the definition of goods has been replaced with the "supply of goods". Under the present indirect tax regime in India various central and state levies are triggered by distinct taxes like service tax provision of services, VAT on sale of goods and excise duty on manufacture of goods. The GST proposes to subsume all these taxes into a single tax trigger – “supply”.

## Taxable event

GST is a tax on the supply of goods and services. Though ‘supply’ has not been defined, it is not restricted by the traditional terms such as ‘sale’ and ‘manufacture’. Under GST, all goods and services transactions will be taxed, unless they are specifically excluded. Therefore, we can expect a wide range of activities (which are not taxable under present regime) to become liable to GST, given that a supply will subsume multiple taxable events. For example, the manufacture and sale of goods currently attracts two separate levies (excise duty and VAT), will attract a single levy as a supply under the GST regime (central GST and state GST).

The important outcome of ‘supply’ being the tax trigger is the *elimination of the potential for dual taxes.* GST will likely be levied on supplies of both goods and services at same rate. Under the GST bill, the term ‘services’ has been defined as “anything other than goods”. This mutual exclusivity will be followed in various GST laws enacted by the states and central government. This will solve various longstanding disputes in relation to the duality of taxes.



With the introduction of the concept of ‘supply’- even supplies of personal goods or supplies of goods to agents could attract GST. This would ensure the continuity of the tax chain, allowing credit to flow freely.

## Place of supply

The rules governing the place of supply are closely linked to the taxable event. The rules of place of supply will determine not only whether a given transaction is subject to GST, but also determine which state can claim to the state GST component built into central GST. As GST is a destination-based consumption tax, the rules for the place of supply should be aligned with this principle. As per the destination-based principle, the default rule for determining place of supply is the location of the recipient. The supply rules for the services will be more complex as the place of supply cannot be determined in some cases like telecom services and supply of fuels through dedicated pipelines. The place of supply rules must be simple and clear to address the issues related to place of supply of services– particularly given the growth in e-commerce and electronic delivery of services. Any ambiguity in rules may result in endless disputes not only between taxpayers and the revenue authorities, but also between states that assert jurisdiction over the supply of goods and services.

## Issue of Proposed 1% levy on Supply of Goods

The proposed GST is a destination-based consumption tax. The taxes will accrue to the state where consumption of goods happens. This is opposed by the producer states as they have spent on infrastructure and now they won't get any benefit under the GST model.

To allay the problems of those manufacturing states, the *NDA government has provided for an additional levy of 1% over the GST for supply of goods for a two year time period.* However it is criticised on the grounds that it could make the intra-sate movement of goods more expensive and it will hurt the Make in India campaign. For example, if a good is going form Gujarat to Tamil Nadu, crossing four states, the good would embody an additional tax of about four-five percent, because it is 1% for each state. This makes it easier to import the good from Thailand to Tamil Nadu. The 1% levy will burden the individuals in the consumption state and so is opposed by the northern and eastern states. Many economists are also argued that there is no point implementing the GST in this manner and it should be delayed till it can be launched as a single tier levy. The 1% additional levy also creates the distinction between the manufacture of goods and provision of services. The GST Council has the power to extend the levy beyond the proposed interim period of 2 years. This presents a major concern of the additional levy remaining over a long period of time. The proposed levy also violates the principle of "Supply of goods". The solution to the issue is the centre should drop the 1% additional levy and compensate the states directly for a two year time period.

## GST Possible Implications



Till now, introduction of Value Added Tax (VAT) at the state level and CENVAT at central level are considered to be largest indirect tax reforms in the country and GST is the next logical step towards making India a unified market. The biggest advantage of GST is economic unification of India. It has potential to end the long-standing distortions arising out of the differential treatment of the manufacturing and service sectors. Further, it would also improve tax compliance by making it easier for businesses to return files, pay taxes and get refunds. For importers, the input tax credit would be available for countervailing duty of customs (CVD) and additional customs duty (ACD) and thus would help them. GST would substantially enhance the competitive edge of both the manufacturing and services industry by removing the disability that domestic producers suffer from. The following are specific implications of GST on various stakeholders.

### Impact of GST on Consumers and businessmen

The several types of taxes that currently exist such as excise, octroi, sales tax, CENVAT, Service tax, turnover tax etc. would come under the GST umbrella. Since this would eliminate double taxation, it might result into fall of prices; thus relieving consumers.

This is also because the GST provides tax credit at every stage of taxation from manufacturing to consumption. Currently, margin is added at every stage and tax is paid on the amount including margins. These taxes on profit and taxes on tax add to the cost of goods and services whose burden is to be borne by the final consumer. GST would provide a continuous chain of set- off from the producer's point to the retailer's point and would result in fall in prices. The chain of set offs would also result in better tax compliance of industry, trades and businessmen.

For businesses, the GST would make life easy because of easier compliance (due to absence of multiple taxes) and easier return filing, tax payment and refund process due to robust IT infrastructure.

### Impact of GST on Services

Currently, central government levies service tax for more than 100 services. No sales tax / VAT are levied by the states on services. However, once GST is in place, the service providers would need to pay the SGST to the states. Further, there will be a common tax rate on all services. This implies that services might become costly when GST is in place.

### Impact of GST on Small Businesses and Unorganized sector

The GST is not applicable until gross annual turnover crosses Rs. 10 Lakh. A few states, which have lower VAT threshold, will be at loss and the Central Government promises to compensate them. The GST is unlikely to benefit the unorganized sector because it would not get any tax credit for purchases that it makes from organized sector. Further, if a business from unorganized sector sells



the goods to unorganized sector, it would not be able to pass on the benefits of setoff. Due to this, it can be expected that unorganized sector might become less competitive and may face decline. Any such decline might further aggravate the unemployment in the country.

**Implications of GST**

1. Abolition of multiple taxes
2. Increase in voluntary tax compliance
3. Removes distortion in economy
4. Removes cascading effects of taxation
5. Enhances manufacturing and distribution efficiency
6. Widening tax base

### Impact of GST on Inflation Management and GDP

The GST with its uniform taxation structure can be one of the most important steps towards achieving the task of inflation management and GDP growth. The current indirect tax regime suffers from significant cascading which leads to higher cost of goods and services consumed in the country. There are also numerous examples where the tax payers or consumers have to pay both Centre and State taxes on a single sale which adds to increased tax costs for business and consumers. Such increase costs add to the inflationary pressure in the economy.

In the GST regime, a free flow of credits across transactions decrease the tax cost for businesses. Given that both Centre and State taxes would be levied simultaneously on all supplies, the issue relating to dual taxation on certain products would also come to rest. The decrease in tax costs would boost the exports in the country. The reduction of costs in India would make our products more competitive in the international market thereby not only increasing the GDP of the country but also inflow of foreign currency. There are also estimates that GST can add 2% to GDP.

### Impact of GST on Make-in-India

The 'Make in India' campaign is proposes to make India a world-class manufacturing hub. The tax reforms through GST will play a crucial role to attract large scale investment. The impending Goods and Service Tax (GST) promises a progressive tax system which avoids tax cascades and helps establish India as a true common market. GST will reduce the cost of production and allows the hassle free supply of goods. This can increase the ease of doing business India.



## Key current challenges to GST

Currently, challenges to implementation of GST are as follows:

- Enactment of Constitution amendment bill needs consensus among ruling and opposition parties because ruling party is in minority in Rajya Sabha.
- Setting up IT infrastructure and an enabled centralised agency to settle the IGST claims and work as a clearing house.
- To estimate and formulate a Revenue Neutral Rate (RNR) of the tax, although centre has taken lead to comfort the states by promising compensation for five years.
- The estimation of the tax base in each of the states and since the threshold for the centre and states are different, of the tax base of the centre as well
- How the 'hard to tax' sectors will be dealt with. Such sectors include financial services, real estate and housing. As of now, real estate is left out of purview but later, its inclusion would be warranted.
- The training of tax personnel at both at the Central and state levels.
- To create a permanent institutional arrangement to negotiate, harmonise and monitor the reform process as well as the working of the new tax system.

### Success of a GST – Width of its coverage

The success of a GST system will dependent on the width of its coverage. All items in the tax chain must ideally be included in the GST system to achieve the best results. That will eliminate the incidence of paying tax on taxes, reduces the cascading effect of a tax system and enables producers of goods and services to enjoy the set-off benefits on the taxes they may have paid at various intermediate stages. But the proposed GST regime excluded potable alcohol, tobacco and petroleum products. Taken together, they account for a large chunk of the indirect taxes base in the country. This exclusion is largely triggered by some of the state governments desire to preserve their revenue. Added to this the real estate sector will not be covered under the proposed GST. Thus, all construction activities and the expenditure incurred on them would be outside the GST chain. The new GST regime with all these imperfections may perpetuate the barriers. However, it would be good to make a beginning even with an imperfect GST, with all its flaws, as long as the government is committed to addressing the concerns that arise over time.

# Fiscal Policy

## Objectives and Components of Fiscal Policy in India



The word *fiscal* comes from a French word *Fisc*, which means *treasure of Government*. All the *taxation and expenditure decisions* of the government comprise the Fiscal Policy.

Fiscal Policy is different from monetary policy in the sense that monetary policy deals with the supply of money and rate of interest. The government and RBI use these two policies to steer the broad aspects of the Indian Economy. *While government is conducts Fiscal Policy, RBI is responsible for monetary policy.* RBI also helps the government in implementing its fiscal policy decisions.

Conducting fiscal policy is one of the main duties of the government. Via fiscal policy, the government collects money from different resources and utilizes it for different expenditures. Since all welfare projects are carried out under public expenditures, fiscal policy is closely related to the development policy.

### Objectives of Fiscal Policy

The objectives of the fiscal policy of the government are as follows:

**Resource Mobilization**

Fiscal policy allows the government to mobilize resources for public expenditure and development. There are three ways of resource mobilization viz. taxation, public savings and private savings through issue of bonds and securities.

**Resource Allocation**

The funds mobilized under fiscal policy are further allocated for development of social and physical infrastructure. For example, the government collected tax revenues are allocated to various ministries to carry out their schemes for development.

#### Redistribution of Income

The taxes collected from rich people are spent on social upliftment of the poor and this fiscal policy in a welfare state tried to reduce inequalities of income using resource allocation.

#### Price stability, control of Inflation, Employment generation

Government uses fiscal measures such as taxation and public expenditure to stabilize the prices and control inflation. Government also generates employment by speeding infrastructure development.

#### Balanced Regional Development

A large part of the government tax revenues are given out to less developed states as statutory and discretionary grant. This helps in the balanced regional development of the country.

#### Balance of Payments

Using fiscal policy measures government tries to promote exports to earn foreign exchange. This helps in maintaining favourable balance of trade and balance of payments.

#### Capital Formation and National Income

Fiscal policy measures help in increasing the capital formation and economic growth. Increased capital formation leads to increase in national income al



### Components of Fiscal Policy

There are four key components of Fiscal Policy are as follows:

- Taxation Policy
- Expenditure Policy
- Investment & Disinvestment policy
- Debt / surplus management.

#### Taxation Policy

We have already discussed in detail about the taxation policy in previous module. The government gets revenue from direct and indirect taxes. Via its fiscal policy, government aims to keep the taxes as much progressive as possible. Further, judicious taxation decisions are very important for economy because of two reasons:

- Higher than usual tax rate will reduce the purchasing power of people and will lead to an decrease in investment and production.
- Lower than usual tax rates would leave more money with people to spend and this would lead to inflation.

Thus, the government has to make a balance and impose correct tax rate for the economy.

#### Expenditure Policy

Expenditure policy of the government deals with revenue and capital expenditures. These expenditures are done on areas of development like education, health, infrastructure etc. and to pay internal and external debt and interest on those debts. Government budget is the most important instrument embodying expenditure policy of the government. The budget is also used for deficit financing i.e. filling the gap between Government spending and income.

### Investment and Disinvestment Policy

Optimum levels of domestic as well as foreign investment are needed to maintain the economic growth. In recent years, the importance of FDI has increased dramatically and has become an instrument of integrating the domestic economies with global economy.

### Debt / Surplus Management

If the government received more than it spends, it is called surplus. If government spends more than income, then it is called deficit. To fund the deficit, the government has to borrow from domestic or foreign sources. It can also print money for deficit financing.

## India's Fiscal Policy Framework

The overarching framework for India's fiscal policy is provided by the constitution. This framework is made of:

- Article 246, Article 248 (residuary power of taxation) and Seventh Schedule



- Article 280 provision for Finance Commission
- Article 112 and other articles related to Budget
- Part IX and IX-A (local administration)
- Article 360 (Financial Emergency)

Article 246 and Seventh Schedule clearly divide the powers of taxation between Central and the State governments. Article 248 makes provision for enabling parliament to exercise residual power of taxation when a particular subject of taxation is not available in any of the Union, State or Concurrent list of the constitution. Further, there are provisions for financial powers of local administration in part IX and IXA.

Since the tax powers of states is not equal to the centre, the constitution makes provision for a finance commission via article 280 which recommends allocation of some resources of centre to states via statutory grants and discretionary grants. The constitution also mandates the central government to prepare budget or annual financial statement of its proposed taxation and expenditure for Legislative debate and approval in the parliament under article 112.

## Fiscal Responsibility and Budget Management Act, 2003

In 1980s, India saw a sharp deterioration of the fiscal situation, which ultimately culminated in the balance of payments crisis of 1991. Within a decade of economic liberalisation, the fiscal deficit and debt situation again seemed to head towards unsustainable levels around 2000. At that time, a need to *institutionalize a new fiscal discipline framework*. The FRBM Bill 2000 was introduced by previous NDA government in the parliament to institutionalize the fiscal discipline at both the centre and state level. However, the bill took three years to become an act and during this process, it lost most of its teeth.

Under the Fiscal Responsibility and Budget Management Act (FRBMA) 2003, both the Centre and States were supposed to wipe out revenue deficit and cut fiscal deficit to 3% of GDP by 2008-09, thus bringing much needed fiscal discipline. Originally, the FRBM bill had given annual numerical targets as well. But in the process of making it a law, the annual targets were dissolved and the act simply said that the Centre will take appropriate measures to eliminate revenue deficit by March 31, 2008. The act left the annual numerical targets to be formulated by the Central Government in the form of FRBM rules under the FRBM Act 2000.

However, the NDA government (which passed this act) was replaced by UPA in 2004. The UPA-I Government notified the FRBM Rules in July 2004. As Parliament is the supreme legislative body, the Act and the Rules legally bind the Finance Ministers and Governments. The key provisions of the Act as well as FRBM rules are as follows:



- Every year the government will bring down revenue deficit by 0.5% and eliminate it by 2007-08.
- Every year, the government will bring down fiscal deficit by 0.3% and bring it down to 3% by 2007-08.
- Total liabilities of the Union Government should not rise by more than 9% a year.
- Union Government would not give guarantee to loans raised by PSUs and State governments for more than 0.5% of the GDP in aggregate.
- Union Government would place three more documents along with the budget documents viz. Macroeconomic Framework Statement, Medium Term Fiscal Policy Statement and the Fiscal Policy Strategy Statement.
- At the end of second quarter, the Finance Minister would make a statement on the trend of fiscal indicators and corrective measures taken thereof.

However, due to the 2007 international financial crisis, the deadlines for the implementation of the targets in the act was initially postponed and subsequently suspended in 2009. In last few years, the act has been largely neglected.

Central Government is required to lay before both Houses of Parliament the following documents: (1) Medium Term Fiscal Policy Statement (2) Fiscal Policy Strategy

Statement and (3) Macro Economic Framework Statement along with Annual Financial Statement and Demand for Grants.

## Critical Analysis of the FRBM Act

The act was passed to make the central government and finance minister accountable to parliament for fiscal discipline. However, due to lack of an autonomous Fiscal Management Review Committee (as proposed originally) the act more or less became like a Directive Principle of State policy which is not enforceable via courts. Its mandate was diluted and even today we find both revenue deficit and fiscal deficits in budget documents.

### Why Government deviated from path of fiscal correction?

The government deviated from the path of fiscal correction in the wake of the global financial crisis and unanticipated changes in the prices of oil and fertilizers in 2008-09. In those days, the subsidy bill shot up and government needed to issue fertilizer and oil bonds to raise money from market. Further, in 2008-09, the government also included a fiscal stimulus package to revive the economy and this led India's fiscal deficit to go up to 6.5%.

A huge fiscal deficit forced the government to relax the FRBM targets and subsequently ask the 13th finance commission to rewrite the whole plan for fiscal consolidation.



In 2010-11, Government gave further blow to this act by including the concept of *Effective Revenue Deficit* in the budget documents. In Budget 2012-13, the finance act changed the FRBM act and dumped the centre's commitment to eliminate the revenue deficit. Instead, it brought in a new commitment of eliminating the effective revenue deficit rather. The amended rules extended the time for elimination of Effective revenue deficit by March 2015 and bringing down fiscal deficit to 3% by March 2017. Currently we have 2.9% revenue deficit and 4.1% fiscal deficit.

From the above discussion, it appears that the FRBM act and the rules framed for fiscal discipline was an exercise in futility. The government wants fiscal consolidation but is not ready to pay the short term costs. Increasing taxes to raise revenue is painful, while cutting subsidy has political costs to the ruling parties. In summary, the experience with FRBM has been of shifting goalposts and bypassing the spirit to achieve fiscal consolidation.

### Where is the problem?

The problem lies in the act itself. The FRBM rules can be simply amended by gazette notification. They lack transparency and adequate monitoring and compliance by the government. The Economic Survey 2013-14 had recommended for a new FRBM act with teeth. Further, there are some other approaches which can help:

- Move the annual numerical targets from FRBM rules (which are framed and amended by central Government at whim by gazette notification) to the FRBM act itself (so that at least a parliamentary approval is needed to make changes)

- Do away with the ambiguous concept of the Effective Revenue Deficit which is nothing but a jugglery to rewrite revenue expenditure as capital expenditure.

The FRBM Committee Report of 2000 had recommended an autonomous Fiscal Management Review Committee (FMRC) which would conduct an annual independent and public review of FRBM compliance. The current act lacks that, and there is a need to institute an independent review and monitoring of implementation of the FRBM law.

# Investment Models

## Basic Concepts

### Financial Investment and Real Investment

The meaning of the term "**investment**" is different for economists than the rest of the world. When we ask our banker for investment, he / she would probably start taking about stocks, mutual funds, some deposit accounts or insurance products. But, for an economist, these purchases of financial assets are **NOT investment** simply for the reason that financial assets do not represent real net



wealth for the economy as a whole. Rather, when somebody purchases a financial asset, it would reflect the credit relationship within the economy. For example,

- Loans and bank accounts represent contracts to pay interest and repay principal on borrowed money.
- Stocks represent partial ownership of a corporation, or right to receive dividends etc.

In these cases, the financial asset of one party in the economy would be offset by a financial liability of another party. Thus, when we aggregate the wealth of all members of the economy, these assets and liabilities cancel and financial assets disappear. This implies that when I am investing in an asset, somebody is disinvesting at the same time. *By my investment in a financial asset, the aggregate or social investment doesn't increase. Such an investment only signifies change of ownership. This kind of investment has significance only from individual point of view; it has no importance from social point of view.*

An economist would reserve the term investment for those transactions that *increase the magnitude of real aggregate wealth in the economy*. This implies that investment refers to creation / purchase of new durable assets such as factories and machines, which are used for production. Here please note that resale of the assets is not counted in such investments.

In the expenditure side computation of the National Income, the GDP is represented by a formula **GDP = C + I + G + NX,** where C is consumption, I is investment G is government spending, and NX is net exports, given by the difference between the exports and imports, X – M. By this, we can arrive at

I=GDP-G-NX

This means *investment is everything that remains of total expenditure after consumption, government spending, and net exports are subtracted. This kind of investment results in* ***net addition to the total capital stock of the society****, causing increase in employment. This is called* ***Real Investment.***

**Notable points: Real Investment**

- Real Investment results in increment of capital equipment
- By real investment, we don't mean to purchase the existing paper securities, bonds, debentures or equities, but the purchase of new factories, machines, railroads etc.
- Investment expenditure is a related concept, which refers to the expenditures which are done for producer's durable equipments, new construction and the change in inventories.

## Induced and Autonomous Investment

Induced investment is that investment which is governed by income and amount of profit. The inducing factors are changes in income and profit. Where there is a possibility of increase in income and profit, the induced investment increases and when there is a decreased possibility of income and profit, the induced investment decreases. This implies that the induced investment is profit and income elastic. In simple language, when increase in investment is due to the increase in current level of income and production, it is known as induced investment. The relations of the income/ profit and investment are shown by the below graph.


Induced Investment

The graph shows that at very low level of income / profit, the induced investment may be negative also. Autonomous investment is that investment which is independent of the level of income or profit. Thus, it is not induced by any changes in the income. The investments which are made with the aim of introducing new techniques, new inventions etc. or enhance the level of effective demand during the period of depression and unemployment are kept in the category of autonomous investments. Thus, the autonomous investment is generally associated with:

- Introduction of new techniques of production
- Development of new resources
- Growth of population
- Depression or recession.

In the graphical representation, the autonomous investment remains parallel to the Income/ profit axis as shown in the below graph.

**Autonomous Investment**



There will be no change in investment whether the income increases or decreases. Please note that autonomous investment does not vary with variation in income. It does not mean that autonomous investment does not change at all. The autonomous investment **can be increased and decreased** any time, notwithstanding the changes in income or profit. Thus, in such changes, the I-I curve in the above graph will shift either upward or downward.

The above discussion also leads us to conclude that the autonomous investment is not determined by consideration of profit. Instead, it is determined by consideration of the social welfare. In the times of economic depressions, the governments **try to boost the autonomous investment**. Thus, autonomous investment is ***one of the key concepts in welfare economics.***

## Private Investment and Public Investment

Investment can be divided into two factions on the basis of ownership of investment viz. Private Investment and Public Investment.

### Private Investment

**Private Investment** is the investment which is made by the private individuals with the *sole* *objective of earning profit.* According to classical economist Keynes, there are two factors which decide the Private Investment viz. *Marginal Efficiency of Capital (MEC)* and *Rate of Investment.* It can be simply understood by the fact that the output in an economy depends upon the stock of capital. If there is an increase in stock of capital, the output increases. But, how much increase in investment in capital would raise the output, this would depend upon the productivity of new capital i.e. on the marginal efficiency of capital. The marginal efficiency of capital (MEC) is that rate of discount which would equate the price of a fixed capital asset with its present discounted value of expected income.

A businessman while investing in a new capital asset examines the expected profit on it during its lifetime against the supply price of capital asset (interest). If the Marginal Efficiency of Capital (MEC) is greater than the rate of interest, more private investment will be made.

### Public Investment

Public Investment is that investment which is made by the central, provincial or local self government of a country. This investment is made for social welfare, defense and economic development. Profit does not motivate such investment.

## Gross Investment versus Net Investment

Investment is closely related to Economic growth. One of the important reasons for making investments is **Capital Consumption,** which is another technical term used for **depreciation**. By capital consumption, we mean to replace worn out, or failing machinery, equipment or buildings. Capital consumption arises from the continuous depreciation of fixed capital assets. The other obvious reason is to undertake purchase of a new machinery, equipment, railroad, buildings and factories to increase the productive capacity. The long term objective of such investments is to increase competitiveness, reduce long term costs and raise profits.

The investment made for both *new acquires* and *Capital Consumption* is called **Gross Investment.** However, *net investment only measures new assets* rather than replacement assets. This relationship is expressed as follows:

***Net investment = gross investment – depreciation***

We take an example here. We suppose that a shipping company replaces five worn out ships with identical new ships. At the same time, it also purchases two new ships for increasing the traffic capacity. In this case, the gross investment is seven ships but net investment is only two ships. Here, the net investment is what attracts the economists as a basis for economic growth.

## Factors affecting Investments

Investment in public sector is induced by objectives like defence of the country, economic development and social welfare. Investment in this sector is independent of income or profit motive.

Investment must be made, if deemed necessary for the defence of the country or the welfare of the people irrespective of any profit or income.

Deficiency of private investment also calls for public investment. However, it should not be construed that government does not undertake any public investment for profit motive. Under normal conditions, many a time, government also makes investment to earn profit. But the purpose is not to compete out private sector. There are several industries of public interest wherein private sector does not want to invest. Government makes investment in these sectors. For example, in India, construction of roads and running of air, traffic etc. are done largely by government itself. Often government makes investment even at a loss. Volume of this kind of investment increases mostly during war or depression.

The major factors are discussed below:

**Technological Advance and Innovation**

- The technological challenges influence the investment decisions. The investment in labour saving and capital saving machines and other facilities are an example. *In other words, a rapid rate of innovation is conducive to high level of investment.*

**Discovery of resources**



- Discovery of new natural resources such as metals, minerals and oil induce investment.

**Government Policy**

- The monetary and fiscal policies of the government affect investment mainly in three ways:
  - Firstly, when the government pursues expansionary (cheap money) policy, the investment increases because of easy availability of the credit. Reverse happens when the government pursues tight policy.
  - Secondly, taxation, which is a part of business cost, affects investment. Higher taxes reduce the expectations of the profit and lower the investments. Reverse happens in lower taxations.
  - Thirdly, the government expenditure also affects investment in a big way. When the government initiates new projects and spends huge funds on them, the investment increases.

**Foreign Trade**

- When there is a possibility of increase in a country's foreign trade, it will have a favourable effect on investment, i.e., more investment will take place.

**Political Environment**

- Peaceful and stable political environment favour investments.

**Business Expectations**

- Business investments are very much dependent on expected profit, so favourable business expectations induce investment.

### Rate of Population Growth

- More and more population will need more new houses, schools, public services, roads, motor vehicles and consumer goods, so investment will increase. Rapid population growth also increases supply of labour which results in fall in wages, further increasing profit expectations and investments.

### Price Levels

- When there is a tendency for the price level to rise, it will increase the possibility of the profits of investors and so they will go on for more investment.

### Other Factors

- Availability of finance, stock of capital goods, aggregate demand and conditions of labour market are other factors.

## Measures to stimulate Private Investments

Various measures to stimulate the Private Investments in an economy include reduction in interest rates, reduction in taxes, adopting a policy of wage cut, increase in government expenditure and pump pricing. They are discussed below:

### Reduction in rate of Interest



- During depression period, monetary authorities should deliberately lower the rate of interest with a view to stimulate investment. This policy was propounded by Keynes. However there are two problems with this policy.
  - Firstly, the rate of interest can not be made below a particular limit because it depends on **liquidity preference.** This in simple language means that the interest rate can not go below the **liquidity preference** (**demand for money**).
  - Secondly, Investment is influenced by marginal efficiency of capital than rate of interest that is why during the period of depression, despite fall in in the rate of interest there is no increase in investment. Ordinarily, lowering the interest rate can induce investment in some sectors of economy.

### Reduction in Taxes

- Taxation system should be such that the investor is not much burdened. Here, the problem is that if the taxation is generally low, the government revenues will fall and it will badly affect public investments.
- The economists say that the people who spend their income on consumption and not investment can be taxed more. This further implies that the government should impose more indirect taxes and luxury taxes and rationalize the direct taxes such as Income Tax and

Corporation Tax.

### Policy of wage cut

- This was propounded by the classical economists. It says that reduction in money wages would lead to fall in cost of production and thereby increase investment. This theory was not approved by Keynes though.

### Increase in Government Expenditure

- Government expenditure proves to be very effective in stimulating investment.

### Other measures:

- **Price Support Policy** by the government under which some essential goods are bought and sold by the government in the open market to keep the prices in equilibrium. *Monopolistic hold of big firms on the production of a commodity should be abolished*, so that new firms can enter to make fresh investments.
- Government should government should enhance its expenditure on research and development. **The R&D** findings will attract investments from the private investors. During the depression, **Pump Priming** stimulates the private investments.
- During depression period, private investment is at its lowest ebb. In order to stimulate it, increase in public investment is quite necessary. The policy of increasing public investment with a view to stimulating private investment is caused Pump Priming



## Types of Growth Models

There are several drivers of Economic Growth. The main cause of increased output in the short run is increase in the aggregate demand, thus known as **Demand-led Growth**. The increase may be caused by rise in investment, Government spending, expenditure, exports or a combination of any of them. The higher investment increases the productive capacity of the economy and thereby raises the potential output of capital and consumer goods. Such a growth in the economy is called **Investment-led growth**. Here we note that the investment and output are closely related as increase in investment raises the output which further stimulates more investment. *The Economic growth model of China in recent decades is most suitable example of Investment-led growth model.*

Similarly, the USA is best example of **Consumption-led Economic Growth**. This model is based upon the fact that the well of people are able to consume the goods and services in such a way that there is an increase in aggregate demand thereby leading to increased output to satisfy that demand. Rises in government spending on education, training, research & development, infrastructure etc. are likely to have more impact on long lasting influence on economic growth than spending on welfare benefits such as subsidies. The economic growth led by such spending is called **Government**

**Expenditure led growth**. Finally, the exports also cause the economic growth because some of the exports proceeds can be used to fund imports which may lead to increase the productivity and output to a great extent. Such economic growth is called **Export-led growth**. In countries like India, the growth tends to be more driven by the savings and is thus called **Savings driven growth.**

## Shanghai Model

India and China as large economies of Asia hold development lessons for each other. The growth models of these two economies are essentially different from each other.



The Investment-led growth model of China has given birth to the so called **Ghost Towns** whereby 64 million vacant homes lie without occupants.

Today, China is world's second largest economy after United States. The seeds of China's rapid economic growth since the 1990s were first planted back in 1978 when the Communist Party started to introduce capitalist market principles, initially in the agricultural sector. While, in 1980s, the country was powered by the bottom-up enterprises, especially in the rural areas; the economic expansion accelerated dramatically in the 1990s as a result of mass privatisations, and the opening up of the country to foreign investment.

Overseas firms rushed to build factories in China to take advantage of its low labour costs. In this rush, China had changed its development strategy by placing greater emphasis on big cities like Shanghai and Beijing. This was the so called **Shanghai Model**. The Shanghai Model is an **extreme version of investment led growth** model.

### Implication of the Investment-led Growth Model

- The So called Shanghai model was effective in building up production but not in ramping up the consumption base.

- It is alleged that China has been successful in generating GDP growth, but far less successful in generating household income growth.
- Almost half of China's GDP comes from Investment, which has a huge multiplier effect on GDP. However, maintaining a high growth rate is not sustainable for an economy which is heavily relied on investment and subsequent manufacturing and export cycle.
- Most of the experts agreed that the fast GDP growth in China powered by investment is a time bomb. In terms of household income and small asset base, China is poor, indeed poorer than India. The *Consumption-to-GDP Ratio* of China is lower than India. The Household savings rate in China is not as high as that of India.

The impact of this investment-led growth model was that ***China witnessed over-investing***, which led to over-capacity that resulted in wastage of resources.

*However, it does not mean that China has no savings at all. In fact, China has persistent Current Account Surplus and has generated excessive savings, but, despite their exceptionally high levels, savings have not been absorbed in domestic investment, and have to be exported.*

**Why Investment led growth is not sustainable?**



One way to assess the impact of investment on growth is to examine whether investment adds value to the capital stock. If investment does not add value in terms of creating a future flow of goods and services (i.e., the value added concept of national accounts), then that part of investment will not contribute to the productive capital stock. It will initially be captured as excess capacity and then, once depreciation sets in, as wasted. Such investment will contribute to GDP growth only at the time it is implemented, reduce the marginal product of capital, and lead to deadweight loss.

## The Shift in China's strategy

In recent times, China has decided to take a pause from the investment-export led growth and focus *its attention on the consumption side*. The Chinese government is trying to increase domestic consumption; however, they're trying that within the existing level of the income rather than thinking of growing the income.

Some of the important measures being taken are summarized as below:

- The government is emphasising on rebuilding the social safety nets and narrowing the income gaps between the rural and urban areas.
- Eliminate the operational taxes on small businesses so that small businesses which provide employment to millions can thrive
- Tax exemptions so that people see more disposable income to spend off.

Overall, the Chinese seems to be convinced that the Economic Growth should not be investment led growth, but consumption led growth; the latter being much more sustainable and least susceptible to external shocks. The experts say that as China moves into consumption led growth, there may be a slowdown of temporary nature, which may indeed help India.

## India's Growth Model: Saving-led growth

India's growth model is quite distinct from other rapidly growing Asian economies. India has a growth model that is quite distinct from the Investment-export-oriented strategy adopted by China. Here are a few points for comparison.

- While China has derived a predominant part of its growth from the external sources both in terms of foreign investments and export markets, India's growth has mostly come from its internal sources. India's net exports to GDP ratio has been significantly lower than that of China.
- India has a large trade deficit, yet, India has managed to grow at reasonably high rates. The role that services exports, principally software exports, have played in maintaining an external sector balance for India and in sustaining high GDP growth rates as well is evident from the surplus in the invisibles account.
- The domestic savings investment gap in India has been kept at low levels and India has managed to finance a predominant part of its capital formation from domestic savings. Unlike China, India has not generated excessive savings. Till recent rise in CAD, India had a comparatively small current account deficit, a modest level of foreign exchange reserves and limited inflow of foreign capital. The foreign investments in India were hardly a fraction of the investments made in China, but small investments gave India ample insurance against external shocks.

Further, India's economic growth has been a services-led growth. The post-1991 high GDP growth has largely been attributed to the spectacular performance of the services sector, especially the software and IT-enabled services sector, in India.

# Sources of Investment

There are three main sources of investments viz. **Internal funding** using accumulated profits of a firm; **Borrowing** either from banks or through the issue of financial assets such as bonds (long term debt) or Commercial Papers (short-term) and **Issuing new shares of stock** i.e. new equity.

Each of the above funding methods imposes explicit and/or implicit costs. For example, if the firm borrows in order to fund an investment, it pays interest cost. If the internal funds are used, it is forgoing other uses of those funds. Had the firm not used the internal funds for new capital, it could have earned interest on the funds by lending them or purchasing financial assets. This means that *implicit cost of each rupee of internally funded investment is the interest of forgone lending*

## Foreign Investments- Basics and Models

Any investment in India which has its source any other country than India is Foreign Investment. The foreign money can be invested in India by *Foreign Corporate* and *nationals* or *Non Resident Indians.* The money can be invested in shares, properties, ownership / management or collaboration. On the basis of this, the Government of India classifies the Foreign Investment into the following forms:

- Foreign Direct Investment (FDI)
- Foreign Institutional investment (FII)
- Non-resident Indian (NRI) investment

### FDI

The Foreign Direct Investment refers to the direct investment into the production and management. This can be one by either buying a company or by expanding operations of an existing business. One example is Unilever which has its own subsidiary and long term investment here via its subsidiary Hindustan Unilever. This means that FDI brings foreign capital, technology & management.

### FII

FII (Foreign Institutional Investment) and FPI (Foreign Portfolio Investment) are same things. The

foreign institutions invest in a capital / money market which is not their home country. Such kinds of investments are seen in the Mutual Funds, Investment Companies, Pension Funds and Insurance Houses. This means that FII/ FPI brings only capital. FII is also called Foreign Indirect Investment.

### QFI

QFI (Qualified Foreign Investor) is an individual, group or association, resident in a foreign country that is compliant with Financial Action Task Force (FATF) standard and that is a signatory to International Organization of Securities Commission's Multilateral Memorandum of Understanding. Though, QFI are also portfolio investors, yet in context with India, QFIs do not include Foreign Institutional Investors or Sub-accounts as per the regulations.

### Differences between FDI and FII

The first notable difference is that while FDI brings foreign capital, technology & management, FII brings only foreign Capital.

Second difference we can understand with an example. Suppose, Wal-Mart comes to India and opens up stores here, this means that the investment made by Wal-Mart would come with a long term commitment. Thus, FDI brings in funds with long term commitments. On the other hand, if the company of Warren Buffett buys shares of an Indian company, they can sell it any time (as per regulations). This means that FII does not come with long term commitment. This also means that the money invested in India via FII can be taken back more easily than FDI. Thus, there is always a risk of flight of capital in terms of FII outflows but not generally in FDIs.

### Why Foreign Investors go for FDI?

Foreign direct investment is done for many reasons including to take advantage of cheaper wages in the country, special investment privileges such as tax exemptions offered by the country as an incentive to gain tariff-free access to the markets of the country. FDI can be done to acquire lasting interest in enterprises operating in the target country.

### Why Foreign Investors go for FII?

A portfolio investment does not entail active management or control of the target organization. This is done by the investors if they are not interested in involvement in the management of a company. The objective of the indirect investment is to financial gain only and does not create a lasting interest in or effective management control over an enterprise.

### How a Foreign Company can enter in India?

A foreign company planning to set up business operations in India need to set up a company under the Companies Act, 1956. For example, Hindustan Unilever is the Indian subsidiary of Unilever, British–Dutch multinational consumer goods company. The incorporation of the company can be done via a Joint Venture or Wholly owned Subsidiary. Foreign equity in such Indian companies can  be up to 100% depending on the requirements of the investor, subject to equity caps in respect of the sector/area of activities under the FDI policy.

These companies enter into India via an office or representation in India which is known as Liaison Office/Representative Office or Project Office or even Branch Office. Such offices can undertake activities permitted under the Foreign Exchange Management Regulations, 2000 (Establishment in India of branch or office of other place of business).

### What attracts Foreign Direct Investment?

The growth rate of the source economy is an important determinant of FDI into the country. The political and economic stability of the target region attracts FDI. Any FDI investment into the target country depends upon how 'open' the economy is towards foreign trade (both imports and exports). Apart from that, the policies, rule, regulations and loopholes incidental thereto also affect the flow of FDI. For example, Mauritius has been top FDI source for India due to the later reasons.

### What is the impact of FDI on Inflation?

*FDI has been generally touted as a measure to dampen inflation. But this can NOT be concluded in all situations.* The FDI's impact on dampening the inflation is based upon the assumption that FDI would result in the developing of country's back-end infrastructure and crack the supply bottlenecks. Practically, it may or may not happen. Economics has no rule to link FDI and Inflation because Inflation may have many reasons behind it rather than only infrastructure and supply bottlenecks.

Generally the FDI's role in containing inflation is supported by the facts that:

- It improves Infrastructure
- It improves supply chain
- It brings permanent investment

## What is the impact of FII on Inflation or vice-versa?

The FII impact inflation indirectly rather than directly. If there an excess inflow of FII, it may shoot the prices of stocks very high. When stocks become costly, there would be a huge demand for Indian rupees. To fulfil that demand, RBI would need to print more money and pump this money to economy. All of a sudden, if FII withdraw the funds, there would be an excess of liquidity in the markets. This would lead to a situation of too much money chasing too few goods and thus things would become costlier. *Thus, unchecked FII inflow and outflow can bring into demand pull inflation.*

When there is a high inflation in the country, it repels FII. Rising inflation in India makes the investors bothering.

## What are benefits of FII?

Controlled FII helps in improving the local environment. When huge FII comes in, there is much availability of fund for local companies to increase their capacity. The sufficient FII inflow in the

country means that the need to borrow from international sources seldom arrives. This helps in those countries where domestic saving is not sufficient for funding the expansion plans.

## Why FII inflows are volatile?

FII inflows are aimed at making money on the invested capital i.e. Capital gains. The capital gains are linked to the interest rates and stock market environment. If the interest rates / potential gains in one country go down in comparison to other target country, the FII inflow may halt or outflow may begun. That is why FII money is called hot money sometimes. In summary, the most suitable conditions for FII are as follows:

- Attractive Interest Rates
- Adequate money supply and stable rate of inflation
- Stable exchange rates
- Low deficit in Balance of payments.

## Key factors that influence the Foreign Investment Decisions

### Trade barriers

Government may impose tariffs, quotas, embargo and other restrictions on export and imports goods and services hindering the free flow of these products across national boundaries.

Sometimes governments may even impose complete bans in the international trade of certain products. Foreign investors can circumvent these restricitons by establishing production facilities in foreign countries.

**Imperfect labor market**

Labor is immobile because of immigration barriers, firm themselves should move the workers in order to benefit from the underpriced labor services.

This one reasons MNCs are making FDIs is less developed countries such as Mexico, China, India and Southeast Asian countries like Thailand, Malaysia and Indonesia, where the labor services are underpriced relative to their productivity.

**Intangible assets**

MNCs often enjoy comparative advantages due to special intangible assets they posses. Example including technological, managerial and marketing know-how, superior R&D capabilities and brand names.

These intangible assets are often hard to packages and sell to foreigners.

In addition the property rights in intangible assets are difficult to establish and protect, especially in foreign countries where legal resources may not be readily available.

As a result, firms may find it more profitable to establish foreign subsidiaries and capture returns directly by internalizing transactions in these assets.



The theory internalization of FDI, stated that the firms have intangible assets with a public good property tend to invest directly in foreign countries in order to use these assets on a larger scale and at the same time avoid the misappropriations of intangible assets that may occur while transacting in foreign markets.

**Vertical integration**

- MNCs may undertake FDI in countries where inputs are available in order to secure the supply of inputs at a stable price.
- MNCs with monopolistic / oligopolistic control over the input market, this can be served as a barrier to entry to the industry.
- Many MNCs often find it profitable to locate their manufacturing / processing facilities near the natural resources (oil fields, mine deposits and forest) in order to save transportation costs.
- Backward vertical FDI – an industry abroad that produces inputs for MNCs.
- Forward vertical FDI can take an example where they involve industry abroad that sells a MNC's output.

**Product life cycle (Raymond Vernon Model)**

Raymond Vernon (1966) firm undertake FDI at a particular stage in the life cycle of the product that they initially introduced. This can be understood by an example. The personal computers (PCs) were first developed by US firms ( such as IBM and Apple Computer) and exported to overseas markets. As PC's became a standardized commodity, however, the US became a net importer of PCs from foreign producers based in such countries as Japan, Korea and Taiwan as well as foreign subsidiaries of US firms.

#### Shareholder diversification services

If investors cannot effectively diversify their portfolio holdings internationally because of barrier to cross border capital flows, firms may be able to provide their shareholders with indirect diversification services by making their direct investments in foreign countries.

When a firm holds assets in many countries, the firm's cash flows are internationally diversified. Thus, shareholders of the firm can indirectly benefit international diversification even if they are not directly holding foreign shares.

### Important Terms Related to FDI

#### Inward FDI

When a foreign country invests in the country in question.

#### Outward FDI

When the home country invests abroad.

#### Green field investment



Building new production facilities in a foreign country.

It refers to investment in a manufacturing, office, or other physical company-related structure or group of structures in an area where no previous facilities exist.

#### Brownfield investment

Used for purchasing or leasing existing production facilities to launch a new production activity.

#### Backward Vertical FDI

Where an industry abroad provides inputs for a firm's domestic production process.

#### Forward Vertical FDI

Where an industry abroad sells the outputs of a firm's domestic production.

## Five Models of Foreign Direct Investments

There are five major types of Foreign Direct Investments viz. Access to Intangible assets, Access to cheaper factors of production, Mutual Investment Model, Host Country Market Model and Regional Integration. These have been discussed below:

#### Access to Intangible Assets

The first type of FDI is taken to gain access to intangible assets, e.g. resources, technical knowledge, material know-how, patent or brand names, owned by a company in the host country.

#### Access to Cheaper Factors of Production

According to this model the company shall invest in order to gain access to cheaper factors of production, e.g. low-cost labour. The government of the host country may encourage this type of

FDI if it is pursuing an export-oriented development strategy. Since it may provide some form of investment incentive to the foreign company, in form of subsidies, grants and tax concessions.

If the government is using an import-substitution policy instead, foreign companies may only be allowed to participate in the host economy if they possess technical or managerial know-how that is not available to domestic industry. Such know-how may be transferred through licensing. It can also result in a joint venture with a local partner.

#### Mutual Investment Model

This model involves international competitors undertaking mutual investment in one another, e.g. through cross-shareholdings or through establishment of joint venture, in order to gain access to each other's product ranges. As a result of increased competition among similar products and R&D-induced specialisation this type of FDI emerged.

Both companies often find it difficult to compete in each other's home market or in third-country markets for each other's products. If none of the products gain the dominant advantage, the two companies can invest in each other's area of knowledge and promote sub-product specialisation in production.

#### Host country market Model



This concerns the access to customers in the host country market. In this type of FDI there are not observed any underlying shift in comparative advantage either to or from the host country.

Export from the companies' home base may be impossible, e.g. certain services, or the capability to request immediate design modifications. The limited tradability of many services has been an important factor explaining the growth of FDI in these sectors.

#### Regional Integration

This related to trade diversionary aspect of regional integration. This type occurs when there are location advantages for foreign companies in their home country but the existence of tariffs or other barriers of trade prevent the companies from exporting to the host country.

The foreign companies therefore jump the barriers by establishing a local presence within the host economy in order to gain access to the local market. The local manufacturing presence need only be sufficient to circumvent the trade barriers, since the foreign company wants to maintain as much of the value-added in its home economy.

## Disinvestment and Related Issues

Disinvestment and Privatization are two different terms in technical sense, though both involve the sale of Government's share in the Public Sector Undertakings. The term privatization is used for a stake sell in which there is a transfer of 51% or more equity to the private players. In disinvestment, the government sells only a part of the equity which is essentially less than 51% so that ownership and management rights can be hold by the Government itself.

## Rationale behind Disinvestment

The rationale behind the disinvestment and privatization are as follows:

- It is believed that the **private ownership leads to better use of resources**and their more efficient allocation.
- The **proliferation of market based economy resulted in the fact that State could no longer meet the growing demands of the economy.**It was believed that the government can deliver better results when it responds according to the market driven forces.
- **Globalization and WTO commitments need quick restructuring of the Public Sector Undertakings**. If they are not able to adapt to this, they would not be able to survive. Public enterprises, because of the nature of their ownership, can restructure slowly and hence the logic of privatization gets stronger. Besides, techniques are now available to control public monopolies by regulation/competition, and investment of public money to ensure protection of consumer interests is no longer a convincing argument.

## Objective of Disinvestment

The Industrial Policy Statement of 1991 had envisaged the disinvestment of a part of Government

holdings in select Private sector companies. This became necessary because of the withdrawal of the budgetary support of 60 percent by the government to the loss making units in those times. The disinvestment policy in July 1991 had outlined the following objectives:

- To meet the budgetary needs
- To improve overall economic efficiency
- To reduce fiscal deficit
- To diversify the ownership of PSU for enhancing efficiency of individual enterprise
- To raise funds for technological upgradation, modernization and expansion of PSUs
- To raise funds for golden handshake (VRS)

## The Rangarajan Committee on disinvestment 1993

The Rangarajan Committee of 1993 was constituted by the government for making recommendations in context with the disinvestment. The committee said that

- The units to be disinvested should be identified and disinvestment could be made upto any level, except in defence and atomic energy where the government should retain the majority holding in equity.
- Disinvestment should be a transparent process duly protecting the right of the workers.
- An autonomous body for the smooth functioning and monitoring of the disinvestment

programme should be established. *This recommendation led to the Disinvestment Commission in 1996 as an advisory body having a full time chairman and four part-time members.* The Commission was required to advise the government on the extent, made, timing and princing of disinvestment.

- It suggested **four modes of disinvestment viz. Trade sale, Strategic Sale, Offer of shares and Closure or sale of Assets.**

In its budget speech of 2000-01, the government emphasized that more emphasis would now be paid on the strategic sale of public sector enterprises.

**Strategic Sale : Major Route for disinvestment in India**

In Strategic sale, the disinvestment / privatization take place by auctioning a state-owned enterprise to the highest bidder. It is in contrast with the minority sale where shares in an enterprise are sold as public offers. The emphasis on strategic sale in Indian privatisation is relatively recent in origin. From 1991 until 2000, the general policy was to sell minority shares in public sector companies. In March 2000, the the finance minister's budget speech spoke of a "fresh impetus to privatization programme that will emphasise increasingly on strategic sales of identified PSUs." The first important strategic sale in India was of Modern Foods to the multinational subsidiary, Hindustan Lever during times of NDA Government. The strategic sale invited lesser criticism from political parties mainly because the process is aimed at maximizing revenues to the government. Today, strategic sale is the most important route of disinvestment of Indian PSUs.

## Later Developments

Up to November 1999, the Disinvestment commission had submitted 12 reports to the government covering 58 public sector enterprises. On 30th November 1999, the term of the Commission expired. However, it was reconstituted in July 2001. Initially the Department of Disinvestment was constituted which was later on upgraded as the ministry of disinvestment in order to streamline and speed up the process of disinvestment including restructuring.

- The Disinvestment Commission also recommended creation of **separate disinvestment fund**in which the disinvestment proceeds would be placed to be used for the purpose of financial restructuring of the concerned unit before disinvestment and for carrying out voluntary retirement schemes. It also suggested merger of National Renewal Fund with the disinvestment fund.

## Current Issues

As we read above, post 2000, the focus of the disinvestment has shifted to strategic sale of the identified public sector units. For the period 1991-2012, the progress of disinvestment has been a normal and Government could seldom collect more than what it had targeted. The pace of disinvestment has been largely restricted due to political opposition.

## Does we disinvest only loss making companies?

The policy at privatization pursued by the NDA regime was disinvestment of the profit making CPSUs. However, later UPA Government declared that no profit making PEs will be disinvested. However, currently, it is not a policy of the Government to disinvest or privatize only profit making or only loss making companies.

## What is the Philosophy of the Government?

The Government says that as long as the it retains control over the PE, and its public sector character is not affected, the government may dilute its equity and raise resources to meet the social needs at the people. Thus, the government takes the Disinvestment and privatization as useful economic tools and wishes to use them selectively.

**Examples of companies in which disinvestment has taken place:**

- Shipping Credit and Investment Corporation of India
- Container Corporation of India Ltd.
- Videsh Sanchar Nigam Ltd. (VSNL)
- Oil and Natural Gas Corporation (ONGC)
- Gas Authority of India Ltd. (GAIL)
- Steel Authority of India Ltd. (SAIL)
- Mahanagar Telephone Nigam Ltd. (MTNL)
- Indian Petrochemicals Corporation Ltd. (IPCL)
- Power Grid Corporation
- Shipping Corporation of India
- National Aluminum Company (NALCO)
- National Fertilisers Ltd. (NFL)
- Indian Airlines
- Dredging Corporation
- LNG Petro Net
- Madras Refineries Ltd.
- Hindustan Zinc Ltd.
- Maruti Udyog Ltd.
- Modern Food Industries (India) Ltd.
- Indian Tourism Development Corporation (10 Hotels)

- Hotel Corporation of India etc

**Challenges before disinvestment**

- Process of disinvestment is not favoured socially as it is against the interest of socially disadvantageous people.
- Political pressure from left and opposition
- Loss making units don't attract investment so easily.
- Lack of well defined investment policy

The disinvestment process needs to be taken up more seriously by the government. The Government should try to come out with a time bound programme to conduct the process with transparency in all the activities need to reach. Some consensus is very essential. Only then the real benefits can be reaped.