# INDIAN TAX SYSTEM, ECONOMIC DEVELOPMENT IN THE CONTEXT OF BRIC[1]

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*During the current economic meltdown, it is also felt that the emerging countries such as Brazil, Russia, India and China (BRIC) are expected to perform better than the global average. India as an emerging country is no exception to this trend. This performance is largely due to unilateral trade and structural reforms, which have been continued during the period. Growth has been led by the services sector, where liberalization has been most rapid. Here is an analysis of Indian tax system relating to its structure and constitutional provisions with an overview of recent economic development and issues related to international trade in India particularly, and these countries generally. A broad analysis of the provisions in Indian Constitution related to taxation and its distribution has been done along with the issues related to the transition from cascading type indirect taxes to comprehensive value added system or goods and service tax.*

## INTRODUCTION

THE BRIC Nations *viz*, Brazil, Russia, India and China together account for 40 per cent of the world's population and 40 per cent of global gross domestic product (GDP). There is an increasing realisation that the success of BRIC economies would lead global economic growth. The cooperation among BRIC is gradually gaining more substance with growth in trade and

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investment. On June 16, 2009, the leaders of the BRIC countries held their first summit in Yekaterinburg, Russia and issued a declaration calling for the establishment of a multipolar world order.

India is among the fastest growing BRIC economies, and plays the part in coordinating international efforts to overcome the ongoing financial and economic slowdown. In the recent past, India has witnessed high economic growth with rapid expansion in trade and outbound investment to developing countries including Brazil, Russia and China (BRC). The trend has attracted attention at international forums also. The analysis emanating from such forums emphasises the need for long-standing partnership between India and BRC.

It is being noted that India-BRC economic relationship is picking up steadily in the new millennium. However, a situation of business uncertainty is being created after the emergence of global meltdown, which surfaced in October 2008. The symptoms of global recession are predicted to be disastrous for the global economy. After a prolonged phase of recession, the world economy just revived from deep recession in 2002 and buoyancy continued since then till 2007 before plunging into another episode of recession in 2008. According to IMF projections in 2008, the global output growth is likely to decline in near future.

In such a critical situation, advanced countries and emerging economies are capable of taking the heat of the recession in terms of emerging global economy to create conditions for the early recovery so that tenure of the recessionary phase for the global economy can be shortened. Less developed countries, which suffered severely during the so-called 'lost decades of growth', are likely to face the severity of the global meltdown if the present economic impasse continues for a longer period of time. This would adversely affect growth prospects of less developed economies because many of these countries resort to depend high on exports. In many such cases, export becomes a major driver to maintain high growth in the economy. Decline in the demand for global absorption may have a dampening effect on the export prospects of these economies.

Considering high propensity of imports in advance countries, it is expected that these countries can become major part of global imports to absorb exports originating from less developed countries. But industrialised countries are already in deep crisis before the eruption of full-flagged recession in the world economy. Average real growth rate of industrialised countries has already started declining much before October 2008. The developed countries have registered sharp fall in real growth rate of GDP in 2007, and it is likely to be negative in near future.

In this situation, emerging countries such as BRIC are expected to

perform better than the global average, despite the fact that these economies are likely to face downturn during this episode of global recession. India as an emerging country is no exception to this trend. It may be noted that India posted a robust average growth rate of more than nine per cent during 2005-07. But growth performance is likely to go down in near future. Despite decline in India's growth prospects as projected by various domestic and multilateral agencies, the achievable targets for real GDP growth can project India as the fastest growing market-driven emerging economy in the world. India's major driver of growth during the period of crisis would be domestic demand as projected by IMF[2].

In this context, relevance of BRIC economic cooperation is important in terms of mitigating the severity of anticipated impact of global meltdown. As India is likely to grow fast during the period of crisis, over two and a half times higher than the growth of global output, expansion of the economy will be mostly driven by the surging domestic demand, and in the process, it can offer a larger market access to BRC countries. The domestic demand for India could range from high-technology intensive products to primary products.

As can be seen from Tables 1, 2 and 3, India's trade with BRC has increased about ten times between 2000 and 2008.

TABLE 1: GLOBAL RANKINGS OF THE BRIC

| *Categories* | *Brazil* | *Russia* | *India* | *China* |
|---|---|---|---|---|
| Area | 5th | 1st | 7th | 3rdor4th |
| Population | 5th | 9th | 2nd | 1st |
| GDP (nominal) | 10th | 8th | 12th | 3rd |
| GDP (PPP) | 9th | 6th | 4th | 2nd |
| Exports | 21st | 11th | 23rd | 2nd |
| Imports | 27th | 17th | 16th | 3rd |
| Current account balance | 47th | 5th | 169th | 1st |
| Received FDI | 16th | 12th | 29th | 5th |
| Foreign exchange reserves | 7th | 3rd | 4th | 1st |
| External debt | 24th | 20th | 27th | 19th |
| Public debt | 47th | 117th | 29th | 98th |
| Electricity consumption | 10th | 3rd | 7th | 2nd |
| Number of mobile phones | 5th | 4th | 2nd | 1st |
| Number of internet users | 5th | 11th | 4th | 1st |

SOURCE: Wikipedia.

[2]Mohanty, S.K. and Sachin Chaturvedi, 2009.

TABLE 2: CONTRIBUTION OF INDIA'S EXPORT TO THE WORLD AND BRC

(Rs. Billion)

| *Year* | *World* | *Brazil* | *China* | *Russia* | *BRC Total* | *BRC % to total of world* |
|---|---|---|---|---|---|---|
| 2000-01 | 2013.6 | 10.2 | 37.9 | 39.7 | 87.7 | 4.4 |
| 2001-02 | 2090.2 | 10.4 | 45.4 | 38.1 | 93.9 | 4.5 |
| 2002-03 | 2551.4 | 23.2 | 95.6 | 34.1 | 152.9 | 6.0 |
| 2003-04 | 2933.7 | 12.7 | 135.8 | 32.8 | 181.3 | 6.2 |
| 2004-05 | 3753.4 | 30.5 | 252.3 | 28.4 | 311.2 | 8.3 |
| 2005-06 | 4564.2 | 48.3 | 299.2 | 32.5 | 380.0 | 8.3 |
| 2006-07 | 5717.8 | 65.8 | 375.3 | 40.9 | 481.9 | 8.4 |
| 2007-08 | 6558.6 | 90.8 | 434.1 | 37.8 | 562.7 | 8.6 |

SOURCE: Centre for Monitoring India Economy (India Trade).

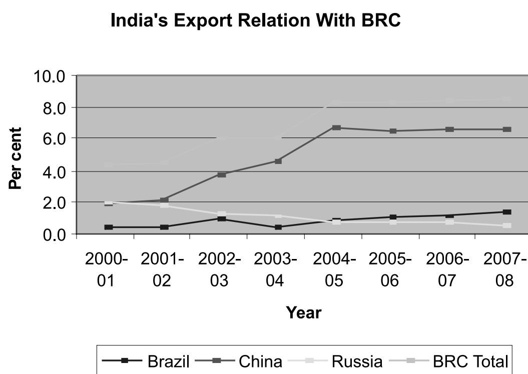
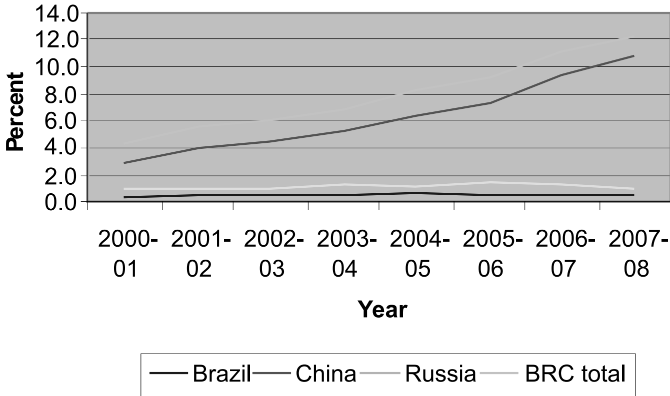



TABLE 3: IMPORT TO INDIA FROM THE WORLD AND BRC

(Rs. Billion)

| *Year* | *World* | *Brazil* | *China* | *Russia* | *BRC Total* | *BRC % to total of world* |
|---|---|---|---|---|---|---|
| 2000-01 | 2283.1 | 6.5 | 68.2 | 23.6 | 98.3 | 4.3 |
| 2001-02 | 2452.0 | 14.7 | 97.1 | 25.5 | 137.4 | 5.6 |
| 2002-03 | 2972.1 | 15.3 | 135.1 | 28.7 | 179.1 | 6.0 |
| 2003-04 | 3591.1 | 14.4 | 186.3 | 44.1 | 244.8 | 6.8 |
| 2004-05 | 5010.6 | 35.6 | 318.9 | 59.4 | 414.0 | 8.3 |
| 2005-06 | 6604.1 | 39.5 | 481.2 | 89.5 | 610.2 | 9.2 |
| 2006-07 | 8380.5 | 44.9 | 790.1 | 109.0 | 944.0 | 11.3 |
| 2007-08 | 10123.1 | 38.2 | 1090.3 | 99.6 | 1228.1 | 12.1 |

SOURCE: Centre for Monitoring India Economy (India Trade)




The share of India's export to BRC in total India's export has also increased from four to nine per cent from 2000-01 to 2007-08 (Table 2). Moreover, India's import from BRC as a share of India's total import has increased three fold from four to twelve per cent in the corresponding period. It can be seen from above graph that trade relation with BRC countries is expanding. India's imports from BRC are increasing at faster rate in comparison to exports to BRC (Table 4).

Wilson and Puroshothaman (2003) in their paper or "Dreaming with BRICs: The Path to 2050" recognises that Brazil, Russia and China have changed their political systems to adopt globalisation and liberalisation. The paper predicts that China and India would be the dominant global suppliers of manufactured goods and services while Brazil and Russia would become dominant as suppliers of raw materials. Economic cooperation is envisaged to be logical among the BRICs because Brazil and Russia together form the logical commodity suppliers to India and China. Investment linkages between the two have also increased significantly in recent years (Table 5).

However, much more needs to be done to facilitate capacity building in BRIC countries so that developing countries in general, trade directly with each other rather than through transnational corporations, which results in increased transaction costs. There is a need for a mutual commitment to fight for larger gains in the global trading system for the developing world. The process must address, not perpetuate or aggravate, existing inequalities. BRIC Summit is a testimony, that all the four nations stand for strengthening cooperation and coordination among themselves. In the Summit, the leaders of BRIC countries, "agreed upon steps to

TABLE 4: TOP FOUR COMMODITIES OF INDIA'S EXPORT TO BRC

| *Importer* | *China* | | | | *Brazil* | | | | *Russia* | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| *Comm-odity* | *Iron ore* | *Cotton raw including waste* | *Other ores & minerals* | *Non-ferrous metals* | *Petroleum & crude products* | *Drugs, pharma-ceuticals & fine chemicals* | *Manmade yarn fabrics madeups* | *Machinery & instruments* | *Drugs, pharma-ceuticals & fine chemicals* | *Tea* | *Machinery & instruments* | *Transport equipment* |
| Year/ Unit | 1000 tonnes | 1000 tonnes | Rs. billion | 1000 kgs | 1000 tonnes | Rs. billion | Rs. billion | Rs. billion | Rs. billion | 1000 kgs | Rs. billion | Rs. billion |
| 1999-00 | 35.2 | 0.0 | 2.8 | 0.0 | 0.0 | 1.9 | 0.3 | 0.3 | 5.3 | 70.1 | 1.1 | 0.2 |
| 2000-01 | 59.4 | 1.5 | 3.3 | 8.2 | 0.7 | 3.7 | 0.4 | 0.4 | 5.0 | 47.9 | 0.6 | 0.1 |
| 2001-02 | 98.7 | 0.0 | 5.4 | 1.4 | 2.6 | 3.5 | 0.5 | 0.8 | 4.8 | 40.3 | 0.8 | 0.3 |
| 2002-03 | 197.6 | 0.1 | 7.4 | 10.2 | 123.9 | 3.7 | 0.8 | 0.8 | 5.2 | 28.7 | 0.6 | 0.7 |
| 2003-04 | 378.4 | 16.3 | 5.9 | 19.9 | 10.5 | 4.0 | 0.7 | 0.8 | 6.4 | 26.0 | 0.7 | 0.3 |
| 2004-05 | 1206.1 | 9.1 | 16.1 | 29.4 | 132.6 | 4.9 | 2.0 | 1.5 | 7.7 | 23.4 | 1.0 | 0.6 |
| 2005-06 | 1449.0 | 183.7 | 14.1 | 53.5 | 248.9 | 6.2 | 1.9 | 2.0 | 10.8 | 23.8 | 1.3 | 1.1 |
| 2006-07 | 1508.3 | 297.0 | 30.3 | 267.5 | 353.8 | 7.8 | 4.0 | 2.4 | 13.2 | 27.9 | 2.0 | 1.0 |
| 2007-08 | 2148.5 | 404.0 | 37.4 | 164.4 | 442.3 | 7.5 | 6.6 | 6.1 | 12.0 | 28.5 | 2.4 | 1.9 |

SOURCE: Centre for Monitoring India Economy (India Trade).

TABLE 5: IMPORT FROM BRC COUNTRIES TO INDIA

| *Exporter* | *China* | | | | *Russia* | | | | *Brazil* | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| *Commodity* | *Electronic goods* | *Non-electrical machinery* | *Iron & steel* | *Organic chemicals* | *Iron & steel* | *Non-ferrous metals* | *Wheat* | *Fertiliser manufactured* | *Metaliferrous ores & metal scrap* | *Vegetable oils (edible)* | *Sugar* | *Non-electrical machinery* |
| Year/ Unit | Rs. billion | Rs. billion | 1000 tonnes | Rs. billion | 1000 tonnes | Rs. billion | 1000 tonnes | 1000 tonnes | Rs. billion | 1000 tonnes | 1000 tonnes | Rs. billion |
| 1999-00 | 7.7 | 2.3 | 13.3 | 7.7 | 26.4 | 2.6 | n.a. | 87.0 | 0.3 | 38.6 | 51.5 | 0.8 |
| 2000-01 | 11.2 | 2.8 | 3.4 | 8.3 | 46.2 | 2.8 | n.a. | 39.4 | 0.2 | 10.0 | 0.8 | 0.8 |
| 2001-02 | 18.3 | 3.4 | 6.9 | 11.5 | 24.4 | 2.8 | n.a. | 65.5 | 0.3 | 59.1 | 0.0 | 1.4 |
| 2002-03 | 39.2 | 5.1 | 4.5 | 15.8 | 49.5 | 3.3 | n.a. | 46.7 | 0.5 | 66.6 | 3.2 | 1.3 |
| 2003-04 | 63.4 | 8.5 | 14.5 | 21.7 | 86.8 | 6.7 | n.a. | 64.6 | 1.1 | 56.7 | 0.0 | 1.3 |
| 2004-05 | 95.3 | 20.5 | 63.5 | 28.4 | 152.1 | 7.0 | n.a. | 104.0 | 2.9 | 75.1 | 86.8 | 2.0 |
| 2005-06 | 154.6 | 44.9 | 147.2 | 43.0 | 250.3 | 10.8 | n.a. | 214.7 | 3.0 | 85.1 | 52.6 | 3.8 |
| 2006-07 | 226.7 | 83.3 | 672.3 | 58.3 | 184.0 | 12.4 | 203.3 | 142.4 | 12.0 | 32.5 | 0.0 | 4.5 |
| 2007-08 | 307.3 | 130.6 | 770.3 | 68.8 | 163.0 | 15.4 | 115.1 | 110.4 | 9.2 | 58.2 | 0.0 | 3.8 |

SOURCE: Centre for Monitoring India Economy (India Trade).

promote dialogue and cooperation among our countries in an incremental, proactive, pragmatic, open and transparent way.[3]" The article is an attempt towards that direction.

This article presents an analysis of Indian tax system relating to its structure and constitutional provisions. It also presents the summary of recent economic development and issues related to international trade in India particularly wit BRIC. The article is presented in the four sections. Section I presents the broad analysis of the provisions in Indian constitution related to taxation and its distribution. Section II discusses various issues related to major taxes in India. The issues related to the transition from cascading type indirect taxes to comprehensive value added system or goods and service tax have also been discussed. The section also critically analyses the structure of custom and tariff in India. Section III presents the account of India's development under various parameters. The last section IV concludes the paper.

## CONSTITUTION AND TAX STRUCTURE IN INDIA

### *Tax Structure in India: The Legislative Framework*[4]

The Constitution makes elaborate and complex arrangements relating to the distribution, between the Union[5] and the states, of taxes, and power of borrowing, and provision for grants-in-aid by the Union to the states. The underlying philosophy of these arrangements is to place at the disposal of the two tiers of government adequate financial resources to enable them to discharge their respective responsibilities under the Constitution.

Seventh Schedule of the Constitution specifies the powers between the Union and states. List I in the Seventh Schedule refers to the taxation powers of the Union government (Table 6). List II in the same Schedule specifies the taxation powers of the state governments (Table 7). List III which is a concurrent list does not contain any item related to taxation except one related to stamp duty. In other words, the tax assignment follows the principles of separation.

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[3]Joint Statement of the BRIC countries' leaders, on June 16, 2009 at Yekaterinburg, Russia.

[4]Initial part of this section is drawn from www.wto.org.

[5]The term "Union" and "Centre" has been used interchangeably in this article.

TABLE 6: TAXES WITHIN THE JURISDICTION OF THE UNION AS ENUMERATED IN THE SEVENTH SCHEDULE OF THE CONSTITUTION OF INDIA

| *S. No.* | *Entry No. in List I* | *Description of the tax/ duty* |
|---|---|---|
| 1. | 82 | Taxes on income other than agricultural income. |
| 2. | 83 | Duties of customs including export duties. |
| 3. | 84 | Duties of excise on goods manufactured or produced in India except alcoholic liquors for human consumption and narcotics but including medicinal and toilet preparations containing alcohol. |
| 4. | 85 | Corporation tax. |
| 5. | 86 | Taxes on the capital value of assets, exclusive of agricultural land, of individuals and companies; taxes on the capital of companies. |
| 6. | 87 | Estate duty in respect of property other than agricultural land. |
| 7. | 88 | Duties in respect of succession to property other than agricultural land. |
| 8. | 89 | Terminal taxes on goods or passengers, carried by railway, sea or air; taxes on railway fares and freights. |
| 9. | 90 | Taxes other than stamp duties on transactions in stock exchanges and future markets. |
| 10. | 91 | Rates of stamp duty in respect of bills of exchange, cheques, promissory notes, bills of lading, letters of credit, policies of insurance, transfer of shares, debentures, proxies, and receipts. |
| 11. | 92 | Taxes on the sale or purchase of newspapers and on advertisements published therein. |
| 12. | 92A* | Taxes on the sale or purchase of goods other than newspapers, where such sale or purchase takes place in the course of inter-State trade or commerce. |
| 13. | 92B** | Taxes on the consignment of goods (whether the consignment is to the person making it or to any other person), where such consignment takes place in the course of inter-State trade or commerce. |
| 14. | 92C*** | Taxes on services |
| 15. | 97 | Any tax not enumerated in List II or List III of the Seventh Schedule. |

* Inserted by the Constitution (Sixth Amendment) Act, 1956 (w.e.f. 11-6-1956)

** Inserted by the Constitution (Forty-sixth Amendment) Act, 1982. (w.e.f. 2-2-1983)

*** Inserted by the Constitution (Eighty-eighth Amendment) Act, 2003.

Source: Government of India (2005)

Service tax has been placed, after Constitution (Eighty-eighth Amendment) Act, 2003 under the Union List in the Seventh Schedule under Article 268A which reads as follows:

1) Taxes on services shall be levied by the Government of India and such tax shall be collected and appropriated by the Government of India and the states in the manner provided in clause (2).
2) The proceeds in any financial year of any such tax levied in accordance with the provisions of clause (1) shall be
   a) collected by the Government of India and the States;
   b) appropriated by the Government of India and the States;

In accordance with such principles of collection and appropriation as may be formulated by Parliament by law."

The property of the Union is exempt from state taxation under Article 285(1). Likewise, the property and income of the states are exempt from Union taxes, except that Parliament may by law provide for Central taxation of any trading activities of a state which are not incidental to the ordinary functions of state government, and of government - Article 89(2). As regards Union Territories, the Parliament has the power to impose any tax included in the state List.

Constitution also imposes certain restrictions on the taxation powers of the states. Although a State legislature enjoys the power to levy any of the taxes mentioned in List II, in the case of certain taxes, this power is subject to restrictions imposed by substantive provisions of the Constitution. Some examples of these restrictions are as follows.

The powers to impose taxes on the sale or purchase of goods, other than newspapers, belongs to the state vide entry 54 of List II. However, Article 286 ensures that sales taxes imposed by the states do not interfere with imports and exports or inter-state trade and commerce which are matters of national importance. In view of this, Article 286 places the following restrictions on the power of the states to enact sales tax legislation.

a) No law of a State shall impose a tax on the sale or purchase of goods where such sale or purchase takes place (i) outside the state; or (ii) in the course of import into or export out of the territory of India;
b) with regard to inter-state trade, there are two restrictions (i) the power to tax sales taking place in the course of inter-state trade and commerce belongs to the Union *vide* entry 92A of List I in the Seventh Schedule, and (ii) the sales tax on intrastate sales of 'declared goods' (*i.e*. goods of special importance in inter-state trade) is subject to certain restrictions in terms of the nature of the levy and the rate of tax.

TABLE 7: TAXES WITHIN THE JURISDICTION OF STATES AS ENUMERATED IN THE SEVENTH SCHEDULE OF THE CONSTITUTION OF INDIA

| *S. No.* | *Entry No. in List II* | *Description of the tax/ duty* |
|---|---|---|
| 1. | 45 | Land revenue. |
| 2. | 46 | Taxes on agricultural income. |
| 3. | 47 | Duties in respect of succession to agricultural land. |
| 4. | 48 | Estate duty in respect of agricultural land. |
| 5. | 49 | Taxes on lands and buildings. |
| 6. | 50 | Taxes on mineral rights subject to any limitations imposed by Parliament by law relating to mineral development. |
| 7. | 51 | Duties of excise on alcoholic liquors and narcotics manufactured or produced in the State but not including medicinal and toilet preparations containing alcohol. |
| 8. | 52 | Taxes on the entry of goods into a local area for consumption, use or sale therein. |
| 9. | 53 | Taxes on the consumption or sale of electricity. |
| 10. | 54* | Taxes on the sale or purchase of goods other than newspapers, subject to the provisions of Entry 92A of List I. |
| 11. | 55** | Taxes on advertisements other than advertisements published in the newspapers (and advertisements broadcast by radio or television) |
| 12. | 56 | Taxes on goods and passengers carried by road or on inland waterways. |
| 13. | 57 | Taxes on vehicles, whether mechanically propelled or not, suitable for use on roads, including tram-cars subject to the provisions of Entry 35 of List III. |
| 14. | 58 | Taxes on animals and boats. |
| 15. | 59 | Tolls. |
| 16. | 60*** | Taxes on professions, trades, callings and employment. |
| 17. | 61 | Capitation taxes. |
| 18. | 62 | Taxes on luxuries, including taxes on entertainment, amusements, betting and gambling. |
| 19. | 63 | Rates of stamp duty in respect of documents other than those specified in the provisions of List I with regard to rates of stamp duty. |

* Substituted by the Constitution (Sixth Amendment) Act, 1956:

** The words 'and advertisements broadcast by radio or television' inserted by the Constitution (Forty-second Amendment), Act, 1976:

*** The scope of these taxes is spelt out in Article 276, the clause (2) of which fixes the amount payable by a person on account of these taxes.

SOURCE: Government of India (2005)

A State legislature is empowered to levy a tax on professions, trade, calling or employment *vide* entry 60 of List II. However, the total amount payable in respect of any one person to the state by way of such tax is not to exceed Rs. 2,500 per annum [Article 276(2)].

*Tax Jurisdiction and Apportionment*

Like most federations, the tax powers in India are specified by law between the Union and the constituent units, namely the states[6]. The powers and functions of the respective levels of government are enumerated in the Seventh Schedule to the Indian Constitution. The concurrent list has no item that has any direct bearing on taxation except one. This relates to 'stamp duties other than duties or fees collected by means of judicial stamps, but not including rates of stamp duty'. Recovery of taxes like other public demand also occurs in the concurrent list. The residual powers of taxation, as in general legislation, belong to the Union *vide* entry 97 of List I in the Seventh Schedule. The Union, therefore, can enter tax fields not charted in the Constitution. For example, the Union government, under such power, imposed gift tax in the past which was abolished in 1998. Similarly, service tax was also imposed in the beginning of this millennium under such power.

Contrary to the practice in several other federations where taxes can be levied concurrently at two levels, the right to levy a given tax, in Indian Constitution, belongs exclusively to the tier to which it is assigned. In practice, the tax arrangements of Union taxes can be classified into the following categories.

- Service Tax levied by the Union and collected and appropriated by the Union and the states (Article 268A).
- Duties levied by the Union but administered and appropriated by the states (Article 268): *e.g.* duties of excise on medicinal and toilet preparations containing alcohol, and stamp duties on bills of exchange etc. as mentioned in the entries 84 and 91 of the Union List respectively and taxes on the sale or purchase of goods where such sale or purchase takes place in the course of inter-State trade or commerce, and taxes on the consignment of goods where such consignment takes place in the course of inter-State trade or commerce as per the entries 92A and 92B in the Union List.
- Taxes levied and shared between the Union and the states (Article 277): All taxes referred to in the Union list except

[6] An exception is the USA where the Constitution is silent on the assignment of indirect taxes except tariffs (McLure, 1983).

mentioned above, are levied and collected by the Government of India and form a divisible pool that is shared between the Union and the states.

Moreover, there are taxes mentioned under entries 87, 88 and 92 B in the Union List that are not being levied. These entries pertain to estate duty, and succession duty in respect of property other than agricultural land and taxes on the consignment of goods where such consignment takes place in the course of inter-state trade or commerce. The incidence of both estate duty and succession duty is on the same object, *viz*. property being inherited after the death of the owner. In the case of the estate duty, the value of the whole estate, even if situated in more than one state, is the base for tax. The succession duty is related to the value of individual shares (i.e. parts of an estate) being inherited by the successors. The Estate Duty was imposed in India in 1953 and abolished in 1985.

Local governments, both rural and urban, have been recognised in the book of statute after 1992. They have no exclusive power of taxation under the Constitution[7]. They derive their taxing authority from the state governments. The states on their own may assign any of the taxes in the State List to the local governments. The taxes generally assigned to local governments are property taxes, octroi, and taxes on vehicles, taxes on professions, trades, callings license fee etc.

Seemingly, the tax assignment in the Indian Constitution is in conformity with the theories of tax assignment in federations, "the basic scheme of the Constitution dividing the field of taxation between the Union and the states and incorporating adequate arrangements for sharing of resources between them is sound and no major modifications in it are called for" observed by the Commission on Centre-State Relations in 1988. From the equity and efficiency criteria, progressive income and expenditure taxes should be with the federal government. Destination-based consumption taxes like sales tax should be with the sub-national government. Local government should levy property taxes, and all three levels of government should have the authorities to collect user charges (McLure, 1983, Shah, 1994). Tax assignments mentioned in the Indian Constitution are consistent with the theoretical literature. The exception related to the power to the states to tax natural resources such as minerals was corrected subsequently by giving dominant power to the Union to levy or regulate the tax on minerals.[8]

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[7]See Alok, 2006 for more details

[8]Mines and Minerals (Regulation and Development) Act of 1957.

Though, the Indian constitutional scheme on tax assignment seems good on paper, its actual working has revealed many shortcomings including the following:

*Vertical imbalance*: The substantial number of taxes has been assigned to the states but the most buoyant taxes, *i.e.* customs, union excise, corporate income tax and personal income tax are with the Union. As a result, the Union government collects two third of the total revenue. The states together with local governments[9] collect the rest. Since sub national governments are assigned about two third expenditure responsibilities it necessitates large fiscal transfers from Union to state governments. Vertical imbalance is considered desirable in a federation to ensure the redistribution of income and the constitution makers deliberately made this provision but not to this degree. Initially, when governments' budgets used to have revenue surplus and capital investments were funded through borrowings, vertical imbalance of small magnitude was justified. In the eighties, both levels of governments started showing revenue deficit and huge fiscal deficit. "The accountability suffers when revenue and expenditure decisions are delinked."[10] It erodes fiscal discipline and creates a widening vertical fiscal gap;

*Tax Exportation*: The Union has the power to tax central sales tax on inter state sales. It delegates the power to the state to administer the tax and retain the revenue. Under the scheme, the exporting state collects the revenue by levying central sales tax on the sale of goods from the state. The consumer of the importing state has to bear the tax. Thus, the central sales tax is the major vehicle of tax exportation and distorts common market that the union of states in India offers.

*Tax Competition*: The power of sales taxation is with the states. In the past, in the absence of coordination among them, the states engaged in tax war by lowering tax rates on automobiles and electronics items to lure consumers, providing tax incentives, exemption and deferment of different kinds to encourage trade and industry in their jurisdictions. All of them led to revenue loss and distortion in the location of industries.

### *Sharing of Union Taxes*

Though exclusive powers have been assigned to both the Union and the states, but the Union can not appropriate all the proceeds of the taxes collected by them. As per the design of the Constitution, revenue from Union taxes to be shared with the states to fulfil their needs.

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[9]Local governments collects very little (Alok, 2009).

[10]Bagchi, 1998, p 324.

Prior to 2003, only personal income tax and the Union excise duties were shared with the States. The sharing of the income tax was mandatory under Article 270 while that of the Union excise duties was discretionary under Article 272. Under the tax rental arrangements with the States, the Union government collected the tax on behalf of the states and then distributed the proceeds among the states on the basis of criteria recommended by the successive finance commissions. These were (a) additional excise duties in lieu of sales tax on textiles, tobacco and sugar[11] and (b) grant in lieu of tax on railway passenger fares.

Following the Constitution (80th Amendment) Act, 2000, all central taxes have been brought into a divisible pool and a certain percentage is shared with the states. The article 270 is amended and provide for the sharing of all central taxes except taxes under Articles 268 and 269 and cesses, and surcharges under Article 271. Only net revenues are shared, after deducting cost of collections.

Prior to 88 Amendment to the Constitution, Union government levied the service tax under its residual powers (vide entry 97 of List I in the Seventh Schedule) and it was part of the divisible pool. It is now excluded. *"In the 80th amendment, the objective was to construct a pool of all central taxes for sharing so that a holistic view can be taken and both sides could share in the aggregate buoyancy of the central tax revenues. With service taxes having been excluded from the ambit of the recommendations of the finance commission, the idea of overall shareable pool of central taxes appears to be in the process of being reversed. While service taxes are likely to prove highly buoyant in the near future, these will not be subjected to sharing with the states under the Constitution, although other statutory arrangements can be made, which can include sharing as well as assignment. It may be noted that hitherto items under articles 268 and 269 were subjects that were generally of inter state nature with limited revenue importance. These were wholly assigned to the States. In this context, it need to be stressed that any legislation passed by Parliament with respect to appropriation of service tax proceeds must take care to ensure that the revenue accruing to the states through any proposed changes should not be less than the share that would accrue to them, had the entire service tax proceeds been part of the shareable pool."* [12]

[11]These commodities were considered to be of national importance and the states do not levy sales tax on these items as per the agreement, in 1956, between the Union and states,

[12]Government of India 2004, p.15-16.

## TAX SYSTEM IN INDIA

As mentioned in the previous section, the power to levy taxes, in India, is clearly demarcated between the Union government and the state governments. The Union government levies both direct taxes such as corporate income tax and personal income tax and indirect taxes such as customs and excise duties/CENVAT and a service tax. States levy a VAT on good, state sales taxes (in States where VAT is not yet in force), stamp duty, state excise, land revenue and tax on professions. State can also levy tax on agricultural income. Local governments both rural and urban are empowered by their respective State governments to levy tax on properties, octroi and for utilities like water supply, drainage etc.

TABLE 8: FISCAL TRENDS IN INDIA

(% of GDP)

| Year | Revenue Deficit (Centre) | Fiscal Deficit (Centre) | Primary Deficit | Tax Ratio (Centre) | Tax Ratio (States) | Tax Ratio (Total) |
|---|---|---|---|---|---|---|
| 1990-91 | 4.2 | 9.3 | 4.9 | 7.6 | 5.3 | 12.8 |
| 1995-96 | 3.2 | 6.5 | 1.6 | 6.9 | 5.4 | 12.2 |
| 1996-97 | 3.6 | 6.3 | 1.1 | 6.8 | 5.2 | 12.0 |
| 1997-98 | 4.2 | 7.2 | 2 | 6.3 | 5.3 | 11.6 |
| 1998-99 | 6.4 | 9 | 3.6 | 6.0 | 5.1 | 11.1 |
| 1999-00 | 6.3 | 9.5 | 3.8 | 6.6 | 5.3 | 11.8 |
| 2000-01 | 6.5 | 9.2 | 3.3 | 6.5 | 6.0 | 12.5 |
| 2001-02 | 6.9 | 9.6 | 3.4 | 5.9 | 6.6 | 12.5 |
| 2002-03 | 6.6 | 9.3 | 3.0 | 6.5 | 6.7 | 13.2 |
| 2003-04 | 5.7 | 8.4 | 2.0 | 6.8 | 7.0 | 13.8 |
| 2004-05 | 3.6 | 7.3 | 1.2 | 7.1 | 7.3 | 14.5 |
| 2005-06 | 2.6 | 6.6 | 0.8 | 7.5 | 7.6 | 15.1 |
| 2006-07(RE) | 2.1 | 6.5 | 0.9 | 8.4 | 8.1 | 16.5 |
| 2007-08(BE) | 1.2 | 5.7 | 0.3 | 8.6 | 8.2 | 16.8 |

SOURCE: Indian Public Finance Statistics and CMIE.
RE: Revised Estimates
BE: Budget Estimates

### *Direct Taxes*

In the beginning after independence in India, the direct taxes were highly influenced by the 'socialist pattern of society'. The taxes were levied to finance planned economic development. The Report of Taxation Enquiry Commission in 1954 recommended to raise revenues through high rates of

taxes in a progressive structure. Later in 1956, Kalder Committee prescribed a host of other direct taxes, i.e. expenditure tax, a wealth tax and a gift tax etc. to be integrated with the taxes on income, capital gains and estates. As a result, the personal income tax, in 1973-74 had, eleven tax slabs with highest rate of 85 per cent above the income of Rs. 2,00,000. With 15 per cent surcharge, the effective rate was 97.5 per cent. In a way, the system encouraged people to evade taxes and generate black money. In the next two decades, there were sporadic efforts to reduce the tax rates. Finally, when Manmohan Singh became Finance Minister in 1991, he initiated structural adjustment programme and tax reform was its integral part. The Tax Reforms Committee under the chairmanship of Raja Chelliah was constituted. As per the recommendations of the Committee the personal income tax rates were simplified considerably with only three slabs rates of 20-30-40 per cent. This was reduced further to 10-20-30 per cent in 1997-98.

TABLE 9: COMBINED REVENUE RECEIPTS OF UNION AND STATES IN INDIA

Rs. billion

| *Year* | *1990-91* | *1995-96* | *2000-01* | *2005-06* | *(RE) 2006-07* | *(BE) 2007-08* |
|---|---|---|---|---|---|---|
| GDP | 5696 | 11918 | 21023 | 35867 | 41292 | 47234 |
| Tax Revenue | 877 | 1753 | 3053 | 5877 | 7355 | 8548 |
| Direct taxes | 123 | 358 | 718 | 1676 | 2310 | 2688 |
| a) Corporation income tax (CIT) | 53 | 165 | 357 | 1013 | 1465 | 1684 |
| b) Personal income tax (PIT) | 54 | 156 | 318 | 608 | 782 | 936 |
| c) Other direct taxes* | 15 | 37 | 43 | 56 | 63 | 67 |
| Indirect taxes | 755 | 1395 | 2336 | 4201 | 5045 | 5860 |
| a) Customs | 206 | 358 | 475 | 651 | 818 | 988 |
| b) Union excise duties | 245 | 402 | 685 | 1112 | 1173 | 1302 |
| c) Service tax | 0 | 9 | 26 | 231 | 382 | 502 |
| d) State excise duty | 50 | 87 | 159 | 264 | 308 | 331 |
| e) General sales tax | 182 | 357 | 729 | 1365 | 1665 | 1928 |
| f) Other indirect taxes** | 71 | 183 | 261 | 578 | 699 | 810 |

Source: Union Budgets, Indian Public Finance Statistics, and CMIE.

Note:* Other Direct Taxes includes Estate duty, Interest tax, Wealth tax, Gift Tax, Land Revenue, Hotel receipts tax, and expenditure tax.

** Other Indirect Taxes includes Stamp and registration fees, Sales tax, Taxes on vehicles, Tax on goods & passengers, Tax & duty on electricity and Other.

TABLE 10: CONTRIBUTION OF EACH MAJOR TAXES OF CENTRE AND STATES IN GDP

(%)

| *Year* | *1990-91* | *1995-96* | *2000-01* | *2005-06* | *(RE) 2006-07* | *(BE) 2007-08* |
|---|---|---|---|---|---|---|
| Tax Revenue | 15.4 | 14.7 | 14.5 | 16.4 | 17.8 | 18.1 |
| Direct taxes | 2.2 | 3.0 | 3.4 | 4.7 | 5.6 | 5.7 |
| a) Corporation income tax (CIT) | 0.9 | 1.4 | 1.7 | 2.8 | 3.5 | 3.6 |
| b) Personal income tax (PIT) | 0.9 | 1.3 | 1.5 | 1.7 | 1.9 | 2.0 |
| c) Other direct taxes | 0.3 | 0.3 | 0.2 | 0.2 | 0.2 | 0.1 |
| Indirect taxes | 13.2 | 11.7 | 11.1 | 11.7 | 12.2 | 12.4 |
| a) Customs | 3.6 | 3.0 | 2.3 | 1.8 | 2.0 | 2.1 |
| b) Union excise duties | 4.3 | 3.4 | 3.3 | 3.1 | 2.8 | 2.8 |
| c) Service tax | 0.0 | 0.1 | 0.1 | 0.6 | 0.9 | 1.1 |
| d) State excise duty | 0.9 | 0.7 | 0.8 | 0.7 | 0.7 | 0.7 |
| e) General sales tax | 3.2 | 3.0 | 3.5 | 3.8 | 4.0 | 4.1 |
| f) Other indirect taxes | 1.2 | 1.5 | 1.2 | 1.6 | 1.7 | 1.7 |

SOURCE: Union Budgets, Indian Public Finance Statistics, and CMIE.

The Corporate Income Tax rate was also reduced in a phased manner to 40 per cent in 1993-94. It reduced further to 35 per cent in 1997-98. Minimum Alternate Tax (MAT) was introduced to discourage zero tax companies avoiding taxes by taking full advantages of concessions and tax incentives in the tax structure. The prevailing rates and the provision of personal income tax, corporate income tax, capital gain tax and withholding tax are given in Annex 1. The fiscal importance of direct taxes can be seen in Tables 8 to 13.

*Indirect Taxes A Move towards Goods and Service Tax*[13]

At present, the move in India is towards comprehensive goods and service tax by integrating primarily Union Excise Duty, State Sales Tax and Service Tax. As mentioned earlier, the Indian Constitution assigns Union Government to impose a broad spectrum of union excise duties (UEDs) on production or manufacture of goods and the state governments the power to levy tax on sale of goods. The authority to levy tax on services has been assigned to the Union List. However, the states are empowered to levy tax

[13]This section is drawn liberally from Purohit 2009.

TABLE 11: CONTRIBUTION OF EACH MAJOR TAXES IN THE TOTAL TAX REVENUE OF THE UNION AND STATES

(%)

| *Year* | *1990-91* | *1995-96* | *2000-01* | *2005-06* | *(RE) 2006-07* | *(BE) 2007-08* |
|---|---|---|---|---|---|---|
| Direct taxes | 14.0 | 20.4 | 23.5 | 28.5 | 31.4 | 31.4 |
| a) Corporation income tax (CIT) | 6.1 | 9.4 | 11.7 | 17.2 | 19.9 | 19.7 |
| b) Personal income tax (PIT) | 6.1 | 8.9 | 10.4 | 10.3 | 10.6 | 11.0 |
| c) Other direct taxes | 1.8 | 2.1 | 1.4 | 1.0 | 0.9 | 0.8 |
| Indirect taxes | 86.0 | 79.6 | 76.5 | 71.5 | 68.6 | 68.6 |
| a) Customs | 23.5 | 20.4 | 15.6 | 11.1 | 11.1 | 11.6 |
| b) Union excise duties | 27.9 | 22.9 | 22.4 | 18.9 | 15.9 | 15.2 |
| d) Service tax | 0.0 | 0.5 | 0.9 | 3.9 | 5.2 | 5.9 |
| e) State excise duty | 5.7 | 4.9 | 5.2 | 4.5 | 4.2 | 3.9 |
| e) General sales tax | 20.8 | 20.4 | 23.9 | 23.2 | 22.6 | 22.6 |
| f) Other indirect taxes | 8.1 | 10.5 | 8.5 | 9.8 | 9.5 | 9.5 |
| Total Tax Revenue | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 |

SOURCE: Union Budgets, Indian Public Finance Statistics, and CMIE.

TABLE 12: GROSS REVENUE RECEIPTS OF THE CENTRE

(Rs. billion)

| *Year* | *1990-91* | *1995-96* | *2000-01* | *2005-06* | *2007-08* | *2008-09* | *2009-10* |
|---|---|---|---|---|---|---|---|
| GDP | 5696 | 11918 | 21023 | 35867 | 47234 | 53218 | n.a. |
| Total Revenue | 550 | 1100 | 1927 | 3480 | 5419 | 5622 | 6145 |
| Gross Tax Revenue | 430 | 819 | 1369 | 3662 | 5931 | 6279 | 6411 |
| Direct taxes, of which | 69 | 223 | 497 | 1623 | 2959 | 3450 | 3700 |
| a) Corporation tax (CIT) | 53 | 165 | 252 | 1013 | 1929 | 2220 | 2567 |
| b) Personal income tax (PIT) | 13 | 43 | 238 | 608 | 1026 | 1226 | 1129 |
| c) Other direct taxes* | 3 | 15 | 7 | 3 | 3 | 4 | 4 |
| Indirect taxes, of which | 361 | 596 | 873 | 2038 | 2972 | 2829 | 2711 |
| a) Customs | 206 | 358 | 342 | 651 | 1041 | 1080 | 980 |
| b) Union excise duties | 141 | 222 | 498 | 1112 | 1234 | 1084 | 1065 |
| c) Service tax | 0 | 9 | 20 | 231 | 513 | 650 | 650 |
| d) Other indirect taxes | 14 | 9 | 14 | 45 | 79 | 16 | 16 |

SOURCE: Union Budgets, Indian Public Finance Statistics, and CMIE.

TABLE 13: SHARE OF EACH MAJOR TAXES IN GROSS TAX REVENUE OF THE CENTRE (%)

| *Year* | *1990 -91* | *1995 -96* | *2000 -01* | *2005 -06* | *2007 -08* | *2008 -09* | *2009 -10* |
|---|---|---|---|---|---|---|---|
| Direct taxes, of which | 16.1 | 27.2 | 36.3 | 44.3 | 49.9 | 54.9 | 57.7 |
| a) Corporation income tax (CIT) | 12.4 | 20.1 | 18.4 | 27.7 | 32.5 | 35.4 | 40.0 |
| b) Personal income tax (PIT) | 2.9 | 5.3 | 17.4 | 16.6 | 17.3 | 19.5 | 17.6 |
| c) Other direct taxes | 0.7 | 1.8 | 0.5 | 0.1 | 0.1 | 0.1 | 0.1 |
| Indirect taxes, of which | 83.9 | 72.8 | 63.7 | 55.7 | 50.1 | 45.1 | 42.3 |
| a) Customs | 48.0 | 43.6 | 25.0 | 17.8 | 17.6 | 17.2 | 15.3 |
| b) Union excise duties | 32.8 | 27.1 | 36.3 | 30.4 | 20.8 | 17.3 | 16.6 |
| c) Service tax | 0.0 | 1.1 | 1.4 | 6.3 | 8.6 | 10.4 | 10.1 |
| d) Other indirect taxes | 3.2 | 1.0 | 1.0 | 1.2 | 1.3 | 0.3 | 0.2 |
| Gross Tax Revenue | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 |

SOURCE: Union Budgets, Indian Public Finance Statistics, and CMIE.

on some services, through entertainment tax, electricity duty, motor vehicles tax, passengers and goods tax, entry tax, octroi etc.

*Central Excise Duty/Cen-VAT*

Central Excise Duty/CenVAT is levied by the Union Government at the manufacturing level on almost all manufactured goods except hydrocarbon and tobacco. It is levied mainly on finished goods but also covered raw materials, intermediate goods and capital goods. Introduction of modified value added tax (Modvat) was the first major reform in the central excise duty in 1986 through the Report of the Jha Committee[14]. Under Modvat, a set-off was provided for the taxes paid on inputs used in few commodities. This was further reformed on the recommendations of the Report of the Tax Reforms Committee (TRC) in 1993, the Modvat was extended to a large number of commodities[15]. Slowly but steadily the reform continued. The CenVAT, in the Union Budget 2006-2007 entailed a two-rate structure of 16 per cent (reduced to 14% later) and eight per cent. CenVAT allows credit for the taxes paid on inputs in the form of Modvat/CenVAT), additional duties of excise (ADE) and countervailing duty (CVD). However, for capital goods, only 50 per cent of the duty can be claimed as input credit in a financial year; the remaining in the subsequent financial year.

[14]Government of India, 1978.
[15]Government of India, 1993.

The Union government also levies additional excise duty in lieu of sales tax[16]; additional duty of excise on textiles and textile articles; and cess on specified commodities.

*Service Tax*

Since the services sector contributes the largest share in GDP, it was first introduced under residuary entry in the Union List in 1994-95. Later, the Constitution was amended to include service tax in the Union List by inserting item 92(C) into the Seventh Schedule. But, the tax was kept outside the divisible pool. Over the years and the rate of service tax leviable was also revised (Table 14). Initially, only three services were taxed, viz. general insurance, stock broking, and telephone. The tax was gradually expanded and covered 106 services. It is now integrated with CenVAT.

TABLE 14: SERVICE TAX: GROWING REVENUE SOURCE

| Year | Number of services | Number of assesses | Tax rate (per cent) | Revenue (Rs. billion) | Growth (per cent) |
|---|---|---|---|---|---|
| 2002-03 | 52 | 232048 | 5 | 41.2 | 24.8 |
| 2003-04 | 60 | 403856 | 8 | 78.9 | 91.4 |
| 2004-05 | 75 | 740267 | 10 | 142.0 | 80 |
| 2005-06 | 84 | 806585 | 10 | 230.6 | 62.4 |
| 2006-07 | 99 | 918746 | 12 | 376.0 | 63.1 |
| 2007-08[P] | 106 | NA | 12 | 513.0 | 36.4 |
| 2008-09(RE) | | NA | 12* | 650.0 | 26.7 |

Provisional

SOURCE: Government of India, 2009.

*State-VAT*

The Constitution empowers states to levy sales tax on goods sold within the state. Prior to the present tax reform, variety of models of sales tax had been adopted in different states. These models of single-point, double-point and multi-point were replaced by a first-point sales tax. Additional sales tax, turnover tax and/or surcharge on sales tax were also levied in many states in addition to first-point sales tax. The system was complex with multiplicity of rates. The difference of two adjacent rates was as little as

[16] Additional excise duty in lieu of sales tax was levied since 1956 on tobacco, textiles and sugar under a tax rental arrangement between the Union and the States. According to this arrangement, the Union government was levying additional excise duty on these items and the States refrained from levying sales tax on them. The net proceeds of this duty were being distributed amongst the States on the basis of consumption. Since the country is moving towards VAT, the proceeds of this tax are now included in the Union divisible pool and the states have also been allowed to levy VAT on these items.

0.5 per cent. No social or economic objective could that minute to allow that degree of rate differentiation.

The system had many weaknesses such as cascading and uncontrolled incidence, vertical integration of firms, non-neutrality and lack of efficiency in the tax system. In order to attract industries the states offered concessions and tax incentives in the form of exemption and tax deferment. The tax wars among states were on. Through consensus building exercise the rates were compressed and a structure of State-VAT was evolved by following a study report of 1994[17]. States, *inter alia*, agreed on the following:

- a four-rate structure, i.e. 0, 4, 8 and 12.5 per cent (two special rates of one per cent and 20 per cent for a few specified items);
- exemptions under sales tax be curtailed considerably;
- No new tax exemptions to the industries
- VAT replacing sales tax.

From April 1, 2005, the VAT was introduced in most of the states. Today, all the states have a system of VAT, known as state-VAT. The coverage of tax includes sale of all goods except diesel oil, petrol, aviation turbine fuel, natural gas and liquor. It has two basic rate categories of four per cent and 12.5 per cent (standard rate) with some tax-exempt items and two special categories: one per cent on gold, silver, and ornaments, and 20 per cent on petroleum products.

*Harmonisation of Interstate Tax*

As stated earlier, taxation of inter-state transactions is in of the Union List of the Constitution. However, the Union Government fixes the rates of the Central Sales Tax (CST) and entrusts it to the states that export the goods to collect the tax and retain the revenue. The rate of the tax was one per cent in 1956. Subsequently it became two per cent only to be increased to four per cent. The idea was to regulate the flow of interstate movement of goods. But it became a major source of revenue for many states (Table 15). It distorted the common market that the Union of India offers as the CST was the major vehicle of tax exportation. It promoted corruption in the tax administration. While, free trade was agreed among SAARC countries, tax barriers were unbroken across states within India. Through the reform exercise the CST is phased out by one per cent point every year, so as to reduce it to zero. In order to convince the states, the Union Government had to bargain by providing some compensation for the revenue loss to the states.

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[17]NIPFP 1994.

TABLE 15: CONTRIBUTION OF EACH MAJOR TAXES OF STATES IN GDP

(% of GDP)

| *Year* | *1990-91* | *1995-96* | *2000-01* | *2005-06* | *(RE) 2006-07* | *(BE) 2007-08* |
|---|---|---|---|---|---|---|
| Tax revenue# | 5.29 | 5.37 | 6.00 | 7.60 | 8.09 | 8.20 |
| Direct taxes^ | 0.22 | 0.19 | 0.37 | 0.87 | 0.96 | 1.00 |
| a) Land revenue | 0.11 | 0.11 | 0.07 | 0.08 | 0.07 | 0.07 |
| b) Corporation income tax (CIT) | n.a. | n.a. | 0.21 | 0.72 | 0.81 | 0.85 |
| c) Wealth tax | n.a. | n.a. | neg. | neg. | 0.01 | 0.01 |
| d) Others* | 0.11 | 0.07 | 0.10 | 0.07 | 0.07 | 0.07 |
| Indirect Taxes^ | 5.08 | 5.19 | 5.63 | 6.73 | 7.13 | 7.20 |
| a) State excise duties | 0.84 | 0.72 | 0.75 | 0.73 | 0.74 | 0.70 |
| b) General sales tax | 2.89 | 2.84 | 3.25 | 3.70 | 3.75 | 3.83 |
| c) Stamp & registration fees | 0.37 | 0.50 | 0.44 | 0.72 | 0.77 | 0.81 |
| d) Tax on vehicles | 0.27 | 0.31 | 0.31 | 0.34 | 0.34 | 0.33 |
| e) Custom duties | n.a. | n.a. | 0.23 | 0.51 | 0.55 | 0.57 |
| f) Service tax | n.a. | n.a. | 0.01 | 0.19 | 0.25 | 0.28 |
| g) Others** | 0.71 | 0.82 | 0.63 | 0.54 | 0.74 | 0.69 |
| Non-tax revenue | 0.97 | 1.50 | 0.96 | 0.96 | 0.99 | 0.90 |

Source: Indian Public Finance Statistics, and CMIE.

Note:* Hotel receipts tax, Share of estate duty, Agriculture tax, and others

** Motor spirit sales tax, Tax on goods & passengers, Tax & duty on electricity, Entertainment tax, Tax on purchase of sugarcane (incl. cess on sugarcane), and Others

^ Direct and Indirect taxes minus share of income tax, share of union excise duties

# Gross tax revenue minus share of income tax, share of union excise duties neg.: negligible

### *A Move towards GST*

Since dual-VAT both Cenvat and state-VAT exclude services, introduction of a goods and services tax (GST) is under way. The 1st April 2011 is the date for the switchover. However, the time frame seems unrealistic as a number of legal, economic and administrative issues are to be ironed out. The federal polity of the country ensures the sovereign powers of the Union and State governments in tax matters. The Empowered Committee of State Finance Ministers (EC) felt that a single harmonised GST is not possible given the prevailing Centre-state relationship as well as

the federal character of the economy. A Working Group of the EC recommended a Cen-GST could replace Cen-VAT and subsume all the indirect taxes including Central Excise duties and the Additional Excise duties, additional customs duty in the nature of countervailing duties; special additional duty and other domestic taxes imposed on imports, cesses and surcharges levied by the Union. Similarly, State-GST could replace State-VAT and subsume purchase tax, state excise duty, entertainment tax, luxury tax, octroi, entry tax in lieu of octroi, tax on consumption or sale of electricity. The rates for both these GSTs could be prescribed separately.

*Customs Duty*

In the initial years after independence, India's dependence on custom duty was lower compared to other low income countries that had significant reliance on taxes on international trade. It was due to India's efforts to restrict imports[18] to save scarce foreign exchange.

Duties of customs are levied on goods imported or exported from India at the rate specified under the customs Tariff Act, 1975, and administered by Central Board of Excise and Customs in the Ministry of Finance, Government of India. For the purpose of exercising proper surveillance over imports and exports, the Union government has the power to notify the ports and airports for the unloading of the imported goods and loading of the exported goods, the places for clearance of goods imported or to be exported, the routes by which above goods may pass by land or inland water into or out of India and the ports.

Rates of customs duty for goods imported from countries with whom India has entered into free trade agreements such as Thailand, Sri Lanka, BIMSTEC, south Asian countries and MERCOSUR countries are different.

Custom duty consists of basic tariff, which is the protecting element, and the Additional Duty of Customs (AD), that is a counterpart of excise duties paid by Indian manufacturers on a like product produced in India. If a like product is not manufactured or produced in India, the excise duty that would be leviable on that product had it been manufactured or produced in India is the duty payable. If the product is leviable at different rates, the highest rate among those rates is the rate applicable. Such duty is leviable on the value of goods plus basic custom duty payable. It is also called as countervailing duty (CVD). In addition, Special Additional duty (SAD) is levied to counter taxes imposed on raw materials, components and other inputs similar to those used in the production of such goods.[19] The basic

[18]Chelliah, 1986.

[19]Furthermore, states may also impose taxes on the sale of imported goods after they move from the port or out of the State in which it is located.

duty, is levied under the Customs Act. The rate varies for different items. The Additional Duty (Countervailing Duty) is levied under section 3 (1) of the Custom Tariff Act and is equal to excise duty levied.

Special Additional Duty (SAD) is levied under section 3(3) of the Customs Act. It can be charged on all goods by the Union government. Further, in order to safeguard the interest of domestic manufacturers, as per the situation, the Union government may also impose anti-dumping duty, protective duty and duty on bounty fed articles. On the other hand, Export Duty is levied on export of goods on few articles such as skins and leather. The main objective of this duty is to restrict exports of certain goods.

Thus, the import duty is collected essentially under four sub heads, i.e., basic custom duty, Additional Duty of Custom (AD) or Countervailing Duty (CVD), Special Additional Duty (SAD) and Education Cess. One may notice wide variations between a nominal basic tariff and the effective rate. Some commodities like, alcohol and automobiles have a basic rate higher than the peak rate.

Till the Long Term Fiscal Policy introduced in 1985, the custom tariff rates were very high with complex structure in highly protected and inward looking economy. Attempts were made to rationalise the structure. As a result, the tariff rates have been declining since 1991. The peak rate has come down from 150 per cent in 1991-92 to 40 per cent in 1997-98, 30 per cent in 2002-03, 25 per cent in 2003-04, 15 per cent in 2005-06 and finally 10 per cent in 2007-08. The peak rate of basic customs duty on non agricultural products, which was 20 per cent in 2003-04 was successively reduced in subsequent budgets to reach a level of 10 per cent. In 2007-08, the Budget for 2008-09 did not however carry this forward as the appreciation of the rupee vis-à-vis US $ by 9.8 per cent in 2007-08 itself resulted in lower protection to domestic industry[20].

With the decline of the average tariff rate over the last two decades, the reliance on custom duty in the tax structure has also declined. (Tables 3.1 to 3.9) Though average tariff remains among the highest in the world. All finance ministers in the past had made the statements to bring India's customs tariff to the level of ASEAN (East Asian block). Even if India's peak rate is brought down to 10 per cent it is still have to reach the tariff levels of East Asia. On the other hand, most ASEAN rates have been reduced further under the ASEAN free trade agreement (AFTA). At the same time, the neighbouring countries in South Asia such as Bangladesh, Nepal and Sri Lanka also have lower average tariffs than that of India. This creates another problem of import diversion and smuggling as India

[20]Economic Survey, 2008-09, p. 40.

has some kind of free trade agreement with some of its neighbours. Hence, it is profitable to import items first in the neighbouring countries and export them from there to India. As described above, there have been continuous changes in the customs tariff structure since 1991. It is close to the ASEAN level. Still India's tariff structure is one of the highest in the world. Simultaneously, the custom duty structure is complex as it contains 1150 pages. Secondly, non-agriculture tariff needs to be reviewed with reference to its classification and administration.

*High Tariff*

One can argue to impose a high tax on certain consumer goods so as to discourage their consumption. This does not however translate easily into an argument for imposing higher import tariffs on the "undesirable goods." Thus for example, Government of India wants to discourage the consumption of alcohol the best way to do this is to have higher excise taxes and an equivalent additional custom duty. This is indeed what Government already does. Imposition of a high import tariff on the other hand cuts off competition from better quality alcohol, and removes the incentive for upgrading quality. It also provides an incentive for smuggling.

Items such as automobiles air conditioners, furniture and fixtures are used both by consumers and producers. Higher tariff protection in such cases will have adverse effects on the effective protection provided to all industries, because they constitute a part of the costing structure. There is one argument in the trade literature that has often been used to justify "protection," of both "pure" consumer goods and dual-use items such as cars, the "Infant Industry Argument." Even in this case, however, the (so called) first best or efficient solution is a direct subsidy to producers. Direct subsidies have the additional benefit of transparency in that the cost of protection of each protected item is measured by the known subsidy.

It is very important to note that an industry cannot be an "infant" forever; it may be an "infant" for five years or at the outer limit 10 years. Twenty and 30 year old industries can not be called "infant industries." As time passes the efficiency of the industry diminishes due to complacency. Thus, any such protection must be limited in both scope and time. Moreover, the OECD countries, researchers dealing with infant industry argument have not been able to identify specific industries that would clearly and unambiguously benefit from such temporary protection. It has proved even more difficult to demonstrate that such specific interventions would be welfare improving.

*Low Tariff*

There can also be a valid social argument for lower taxes on certain (pure) consumer goods like life saving drugs, medical devices and equipment

and knowledge related goods. As in the previous case this is really an argument for reducing domestic consumption taxes like CENVAT and Sales tax along with the corresponding additional duty or special additional duty (SAD). Reduction of domestic taxes and SAD is an economically efficient way of 'subsidising' the use of these items.

Once this stand is taken, the classical, efficient, economic solution is quite clear.[21] A direct subsidy on consumption is the best means of facilitating consumption. When there are a large number of suppliers (producers or traders) the administrative costs of such subsidy can be very high.[22] Therefore under exceptional situation of high administrative cost and high standard tariff rate it may be socially desirable to reduce the customs tariff below this rate. The reduction should be considered an interim measure till the standard rate is bought down to a reasonable level.

*Single Rate*

The phased reduction in the "peak" rate of basic customs duty is going on. Simultaneously, exemption and anomalies in the structure should be removed with the exception of those arising from international agreements and higher temporary protection of agricultural raw materials. A single uniform rate of basic (protective) customs duty on all imports has many attractive features:

a. "It ensures that the nominal protection for all imports is the same thus eliminating all classification problems and disputes, resulting in substantial saving in administrative and legal costs.
b. It makes it much easier to administer the duty free import regime for exporters. As a single rate applies to all imports only a total value of imports needs to be specified.
c. Most imports can in principle be on self-declaration basis and customs staff can focus their time and energy on checking smuggling (through mis-declaration of quantity or concealment of item) and chronic misstatement of price.
d. If the uniform rate is reasonably low the incentive for smuggling will be minimised and make the administrative problem of checking it, manageable.
e. With a single, uniform nominal duty the effective protection

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[21]Prof. Bhagwati and Srinivasan demonstrated in a number of elegant papers that the best way of dealing with domestic distortions is through domestic policy changes to offset them, not through trade distorting measures. Please see for example Srinivasan and Vani 2009.

[22]As demonstrated in the case of food and petroleum subsidies.

rate is also identically equal to this rate. The rate of effective protection is therefore neutral and equal for all value added by domestic producers. This will increase the efficiency and competitiveness of the entire economy.

f. Uniform effective protection on all producer goods is more equitable in that it removes the discrimination against other producers. Higher protection for one set of producers inevitably results in lower protection for some other producer.

g. In the case of final finished consumer goods, there is much greater economic justification for a single uniform basic customs duty equal to that on producer goods (with AD/SAD – domestic taxes on consumer goods), than there is for a single uniform rate VAT or CENVAT (applying equally to domestically produced and imported goods).

h. A low uniform rate duty will have the additional benefit of reducing India's weighted average tariff rates below those prevailing in neighbouring countries. Economic interests of India will then become much more closely aligned with neighbours. Indian industry and agriculture will have much less to fear from special free trade arrangements with India's neighbours than is the case today.

i. A low uniform duty that is close to the average for ASEAN countries will enhance India's case for closer economic integration with ASEAN. India can then take the lead in the formation of an Asian Common Market, instead of being treated as a highly protected economy.

j. Such a regime will eliminate the continuous lobbying that now takes place, and the special benefits to large industry & powerful interest groups and losses to the small and unorganised, that inevitably result from such lobbying.[23]

*Taxation and E-commerce*

In general, e-commerce, which refers to conducting trade via the Internet, has a much larger scope than just conducting merchandise transactions electronically. It not only includes all forms of trade in goods but also encompasses services such as banking, insurance and trading in shares.

E-commerce creates diverse functions and revenue streams. Also, it reduces costs of transactions significantly. It is believed that procurement costs will be reduced by 90 per cent through buying online. It is estimated,

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[23] Virmani 2002, pp. 13-14.

for example, that online banking costs one rupee as against Rs. 27 by cash machine and Rs. 114 by bank teller[24].

In view of the reduced costs and increased efficiency of e-commerce as compared to the traditional system of trade and commerce, growth of e-commerce is likely to be highest in India amongst the Asian nations. Estimates show that it will grow at the rate of 246 per cent in India as against 84 per cent in Australia, 110 per cent in Hong Kong, 145 per cent in South Korea and 243 per cent in China[25]. With the industry and trade rapidly picking up computer culture, its full potential will be realised in India in near future. The opening up of the economy and globalisation will stimulate its use and have a profound effect on the system of tax governance in the country.

With a view to encourage e-commerce, most countries initially adopted the policy of exempting e-commerce from taxation. The 'infant industry' argument was the justification for such a policy. It is, however, important to note that the European Union has now started taxing e-commerce. The argument for taxation of e-commerce is based on the premise that such an exemption might induce other dealers/ taxpayers to enter into transactions that saves them some tax. It is, therefore, important to evolve the principles that should govern taxation of e-commerce.

In this context, the Government of India constituted a high powered committee on Electronic Commerce and taxation on December 16, 1999.[26] The objective of the Committee was to examine the projected growth of E-Commerce business and whether it should be subject to tax etc. Some of the observations made by the committee are as follows.

- No reliable data exists as to the estimate of E-Commerce business either in India or elsewhere.
- There has to be uniformity in the taxation of traditional commerce and E-Commerce and to that extent there is no case for exemption of e-Commerce from Director Tax.
- There is no issue regarding domestic e-Commerce taxation except for the need to avoid evasion because of lack of records. In respect of cross border E-Commerce however, there is a need to examine the incidence of tax and a mechanism to levy and collect the same.

Significantly, the Committee has come to the view that applying the existing principles and rules to e-Commerce is impractical and the concept

[24]Purohit and Purohit, 2006.
[25] *Ibid.*
[26]Government of India, 2001b.

of "PE" (permanent place of establishment) adopted by few countries and backed by article 5 of the OECD model tax convention should be rejected.

The Committee feels that the "Base Erosion" approach in the form of a low "Withholding tax" for any payment to a foreign enterprise with the option of being offset by tax on net income by the receiver in his country is a workable option. It has been recommended that Central Board of Direct Taxes (CBDT) should examine this option and the implementation mechanism.

The approach of the Committee is pragmatic. The CBDT should initiate necessary dialogue with the International community to generate consensus on the approach and establish a suitable mechanism. In the interregnum, *status quo* can continue.[27] Presently the revenue from E-commerce is too low to hold the attention of tax authorities.

## ECONOMIC DEVELOPMENT

### *Macroeconomic Developments*

In the late eighties, Prime Minister Economic Advisory Council headed by Sukhmoy Chakravarty drew pointed attention of the Government of India towards two fundamental imbalances, *i.e.* trade imbalance and the fiscal imbalance. The growth rate was also low. Though, India had slow growth during 1950-80 what is called "Hindu growth rate" of 3.5 per cent for GDP.[28] In the early nineties, the Narasimha Rao government of which Manmohan Singh was the finance minister initiated the structural adjustment programme. The programme comprised 10 broad policy prescriptions (Table 16) including fiscal discipline and tax reform. Under the programme, as mentioned in the previous section, many measures were taken to reform major taxes with an underlying direction towards broader bases with moderate rates and fewer exemptions. A conducive environment for trade and industry was created. As a result, the growth rate picked up.

[27]The debate on international taxation of e-commerce is inconclusive. Azam 2007 argues that the debate is oriented and ignores cyber space law and this separation is unjustified and harmful to the development of e-commerce taxation law.

[28]Even growth rate of 3.5 per cent of GDP was more than four times higher than the growth rate of 0.8 per cent per year estimated for the last five decades of British rule (Sivasubramoniam 2000).

TABLE 16: THE WASHINGTON CONSENSUS

| | |
|---|---|
| 1 | Fiscal discipline |
| 2 | Reordering public expenditure in favour of education, health and economic infrastructure |
| 3 | Tax reform (towards broader bases with moderate rates) |
| 4 | Financial liberalisation |
| 5 | Competitive exchange rate |
| 6 | Trade liberalisation |
| 7 | Liberalisation of foreign direct investment |
| 8 | Privatisation (of public enterprises) |
| 9 | Deregulation (of barriers to entry and exit) |
| 10 | Property rights |

SOURCE: Williamson (1990).

The optimism about Indian economic development continued during the period. As a corollary, the economy grew between 1960-79, 1980-91, 1992-2002 and 2002-05 periods at an annual average rate of 3.5, 5.5, 6.0 and 8.1 per cent respectively. The pace of economic growth was unprecedented over 2003-04 to 2007-08 with an average growth rate of 8.8 per cent per year (Table 17). The growth decelerated in 2008-09 to 6.7 per cent. This represented a decline of 2.1 per cent from the average growth rate of 8.8 per cent in the previous five years. However, during the preceding five-year period from 1998-99 to 2002-03 the average growth rate was only 5.5 per cent due to several reasons including political uncertainties of coalitional government, high fiscal deficit due to large public pay increases.

TABLE 17: GROWTH OF NATIONAL INCOME

(Percent per year)

| | 1992/93 -1996/97 | 1997/98 -2001/02 | 2002/03 -2006/07 | 2002/ 03 | 2003/ 04 | 2004/ 05 | 2005/ 06 | 2006/ 07 | 2007/ 08 |
|---|---|---|---|---|---|---|---|---|---|
| GDP(factor Cost) | 6.6 | 5.5 | 7.8 | 3.8 | 8.5 | 7.5 | 9.4 | 9.6 | 9.0 |
| Agriculture | 4.8 | 2.5 | 2.5 | -7.2 | 10.0 | 0.0 | 5.9 | 3.8 | 4.5 |
| Industry | 7.3 | 4.3 | 9.2 | 7.1 | 7.4 | 10.3 | 10.1 | 11.0 | 8.5 |
| Services | 7.3 | 7.9 | 9.3 | 7.5 | 8.5 | 9.1 | 10.3 | 11.1 | 10.8 |
| Per capita GDP | 4.4 | 3.5 | 6.1 | 2.3 | 6.9 | 5.8 | 7.7 | 8.1 | 7.5 |

SOURCE: Acharya, 2008 (Basic Data –CSO).

Note: Agriculture comprises agriculture proper, forestry & logging, and fishing. Industry includes mining & quarrying, manufacturing, electricity, gas & water supply, and construction. Services includes trade, hotel, transport & communication, finance, insurance, real estate and business services, and social & personal services

Many factors are considered to be the major drivers of this economic development. This includes the enhancement of total factor productivity (TFP), buoyant international economic environment and an extraordinary growth of modern service sector including communications, information technology and finance. The expansion of service sector has been unprecedented. Today, its share in GDP is about 55 per cent compared to one fifth share of agriculture and one fourth share of industry (Table 17). Agriculture growth remains low during the period as the sector depends substantially on weather conditions. However, during 2005-08, its contribution to the GDP was noteworthy as it registered the annual growth rate between four to six per cent, whereas the GDP growth rate hovers between nine to 10 per cent in the corresponding period. It is to be noted that despite low growth in agricultural it employs over half of India's labour force.

TABLE 18: SECTORAL COMPOSITION OF GROWTH

| | *Share in real GDP (%)* | | *Contribution to GDP Growth (% )* | | |
|---|---|---|---|---|---|
| | *Average of 1994-97* | *Average of 2004-07* | *1991/92 to 1996/97* | *1996/97 to 2001/02* | *2001/02 to 2007/08* |
| Agriculture | 28.2 | 19.4 | 21.1 | 11.5 | 7.0 |
| Industry | 26.4 | 26.5 | 29.0 | 20.2 | 29.3 |
| Services | 45.4 | 54.1 | 49.8 | 68.3 | 63.6 |
| GDP(Factor Cost) | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 |

SOURCE: Acharya, 2008 (Basic Data –CSO).

On the other hand, Table 19 shows the composition of GDP growth from the expenditure side. Share of aggregate investment expenditure in GDP is showing considerable rise, whereas government and private sector consumption grew between 1996-97 to 2001-02 but declined thereafter.

*Total Factor Productivity*

Many things contributed to the unprecedented economic growth that India witnessed in the last about two decades. Total factor productivity (TFP)[29] is certainly important element. India registered two per cent increase in average annual output growth between period pre reform period of 1978-93 and post reform period of 1993-04. Of this two percentage point increase, 1.2 points were attributable to improved TFP, which more than doubled from an average annual of 1.1 per cent during 1978-93 to 2.3 per cent

[29]TFP reflects the efficiency with which factors of production are used, and is thus a key determinant of an economy's performance, especially its international competitiveness. One of the most important sources of TFP growth in the long run is technological progress

TABLE 19: EXPENDITURE COMPOSITION OF GROWTH

| | *Share in real GDP (%)* | | *Contribution to GDP Growth (% )* | | |
|---|---|---|---|---|---|
| | *Average of 1994-97* | *Average of 2004-07* | *1991/92 to 1996/97* | *1996/97 to 2001/02* | *2001/02 to 2007/08* |
| Investment (GDCF) | 23.9 | 32.6 | 29.2 | 20.4 | 57.3 |
| Government Final | | | | | |
| Consumption | 11.1 | 10.2 | 8.2 | 16.7 | 5.3 |
| Private Final | | | | | |
| Consumption | 65.7 | 59.6 | 54.3 | 60.2 | 47.9 |
| Net Exports of | | | | | |
| Goods and Services (including Discrepancies) | -0.7 | -2.4 | 8.4 | 2.7 | -10.5 |
| GDP( Factor Cost) | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 |

SOURCE: Acharya, 2008 (Basic Data –CSO)..

during the period 1993-04 (Bosworth and Collins 2007). The rest of the rise was largely due to increased investment. Improved TFP contributed to roughly half of the increase in labour productivity, which almost doubled between the two periods; the rest of the increase was due mainly to higher investment. Improved TFP was also largely responsible for the substantial increase in the rate of growth of capital productivity (Table 20).

TABLE 20: TOTAL FACTOR PRODUCTIVITY IN INDIA, 1978-04

(Per cent change per year)

| | *Overall* | | *Agriculture* | | *Industry* | | *Services* | |
|---|---|---|---|---|---|---|---|---|
| | *1978-93* | *1993-04* | *1978-93* | *1993-04* | *1978-93* | *1993-04* | *1978-93* | *1993-04* |
| Output | 4.5 | 6.5 | 2.7 | 2.2 | 5.4 | 6.7 | 5.9 | 9.1 |
| Employment | 2.1 | 1.9 | 1.4 | 0.7 | 3.3 | 3.6 | 3.8 | 3.7 |
| Capital | 1.0 | 1.8 | 0.2 | 0.7 | 1.4 | 1.7 | 0.3 | 1.1 |
| Land | -0.1 | 0.0 | -0.1 | -0.1 | n.a. | n.a. | n.a. | n.a. |
| Education | 0.3 | 0.4 | 0.2 | 0.3 | 0.4 | 0.3 | 0.4 | 0.4 |
| TFP | 1.1 | 2.3 | 1.0 | 0.5 | 0.3 | 1.1 | 1.4 | 3.9 |
| Labour productivity | 2.4 | 4.6 | 1.3 | 1.5 | 2.1 | 3.1 | 2.1 | 5.4 |
| Capital productivity | 1.8 | 2.4 | 1.7 | 0.5 | 1.4 | 2.2 | 3.5 | 5.5 |

n.a. Not applicable.

SOURCE: Bosworth B. and Collins S. 2007 as presented in WTO, 2007.

Growth in both output and TFP has been much faster in the services sector than in industry (where performance has seemingly been hampered by, *inter-alia*, rigid labour laws and inadequate infrastructure). By contrast, growth in output and TFP in agriculture has slowed (possibly owing to weather and other natural factors). It follows that the shifting of resources, especially labour, from agriculture, where more than half of the labour force is employed, to the more productive industry and tertiary sectors would contribute to faster overall growth in output and TFP in the economy as a whole[30].

*The Human Development Index*

In recent years since 1990, performance has been measured beyond income growth to a broader definition of well-being through the Human Development Index (HDI).[31] As per the UNDP's Global Human Development Report (HDR) 2007, the HDI for India improved from 0.577 in 2000 to 0.611 in 2004 and further to 0.619 in 2005 although it has gone down to 0.609 in 2006, the relative ranking of India has not changed much. India ranks at 132 among the countries with medium human development out of 179 countries of the world.

*Infrastructure Development*

Infrastructure is the crucial sector that contributes the key role in the development process of India. For the purpose, special attention is paid to this sector by combining the efforts of public and private sectors. Hence, physical infrastructure especially electric power, telecom, railways, roads and ports have been funded with adequate investment. Total investment in infrastructure has been estimated to be around five per cent of GDP. It is viewed that the gross capital formation (GCF) in infrastructure should rise as a share of GDP from five per cent in 2006–07 to nine per cent by the end of 2011-12 (Table 21).

[30]WTO 2007

[31]HDI provides a composite measure of three dimensions of human development: living a long and healthy life (measured by life expectancy), being educated (measured by adult literacy and enrolment at the primary, secondary and tertiary level) and having a decent standard of living (measured by purchasing power parity, PPP, income). The index is not in any sense a comprehensive measure of human development. It does not, for example, include important indicators such as gender or income inequality and more difficult to measure indicators like respect for human rights and political freedoms. It only provides a broader prism for viewing human progress and complex relationship between income and well-being.

TABLE 21: GROSS CAPITAL FORMATION IN INFRASTRUCTURE BASED ON GROWTH TARGETS

(Top-down Estimates at 2006–07 price)

| *Year* | *2006-07* | *2007-08* | *2008-09* | *2009-10* | *2010-11* | *2011-12* |
|---|---|---|---|---|---|---|
| GDP Market Price (Rs. billion) | 41458.1 | 45189.3 | 49256.4 | 53689.4 | 58521.5 | 63788.4 |
| Rate of growth of GDP (%) | 9.0 | 9.0 | 9.0 | 9.0 | 9.0 | 9.0 |
| GCF in infrastructure as % of GDP | 5.0 | 5.8 | 6.5 | 7.3 | 8.0 | 9.0 |
| GCF in infrastructure (Rs. billion) | 2072.9 | 2598.4 | 3201.7 | 3892.5 | 4681.7 | 5741.0 |
| GCF in infrastructure (US$ billion) | 51.8 | 65.0 | 80.0 | 97.3 | 117.0 | 143.5 |
| Total GCF in Eleventh Plan | Rs 20115 billion or US$ 502.88 billion | | | | | |

SOURCE: Eleventh Five Year Plan Report.

A comparative picture of the sector-specific allocations in the two Plan periods is given in Table 22. Compared with investment levels achieved in the Tenth Plan period, the expected infrastructure investment in the Eleventh Plan is 2.36 times the amount of US$ 217.86 billion at constant 2006–07 price. The telecom, transportation (comprising ports and airports), and storage improve their share in the total investment in the Eleventh Plan as compared to their share in the Tenth Plan. Irrigation, electricity and the transportation sectors comprising roads and railways are expected to invest more than double the actual absolute investment in the Eleventh Plan, but would register some decline as a proportion in the overall pie. The need for investment in the electricity sector is greater than what has been projected. However, a realistic assessment suggests that even the projections made so far would pose serious policy and implementation challenges. If these challenges can be overcome in time, actual investments could exceed these projections.[32]

[32]Eleventh Five Year Plan Report Inclusive growth 11th_Vol l, p 256.

TABLE 22: SECTOR-WISE INVESTMENT ANTICIPATED IN THE 10TH PLAN AND PROJECTED FOR THE 11TH PLAN

(Rs billion at 2006–07 price)

| *Sectors* | *Tenth Plan (Anticipated investment)* | | | *Eleventh Plan (Projected investment)* | | |
|---|---|---|---|---|---|---|
| | *Rs billion* | *US$ billion @ Rs 40/$* | *Share (%)* | *Rs Billion* | *US$ billion @Rs 40/$* | *Shares (%)* |
| Electricity (incl. NCE) | 2918 | 72.96 | 33.49 | 6665 | 166.63 | 32.42 |
| Roads and Bridges | 1449 | 36.22 | 16.63 | 3142 | 78.54 | 15.28 |
| Telecommunication | 1034 | 25.84 | 11.86 | 2584 | 64.61 | 12.57 |
| Railways (incl. MRTS) | 1197 | 29.91 | 13.73 | 2618 | 65.45 | 12.73 |
| Irrigation (incl. Watershed) | 1115 | 27.88 | 12.80 | 2533 | 63.32 | 12.32 |
| Water Supply and Sanitation | 648 | 16.20 | 7.44 | 1437 | 35.93 | 6.99 |
| Ports | 141 | 3.52 | 1.61 | 880 | 22.00 | 4.28 |
| Airports | 68 | 1.69 | 0.78 | 310 | 7.74 | 1.51 |
| Storage | 48 | 1.20 | 0.55 | 224 | 5.59 | 1.09 |
| Gas | 97 | 2.43 | 1.11 | 169 | 4.21 | 0.82 |
| Total (Rs crore) | 8714 | 217.86 | 100.00 | 20562 | 514.04 | 100.00 |

SOURCE: Eleventh Five Year Plan Report.

### *Foreign Investment Flows*

Until recently, international investors were not seeing India as attractive investment destinations due to a number of factors including sub optimal infrastructure, industry unfriendly tax policies, political instability etc. In any case, India on its own had acquired restrictive attitude towards foreign investment. In the nineties as mentioned earlier, India began to open up its economy. As mentioned earlier, many measures were taken to reform the tax system at the level of Centre and states. Foreign investment flows started to pick up in the 1990s and have gathered further momentum in the past few years. Foreign investment comprising foreign direct investment (FDI) and portfolio investment on net basis was US$ 14.8 billion in 2006-07 and US$ 45.0 billion in 2007-08 (204.7% growth), before slowing down to US$ 4.0 billion during 2008-09 (April-December). As a proportion of total capital flows, net foreign investment stood at 41.6 per cent in 2007-08 (32.6% in 2006-07) (Table 24). However, its share declined to 26.4 per cent during 2008-09 (April-December) on account of FII outflows as a result of the global financial crisis[33].

[33]Government of India, 2009.

TABLE 24: SOURCE WISE DISTRIBUTION OF INDIA'S INWARD FDI STOCK 1991-2009

(Rs. Million)

| *Country* | *(1991-1999 Aug-Dec)* | | *(Jan.2000 to March 2009)* | |
|---|---|---|---|---|
| | *Value* | *Per cent* | *Value* | *Per cent* |
| Mauritius | 124659 | 21.611 | 1619734 | 40.906 |
| U.S.A. | 83542 | 14.483 | 285606 | 7.213 |
| Netherlands | 21743 | 3.770 | 159290 | 4.023 |
| Japan | 29694 | 5.148 | 115690 | 2.922 |
| U.K. | 22279 | 3.862 | 229621 | 5.799 |
| Germany | 23511 | 4.076 | 95335 | 2.408 |
| France | 9638 | 1.671 | 55203 | 1.394 |
| Singapore | 12393 | 2.149 | 338565 | 8.550 |
| Korea(South) | 20921 | 3.627 | 20405 | 0.515 |
| Switzerland | 7951 | 1.378 | 38838 | 0.981 |
| Others* | 131253 | 22.755 | 740237 | 18.695 |
| **Brazil** | **23** | **0.004** | **69** | **0.002** |
| **China** | **19** | **0.003** | **507** | **0.013** |
| **Russia** | **1749** | **0.303** | **19345** | **0.489** |
| BRC** | 1791 | 0.310 | 19920 | 0.503 |
| Grand Total | 576821 | 100.000 | 3959647 | 100.000 |

* Includes other countries, advance of inflow, stock swapped, and nri-rbi schemes.

** BRC refers to Brazil, China, and Russia.

Source: Ministry of Commerce & Industry, Department of Industrial Policy & Promotion http://siadipp.nic.in/publicat/pub_mn.htm

Out of both foreign investments, FDI is perceived to be the most coveted type of capital flow for an emerging economy as it brings modern technology and enhances production capabilities. During 2005-06 to 2008-09, FDI flows assumed greater significance. High inflows indicate India as an attractive investment destination as a consequence of its liberalised investment climate, stable and sound economic and political base, opportunities for economic growth, while capital investment abroad reflects the growing global competitiveness of the Indian corporate sector. The two-way flow of FDI, therefore, means that while the world is taking note of India's market potential, Indian companies are also constantly looking for synergistic acquisitions abroad.

With the reforms in policies, better infrastructure and vibrant financial sector, FDI inflows into India have accelerated since 2006-07. On a gross basis, FDI inflows into India increased from US$ 8.9 billion in 2005-06 to US$ 22.8 billion in 2006-07 and further to US$ 34.4 billion in 2007-08. In

the fiscal 2008-09 (April-December) gross FDI into India was US$ 27.5 billion. FDI inflows are spread across a range of economic activities like financial services including banking, manufacturing, information technology services and construction.

FDI has grown significantly on net basis. The year-to-year growth in FDI (net) was 153.6 per cent in 2006-07 and 100.2 per cent during 2007-08. Even as FDI flows into India grew substantially, a simultaneous pick up in outward investment moderated the overall net inflows. Outward investment by India increased from less than US$ 2.4 billion during 2003-04 and 2004-05 to US$ 15.8 billion in 2006-07 and US$ 21.3 billion in 2007-08.

During fiscal 2008-09 (April-December), FDI into India (net) remained buoyant at US$ 27.4 billion (US$ 20.0 billion in April-December 2007) reflecting relatively better investment climate in India and the continuing liberalisation measures to attract FDI. Outward FDI (net) continued to remain high at US$ 12.0 billion during April-December 2008 even in the current economic situation, though it was marginally lower than its previous year's level of US$ 13.1 billion. Due to large inward flows, the net FDI (inward minus outward FDI) was higher at US$ 15.4 billion in April-December 2008, as compared with US$ 6.9 billion in April- December 2007. As per the UNCTAD 2008 India achieved a growth of 85.1 per cent in FDI inflows which was the highest globally[34]. The total flows increased from US$ 25.1 billion in 2007 to US$ 46.5 billion in 2008. This is despite 14.5 per cent decline in global FDI inflows from US$ 1,940.9 billion in 2007 to US$ 1,658.5 billion in 2008. India also ranked 9th in global FDI inflows in 2008[35] followed by Brazil. On the other hand, China is ranked fifth followed by Russia (Table 25). It is considered that robust economic growth, an improved investment environment and opening up of critical sectors like telecommunications, civil aviation, refineries, construction, etc facilitated FDI inflows into India.

[34]In terms of UNCTAD Survey 2008-10, China is the most preferred investment destination, followed by India, the United States, the Russian federation and Brazil. Similarly, AT Kearney's 2007 FDI Confidence Index shows China, India and USA as the most preferred locations in that order. For long-term prospects, JBIC survey of Japanese manufacturing Transnational Corporations (TNCs) showed India replacing China as the most promising country for business operations of Japanese TNCs.( Government of India 2009)

[35]Government of India, 2009.

TABLE 25: FOREIGN DIRECT INVESTMENT IN TOP 11 COUNTRIES

(US$ billion)

| *Rank in 2008* | *Countries* | *2007* | *2008** | *Growth rate (%)* |
|---|---|---|---|---|
| 1 | USA | 232.8 | 320.9 | 37.8 |
| 2 | France | 158.0 | 126.1 | -20.2 |
| 3 | UK | 196.4 | 96.8 | -50.7 |
| 4 | Belgium | 70.0 | 94.2 | 34.6 |
| 5 | China | 83.5 | 92.4 | 10.6 |
| 6 | Russia | 52.5 | 70.3 | 34.0 |
| 7 | Spain | 68.8 | 65.5 | -4.8 |
| 8 | Hong Kong China | 59.9 | 63.0 | 5.2 |
| 9 | India | 25.1 | 46.5 | 85.1 |
| 10 | Brazil | 34.6 | 45.1 | 30.3 |
| 11 | Sweden | 22.1 | 40.4 | 83.1 |
| | World | 1940.9 | 1658.5 | -14.5 |

* Preliminary Estimates

SOURCE: Government of India 2009.

*Portfolio investment*[36]: Net portfolio inflows into India were US$ 7.0 billion in 2006-07 and US$ 29.4 billion in 2007-08. Portfolio investment by FIIs however witnessed large net outflows of US$ 12.4 billion during April-December 2008 (as against net inflows of US$ 24.5 billion in the corresponding period of 2007) due to large scale sale of equities by FIIs in the Indian stock market. FII outflows for the year 2008-09 amounted to US$ 15 billion *vis-à-vis* net inflow of US$ 20.3 billion during the year 2007-08.[37]

*Double Taxation Avoidance*

The Double Taxation Avoidance Agreements (DTAA) came into being when a resident of one jurisdiction has income sourced in another jurisdiction. In such cases the normal rule say that the jurisdiction of which the concerned person is a resident has the right to tax his income. However, the source jurisdiction also has the authority to tax the income. Such taxation by the latter may be subject to a maximum permissible rate. A Double Taxation Avoidance Agreement may effectively provide for avoidance of tax or for relief against double taxation by providing for grant of credit by the jurisdiction

[36]Portfolio investment includes foreign institutional investors (Flls) investment, issue of global depository receipts (GDRs)/American depository receipts (ADRs) and offshore funds.

[37]Government of India, 2009.

of residence of the tax paid in the source jurisdiction. Tax Avoidance Agreements may be confined to a particular type of income. The first concrete step for relieving against double taxation, in so far as India is concerned, was taken in 1939 with the coming into force of the Income-tax -Double Taxation Relief- Indian States Rules. Since then, India has comprehensive DTAA with 79 countries. Under Income Tax Act 1961 of India, there are two provisions -Section 90 and Section 91 - which provide specific relief to tax payers to save them from DTAA. Section 90 is for tax payers who have paid the tax to a country with which India has signed DTAA. While Section 91 provides relief to tax payers who have paid tax to a country with which India has not signed DTAA. Thus, India gives relief to both kinds of taxpayers[38].

## CONCLUSION

Wilson and Puroshothaman 2003 from Goldman Sachs invented the acronym BRIC to describe the Brazillian, Russian, Indian and Chinese economies. It is now widely used and *"BRIC funds are an important part of the emerging-markets universe"*[39]. The Goldman Sachs predicted that the four economies would comprise more than 10 per cent of the global output by the end of the decade; the four economies reached 15 per cent in 2008. Leaders of the four BRIC nations participated in the first BRIC Summit in Yekaterinburg, Russia on June 16, 2009. All of them agreed for strengthening cooperation and coordination among themselves to promote dialogue in an open and transparent way. Many feel that this group can play a vital role in international politics as the world's largest growing economies are getting together on the same platform and discussing common concern. During the current economic meltdown, it is also felt that the emerging countries such as BRIC are expected to perform better than the global average. India as an emerging country is no exception to this trend. For the last few years, India's economic performance has been impressive averaging over seven per cent between 2001-02 and 2006-07. It posted a robust average growth rate of more than nine per cent during 2005-07. Rapid economic growth has translated into an improvement in social indicators, including a decline in infant mortality, a reduction in the percentage of the population living below the poverty line and improvements in literacy, sanitation and access to clean water. This impressive performance is largely due to unilateral trade and structural reforms, which have been continued

[38]en.wikipedia.org/wiki/Double taxation.
[39]*Economist*, April 21, 2008.

during the period. Growth has been led by the services sector, where liberalisation has been most rapid. Manufacturing has also performed well, although further growth may be impeded by infrastructure and other constraints. In contrast, agricultural growth continues to be slow and erratic and dependent on the weather, causing considerable distress, especially among small and marginal farmers[40].

The government is aiming to sustain growth in the longer run. Recognising the importance of continuing its economic reform and especially its trade aspects, India has pushed ahead with further reductions in the tariff: There has also been simplification of the tariff, although it remains complex. The government is targeting higher export growth in order to sustain India's high levels of economic growth and has put in place a set of schemes to reduce the anti-export bias of the trade regime for exporters.

Despite a gradual increase in total tax revenue India's tax to GDP ratio is relatively low and seemingly insufficient to meet its developmental needs. Further public spending on infrastructure and social services is constrained by the Fiscal Responsibility and Budget Management (FRBM) Act, 2003, which requires India to reduce its fiscal and revenue deficits and to eliminate the revenue deficit by 31stMarch 2009. However, the government deviated from these targets in the election year. There is no credible signal from the government for moving towards fiscal consolidation. The Central government use the excuse of the global recession to justify the high public expenditure that is being called fiscal stimulus.

India is a federal country. Powers of taxation has divided between the Centre and states. The local governments both rural and urban are also part of the federal ensemble in India though their powers are decided by the respective state government. As per the constitutional arrangements the Central government has buoyant source of revenue, i.e. corporate income tax, personal income tax, central excise/CenVAT and customs whereas State government relies on sales tax/state VAT. In the Indian Constitution, responsibilities have been decentralised to the sub national government. The provision is largely consistent with provisions mentioned in the theoretical literature of public finance. However, the mismatch between the revenue power and expenditure responsibility gives rise to vertical imbalance that is corrected through the mechanism of intergovernmental fiscal transfers from Centre to states. The money flows through various institutional arrangement. Finance Commission, a constitutional body, and Planning Commission, created through an order of the Executive, are the two most important institutions in this regard. Finance Commission constituted in every five

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[40]WTO, 2007.

years recommends the formula for vertical and horizontal distribution of the taxes that the Central Government collects. These transfers are generally for revenue expenditure, *e.g*. salary to government employees, expenditure on operation and maintenance. The Planning Commission transfers the plan fund. In addition, funds also flows through various central schemes. In short, intergovernmental fiscal transfer mechanism in India is quite complicated and creates dissatisfactions at all levels across states.

Before 1991, the tax system in India was archaic, irrational and complex. It interfered with the free play of market forces and competition, caused economic distortions and entailed high cost of compliance and administration. In the earlier socialist pattern of development, the extraordinary high rate of income taxes was compelling tax payers to evade taxes. The manner in which the commodity taxes were levied and administered caused

- *"loss of output growth and welfare,*
- *Inefficiency and high cost in industry and trade*
- *Impediments to the free flow of trade with the country and growth of the common market that the Indian Union offers*
- *Inter-jurisdictional conflicts*
- *Handicap for exports, and*
- *High costs of compliance and enforcement"*[41] NIPFP, 1994.

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