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Working Paper

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MANAGEMENT OF TAX EXPENDITURES: A STUDY OF THE INDIAN CASE

By

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and machinery is installed for the manufacture of an indigenously developed article or thing, the rate of investment allowance is 35 per cent.[1] Thus, if a company instals a new machine costing, say, Rs. 1 million for manufacturing an indigenously developed article or thing, it will be entitled to claim a deduction of Rs. 350,000 on account of investment allowance. This, using the rate of corporation tax (including surcharge) currently applicable to the generality of cases, viz. 56.375 per cent (55 per cent + 2.5 per cent thereof), will enable the company to reduce its tax liability by Rs. 197,313. In other words, investment allowance provides government assistance to the company. But since the allowance provides government assistance through reduction in tax liability rather than direct aid, it qualifies for treatment as a tax expenditure.

The provision relating to investment allowance is not the only one which qualifies for treatment as tax expenditure. One can readily identify many other provisions in the Income Tax Act which are "special" and represent tax expenditures. Examples are: house rent allowance (sections 10(13A) and 80GG); exemption of income from newly established industrial undertakings in free trade zones (section 10A); additional depreciation allowance (section 32(1)(iia); deduction in respect of capital expenditure on scientific research (section 35(1)(iv); weighted deduction in respect of donation for

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[1] Investment allowance is in addition to the normal depreciation allowances and is not taken into account for determining the written down value of the plant and machinery to which it applies. Hence the allowance acts as a bonus or special allowance over and above the normal recoupment of the cost of plant and machinery through depreciation allowances.

for scientific research undertaken under an approved programme (section 35(2A); weighted deduction in respect of any expenditure incurred by an assessee on scientific research undertaken under an approved programme (section 35 (2B)(a); export markets development allowance (section 35B); agricultural development allowance (section 35C); rural development allowance (section 35CC); deduction in respect of payment to associations and institutions for carrying out rural development programmes (section 35CCA); deduction in respect of payment to associations and institutions for carrying out programmes of conservation of natural resources (section 35CCB); deduction in respect of life insurance premia, contributions to provident fund, etc. (section 80C); deduction in respect of investment in equity shares of new industrial companies and public housing finance companies (section 80CC); deduction in respect of medical treatment of handicapped dependents (section 80D); deduction in respect of donations for charitable purposes (section 80G); deduction in respect of profits and gains from newly established industrial undertaking or hotel business in backward areas (section 80HH); deduction in respect of profits and gains from newly established small scale industrial undertakings in certain areas (section 80HHA); deduction in respect of profits and gains from projects outside India (section 80HHB); deduction (tax holiday) in respect of profits and gains from newly established industrial undertaking, ship or hotel business (sections 80I and 80J); deduction in respect of profits and gains from business of livestock breeding, poultry and dairy farming (section 80JJ); deduction in respect of profits and gains from business of growing mushrooms (section 80JJA); deduction in respect of interest on

certain securities, dividends, etc. (section 80L); deduction in respect of inter-corporate dividends (section 80M); deduction in the case of an Indian company in respect of royalties, etc. received from any concern in India (section 80MM); deduction in respect of dividends received from certain foreign companies (section 80N); deduction in respect of royalty, commission, fees, etc. from foreign enterprises (section 80-O); deduction in respect of remuneration from certain foreign sources in the case of professors, teachers and research workers (section 80R); deduction in respect of professional income from foreign sources in certain cases (section 80RR); deduction in respect of remuneration received for services rendered outside India (section 80RRA); deduction in the case of totally blind or physically handicapped resident persons (section 80U); and tax relief in relation to export turnover (section 89A).

It is not just the income tax system which includes provisions that result in tax expenditures. Other tax systems also include such provisions. For example, the Wealth Tax Act excludes from the net (taxable) wealth of an assessee the capital investment bonds and does not put any limitation on investment in these bonds; the system of central excise taxation gives preferential treatment to labour-intensive sectors in the match industry; the system of entertainment tax in Madhya Pradesh provides for exemption to national or international award winning feature films; the sales tax system in Gujarat provides for exemptions and deferments to pioneer industrial units.

Tax expenditures have become very popular. Practically all government committees set up to look into specific problems of public policy have come up with recommendations for introduction, extension, enlargement, or maintenance of tax expenditures. Thus, the Task Force on Marine Products Industry, set up by the Government of India in April 1981, is reported to have recommended the grant of tax holiday benefits to fishing vessels. The Task Force has also recommended raising of investment allowance entitlement from the current level of 25 per cent to 40 per cent. These special incentives, the Task Force believes, will promote deep-sea fishing.[1] The Committee on Free Trade Zones, which submitted its final report to the Government of India recently, feels that tax holiday of five years offered to free trade zone enterprises in the 1981-82 budget is inadequate. This, according to the Committee, should be extended to ten years and even after that further concession should be granted on a case by case basis.[2]

When people look for financial support for any public cause, they generally end up with pleas for government support through the tax system. Let me give one recent example. There is an organisation called Dardionu Rahat Fund which provides medicines, fruits, and other requirements to poor patients free of cost. The Fund recently organised a function which was attended, among others, by Mr. Pranab Mukherjee, Finance Minister, Government of India, and Mr. P N Bhagwati,

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[1] For a press report on the recommendations of the Task Force, see The Hindustan Times (New Delhi), September 15, 1982.

[2] For a press report on the report of the Committee, see The Hindustan Times (New Delhi), September 25, 1982, pp. 1 and 8.

Justice, Supreme Court of India. Speaking at the function, Mr. Justice Bhagwati is reported to have urged the Finance Minister to help the Fund in securing recognition for it so that the donations received by it are exempted from tax.[1] One wonders why Mr. Justice Bhagwati urged the Finance Minister to provide governmental financial support through the tax system rather than through direct government aid.

Then, there are organisations like the Federation of Indian Chambers of Commerce and Industry, the Associated Chambers of Commerce and Industry, the Punjab, Haryana and Delhi Chamber of Commerce and Industry, the Indian Merchants' Chamber, the Gujarat Chamber of Commerce and Industry, and the Indian Chamber of Commerce which are always ready with proposals for introduction, extension, enlargement, or maintenance of tax expenditures and keep on lobbying for them. The Federation of Indian Chambers of Commerce and Industry, for example, is lobbying these days for (a) raising investment allowance entitlement from the present level of 25 per cent to 45 per cent for those industrial enterprises that go in for modernisation; (b) introduction of a provision allowing a deduction in respect of profits set apart for replacement of plant and machinery and modernisation; (c) broadening the scope of section 80-O of the Income Tax Act so that the entire royalty, commission, fee, and similar incomes qualify for 100 per cent deduction under this section and no part thereof is subjected to tax on the ground that it relates to the rendering of management and other such incidental services;

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[1] See The Times of India (Ahmedabad), September 26, 1982, p. 3.

(d) extension of section 80-O benefit to non-corporate taxpayers; (e) extension of section 80-O benefit to all the partners of a consortium when a consortium is formed to provide technical know-how to foreign enterprises; (f) broadening the scope of section 80M so that one can claim deduction in respect of dividend income from investments in joint ventures abroad irrespective of mode of investment; (g) extension of section 80M benefit to non-corporate taxpayers; (h) raising deduction under section 80RRA from the present level of 50 per cent to 100 per cent; (i) raising deduction under section 80HHB from the present level of 25 per cent to a higher level; and so on.[1]

The Government of India as also the different state and union territory governments in the country seem to have a soft corner for tax expenditures. They generally respond favourably to demands for introduction, extension, enlargement and maintenance of tax expenditures. But what about the accounting of these expenditures? Do we know how many tax expenditure provisions the various tax laws in India contain and how much governmental financial assistance is provided through these provisions?

The Directorate of Inspection (Research, Statistics and Public Relations) in the Department of Revenue, Ministry of Finance, Government of India brings out a publication titled All India Income Tax Statistics (AIITS) which provides, among other things, data on

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[1]See The Economic Times (Bombay), September 8, 1982, p. 4; Federation of Indian Chambers of Commerce and Industry, Workshop on Indian Joint Ventures Abroad and Project Exports-Report (New Delhi, 1982), pp. 22-28; and 16th All India Conference of Corporate Managers and Tax Executives (22-23 October, 1982): Background Paper (New Delhi, 1982), pp. 2-9.

TABLE 1

DEDUCTIONS ALLOWED IN INCOME TAX ASSESSMENTS COMPLETED DURING THE YEARS 1968-69 TO 1979-80

Assessment Year	Sections of the Income Tax Act under which deductions were allowe							
	80C	80D	80E	80F	80G	80H	80J	80K
1968-69								
A	696,617	7,768	4,891	139	3,210	177	2,006	5,870
B	80,356	973	1,252	44	1,524	75	1,119	3,395
C	892,231	8,140	3,568	186	1,402	106	122	1,201
1969-70								
A	770,775	3,350	1,079	506	11,086	1,403	19,645	18,305
B	98,362	432	233	164	5,466	684	9,953	10,118
C	965,555	3,210	815	708	3,624	412	1,584	3,460
1971-72								
A	957,331	1,429	691	579	24,642	11,594	65,876	55,675
B	139,355	240	170	168	13,249	6,248	36,033	31,909
C	1,045,667	1,220	537	435	4,428	465	1,080	4,887
1972-73								
A	1,150,326	789	354	213	23,591	2,752	164,675	31,480
B	142,697	101	121	69	12,524	1,845	91,115	18,081
C	1,112,871	684	184	174	4,198	232	634	3,143

Assessment Year	Sections of the Income Tax Act under which deductions were allowed							
	80L	80P	80Q	80R	80S	80T	80U	80I
1968-69								
A	1,635	7,431	476	80	26	4,095	191	2,540
B	632	1,860	95	34	6	1,233	33	1,457
C	2,746	244	194	37	18	587	113	72
1969-70								
A	32,895	8,729	510	352	254	9,268	456	21,047
B	18,629	2,451	98	73	70	3,517	106	11,897
C	15,905	673	768	325	193	1,209	311	163
1971-72								
A	112,394	21,986	15,111	773	1,051	34,806	2,606	93,484
B	49,730	6,860	8,006	156	266	15,564	981	50,057
C	42,145	1,435	685	481	198	1,963	559	395
1972-73								
A	71,925	40,241	2,928	509	273	21,318	1,174	66,584
B	17,986	11,706	995	106	67	10,499	321	37,703
C	41,248	929	369	258	67	1,232	236	295

Assessment Year	Sections of the Income Tax Act under which deductions were all					
	80M	80N	80MM & 80-O	280-O	Other sections	Total
-x-						
1968-69						
A	29,246	194	9,319	407,958	8,686	1,192,555
B	19,738	84	8,180	154,079	4,472	280,641
C	157	5	4	138,188	1,770	
1969-70						
A	84,647	889	548	312,294	20,489	1,318,527
B	55,930	622	338	116,884	7,712	343,739
C	381	5	5	98,759		
1971-72						
A	214,464	3,294	1,515	89,149	139,230	1,847,680
B	124,848	2,081	975	33,248	63,638	583,782
C	669	24	10	28,569	27,371	
1972-73						
A	239,571	2,102	2,428	14,636	95,017	1,932,886
B	158,338	1,346	1,686	4,491	44,330	556,127
C	806	17	12	5,231	20,192	

Assessment Year	Sections of the Income Tax Act under which deductions were allowed							
	80C	80D	80E	80F	80G	80H	80J	80K
1974-75								
A	1,691,502	516	238	237	20,810	728	48,642	32,193
B	190,557	70	112	98	10,714	243	27,084	19,274
C	1,267,010	407	84	168	4,247	345	704	3,647
1975-76								
A	2,066,176	760	215	405	24,467	1,180	34,593	23,728
B	217,732	92	69	83	12,700	432	19,923	13,504
C	1,150,630	605	98	149	4,276	267	550	3,401
1976-77								
A	2,906,409	528	492	376	22,756	909	36,799	24,949
B	345,624	103	99	137	10,739	184	20,871	14,108
C	1,159,563	339	183	162	4,438	278	427	2,844
1977-78								
A	3,242,915	1,092	228	272	21,225	2,141	43,893	24,071
B	349,740	130	62	54	10,846	1,147	24,745	12,484
C	1,204,844	515	70	156	4,066	164	408	2,591
1978-79								
A	2,333,737	1,088	138	116	24,753	2,599	65,071	36,369
B	317,124	162	28	30	13,413	1,180	37,043	19,167
C	881,436	532	59	82	3,223	156	458	1,900
1979-80								
A	2,341,299	322	48	87	27,378	3,865	258,452	37,950
B	336,651	43	24	30	13,973	2,074	134,489	22,455
C	823,892	184	14	30	2,160	95	234	1,210

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Assessment Year	Sections of the Income Tax Act under which deductions were allowed							
	80L	80P	80Q	80R	80S	80T	80U	80I
1974-75								
A	121,917	28,301	1,239	246	702	37,926	895	18,085
B	35,057	8,416	370	74	175	18,614	221	10,134
C	60,654	909	163	83	99	2,699	166	95
1975-76								
A	98,815	65,384	2,429	266	345	49,153	1,656	11,589
B	22,660	14,413	376	78	83	24,821	310	6,480
C	58,694	1,232	305	97	65	2,908	308	29
1976-77								
A	101,328	106,968	4,149	572	466	48,401	1,135	31,848
B	21,723	37,601	1,085	153	165	25,007	289	18,330
C	55,374	1,202	237	140	85	2,759	274	13
1977-78								
A	99,357	100,964	3,415	369	400	35,788	719	10,974
B	19,069	31,918	942	102	53	17,980	143	6,127
C	56,355	1,093	178	46	75	1,897	176	22
1978-79								
A	78,048	72,036	1,637	342	700	30,433	608	3,780
B	16,707	21,933	534	93	398	12,071	162	2,187
C	38,455	875	188	53	58	1,471	157	11
1979-80								
A	53,337	32,406	444	296	66	17,758	547	18,919
B	11,613	9,946	195	56	12	8,480	131	10,743
C	24,660	635	37	30	24	848	130	10

Assessment Year	Sections of the Income Tax Act under which deductions were allowed 80M	80N	80MM & 80-0	280-0	Other Sections	Total
1974-75						
A	143,953	2,850	2,049	8,354	168,782	2,330,170
B	97,754	2,085	1,153	2,732	73,598	498,535
C	699	12	9	2,837	32,691	
1975-76						
A	121,802	553	384	6,369	119,907	2,630,176
B	80,030	351	226	1,925	57,471	473,759
C	633	12	9	1,961	13,214	
1976-77						
A	166,905	988	83	3,856	93,133	3,553,050
B	108,833	599	48	1,373	38,839	695,910
C	691	4	2	1,008	11,090	
1977-78						
A	123,481	139	538	2,673	218,683	3,933,337
B	74,763	84	368	819	111,321	662,897
C	760	5	3	1,023	9,676	
1978-79						
A	72,194	568	4,231	1,976	119,169	2,849,593
B	46,727	322	2,772	621	47,959	540,633
C	498	15	12	937	10,937	
1979-80						
A	84,977	2,295	6,848	1,515	132,191	3,021,000
B	50,815	1,330	3,968	264	70,897	678,189
C	583	7	9	614	5,257	

A: Amount of deductions allowed (in thousands of rupees).
B: Tax relief (in thousands of rupees).
C: Number of assessments in which the deduction in question was allowed.

Source: See text.

According to these data, the income tax relief allowed on account of various deductions ranged between Rs. 280.64 million in 1968-69 and Rs. 695.91 million in 1976-77, and amounted to Rs. 678.19 million in 1979-80. As a percentage of revenue from income tax, it ranged between 2.25 per cent in 1978-79 and 5.79 per cent in 1971-72, and stood at 2.48 per cent in 1979-80. In other words, according to the AIITS data, the tax relief which the Government of India provides through various income tax deductions does not amount to much.

This is incredible. A careful examination reveals that the AIITS data suffer from two major limitations. Firstly, these data do not cover all special deductions available under the various provisions of the Income Tax Act. Take, for example, the deductions on account of development rebate and investment allowance. The development rebate, which was in operation from April 1, 1955 to May 31, 1974,[1] has been of considerable assistance to Indian industry. An exercise undertaken in 1971 by the Ministry of Finance showed that development rebate resulted in a tax relief to industry of Rs. 700 million in 1970-71 and that the figure might go up to Rs. 850 million in 1973-74.[2] Unfortunately, the AIITS data do not cover deductions allowed on account of development rebate.

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[1]In certain cases the development rebate was allowed if plant and machinery was installed before June 1, 1975. For ships, the rebate was available up to the end of 1976.

[2]See the reply of the Finance Minister, Government of India, to the debate in the Rajya Sabha on the Finance (No.2) Bill, 1971.

The provision relating to investment allowance was introduced in 1976. As things stand, investment allowance is a major tax concession in India. According to an estimate made by an expert committee of economists and tax administrators appointed by the Government of India, the total deduction on account of investment allowance amounted to Rs. 3,000 million in 1979-80, involving a tax relief of about Rs. 1,750 million.[1] Unfortunately, the AIITS data on deductions do not cover even investment allowance.

Secondly, even the data on deductions which the AIITS covers, do not appear to be complete. Take, for instance, the AIITS data on deductions allowed under sections 80J (tax holiday), 80MM, and 80-O (royalties etc. from companies) of the Income Tax Act. According to these data, section 80J deductions amounting to Rs. 34.59 million and Rs. 36.80 million, involving tax reliefs of Rs. 19.92 million and Rs. 20.87 million, were allowed in assessments completed during 1975-76 and 1976-77, respectively. These figures are not complete. The whole issue was studied in detail by the Expert Committee on Tax Measures to Promote Employment. According to the data which the Committee was able to get from the Income Tax Department, the deductions allowed to the corporate assessees under section 80J amounted to Rs. 323 million and Rs. 336.4 million in 1975-76 and 1976-77, respectively. This resulted in a tax relief of Rs. 155.2 million in 1975-76 and of Rs. 183 million in 1976-77. Allowing for the

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[1]Government of India, Ministry of Finance, Department of Revenue, Report of the Expert Committee on Tax Measures to Promote Employment (New Delhi, 1980), p. 31.

fact that these figures relate to corporate assessees only, the total tax relief allowed under section 80J has been put by the Committee at Rs. 200 million in 1976-77.[1] Thus, if one compares the AIITS figure for tax relief through section 80J with that reported by the Expert Committee on Tax Measures to Promote Employment, one finds the latter to be 9.58 times the former. This is not a happy state of affairs, especially in view of the fact that the source of data in both cases is the same, viz. the Income Tax Department.

As regards data on deductions allowed under sections 80MM and 80-0, the state of affairs does not appear to be any better. Sections 80MM and 80-0 have been on the statute book since April 1, 1970 and April 1, 1968, respectively. According to the AIITS, the total number of assessments in which deductions under these sections were allowed during 1968-69, 1969-70, 1971-72, 1972-73, 1974-75, 1975-76, 1976-77, 1977-78, 1978-79 and 1979-80 is 75. But according to the information furnished by the Finance Secretary, Government of India, during the course of a recent (1981) evidence before the Public Accounts Committee, the number of cases dealt with under section 80-0 alone is 1,103.[2] Similar information in respect of section 80MM is not available. But considering the fact that a special cell known as 80MM cell has been created for scrutinising the agreements received

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[1]Ibid, pp. 31-32.

[2]Lok Sabha Secretariat, Fifty-first Report, Public Accounts Committee (1980-81) (New Delhi, 1981), p. 16.

in the Central Board of Direct Taxes for approval under section 80MM, the number of cases dealt with under this section may be quite high. All this suggests that the 80MM and 80-O assessments - and consequently the deductions allowed and the tax relief provided under these sections - have been substantially higher than the figures indicated in the AIITS.

One thing emerges clearly from the foregoing discussion: There is no proper system of accounting of tax expenditure assistance provided through the route of income tax in India. The Directorate of Inspection does bring out some data on special deductions available under the Income Tax Act, but they lack credibility. One wonders why the Directorate keeps on bringing out these data. Is it that the Directorate is not aware of the serious limitations these data suffer from? Or is it that the Directorate, though aware of the limitations, has some other purpose in mind? One does not know what it could be. But one thing is certain: The data which the Directorate brings out are used by some as evidence to show that the tax relief which the Government of India provides through the various income tax deductions does not amount to much. Take, for example, the Federation of Indian Chambers of Commerce and Industry. According to the Federation, the incentive provisions in the Indian income tax law "do not give significant relief."[1]

It is not correct to say that the incentive provisions in the Indian income tax law do not give significant relief. As things stand, the various incentive provisions in the Indian Income tax

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[1]See Federation of Indian Chambers of Commerce and Industry, *op. cit.*, p. 3.

law are such that they enable a large number of taxpayers to generate substantial tax savings.[1] It is because of the various incentive provisions that many companies in India pay little or no income tax. For example, for the six-year period ending March 31, 1982, Tata Engineering and Locomotive Company (TELCO) has reported profits of the order of Rs. 1,200.1 million, but it has reported no income tax liability; Reliance Textile Industries has reported profits of Rs. 488.5 million for its last five accounting years ending December 31, 1981, but it has reported an income tax liability of Rs. 2.5 million only; Modi Rubber has reported profits of Rs. 252.7 million for its five accounting years ending October 31, 1981, but it has not reported any income tax liability;[2] and Bombay Dyeing and Manufacturing Company has reported profits of Rs. 254.5 million for its five accounting years ending March 31, 1981, but it has reported a tax liability of Rs. 9.8 million only.[3]

TELCO, Reliance, Modi Rubber, and Bombay Dyeing are not the only companies which have benefited considerably from various incentive provisions in the Indian income tax law. If one goes through available

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[1] For a discussion on how the various incentive provisions in the Indian income tax law enable companies to generate substantial tax savings, see Anand P. Gupta, "Management of the Income Tax Function: Is India a Tax Haven?", Economic and Political Weekly, Vol. XVI, No.9, February 28, 1981, pp. M 15-21.

[2] Data for the company's latest accounting year ending October 31, 1982 are not presently available.

[3] Data for the company's latest accounting year ending March 31, 1982 are not presently available.

evidence, one finds that the list of such companies is endless: Ahmedabad Advance, Andhra Cement, Calico, Dunlop India, Gabriel India, Great Eastern Shipping, J K Synthetics, KSB Pumps, Kunal Engineering, Mahindra Ugine Steel, Milkfood, Modern Syntex (India), Modipon, Nagarjuna Steels, Punjab Anand Batteries, Raunaq International, Shree Synthetics, Shree Vallabh Glass, Steel Tubes of India, Usha Alloys & Steels, Usha Martin Black, Walchandnagar Industries, Zuari Agro Chemicals, Ahmedabad Electricity, Ashok Leyland, and so on.

One may now ask: What about the accounting of tax expenditure assistance provided through the routes of other taxes such as wealth tax, gift tax, excise duty, and sales tax? The answer to this question is quite simple: There exists no system of accounting of tax expenditure assistance provided through such taxes.

Considering the extensive use which policymakers in India make of the instrument of tax expenditures, what is needed is proper management of all tax expenditures. Four points are involved here. The first is concerned with identifying tax expenditures. In order to identify tax expenditures, one will have to take a careful look at the various provisions in a tax law. Not all provisions allowing exemptions, deductions, etc. constitute tax expenditures. It is only special provisions in a tax law which constitute tax expenditures. These special provisions really have nothing to do with the essentials of a tax, nothing to do with shaping the structural framework necessary to operate a tax. Instead, they are methods of spending government funds.[1] Take, for example, the provision

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[1] Stanley S. Surrey, op. cit., p. 32.

allowing a deduction of 20 per cent in respect of profits and gains from newly established industrial undertakings or hotel business in backward areas (section 80HH of the Income Tax Act, 1961). This provision is not essential for operating an income tax. It is a special provision: Its purpose is simply to provide governmental assistance. It is, therefore, a tax expenditure.

The second point is concerned with measurement of tax expenditures. One way of measuring tax expenditures is to figure out the decrease in tax receipts caused by a tax expenditure provision. The other way of measuring tax expenditures is to figure out the amount of spending that would be required to provide an equal after-tax benefit to the taxpayer. This method makes the tax expenditure data more comparable with direct budget outlays.

The third point is concerned with inclusion of the estimates of tax expenditures in the budget. Tax expenditures, as stated earlier, are similar in purpose to direct government expenditures. What this implies is that if a government which provides assistance through tax expenditures and presents a budget which does not include estimates of tax expenditures, one will be justified in treating such budget as an incomplete budget. The budget of the Government of India belongs to this category: The Government of India provides enormous assistance through tax expenditures, and yet its budget does not include any estimate of these expenditures.

In my view, if a government provides assistance through tax expenditures, its budget must include estimates of these expenditures. It will be useful if tax expenditure estimates are grouped together by functional categories used for direct government expenditures. When including tax expenditures in a budget, one will have to take into account projected economic factors and any changes in tax expenditures resulting from proposals contained in the budget.

The inclusion of estimates of tax expenditures by functional categories in the budget will enable one to find out total government expenditure under each of the functional areas.[1] It will also enable one to figure out how tax expenditures compare with direct government expenditures in different functional areas. For some budget functions, tax expenditures may be quite high relative to direct expenditures. Further, inclusion of estimates of tax expenditures in the budget may encourage government to consider them in budget decisions.

The fourth point is concerned with controlling tax expenditures. As I see things, there appears to be a strong case for controlling tax expenditures. A careful look at available evidence shows that many of the tax expenditure provisions are such that they damage the equity of the tax system, make the tax system more complex, enlarge tax avoidance possibilities, or add to costs of

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[1] Certain tax expenditures interact with other tax expenditures and thus affect their value. This being so, tax expenditure estimates cannot simply be added together to obtain totals for functional areas or a grand total. One will, therefore, have to make some adjustment for the interaction effects in order to obtain accurate totals.

tax administration.[1] Take, for example, sections 80MM and 80CC of the Income Tax Act. Section 80MM, which was put into the Income Tax Act through the Finance Act, 1969, provides for a deduction of 40 per cent of the income received by an Indian company by way of royalty, commission, fee, or any other payment (not being income chargeable under the head "capital gains") from any person carrying on a business in India in consideration for (i) the provision of technical know-how which is likely to assist in the manufacture or processing of goods or materials, or in the installation or erection of machinery or plant for such manufacture or processing, or in the working of a mine, oil well or other source of mineral deposits, or in the search for, or discovery or testing of, mineral deposits or the winning of access to them, or in carrying out any operation relating to agriculture, animal husbandry, dairy or poultry farming, forestry or fishing, or (ii) rendering services in connection with the provision of such technical know-how. The aim underlying this section is to minimise repetitive import of technical knowhow and encourage Indian companies to develop their technical knowhow.[2]

The benefit under section 80MM is subject to the approval of an agreement for the purpose by the Central Board of Direct Taxes, Ministry of Finance, Government of India. The Board has issued

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[1]See Amaresh Bagchi, "Efficiency of Tax Incentives: 'Tax Expenditure Analysis' and Its Relevance for India", Economic and Political Weekly, Vol. IX, No. 24, June 15, 1974, pp. 951-60.

[2]See Government of India, Explanatory Memorandum on the Finance Bill, 1969 (New Delhi), paragraphs 55-56.

detailed guidelines (circular no. 140 dated July 6, 1974) for approval of agreements under the section. A special cell has been created for scrutinising agreements received in the Board for approval under the section. For the facility of scrutiny of agreements, an applicant is required to furnish certain information in a proforma prescribed for the purpose. The head of the special cell scrutinises each of the agreements in the light of the information received and, if necessary, he may call for further information or grant a hearing to the party. He then puts up a note containing his recommendation as to the extent to which the agreement qualifies for approval. The Board Member In-charge takes a decision in the light of the note submitted by the head of the special cell and material on record. If necessary, he also grants a hearing to the party.

If the agreement is approved, the Board informs the concerned Income Tax Officer (ITO). The ITO, before allowing the benefit under the section to the party, has to familiarize himself with the section. He must also study the circular issued by the Board on the subject.

In case the Board refuses approval to the agreement, the applicant may take the matter to a court of law. Indeed, there are cases of companies which have moved the courts in writ petitions challenging the legality of the Board's refusal to approve agreements under section 80MM. All this certainly damages simplicity of the tax system and adds to costs of tax administration.

There is at least one more thing which section 80MM has done: It has enlarged tax avoidance possibilities. The scope of the section is so wide that even with the best of efforts the benefit under it cannot be limited only to those for whom it was intended. Detailed information on the working of the section is not available, but a look at whatever information is available clearly suggests that the section has also been used by those for whom it was not intended. Take, for example, the case of Lurgi India Private Limited. The company was incorporated for the purpose of obtaining consultation and technical knowhow from Lurgi Gesellschaften, Frankfurt. It entered into two agreements with Godrej Soaps Private Limited, an Indian company, for provision of technical knowhow and technical services. The agreements, both dated May 22, 1972, were sent to the Central Board of Direct Taxes for approval under section 80MM. The Board refused approval on the ground that the technical knowhow passed on by Lurgi India to Godrej Soaps as also technical services rendered by Lurgi India to Godrej Soaps were, in fact, done by Lurgi Gesellschaften, a foreign company, through Lurgi India, an Indian company. Lurgi India filed a writ petition against the Board's orders before the Delhi High Court. The Court has held that there is no bar in section 80MM for an Indian company, which claims the benefit under this section, to obtain technical knowhow and processes from a foreign company. The Court has quashed the Board's order and directed the Board to reconsider the application of Lurgi India for grant of approval.[1]

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[1] The judgment of the Court is reported in The Income Tax Reports, Vol. 121 (1980), pp. 141-42.

Let us now move on to section 80CC. This section was put into the Income Tax Act through the Finance Act, 1978. Under this section, individuals, Hindu undivided families, or associations of persons investing in equity shares forming part of any eligible issue of capital are entitled to a deduction in the computation of taxable income of 50 per cent of the amount invested in such shares. The aggregate investment in a year qualifying for this deduction is limited to Rs. 20,000. For the purpose of this section, "eligible issue of capital" means an issue of equity shares which satisfies the following conditions: (a) the issue is made by a public company formed and registered in India with the main object of carrying on the business of (i) construction, manufacture, or production of any article or thing, not being an article or thing specified in the list in the Eleventh Schedule, or (ii) providing long-term finance for construction or purchase of houses in India for residential purposes; (b) the issue is an issue of capital made by the company for the first time; and (c) the shares forming part of the issue are offered for subscription to the public.

Two points may be noted here. The first relates to the impact of section 80CC on the equity of the income tax system. The section provides for a deduction of 50 per cent of the amount invested in eligible equity shares. This means that if an individual belonging to the taxable income bracket of over Rs. 100,000 buys eligible equity shares of Rs. 1,000, the effective cost to him will be as

ow as Rs. 670 -- Rs. 1,000 minus tax benefit of Rs. 330.[1] If an individual belonging to the taxable income bracket of Rs. 15,000 - 25,000 also buys eligible equity shares of Rs. 1,000 the effective cost to him will be Rs. 835 -- Rs. 1,000 minus tax benefit of Rs. 165.[2] In other words, while both individuals invest equal amounts, tax benefit to the rich individual works out 100 per cent higher than that to the less well-off individual. What is worse, there is no provision for any benefit if equity shares are bought by, say, an industrial worker who does not belong to the income tax-paying fraternity.

The damage which section 80CC does to the equity of the tax system is thus obvious. There are some other sections (e.g. sections 80C and 80L) which are equally damaging.

The second point relates to the Eleventh Schedule to the Income Tax Act. As indicated above, one can claim benefit under section 80CC if one invests in equity shares issued by a public company which is engaged in the business of construction, manufacture, or production of any article or thing, not being an article or thing specified in the Eleventh Schedule. When the section was

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[1]The figure of Rs. 330 has been arrived at by applying the marginal rate of income tax (including surcharge) currently applicable to taxable income in excess of Rs. 100,000.

[2]The figure of Rs. 165 has been arrived at by applying the marginal rate of income tax (including surcharge) currently applicable to taxable income exceeding Rs. 15,000 but not exceeding Rs. 25,000.

introduced, the Schedule contained 29 groups of articles or things. The Schedule was reviewed in 1981. As a result of this review, the following 14 groups were removed from the Schedule: broadcast television sets, radios (including transistor sets), radiograms and tape recorders (including casette recorders and tape decks); electric fans; domestic electrical appliances; household furniture, utensils, crockery and cutlery; pressure cookers; vacuum flasks and other vacuum vessels; tableware and sanitaryware; glass and glassware; chinaware and porcelainware; mosaic tiles and glazed tiles; organic surface active agents, surface active preparations and washing preparations whether or not containing soap; synthetic detergents; pigments, colours, paints, enamels, varnishes, blacks and cellulose lacquers; and amplifiers or any other apparatus used for addressing the public. With the removal of these groups, the Eleventh Schedule now contains 15 groups. These are: beer, wine and other alcoholic spirits; tobacco and tobacco preparations such as cigars and cheroots, cigarettes, chewing tobacco and snuff; biris, smoking mixtures for pipes and cigarettes; cosmetic and toilet preparations; tooth paste, dental cream, tooth powder and soap; aerated waters in the manufacture of which blended flavouring concentrates in any form are used; confectionery and chocolates; gramophones, including record players, and gramophone records; cinematograph films and projectors; photographic apparatus and goods; office machines and apparatus such as typewriters, calculating machines, cash registering machines, cheque writing machines, intercom machines and teleprinters; steel furniture, whether made partly

or wholly of steel; safes, strong boxes, cash and deed boxes and strong room doors; latex foam sponge and polyurethane foam; crown corks, or other fittings of cork, rubber polyethylene or any other material; and pilfer-proof caps for packaging or other fittings of cork, rubber, polyethylene or any other material.

It will be seen that while the new Eleventh Schedule does not contain items such as motor cars, airconditioners, mosaic tiles and glazed tiles, it contains items such as tooth powder, soap, and typewriters. This means that whereas individuals, Hindu undivided families, and associations of persons investing in equity shares issued by public companies engaged in the production of motor cars, airconditioners, mosaic tiles, and glazed tiles are eligible to claim the tax benefit available under section 80CC, those investing in equity shares of public companies engaged in the production of tooth powder, soap, and typewriters will be ineligible for the benefit. There appears to be no justification for such discrimination.

One can go on giving examples of tax expenditure provisions which damage the equity of the tax system, make the tax system more complex, enlarge tax avoidance possibilities, or add to costs of tax administration. But the question which arises here is: What is it that should be done in order to control tax expenditures? This, in my view, is an important public policy question.

In order that tax expenditures are effectively controlled, it will be absolutely necessary to study in detail each of the

tax expenditure provisions. When studying a tax expenditure provision, one will have to deal with questions such as: How much does this provision cost? Is the activity benefiting from this provision high on the national agenda? Is the tax route the better way of assisting this activity? Once the various tax expenditure provisions have been studied in this manner, one should be in a position to come up with a list of provisions which deserve to be eliminated.

One may ask: What can be expected to happen when things begin to improve on the front of tax expenditures in India? Firstly, the tax system will become much less complex. In my view, it will be impossible to bring about any meaningful simplification in India's tax system so long the country's policymakers and their advisors continue to believe in the proliferation of tax expenditures. The point to remember is: If you add to tax expenditures, you add to tax complexity.

Secondly, proper management of tax expenditures will help in restoring the confidence of the people in the tax system. The people seem to believe that the present tax system is unfair - in the sense that while the privileged groups escape the tax net by paying little or no tax, the average person must pay his taxes.

Finally, proper management of tax expenditures will also help government in mobilising additional resources. The importance of this for meeting the challenges which the country faces today can hardly be overemphasised.

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