
CHAPTER 17

# TAX STRUCTURE IN INDIA

*Through taxes, government in reality decides how to draw the required resources from the nation's households and businesses for public purposes–the money raised so is the 'vehicle' by which real resources are transferred from private goods to public goods.**

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** See Paul A. Samuelson and William D. Nordhaus, **Economics**, The McGraw-Hill Company, New York, 2005, pp. 327–340. Also see Joseph E. Stiglitz and Carl E. Walsh, **Economics,** W. W. Norton, New Yok, 4th Edition, 2006, pp. 380–86.*

## TAX

Modern economics ***defines*** tax as a mode of income redistribution.[1] There might be other ways also to look at it—the usual meaning of tax people think is that a tax is imposed by the government to fulfil its important obligations on the expenditure front.[2] We may take an example to see how taxes redistribute income:

Suppose an economy has a flat rate of income tax 30 per cent. Just see the impact of this tax on the income disparity of two people A and B earning Rs. 50,000 and Rs. 80,000, respectively.

| *Individual* | *Nominal Income* | *Income Disparity before Tax* | *Income after Paying Tax* | *Income Disparity after Tax* |
|---|---|---|---|---|
| A | Rs. 50,000 | Rs. 30,000 | Rs. 35,000 | Rs. 21,000 |
| B | Rs. 80,000 | | Rs. 56,000 | |

We see here through the above-given Table as how the income disparity between two individuals A and B decreases from Rs. 30,000 to Rs. 21,000 after paying taxes—this is the *first level* when incomes of these individuals have got re-distributed.

Now the money the government has got by tax collection, i.e., Rs. 39,000 (Rs. 15,000 + Rs. 24,000) will be spent on different sectors—infrastructure, education, health etc.—which will provide services to each and everybody alike. Here income is re-distributed at the *secondary* level. Consider a person who pays income tax, but does not take services of government schools for his children's education, nor goes to the government hospitals for medical services and compare him with a person who has no option other than the government schools and the hospitals—the higher tax payer getting no government services and a lower tax payer getting all the services. Here income looks re-distributed from the consumption side.

### INCIDENCE OF TAX

The point where tax looks as being imposed is known as the incidence of tax—the event of tax imposition.[3]

### IMPACT OF TAX

The point where tax makes its effect felt is known as the impact of tax—the after effect of tax imposition.[4]

### DIRECT TAX

The tax which has incidence and impact both at the same point is the direct tax—the person who is hit, the same person bleeds.[5] As for example income tax, interest tax, etc.

### INDIRECT TAX

The tax which has incidence and impact at the different points is the indirect tax—the person who is hit does not bleed[6] someone else's blood. As, for example, excise, sales tax, etc., are imposed on either the producers or the traders, but it is the general consumers who bear the burden of tax.

## METHODS OF TAXATION

There are three methods of taxation prevalent in economies with their individual merits and demerits.

1. P.A. Samuelson and W.D. Nordhaus, ***Economics,*** (New Delhi: Tata McGraw Hill, 2005), p. 327.
2. For further reference, J.E. Stiglitz and C.E. Walsh, ***Economics,*** (New York: W.W. Norton & Company, 2006), pp. 378–79.
3. Samuelson and Nordhaus, ***Economics,*** pp. 75–77.
4. Ibid., pp. 75–77.
5. Ibid., p. 329.
6. Ibid., p. 329.

### PROGRESSIVE TAXATION

This method has increasing rates of tax for increasing value or volume on which the tax is being imposed.[7] Indian income tax is a typical example of it. The idea here is less tax on the people who earn less and higher tax on the people who earn more—classifying income earners into different slabs. This method is believed to discourage more earnings by the individual to support low growth and development unintentionally. Being poor is rewarded while richness is punished. Tax payers also start evading tax by showing lower unreal income. But from different angles this tax is pro-poor and taxes people according to their affordability/sustainability. This is the most popular taxation method in the world and a populist one, too.

### REGRESSIVE TAXATION

This is just opposite to the progressive method having decreasing rates of tax for increasing value or volume on which the tax is being imposed.[8] There are not any permanent or specific sectors for such taxes. As a provision of promotion, some sectors might be imposed with regressive taxes. As for example, to promote the growth and development of small scale industries, India at one time had regressive excise duty on their productions—with increasing slabs of volume they produced, the burden of tax used to go on decreasing.

This method while appreciated for rewarding the higher producers or income-earners, is criticised for being more taxing on the poor and low-producers. This is not a popular mode of taxation and not as per the spirit of modern democracies.

### PROPORTIONAL TAXATION

In such a taxation method, there is neither progression nor regression from the point of view rate of taxes point of view. Such taxes have fixed rates for every level of income or production, they are neutral from the poor or rich point view or from the point of view of the levels of production.[9] Usually, this is not used by the economies as an independent method of taxation. Generally, this mode is used as a complementary method with either progressive or regressive taxation. If not converted into proportional taxes, every progressive tax will go on increasing and similarly every regressive tax will decrease to zero, becoming completely a futile tax methods. That is why every tax, be it progressive or regressive in nature, must be converted into proportional taxes after a certain level.

## A GOOD TAX SYSTEM

What are the characteristics of a good tax system? There has always been a debate among economists and policymakers on the issue of design of the tax system. Taxation in developing economies has been even more debated as the trade-off assessment generates enough controversy. Main debatable issues in the design of a tax system are whether progressive or regressive taxation, direct tax or indirect tax collections should be higher, whether revenue deficit is better, etc. The controversies set apart, there is a broad consensus on five ***principles***[10] of a good tax system, among economists and the policymakers:

### FAIRNESS

Though fairness (i.e., the first criteria of a good tax system) is not always easy to define, economists suggest inclusion of two elements in the tax system to make it fair namely, ***horizontal equity*** and ***vertical equity.*** Individuals in identical or similar situations paying identical or similar taxes

7. Samuelson and Nordhaus ***Economics,*** 329; Stiglitz and Walsh, ***Economics,*** p. 380.
8. Ibid.
9. Samuelson and Nordhaus, ***Economics,*** p. 329.
10. Stiglitz and Walsh, ***Economics,*** p. 382. A comprehensive analysis of good tax structure is also given in ***Meade Committe Report,*** Institute for Fiscal Studies (IFS), Washington DC, 1978.

is known as ***horizontal equity.*** When 'better off' people pay more taxes it is known as ***vertical equity***.

### EFFICIENCY

Efficiency of a tax system is its potential to affect or interfere the efficiency of the economy. A good tax system raises revenue with the least cost on the taxpayers and least interference on the allocation of resources in the economy. The tax system affects the economic decisions of individuals and groups by either encouraging or discouraging them to save, spend, invest, etc. Taxes can improve efficiency of the economy—taxes on pollution or on smoking give revenue to the government and serves broader social purposes, too. This is known as the ***double dividend*** of a tax.

### ADMINISTRATIVE SIMPLICITY

This is the third criterion which includes factors like computation, filing, collection, etc. of the taxes that all should be as simple as possible. Simplicity checks tax evasion too. Tax reform in India has simplification of tax as its major plank—also recommended by the Chelliah Committee.

### FLEXIBILITY

A good tax system has the scope of desirable modifications in it if there is any such need.

### TRANSPARENCY

How much tax taxpayers are actually paying and what are they getting against it in the form of the public services should be ascertainable, i.e., the transparency factor.

## METHODS OF EXPENDITURE

Similar to the methods of taxation the modes of government expenditure are also of three types—Progressive, Regressive and Proportional.[11]

At first instance it seems that as a country achieves better levels of development, sectoral and the item-wise expenditure of the economy must have decreasing trends. But practical experience shows that the level of expenditure needs enhancement everyday and economy always needs more and more revenues to fulfil the rising expenditures. That is why for economies the best form of government expenditure is the progressive expenditure.

The best way of taxation is progressive and the best way of government expenditure is also progressive and they suit each other beautifully. Most of the economies around the world are having progressive taxation with progressive expenditure.

## VALUE ADDED TAX

The value added tax (VAT) is a method of tax collection as well as name of a state level tax (***at present***) in India. A tax collected at every stage of value addition, i.e., either by production or distribution is known as value added tax.[12] The name itself suggests that this tax is collected on the value addition (i.e., production).

Production of goods or services is nothing but stages of value additions where production of goods is done by the industrialists or manufacturers. But these goods require value addition by different service providers/ producers (the agents, the wholesalers and the retailers) before they reach the consumers. From production to the level of sale, there are many points where value is added in all goods. VAT method of tax collection is different from the non-VAT method in the sense that it is imposed and collected at different points of value addition chain, i.e., ***multi-point tax collection***. That is why there is no chance of imposing tax upon tax which takes place in the non-VAT method—***single point tax*** collection. This is why VAT does not have a 'cascading effect' on the

11. Based on the discussion on Government Expenditure in Samuelson and Nordhaus, ***Economics.***

12. Ibid., p. 333

prices of goods it does not increase inflation—and is therefore highly suitable for an economy like India where due to high level of poverty large number of people lack the market level purchasing capacity. It is a pro-poor tax system without being anti-rich because rich people do not suffer either.

## NEED OF VAT IN INDIA

Over 160 nations in the world have implemented the VAT system of taxation regarding collecting their indirect taxes. There have been valid reasons why India should move towards the VAT method of tax collection. We may see some of the major reasons:[13]

(i) Due to single point tax collection, Indian indirect tax collection system was price-increasing (having *cascading effect* on the price) which was highly detrimental to the poor masses. Implementation of VAT will improve the purchasing capacity and so living standard of the poor people.[14]

(ii) India is having a federal political system where side by side the central government, states have also been given power to impose taxes and collect them. At the central level, there had been uniformity of taxes for the economy. But there was no 'uniformity' at the state level taxes (i.e., state excise, sales tax, entertainment tax, etc.). This was detrimental to the development of a single market for Indian economy as a whole. India basically had many markets, but no Indian market as such. To bring in uniformity at the state-level taxes, VAT was a necessary step in India.

(iii) With the process of economic reforms, India moved towards the market economy. And for this, firstly India needed to have a single market. Without uniformity at the state level taxes (***uniform VAT***) this was not possible.

(iv) Indian federal design has resulted in economically weaker states and stronger centre. As VAT increases the total tax collection (experience of the world suggests so) it was fit to be implemented at the state level.

(v) India has been a country of high level tax evasion. By implementing VAT method of indirect tax collection, it becomes almost impossible to go for large scale tax evasion. To prove one's level of value addition, the purchase invoice/receipt is a must which ultimately makes it cross-check the level of production and sale in the economy.[15]

(vi) If some of the state level taxes (which are many) are converted into state VAT the complexity of taxation will also be minimised. And at the end, it is possible to merge some of the centre's indirect taxes with it, i.e., arrival of the ***single VAT***.

Keeping all such things in mind, India started tax reform (*Chelliah Committee* and *Kelkar Committee*) and a certain level of sucess has been achieved in this area which can boost our motivation.

In the year 1996, the central government started collecting its excise duty on the VAT method and the tax was given a new name—the CENVAT.

The next proposal was to merge the states excise duty (imposed on intoxicants only) and their sales taxes into one tax—the state VAT or VAT. This could not take place due to states' lack of political

13. Derived from the points forwarded by the ***GoI*** and the ***Empowered Group of State Ministers.***

14. Raja C. Chelliah, Pawan K. Aggarwal, Mahesh C. Purohit and R. Kavita Rao, ***Introduction to Value Added Tax*** , in Amaresh Bagchi (ed.). ***Readings in Public Finance*** (New Delhi: Oxford University Press, 2005), pp. 277–78.

15. Ibid.

will. Ultimately, only sales taxes of the states were changed to be named VAT and was started to be collected on the basis of the VAT method (some states did not join it and some joined later). The experience has been encouraging.

### EXPERIENCE OF VAT

A total number of 20 states/UTs switched over to VAT (from their existing sales tax) in April 2005. Rest of the states went for it by 2008–09. Majority of the states/UTs saw revenue buoyancy due to VAT in the very first year of its implementation while few states availed the Central compensation facility for their revenue losses, that too for hardly one or two years. Experience of implementing VAT has been quite encouraging—by the financial year ***2016–17,*** the tax revenues of the states and UTs were estimated to grow with an annual rate of around 16 per cent.

This way, the view that the VAT will increase the tax collections of states has been validated. Similar impact of the proposed GST is believed to have on the indirect tax collections of the states as well as the Centre.

## GOODS AND SERVICE TAX

After implementing the state VAT, the GoI wanted to go for the proposed GST (Goods and Services Tax). This is aimed at integrating the indirect taxes of Centre and states into a *single national tax*—popularly known as the ***Single VAT*** of India. By creating a *single market* at the pan-India basis it will help the business and industry in a big way. The tax has potential to increase GDP up to 2 per cent (conservative estimates by some experts). All the benefits which the state VAT brought to the market and economy are the same in case of the GST, too. The ***first proposal***[16] of the GST had suggested the following tax arrangements under it—

(i) To be collected on the VAT method (will have all the same features of the VAT).

(ii) To be imposed at *pan-India* level with uniformity in tax—better say a *single rate* of indirect tax—replacing the multiple central and state indirect taxes.

(iii) *Four* taxes of Centre (cenvat; service tax; stamp duty and central sales tax) and *nine* taxes (excise duty, sales tax/vat; entry tax; lease tax; works contract tax; luxury tax; turnover tax; octroi and cess) of the states to be merged into the GST.

(iv) To have a single rate of 20 per cent (12 per cent to flow to Centre and 8 per cent to the states).

### IMPLEMENTATION PROCESS

After studying the Kelkar Committee report, the Government in 2006 decided to introduce the new tax since the financial year 2010-11. Lack of consensus between the centre and states kept the process delayed—to sort out the contentious issues, one after another, two independent *expert committees* submitted[17] their advices to the Government. Finally, the Constitution (101st Amendment) Bill, 2016 was cleared by the Parliament by early August 2016—paving the way for its implementation. By late September 2016, the GST Council (GSTC) was created by the Government. The Council has been entrusted with the power to make recommendations to the Union and the States on various issues—rates, floor rates, exemption, etc.—related to GST.

Finally, the new federal indirect tax GST was enforced[18] by the Government on July 1, 2017. The major features of the tax are as given below:

16. *Vijay Kelkar Task Force on the FRBM Act 2003*, Ministry of Finance, **Economic Survey 2004-05**, (New Delhi: Government of India, 2005), p. 40.

17. First it was from the **National Institute of Public Finance and Policy** (NIPFP) followed by the **Subramanian Committee**, during 2016-17.

18. ***Ministry of Finance***, Government of India, N. Delhi, July, 2017.

(i) The central taxes subsumed in it are—central excise duty (cenvat); additional excise duty; service tax; additional customs duty (commonly known as countervailing duty; and special additional duty of customs (total 5 taxes).

(ii) The state taxes subsumed in it are—state vat; entertainment tax (other than the tax levied by the local bodies); central sales tax (levied by the centre and collected by the states); octroi and entry tax; purchase tax; luxury tax; and taxes on lottery, betting and gambling (total 8 taxes).

(iii) Concept of 'declared goods of special importance' dropped.

(iv) On inter-state transactions of goods and services an Integrated GST will be levied.

(v) Exception from GST on alcoholic liquor for human consumption, petroleum and petroleum products (on latter it will be imposed on a later date).

(vi) The threshold limit for exemption from levy of GST would be Rs. 20 lakhs for normal States and Rs. 10 lakhs for the Special Category States.

(vii) The threshold for availing the Composition scheme would be Rs. 50 lakhs—with the Service providers kept out of it.

(viii) States to get compensation for 5 years for loss of revenue due to implementation of GST (for this base year will be 2015-16 with growth rate of 14 per cent).

(ix) Minor changes in rules and regulations may be permitted with the approval of the Chairperson, if required (due to suggestions from the stakeholders or from the Law Department).

(x) All exemptions/incentives on indirect taxes will rest withdrawn with obligation to pay GST. If any of them continue it will be administered by way of a reimbursement mechanism.

(xi) Bands of rates (in per cent) of goods under GST shall be 5, 12, 18 and 28 and in addition there would be a category of exempt goods. Further, a cess would be levied on certain goods such as luxury cars, aerated drinks, pan masala and tobacco products, over and above the rate of 28 per cent (for payment of compensation to the States).

(xii) Keeping in mind the federal structure of India, there will be two components of GST—Central GST (CGST) and State GST (SGST)—both Centre and States levying GST across the value chain on every supply of goods and services. States will assess 90 per cent of assessees with annual turnover below Rs. 1.5 crore while remaining 10 per cent by the centre. For taxpayers with over Rs. 1.5 core turnover, the split is 50:50 between the centre and states.

After the GST was enforced a state of confusion was seen due to several reasons—related to tax rates, complexity of compliance process, complaints of businesses and trading bodies, etc. The tax being fully online, certain level of dissatisfaction was seen in the area of unawareness and lack of IT services also. Experts believe that in coming times these concerns will be resolved and a new era of federal indirect tax regime will commence in the country.

## UNDERSTANDING THE ECONOMY THROUGH GST

The GST has been widely heralded for many things, especially its potential to create one Indian market, expand the tax base, and foster cooperative federalism. Yet almost unnoticed is its one enormous benefit—it will create a vast repository of information, which will enlarge and surely *alter our understanding of the economy*[19]. Data from the GST can help unveil some long-elusive and basic facts about the Indian economy. As per the ***Economic Survey 2017-18***, some exciting new findings include:

- A large increase in the number of indirect taxpayers has been noticed; many have voluntarily chosen to be part of the GST, especially small enterprises that buy from large enterprises and want to avail themselves of input tax credits.
- The distribution of the GST base among the states is closely linked to their Gross State Domestic Product (GSDP), allaying fears of major producing states that the shift to the new system would undermine their tax collections.
- New data on the international exports of states suggests a strong co-relation between export performance and states' standard of living.
- India's exports are unusual in that the largest firms account for a much smaller share than in other comparable countries.
- Internal trade is about 60 per cent of GDP (even greater than estimated by the *Economic Survey 2016-17*) and compares very favourably with other large countries.
- India's formal sector non-farm payroll is substantially greater than currently believed. Formality defined in terms of being part of the GST net suggests a formal sector payroll of 53 per cent of the non-agricultural work force. However, it stands only at 31 per cent in terms of social security provisions.
- Similarly, the size of the formal sector (defined here as being either in the social security or GST net) is 13 per cent of total firms in the private non-agriculture sector but 93 per cent of their total turnover.
- As per the *Survey*, the above-given list is a mere sampler, giving a hint of the insights that analysis of the GST will be able to provide in the future—a whole new world has indeed opened up and much exciting new research lies ahead.

19. ***Economic Survey 2017-18***, Vol. 1, Ministry of Finance, N. Delhi, pp. 32-42.

## COMMODITIES TRANSACTION TAX

The *Union Budget 2013–14* has introduced (basically, *reintroduced*) the Commodities Transaction Tax (CTT), however, only for ***non-agricultural*** commodity futures at the rate of **0.01** per cent (which is equivalent to the rate of equity futures on which a *Securities Transaction Tax* is imposed in India). Alongwith this, transactions in commodity derivatives have been declared to be made *non-speculative*; and hence for traders in the commodity derivative segment, any losses arising from such transactions can be set off against income from any other source (similar provisions are also applicable for the securities market transactions).

Like all financial transaction taxes, CTT ***aims*** at discouraging excessive speculation, which is detrimental to the market and to bring parity between securities market and commodities market such that there is no tax/regulatory arbitrage. *Futures contracts* are financial instruments and provide for price risk management and price discovery of the underlying asset commodity / currency / stocks / interest. It is, therefore, essential that the policy framework governing them is uniform across all the contracts irrespective of the underlying assets to minimise the chances of regulatory arbitrage. The proposal of CTT also appears to have stemmed from the general policy of the government to widen the tax base.

Commodities Transaction Tax (CTT) is a tax similar to Securities Transaction Tax (STT), proposed to be levied in India, on transactions done on the domestic commodity derivatives exchanges. Globally, commodity derivatives are also considered as financial contracts. Hence CTT can also be considered as a type of 'financial transaction tax'.

The concept of CTT was ***first*** introduced in the *Union Budget 2008–09*. The government had then proposed to impose a commodities transaction tax (CTT) of 0.017 per cent (equivalent to the rate of equity futures at that point of time). However, it was withdrawn subsequently as the market was *nascent* then and any imposition of transaction tax might have adversely affected the growth of organised commodities derivatives markets in India. This has helped Indian commodity exchanges to grow to global standards [MCX is the world's ***No. 3*** commodity exchange; globally, MCX is ***No. 1*** in gold and silver, ***No. 2*** in natural gas and ***No. 3*** in crude oil].

## SECURITIES TRANSACTION TAX

The Securities Transaction Tax (STT) is a type of 'financial transaction tax' levied in India on transactions done on the domestic stock exchanges. The rates of STT are prescribed by the central government through its budget from time to time. In tax parlance, this is categorised as a ***direct tax***. The tax came into effect from *1 October, 2004.* In India, STT is collected for the Government of India by the stock exchanges. With charging of STT, long-term capital gains tax was made ***zero*** and short-term capital gains tax was reduced to 10 per cent (subsequently, changed to 15 per cent since 2008).

The STT framework was subsequently reviewed by the central government in the year 2005, 2006, 2008, 2012 and ***2013***. The STT rates were revised upwards in the year 2005 and 2006 while it was reduced for certain segments in 2012 and 2013. The STT provisions were altered in the year 2008 such that for professional traders (brokers), STT came to be treated as an *expense* which can be deducted from the income instead of treating the same as an advance tax paid. [The 2004 STT provisions provided that the STT payments of professional traders, whose 'business income' arising from purchase and sale of securities could be set off against their total tax liability.]

As on date, STT is not applicable in case of *preference shares, government securities, bonds, debentures, currency derivatives, units of mutual fund other than equity oriented mutual fund,* and *gold exchange traded funds* and in **such cases**, tax treatment of short-term and long-term gains shall be as per normal provisions of law.

Transactions of the shares of listed companies on the floor of the stock exchange or otherwise, mandated under the regulatory framework of SEBI, such as *takeover, buyback, delisting offers,* etc., also does not come under STT framework. The *off-market* transactions of securities (which entails changes in ownership records at depositories) also does not attract STT.

## CAPITAL GAINS TAX

This is a direct tax and applies on the sales of all 'assets' if a profit (gain) has been made by the owner of the asset—a tax on the 'gains' one gets by selling assets. The tax has been classified into two—

(i) *Short Term Capital Gain* (STCG): It applies 'if the Asset has been sold within 36 months of owning it'. In this case the 'rate' of this tax is similar to the normal income tax slab. But the period becomes '12 months' in cases of shares, mutual funds, units of the UTI and 'zero coupon bond'—in this case the 'rate' of this tax is **15** per cent.

(ii) *Long Term Capital Gain* (LTCG): It applies 'if the asset has been sold after 36 months of owning it'. In this case the 'rate' of this tax is **20** per cent. In cases of shares, mutual funds, units of the UTI and 'zero coupon bond' there was 'exemption' (zero tax) though, recently, a LTCG of 10 per cent (above Rs. 1 lakh of capital gains) was introduced[20] on them by the Government.

## MINIMUM ALTERNATE TAX

The Minimum Alternate Tax (MAT) is a direct tax imposed on the 'zero tax' companies at the rate of 18.5 per cent on their book profit. This was first imposed in 1997–98.

Basically, income tax is paid as per the provisions of the Income Tax Act (IT Act), but companies calculate their profit (through profit and loss account) as per the provisions of the Companies Act. The IT Act allows several kinds of exemptions and other incentives from total income together with deductions on the gross income. Again, the rates of 'depreciation' under the Companies Act is higher than the IT Act. As a result of these exemptions, deductions and other incentives under IT Act together with higher depreciation under the Companies Act, companies show their taxable income either 'nil' or 'negative', and this way, the 'zero tax' companies emerge.

Practically, 'zero tax' companies, might be having high 'book profit' and distributing huge dividends (under the Companies Act) to their shareholders, too, but showing 'nil' or 'negative' taxable income (under the IT Act) they might not pay any income tax! To bring such companies under the income tax, *Section 115JB* was introduced in the IT Act in 1997–98 and MAT was imposed accordingly.

MAT is a way of making companies pay minimum amount of tax. It is applicable on all companies except those engaged in infrastructure and power sectors, free trade zones, charitable activities, venture and angel funds. Foreign companies with income sources in India also come under it. The *Union Budget 2015–16* has rationalised the MAT provisions for the FIIs (Foreign Financial Institutions)—now they do not need to pay MAT on their profits from capital gains on transactions in securities (which are liable lower tax rate).

We may take an example – suppose a company has 'book profit' of Rs. 10 lakh. And, after claiming the deductuions, exemptions and depreciation its 'gross taxable income' comes down to Rs. 6 lakh, its taxable income becoming Rs. 4 lakh. In this case, the applicable income tax would be Rs. 1.2 lakh (if rate of income tax is 30 per cent flat). But the comapny will pay a MAT of Rs. 1.85 lakh (at the rate of 18.5 per cent on its 'book profit' of Rs. 10 lakh). The concerned comapny needs to pay the tax which is higher—here, the tax to be paid will be Rs. 1.85 lakh.

At present the tax is collected as an advance tax. The tax can be carried forward and set off (adjusted) against regular tax payable during the subsequent 10-year period (known as MAT credit). There has been a strong demand to abolish this tax in the country. Meanwhile, the ***Union Budget 2017-18*** announced to start phasing out the exemptions available to the companies on it from April 2017. So that companies are able to use MAT credit, the carry forward period has been also increased to 15 years.

## INVESTMENT ALLOWANCE

The GoI, in 2013–14, had announced an 'investment allowance' of 15 per cent to the companies investing Rs. 100 crore or more in plant and machineries. This was valid up to March 2016. This move was aimed at promoting investment in the industrial sector as part of the fiscal stimulus programme started in wake of the global recession.

20. ***Union Budget 2018-19*** introduced this tax (other than the Security Transaction Tax which these financial instruments already attract).

Meanwhile, the government started a process of 'corporate tax rationalisation' linked to 'phasing out various incentives' availed by the companies *(calibration process).* In its first phase, in 2016-17, two changes were implemented regarding the corporate tax liabilities of the companies:

(i) New manufacturing companies, incorporated on or after March 1, 2016, will have an option to pay **25** per cent (plus surcharge and cess) corporate tax. To avail this, the companies will not have to claim profit-linked deductions, accelerated depreciation and *investment allowance.* For the other companies the rate of tax to remain 30 per cent (plus surcharge and cess).

(ii) **One** per cent cut in the corporate tax for the small companies. The companies which had turnover up to Rs. 5 crore till last year will now pay 29 per cent corporate tax (plus surcharge and cess). This is seen as an alternative to the existing investment allowance scheme.

## TAX EXPENDITURE

There has been a divergence between the official tax rate and effective tax rate in India—defined as the ratio of total tax collected to the aggregate tax base. The divergence occurs mainly on account of tax exemptions. Tax expenditure is also known as *revenue forgone*. But such forgone taxes doe not necessarily mean that they have been waived off by the government. Better, it should be interpreted as incentives given by the government to promote certain sectors, in absence of which they may not have come up.

High tax expenditure can make the tax system unduly complex and bring in distortions in it. As a result of simplification in the tax system and improvements in tax administration in recent years have brought *tax expenditure down*—current situation[21] is as given below:

(i) 15 per cent for corporate tax (32 per cent of 2007-08).

(ii) 16 per cent for income tax (37 per cent in 2007-08).

(iii) 100 per cent for excise duty (70 per cent in 2007-08). It was at a high level of 162 per cent in 2009-10 on account of tax concessions announced by the GoI to control inflation.

(iv) 160 per cent for custom duty (92 per cent in 2007-08). It was at a high level of 235 per cent in 2009-10 due to concessions announced for custom duty in wake of controlling prices.

To realise full tax potential the governments needs to limit exemptions and their *grandfathering*[22] together with broadening the tax base. The level of tax expenditure is slated to fall steeply once the proposed GST is operationalised in the country. Under its process of rationalising the corporate tax (cutting it down from 30 to 25 per cent), the government is also aimed at calibrating (phasing out) the various tax exemptions/incentives which exists for the various industries. Its first phase has already commenced in 2016–17.

21. Statement of Revenue Forgone, Budget documents & CSO, MInistry of Finance, **Economic Survey 2015–16**, p. 37.

22. **Grandfather Clause** – a clause in a new law that exempts certain persons or businesses from abiding by it. For example, suppose a country passes a law stating that it is illegal to own a cat. A grandfather clause would allow persons who already own cats to continue to keep them, but would prevent people who do not own cats from buying them. Grandfather clauses are controversial, but they are common around the world. [*Source:* **Farlex Financial Dictionary**, Farlex Inc., N. York, USA, 2012; **Collins English Dictionary- Complete & Unabridged**, HaperCollins, N. York, USA, 2003.]

## COLLECTION RATE

Collection rate is the ratio of total customs revenue and the total value of imports for a year. This is an indicator of overall incidence of customs including countervailing duties (CVD) and special additional duties (SAD) on imports. Several exemptions are offered by the GoI in customs duty on a variety of imports. This is the reason why India's customs collection does not increase as much as much its imports increase.

India's collection rates have been lower between 2009–2013 due to various exemptions announced by the GoI on the imports of petroleum, oil and lubricants (POL) and other commodities. These exemptions in the base custom duties were announced to check the rising commodities prices in the world market together with a general inflationary trend seen in India due to food inflation. At present the collection rate for India stands at 6.1 per cent[23].

## 14TH FINANCE COMMISSION

The 14th Finance Commission (FFC) was constituted on 2 *January, 2013* under the Chairmanship of Dr. Y. V. Reddy, former RBI Governor with Prof. Abhijit Sen, Ms. Sushma Nath, Dr. M. Govinda Rao and Dr. Sudipto Mundle as the other *four* members. The recommendations of the commission will apply on the period ***2015–20*** and its report has to be submitted by 31 October, 2014.

The broad *Terms of Reference* and the *matters* to be taken into consideration by the commission are:

(i) *Tax Devolution* & *Grant* related references
   (a) the distribution between the union and states of the net *proceeds of taxes* which are to be, or may be, divided between them under *Chapter I, Part XII* of the Constitution and the allocation between the states of the respective shares of such proceeds;
   (b) the principles which should govern the *grants-in-aid* of the revenues of the states out of the Consolidated Fund of India and the sums to be paid to the states which are in need of assistance by way of grants-in-aid of their revenues under *Article 275* of the Constitution for the purposes other than those specified in the provisos to *Clause (1)* of that article; and
   (c) measures needed to augment the Consolidated Fund of a state to supplement the resources of the *panchayats* and *municipalities* in the state on the basis of the recommendations made by the finance commission of the state.

(ii) To review the state of finances, *deficit*, and *debt* levels of the union and states, and suggest measures for maintaining a stable and sustainable fiscal environment consistent with equitable growth including suggestions to amend the FRBMAs currently in force. The commission has been asked to consider and recommend incentives and disincentives for states for observing the obligations laid down in the FRBMAs.

(iii) In commission is required to consider—
   (a) the *resources* of the Central government and the *demands* on the resources of the central government;
   (b) the *resources* of the state governments and *demands* on such resources under different heads, including the impact of debt levels on resource availability in debt-stressed states;

23. Department of Revenue Ministry of Finance, Government of India, New Delhi, March 2017.

(c) the objective of not only balancing the receipts and expenditure on revenue account of all the states and the union but also generating surpluses for capital investment;

(d) the *taxation efforts* of the central government and each state government and the potential for additional resource mobilisation;

(e) the level of *subsidies* required for sustainable and inclusive growth and equitable sharing of subsidies between the central and state governments;

(f) the *expenditure* on the non-salary component of maintenance and upkeep of capital assets and the non-wage-related maintenance expenditure on Plan schemes to be completed by March 31, 2015 and the norms on the basis of which specific amounts are recommended for the maintenance of capital assets and the manner of monitoring such expenditure;

(g) the need for *insulating the pricing* of public utility services like drinking water, irrigation, power, and public transport from policy fluctuations through statutory provisions;

(h) the need for making public-sector enterprises competitive and market oriented; listing and disinvestment; relinquishing of non-priority enterprises;

(i) the need to balance *management of ecology, environment, and climate change* consistent with sustainable economic development; and

(j) the impact of the proposed *goods and services tax* on the finances of the Centre and states and the mechanism for compensation in case of any revenue loss.

(iv) To review the present *public expenditure management* systems and recommend, including—

(a) budgeting and accounting standards and practices;

(b) the existing system of classification of receipts and expenditure;

(c) linking outlays to outputs and outcomes; and

(d) best practices within the country and internationally.

(vi) To review the present arrangements of financing of *Disaster Management* with reference to the funds constituted under the Disaster Management Act 2005 and make recommendations.

(vii) To indicate the basis on which it has arrived at its findings and make available the *state-wise estimates of receipts and expenditure*.

The commission is required to generally take the base of population figures as of 1971 in all cases where population is a factor for determination of devolution of taxes and duties and grants-in-aid. However, the commission may also take into account the demographic changes that have taken place subsequent up to 1971.

## FFC RECOMMENDATIONS

The 14th Finance Commission (FFC) submitted its report by early 2015. It has advised for far-reaching changes for sharing of revenues between the Center and the States, on the one hand, and between the States, on the other. The advices apply on the period 2015–20 and are likely to have major implications for Center-State relations, for budgeting by, and the fiscal situation of, the Center and the states. 'Successful implementation of the advices will advance the cause of cooperative federalism that the new government has enthusiastically embraced', the *Economic Survey 2014–15* concluded. Some of the ***major recommendations*** are as follows:

(i) It has radically enhanced the share of the states in the central 'divisible pool' of taxes from the current **32** per cent to **42** per cent which is the biggest ever increase in vertical tax devolution. The last two Finance Commissions, viz., Twelfth (2005–10) and Thirteenth (2010–15) had recommended a state share of 30.5 per cent (increase of 1 per cent) and 32 per cent (increase of 1.5 per cent), respectively in the central divisible pool.

(ii) It has also proposed a new horizontal formula for the distribution of the divisible pool among the states. There are changes both in the variables included/ excluded as well as the weights assigned to them. Relative to the Thirteenth Finance Commission, the FFC has incorporated two new variables—

(a) 2011 population and forest cover; and

(b) Excluded the variable relating to fiscal discipline.

(iii) Implementing these recommendations will move the country toward greater *fiscal federalism*, conferring more fiscal autonomy on the states. For example, based on assumptions about nominal GDP growth and tax buoyancy and the policy measures that are contemplated for 2015–16, it is estimated that the additional revenue for the states could be as much as Rs. 2 lakh crores relative to 2014–15. Of this, a substantial portion represents the difference that is purely due to the change in the States' share in the divisible pool.

(iv) Preliminary estimates suggest that *all States stand to gain* from FFC transfers in absolute terms. However, to assess the distributional effects, the increases should be scaled by population, Net State Domestic Product (NSDP) at current market price, or by States' own tax revenue receipts. This will make the following effects on the ststes' revenue—

(a) The biggest gainers when scaled by any of these indicators tend to be the Special Category States (SCS, mostly those in the North-East) and by orders of magnitude.

(b) The major gainers in per capita terms turn out to be Arunachal Pradesh, Mizoram and Sikkim for the SCS states and Kerala, Chhattisgarh and Madhya Pradesh for other states (GCS or General Category States). Clearly, this increase in taxes to the States is sustainable for the center, only if there is a reduction in the central (Plan) assistance to the states (CAS).

In other words, States will now have greater autonomy both on the revenue and expenditure fronts.

(v) It is also possible to tentatively estimate what the FFC recommendations would do to net spending capacity of the States, where net refers to the difference between the extra FFC transfers and the reduced CAS that will be required by the FFC recommendations. Broadly, the Special Category States will be the biggest gainers. In addition, there are nine States among the GCS which are expected to get more than 25 per cent of their own tax revenue.

(vi) A collateral benefit of moving from CAS to FFC transfers is that overall progressivity will improve; that is, on average, States with lower per capita NSDP will receive more than those with a higher per capita NSDP. This results from the fact that CAS transfers, which tended to be discretionary, were less progressive than Finance Commission transfers.

To be sure, there will be transitional costs entailed by the reduction in CAS transfers. But the scope for dislocation has been minimised because the extra FFC resources will flow broadly to the states that have the largest CAS-financed schemes.

The far-reaching recommendations of the FFC, along with the creation of the *NITI Aayog*, will further the government's vision of *cooperative* and *competitive* federalism. The necessary, indeed vital, encompassing of cities and other local bodies within the embrace of cooperative and competitive federalism is the next policy challenge, which is believed to be strengthened by the body NITI Aayog.

## CONCEPTS RELATED TO FC

### TAX DEVOLUTION

Advising a formula to distribute the Union tax proceeds between Union and the States is the most important task of a FC, as the share of states in the net proceeds of Union taxes is the *predominant channel* of resource transfer from the Centre to states.

### DIVISIBLE POOL

It is that portion of gross tax revenue which is distributed between the Centre and the States. The divisible pool consists of all taxes, except surcharges and cess levied for specific purpose, net of collection charges.

Before the 80th Constitution Amendment (2000), the sharing of the Union tax revenues with the states was in accordance with the provisions of articles 270 and 272, as they stood then. This amendment altered the pattern of sharing of Union taxes in a fundamental way—dropping the Article 272 and substantially changing the Article 270. The new Article 270 provides for sharing of all the taxes and duties referred to in the Union List putting all in a 'divisible pool'. There are some exceptions to it. The taxes and duties referred in the Articles 268 and 269 of the Constitution, together with surcharges and cesses on taxes and duties (referred in the Article 271) and any cess levied for specific purposes—do not fall under this 'pool'.

The new arrangement of tax devolution came as a follow-up to the recommendations of the 10th FC (1995–2000) which the FC termed as the 'Alternative Method of Tax Devolution' (AMD). A concensus between Union and States was a advised by the FC for such an arragnement to be effected. States were going to get extra 5 per cent share in the Union taxes in the AMD, thus, a serious demand came from them—ultimately, the AMD was accepted by the Centre. To make the AMD irreversible, the Goverment of India went for the 80th Amendment in the Constituion.

### GRANTS-IN-AID

Though, tax devolution (from the *Divisible Pool*) is the primary instrument to attend the issue of 'horizontal imbalances' of revenue accruing to the states, the grants-in-aid is a complimentary/secondary instrument regarding the same. As per the Article 275, the FC recommends the *principles* as well as the *quantum* of grants to those states which are in need of assistance – different sums may be fixed for different states (one of the pre-requisites for such grants is the assessment of the needs of the states). The 1st FC had laid down *five broad principles* for determining the eligibility of a state for grants:

(i) The Budget of a state as the starting point for examination of a need.

(ii) The efforts made by states to realize the potential.

(iii) The grants should help in equalizing the standards of basic services across states.

(iv) Any special burden or obligations of national concern, though within the state's sphere, should also be taken into account.

(v) Grants might be given to further any beneficent service of national interest to less advanced states.

The grants recommended by FC are predominantly in the nature of general purpose grants meeting the difference between the assessed expenditure on the *non-plan revenue* account of each state and the *projected revenue* including the share of a state in Central taxes. These are often referred to as 'gap filling grants'.

The scope of grants to states, over the yaer, was extended further to cover special problems. Following the 73rd and 74th Amendments to the Constitution, FCs were charged with the additional responsibility of recommending measures to augment the *Consolidated Fund of a State* to supplement the resources of local bodies. This has resulted in further expansion in the scope of FC grants. The 10th FC was the first Commission to recommend grants for *rural* and *urban local bodies*. This way, the scope of grants-in-aid has gone for considerable extension, over the time.

### Fiscal Capacity

The *fiscal capacity* (also called 'income distance') criterion was first used by the 12th FC, measured by per capita GSDP as a proxy for the distance between states in *tax capacity*. When so proxied, the procedure implicitly applies a single average tax-to-GSDP ratio to determine fiscal capacity distance between states. The 13th FC changed the formula slightly and recommended the use of 'separate averages' for measuring tax capacity, one for general category states (GCS) and another for special category states (SCS).

### Fiscal Discipline

This as a criterion for tax devolution was used by the 11th and 12th FCs to provide an *incentive* to states managing their finances prudently. The criterion was continued in the 13th FC also. The index of fiscal discipline is arrived at by comparing improvements in the ratio of own revenue receipts of a state to its total revenue expenditure relative to the corresponding average across all states in the country.

### PC as Collaborator

While the 12th FC (2005–10) was being set up, the GoI decided to make the Planning Commission (PC) function as a 'collaborator' to the FC—one member of the PC was added as an 'additional member' on the panel of the FC (the FC includes four members including the Chairman)—as a link between the bodies. This arrangement was continued with in the 13th and 14 FCs. It is believed that this arrangement was greatly helpful in bringing in a better idea about the revenue imbalances of the states. While the government did set up the NITI Aayog, no announcement came in this regard – there might be some developments in this regard once the 15th FC (2020–25) is set up in future.

## LEGITIMACY AND TAXATION

India commenced with a broad-based tax reforms programme in 1991 as an important part of the economic reforms process. Simplifying tax structure, cutting rate of taxes, enhancing tax compliance and broadening the tax base are the major contours of this reform programme. But even today, India has not fully translated its democratic vigour into commensurately strong fiscal capacity. The tax base of India is still not adequate. To build fiscal capacity it is essential to create legitimacy in the state. In this regard the latest *Economic Survey 2015-16* has presented a very timely and suitable piece of analysis. The document adds that to build fiscal capacity the government needs to put in place a better tax regime which is only possible once the government is able to enhance its legitimacy among the citizens. The suggestions[24] forwarded by the Survey in this regard are briefly being given here:

(i) The *spending priorities* of the government must include essential services which are consumed by all citizens. For that matter, action needs on public infrastructure, law and order, less pollution and congestion, etc.

(ii) *Reducing corruption* must be a high priority. Though this will be fiendishly (clever and imaginative) difficult. This is needed not just because of its economic costs but also because it undermines legitimacy of the state. The more citizens believe that public resources are not wasted, the greater they will be willing to pay taxes. Improving transparency through efficient auctioning of public assets will help create legitimacy, and over time strengthen fiscal capacity.

(iii) *Subsidies to the well-off* need to be scaled back. At present[25], it is estimated to be around Rs. 1 lakh crore. Phasing down these bounties and targeting subsidies for the poor is important in strengthening legitimacy.

In the same way, the existing regime of tax exemptions redistributes income towards the richer private sector—it dilutes the legitimacy of the state in the eyes of the poor citizens. There is need of putting in place a reasonable taxation provision for the 'better off' section in the country regardless of where they get their income from— industry, services, real estate, or agriculture.

(iv) *Property taxation* needs to be developed. India lacks systematic data on property tax and whatever is there it is very sparse. This proves the low attention the country has given to this issue. As property taxes are 'progressive' they are desirable. It makes more sense because evading this tax is difficult as they are imposed on immovable (non-mobile) assets. With the help of today's technologies such properties can be easily identified.

Higher rates on properties (with values updated periodically) can be the foundation of local government's finances. This can provide local public goods and strengthen democratic accountability and more effective decentralisation. Higher property tax rates would also put sand in the wheels of property speculation. *Smart cities* require smart public finance and for India's urban future a sound property taxation regime will be vital.

One low hanging fruit is to avoid raising exemption threshold and allow natural growth in income to increase the number of the taxpayers. The Survey has suggested a simple method for it—*inaction*. The **Union Budget 2016–17** has already begun this process—exemption limit for individual income tax has been left unchanged together with a programme to link corporate tax cut and phase out of the exemption regime existing for the companies.

## INCOME AND CONSUMPTION ANOMALY

India's tax to GDP ratio is very low, and the proportion of direct tax to indirect tax is not optimal from the view point of social justice. The data released by the Government[26] indicate that

24. **Ministry of Finance**, Department of Revenue, Government of India, N. Delhi, April 2016.
25. Ministry of Finance, **Economic Survey 2015–16**, Vol. 1, pp. 105-117.
26. Based on the **Union Budget 2017-18** and **Economic Survey 2016-17**.

India's direct tax collection is not commensurate with the income and consumption pattern of the people:

**Corporate tax:** As against 5.6 crore *informal sector* (unorganised sector) individual enterprises and firms doing small business, of which 1.81 crore filed tax returns. Out of the 13.94 lakh companies registered in India, 5.97 lakh filed tax returns for 2016-17 (Assessment Year) which show the following annual profit before tax pattern:

- 2.76 lakh companies have shown losses or zero income.
- 2.85 lakh companies had less than Rs. 1 crore profit.
- Profit of 28,667 companies was between Rs. 1 crore to Rs. 10 crore, and
- Only 7781 companies have profit of more than Rs. 10 crores.

**Individual income tax:** As against estimated 4.2 crore persons engaged in *organised sector* employment, the number of individuals filing return for salary income are only 1.74 crore. In 2015-16 (Assessment Year 2016-17), a total of 3.7 crore individuals filed income tax returns which did show the following annual income pattern:

- 99 lakh show annual income below the exemption limit of Rs. 2.5 lakh;
- 1.95 crore show income between Rs. 2.5 to Rs. 5 lakh;
- 52 lakh show income between Rs. 5 to Rs. 10 lakhs;
- Only 24 lakh people show income above Rs. 10 lakhs;
- 76 lakh people declared income above Rs. 5 lakh (56 lakh being salaried class); and
- Only 1.72 lakh people did show income more than Rs. 50 lakh.

The demonetisation process has given the government new data related to people's income—about 1.09 crore accounts saw average deposit between Rs. 2 to 80 lakh. Deposits of more than 80 lakh were made in 1.48 lakh accounts with average deposit size of Rs. 3.31 crores. This data mining will help the Government in increasing the tax net and tax revenue in future.

The above-given data can be contrasted with the fact that in the last five years, more than 1.25 crore cars have been sold, and number of Indian citizens who flew abroad, either for business or tourism, was 2 crore in the year 2015. From all these figures it can be concluded that India is largely a tax *non-compliant* society. The predominance of *cash* in the economy makes it possible for the people to evade their taxes. When too many people evade taxes, the burden of their share falls on those who are honest and compliant.

**Impact of Demonetization:** As per the *Economic Survey 2017-18*, one of the aims of demonetization and the GST (Goods and Services Tax) was to increase the *formalization* of the economy and bring more people into the *income tax net*, which includes only about 59.3 million individual taxpayers (filers and those whose tax is deducted at source in 2015-16), equivalent to 24.7 per cent of the estimated non-agricultural workforce.

It looks happening! In 13 months from demonetisation (November 2016 to November 2017) 10.1 million new income tax filers were added (in the preceding 6 years only 6.2 million new income tax filers were added). Though, the new tax filers, in many cases reported income close to tax threshold (standard deduction) of Rs. 2.5 lakhs per annum. As the income growth of such tax filers crosses the threshold, tax revenue of the Government will also grow.

## LOOKING AHEAD

Tax reform has been an integral part of the economic reform process in the country. Much reforms have been done by now, though the pace and method at times have not been so praiseworthy. As India's reforms have been gradual and incremental the laxity in tax reforms might be due to this also. In the backdrop of the developments by far, a five-pronged strategy was suggested[27]:

(i) GST should be broad in coverage to include activities that are sources of black money creation—land and other immovable property;
(ii) Individual income tax rates and real estate stamp duties should be reduced;
(iii) The income tax should be widened gradually and which could progressively encompass all high incomes;
(iv) The timetable for reducing the corporate tax rate should be accelerated; and
(v) Tax administration should be improved by reducing discretionary powers of tax officials and improving accountability.

In the process of collecting taxes on newly disclosed and undisclosed wealth (in the aftermath of demonetisation) *tax harassment* must be avoided by officials at all rungs of hierarchy. The tax administration must *shift* to greater use of data, smarter evidence-based scrutiny and audit, greater reliance on *on-line assessments* with less physical interaction between tax payers and tax officials. Once GST has been enforced much more data will be available on individual transactions—by using this data together with greater information sharing between the direct and indirect tax departments at the centre, along with coordination with the states, greater compliance can be achieved through 'non-punitive means'—in relation to indirect as well as direct tax collections. The promise of *digital age* can be used to improve the tax administration of the country in a big way.

Meanwhile, the *Union Budget 2018-19* looks committed to the ongoing tax reform process in the country. The new set of direct reforms which have been hinted by the Government, is yet to be proposed. As per the Government these reforms will be belonging to a different genre and will be aimed at a paradigmatic shift in the existing direct tax regime in the country.

27. **Economic Survey 2016-17**, Government of India, Ministry of Finance, N. Delhi, Vol. 1, p. 78.