Tax Exemptions in India
Issues and Challenges
A Discussion Paper
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CBGA
Tax Exemptions in India
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Acronyms

CAG: Comptroller and Auditor General of India
CBDT: Central Board of Direct Taxes
CBEC: Central Board of Excise and Customs
CENVAT: Central Value Added Tax
DTC: Direct Taxes Code
DDT: Dividend Distribution Tax
ETR: Effective Tax Rate
EPZ: Export Processing Zone
EOU: Export Oriented Units
FDI: Foreign Direct Investment
Goi: Government of India
IPO: Initial Public Offering
ITA: Income Tax Act
IT: Information Technology
ITES: Information Technology Enabled Services
LLP: Limited Liability Partnership
MAT: Minimum Alternate Tax
NCR: National Capital Region
PBT: Profit before Tax
R&D: Research and Development
RDP: Revised Discussion Paper
SEZ: Special Economic Zone
STT: Securities Transaction Tax
SSI: Small-Scale Industries
SME: Small and Medium Enterprises
STPI: Software Technology Parks of India
VAT: Value Added Tax
• The taxation laws prevailing in a country may include some exemptions, deductions or rebates for certain individuals, organisations or enterprises for various reasons. Such measures in any specific tax law usually refer to an exception to the general rule (pertaining to that tax law) rather than a complete removal of taxation. In this paper, we refer to all such exemptions, deductions or rebates in tax laws as tax exemptions.

• In the Indian context, there could be a number of reasons for exemptions to be given in different kinds of taxes, such as, encouraging individual savings, providing a boost to exports, achieving balanced regional development, encouraging infrastructure development, increasing employment, and providing more resources for education, rural development, and cooperatives etc. However, a periodic review of such exemptions by the government would be necessary to eliminate excessive exemptions/incentives or superfluous tax breaks to investors for preventing the loss of public revenue.

• Starting with the Union Budget for 2006-07, the Union Government of India has been publishing a Statement of Revenue foregone under the Central Tax System as part of the Union Budget documents every year. This document presents a discussion on the exemptions in major taxes levied by the Union Government (or the Centre) and an estimation of the potential tax revenue lost or foregone due to the same.

• The estimates of revenue foregone due to exemptions in the Central tax system have caught the attention of many stakeholders over the last few years mainly because of the very high magnitudes of tax revenue involved in the same. The total estimated amount of revenue foregone due to all kinds of exemptions to all sectors (i.e. individuals, organisations and enterprises) stood at Rs. 2.05 lakh crore or 5.6 % of GDP for the financial year 2005-06, which by the financial year 2012-13 has risen (in absolute terms) to Rs. 5.73 lakh crore or 5.7 % of GDP.

• With a low tax-GDP ratio (at 16.6 % in 2011-12 Budget Estimates), the overall magnitude of public resources available to the government in India has been grossly inadequate in comparison to several other countries. This has led to gross under-financing of public provisioning in the country in social sectors (like, education, health, water and sanitation, nutrition etc.) and almost complete absence of social security measures by government for people in the unorganised sector (who constitute a large majority of the population). Hence, it is very difficult for most observers of public policy in the country to ignore the huge magnitudes of tax revenue involved in the estimates of revenue foregone due to exemptions.

• The actual magnitude of revenue that would get collected if all exemptions in the Central tax system are eliminated could certainly be less than the above stated figures of around 6 % of GDP, since the estimation by the Finance Ministry is based on some assumptions (that are inevitable for such an exercise of estimation); however, the actual revenue potential associated with elimination of tax exemptions cannot be small.

• The proportion of tax revenue foregone is the highest (at 44 % of total revenue foregone) in case of exemptions in Customs Duties, followed by an almost equally high proportion of revenue foregone (around 37 %) in case of exemptions in Excise Duties. Exemptions in Corporate Income Tax have accounted for a much smaller 12 % of the total revenue foregone, while that in Personal Income Tax have accounted for 8 % of the total revenue foregone in the figures pertaining to financial year 2012-13.

• Given that the total magnitude of revenue foregone for 2012-13 is 5.7 % of GDP, even 12 % of this (i.e. the revenue foregone on account of exemptions in Corporate Income Tax) is 0.7 % of GDP or approximately Rs.
68,000 crores in absolute terms. Also, in case of indirect taxes (like Customs Duties and Excise Duties), there is a concern that indirect taxes are not progressive as they affect the rich and the poor alike. Moreover, in India, almost two-thirds of the tax revenue collected (i.e. combined tax revenue of the Centre and States) is from indirect taxes and only about one-third of the tax revenue is from direct taxes. Because of these concerns, it seems, the public discourse on revenue foregone due to exemptions in the Central tax system has focused a lot on exemptions being given to the corporate sector.

- According to the Statement of Revenue Foregone under the Central Tax System, for the financial year 2011-12, the effective tax rates (ETRs) paid by both the manufacturing and service sectors (in the corporate sector) were much less than the statutory tax rate of 33.21%. While the ETR for the manufacturing sector was 24.83%, that for the service sector (in the corporate sector) was even less at 23.40%. The ETR for the entire sample of companies in the corporate sector was 24.10% (excluding dividend distribution tax). For the financial year 2012-13, the overall ETR for the entire sample of companies in the corporate sector is even less at 22.85%.

- We must also note that, as per the Statement of Revenue Foregone under the Central Tax System, companies with higher levels of profits are paying lower ETR than those in the lower range of profits. For instance, companies making profits in the range of Rs. 0-1 crore paid an ETR of 26.26%, whereas companies making profits in the range of Greater than Rs. 500 crore paid an ETR of 21.67% (for the year 2012-13).

- Revenue foregone on account of deduction of export profits for STPI Units (software technology industries), Special Economic Zones (SEZs) and accelerated depreciation are substantial within the total revenue foregone in respect of Corporate Income Tax; in particular, depreciation allowance/accelerated depreciation is a dominant factor underlying this segment of tax revenue foregone. Deductions for Software Technology Parks (STPs), Special Economic Zones (SEZs), Diamond and Gold (precious stones & Jewellery), Mineral Fuels and Mineral Oils and the power sector and weighted deduction for expenditure on scientific research account for major chunks of the revenue foregone in respect of Corporate Income Tax.

- With regard to tax exemptions, committees on tax policies set up by the government over the last two decades (e.g. Chelliah, Shome and Kelkar committees) had recommended rationalisation and minimisation of the exemptions system pertaining not only to direct taxes but also indirect taxes, and stressed that tax exemptions should be justified with sound social and economic reasons.

- The available information and relevant arguments strongly suggest that exemptions need to be minimised, carefully designed and justified with sound social and economic reasons. There is a need to review the extent and nature of tax exemptions provided to Special Economic Zones (deduction of export profits of units located in SEZs), diamond and gold (precious stones and jewellery), mineral fuels and mineral oils and the power sector, among others. The policy measures by the government could focus more on infrastructure and communication facilities etc. instead of relying heavily on tax breaks. Tax breaks need to be project-specific, and should not be treated as a “cost-saving” source for corporations seeking sustained tax holidays. SEZs should be used as a strategic instrument specifically for export promotion purposes and not become a haven for other corporations seeking tax sops.
1. Introduction

The taxation laws prevailing in a country may include some exemptions, deductions or rebates for certain individuals, organisations or enterprises for various reasons. Such measures in any specific tax law usually refer to a legal exception to the general rule (pertaining to that tax law) rather than a complete removal of taxation. In this paper, we refer to all such exemptions, deductions or rebates in tax laws as tax exemptions.

Tax exemptions, therefore, are some kind of concessions provided by the government (for various reasons) that reduce the tax burden/liability of individuals, organisations or enterprises. It could provide a potential taxpayer complete relief from any specific tax, tax them at a reduced rate, or tax them on only a portion of the items subject to taxation.

Sometimes an exemption in case of some specific tax is given to individuals or enterprises to encourage them to invest in particular projects or sectors. It might be in the form of lower tax rates on profits, tax holidays, or accounting rules that allow accelerated depreciation and loss carry forwards for tax purposes. It might also be in the form of lower tariffs on imported equipment and raw materials. Tax exemptions may also be provided for investment in regions that are in a disadvantageous position due to their remoteness. Operating in a remote area might be cost-ineffective due to higher transportation and communication costs in accessing materials used in the production process as well as in delivering final products to the market.

Tax exemptions might be offered due to positive externalities resulting from an investment, such as, diffusion of new knowledge (technology), upgradation of the skills of the workforce, or investment in R&D. Some tax exemptions might be intended to protect and promote “infant industries.” For instance, start-up firms often struggle for funds due to their inability to borrow from the capital market, given their new entry into the market, lack of recognition as well as smaller size etc. Hence, such firms may not be in a position to pay tax on a regular basis in the initial years of business. Other examples include exemption of charitable organisations from property taxes and income taxes, exemptions provided to veterans etc. Pension schemes, governmental entities, educational and research institutions are also provided tax exemptions.

However, a periodic review of the exemptions by the government would be essential for deciding the tax base for which exemptions should be provided, the nature and rates of such exemptions, and the tax elasticity of exemptions etc. Periodic monitoring of the exemptions would help the government to prevent loss of public revenue by eliminating excessive exemptions/incentives or superfluous tax breaks to investors.

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1 It is a practice followed by several companies to avail tax benefits by charging high depreciation of assets in the initial years of their operation. It provides them a way of deferring corporate income taxes by reducing taxable income in current years.

2 Loss carry forward is a technique used in accounting that allows a company to pay lower taxes than under normal circumstances. Such a mechanism allows investors/companies to carry their (reporting) losses forward for a specified number of years (usually 5 - 7 years). A legally specified loss to revenue ratio (with an upper limit) is allowed to carry forward. This method of tax benefits is particularly useful for companies whose projects are expected to make losses in the first couple of years as they try to increase production and penetrate markets.

3 Externalities refer to situations when an activity of somebody creates enjoyment/disturbance for others. If an activity generates utilities/benefits for others, it is called “positive externalities” and “negative externalities” if it generates disutility like pollutant emissions by cars. Please also refer to Glossary.

4 This refers to an argument in favour of protecting the domestic industries through government backing, help and intervention from foreign competition, as domestic producers, at their early stage of business, may lack necessary skills and efficiency to compete with external producers. Therefore, domestic producers are usually protected through the imposition of high tariff barriers (and other related measures) on imported commodities similar in nature to those produced by them.
Following are some conventional examples of tax exemptions:

- **Lower Corporate Income Tax Rate:**
  Governments often offer lower tax rates on corporate incomes compared to the general tax regime in order to attract FDI into specific sectors. For instance, such types of exemptions have been used by Hong Kong, Ireland, Cambodia, Estonia, Indonesia and Laos, among others.

- **Loss Carry Forwards:**
  In many instances, governments allow investors to carry losses forward (or backward) for a specified period (in the range of three to five years) for tax accounting purposes. This preference is usually given to investors whose projects are expected to run losses in the nascent years when they try to penetrate markets.

- **Tax Holidays:**
  These are a common form of tax incentives provided by developing and transitional economies to attract FDI. Under this incentive, newly established firms are exempt from paying corporate income tax for a specified period (the normal tenure being five years).

- **Investment Allowances:**
  These are deductions from taxable income, based on some percentage of new investment (depreciation). Investment allowances tend to lower the price (effective) of acquiring fresh capital by a firm. Under an investment allowance, firms are provided with faster write-offs for qualifying costs. Common forms of investment allowances are Accelerated Depreciation where several companies avail tax benefits by charging high depreciation of assets in the early years of operation and Enhanced Deduction where firms are allowed to claim deductions for the cost of qualifying capital (costs of larger investment).

- **Investment Tax Credits:**
  A tax credit is a sum deducted from the total amount a taxpayer owes to the state. It may be granted for various types of taxes such as an income tax, property tax or VAT. It may also be granted to encourage investment. Tax systems may grant tax credits to businesses/individuals, and such grants vary by type of credit.

- **Preferential Treatment of Long-Term Capital Gains:**
  Many countries provide preferential tax treatment for appreciation in value of capital assets held by enterprises, if the asset is held over a fixed period. In usual cases, long-term capital gains are taxed at half the rate of short-term capital gains. This preferential treatment is provided to encourage investors for more long-term FDI.

- **Zero or Reduced Tariffs:**
  Governments can allow two types of tariff incentives. There can be a reduced rate of tariffs on imports meant for capital investment, or the tariffs might be increased on the final products to protect the domestic market against import competition. However, many developing countries have lowered their tariffs following agreements under the World Trade Organization (WTO).

- **Employment-based Deductions:**
  In some European countries, governments may provide tax credits/allowances for disabled employees/persons. In order to provide incentives for employment of disabled people and women, a number of European countries

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3 Particularly for women who are in a disadvantageous position due to economic hardships, divorcement, human trafficking, disability, old-age etc.
provide exemptions to employers, though the nature of the exemptions vary. Also, in the Washington state in the US, there is a provision for property tax exemption for senior citizens and disabled persons subject to certain conditions.\(^6\)

- **Tax Reductions/Credits for Foreign Hard Currency Earnings:**

The earning of foreign exchange being one of the objectives of exports, incentives are provided to many industries in the services sector (e.g., tourism and hotels) based on the earnings of foreign exchange.

**Box 1: Some Examples of Incomes exempt from Taxation in India\(^7\)**

- Investment income and capital gains are taxed in India. However, long-term capital gains arising from the transfer of listed securities is exempt from tax. Securities Transaction Tax (STT) is liable to be levied on the transfer of capital assets depending on whether the asset is long-term or short-term.
- Dividends from shares held in Indian companies and specified mutual funds are exempt from tax. However, dividends from investments outside Indian Territory are subject to tax. Interest income earned from investments in India is subject to tax.
- “Gift” incomes to the tune of Rs. 50,000 are exempt from taxation in India.
- Certain donations are subject to deductions on the gross income. Deductions are also applicable for health insurance premium payments.
- Deductions are also given for insurance premiums, subscription to National Savings Certificate Scheme, contribution to recognised Provident Fund and Subscription to National Savings Scheme.
- Reimbursement of Medical Expenses that is realised by an employee for him/her or any member of the family is exempted up to Rs.15,000 per year. Also, reimbursement of hospitalisation cost in an acknowledged hospital is not taxable (full exemption).
- Leave Travel Concession/Allowance allowed to an employee and family for travel to any place is exempt for two journeys during a block of four calendar years subject to certain conditions. The present block for such an allowance is 2010-2013.

Source: Tax-payers Information Booklet, Income Tax Department, Gov

\(^6\) See the URL: http://www.dor.wa.gov/docs/pubs/prop_tax/seniorexempt.pdf.

\(^7\) This is developed from the Tax-payers Information Booklet of the Income Tax Department, Department of Revenue, Ministry of Finance, Gov. For details, see the URL: http://www.incometaxindia.gov.in/home.asp. Also see “Income-Tax Act, 1961 as amended by Finance Act” by the Income Tax Department, URL: http://law.incometaxindia.gov.in/DIT/Income-tax-acts.aspx.
2. Revenue Foregone Due to Exemptions in the Central Tax System in India

In the Indian context, there could be a number of reasons for exemptions to be given in different kinds of taxes, such as,

- encouraging individual savings (by providing tax reliefs to various savings schemes),
- providing a boost to exports,
- achieving balanced regional development,
- encouraging infrastructure development,
- increasing employment, and
- providing more resources for education, rural development, and cooperatives etc.

However, as stated earlier, a periodic review of such exemptions by the government would be necessary to eliminate excessive exemptions/incentives or superfluous tax breaks to investors for preventing the loss of public revenue.

2.1 - Estimates of Revenue Foregone due to Exemptions in the Central Tax System

Starting with the Union Budget for 2006-07, the Union Government of India has been publishing a Statement of Revenue foregone under the Central Tax System as part of the Union Budget documents every year. This document presents a discussion on the exemptions in major taxes levied by the Union Government (or the Centre) and an estimation of the potential tax revenue lost or foregone due to the same.

In this Statement, the various kinds of exemptions in the Central tax system are categorized under the following broad heads—

Direct Taxes: Corporate Sector; Non-Corporate Sector, and Individual Taxpayers; and
Indirect Taxes: Excise Duties, and Customs Duties.

Table 1 presents tax category-wise estimates of revenue foregone due to the exemptions in the Central tax system, i.e. estimated amounts of revenue foregone due to exemptions for corporate sector in Corporate Income Tax (CIT), exemptions for individual taxpayers in Personal Income Tax (PIT), and due to exemptions in indirect taxes (Customs Duty and Excise Duty). These estimates, provided by the Union Finance Ministry, are for 2005-06 to 2012-13.

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*Partnership Firms, Association of Persons (AOP) and Body of Individuals (BOI) are also engaged in large business, and benefit from various tax exemptions and deductions. See, "Revenue Foregone under the Central Tax System: Financial Years 2009-10 and 2010-11", Ministry of Finance, URL: http://indiabudget.nic.in/ub2011-12/statrevfor/annex12.pdf; p.23-25.
### Table 1: Revenue Foregone due to Exemptions in the Central Govt. Tax System

<table>
<thead>
<tr>
<th>Items</th>
<th>Corporate Income Tax</th>
<th>Personal Income Tax</th>
<th>Excise Duty</th>
<th>Customs Duty</th>
<th>Total</th>
<th>Less Export Credit related</th>
<th>Grand Total (=Total-Export Credit Related)</th>
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<tr>
<td>Revenue Foregone in 2005-06(in Rs. Crore)</td>
<td>34618</td>
<td>13550</td>
<td>66760</td>
<td>127730</td>
<td>242658</td>
<td>37590</td>
<td>205068</td>
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<tr>
<td>Revenue Foregone as % of GDP in 2005-06</td>
<td>0.9</td>
<td>0.4</td>
<td>1.8</td>
<td>3.5</td>
<td>6.6</td>
<td>1.0</td>
<td>5.6</td>
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<td>Revenue Foregone in 2006-07 (in Rs. Crore)</td>
<td>50075</td>
<td>15512</td>
<td>99690</td>
<td>123682</td>
<td>288959</td>
<td>53768</td>
<td>235191</td>
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<tr>
<td>Revenue Foregone as % of GDP in 2006-07</td>
<td>1.2</td>
<td>0.4</td>
<td>2.3</td>
<td>2.9</td>
<td>6.7</td>
<td>1.3</td>
<td>5.5</td>
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<td>Revenue Foregone in 2007-08 (in Rs. Crore)</td>
<td>62199</td>
<td>38057</td>
<td>87468</td>
<td>153593</td>
<td>341317</td>
<td>56265</td>
<td>285052</td>
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<tr>
<td>Revenue Foregone as % of GDP in 2007-08</td>
<td>1.2</td>
<td>0.8</td>
<td>1.8</td>
<td>3.1</td>
<td>6.8</td>
<td>1.1</td>
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<td>Revenue Foregone in 2008-09 (in Rs. Crore)</td>
<td>66901</td>
<td>37570</td>
<td>128293</td>
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<td>44417</td>
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<tr>
<td>Revenue Foregone as % of GDP in 2008-09</td>
<td>1.2</td>
<td>0.7</td>
<td>2.3</td>
<td>4.0</td>
<td>8.2</td>
<td>0.8</td>
<td>7.4</td>
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<tr>
<td>Revenue Foregone in 2009-10 (in Rs. Crore)</td>
<td>72881</td>
<td>45142</td>
<td>169121</td>
<td>195288*</td>
<td>482432</td>
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<tr>
<td>Revenue Foregone as % of GDP in 2009-10</td>
<td>1.1</td>
<td>0.7</td>
<td>2.6</td>
<td>3.0</td>
<td>7.4</td>
<td>7.4</td>
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</tr>
<tr>
<td>Revenue Foregone in 2010-11 (in Rs. Crore)</td>
<td>57912</td>
<td>36826</td>
<td>192227</td>
<td>172740</td>
<td>459705</td>
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<tr>
<td>Revenue Foregone as % of GDP in 2010-11</td>
<td>0.8</td>
<td>0.5</td>
<td>2.5</td>
<td>2.3</td>
<td>6.0</td>
<td>6.0</td>
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<tr>
<td>Revenue Foregone in 2011-12 (in Rs. Crore)</td>
<td>61765</td>
<td>39375</td>
<td>195590</td>
<td>236852</td>
<td>533583</td>
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<tr>
<td>Revenue Foregone as % of GDP in 2011-12</td>
<td>0.7</td>
<td>0.4</td>
<td>2.2</td>
<td>2.6</td>
<td>5.9</td>
<td>5.9</td>
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</tr>
<tr>
<td>Projected Revenue Foregone in 2012-13</td>
<td></td>
<td></td>
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<tr>
<td>(in Rs. Crore)</td>
<td>67995.0</td>
<td>45480.1</td>
<td>206188.0</td>
<td>253967.0</td>
<td>573630.1</td>
<td>573630</td>
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<tr>
<td>Projected Revenue Foregone as % of GDP in 2012-13</td>
<td>0.7</td>
<td>0.5</td>
<td>2.1</td>
<td>2.5</td>
<td>5.7</td>
<td>5.7</td>
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</table>

**Note:**
(1) 2005-06 figures are Provisional
(2) 2006-07 Figures are Estimates
(3) For 2005-06 and 2006-07, Cooperative Sector exemptions figures are also available, which is however not available for the later years. Therefore, this has not been included for comparability of four categories of exemptions, namely Corporate Income Tax (CIT), Personal Income Tax (PIT), Excise Duty and Customs Duty for all years.
(4) *Since 2009-10, Export Credit Related Items are adjusted against the Customs Duty Exemptions figures, and adjusted data are provided under the head 'Customs Duty'. Hence, since then separate data for 'Less Export Credit related' are not available.

*Source:* Compiled by author from Statement of Revenue Foregone, Union Budget (2006-07 to 2013-14), Ministry of Finance, Govt. of India
The estimates of revenue foregone due to exemptions in the Central tax system have caught the attention of many stakeholders over the last few years mainly because of the very high magnitudes of tax revenue involved in the same. As can be seen from Table 1, the total estimated amount of revenue foregone due to all kinds of exemptions to all sectors (i.e. individuals, organisations and enterprises) stood at Rs. 2.05 lakh crore or 5.6% of GDP for the financial year 2005-06, which by the financial year 2012-13 has risen (in absolute terms) to Rs. 5.73 lakh crore or 5.7% of GDP.

With a low tax-GDP ratio (at 16.6% in 2011-12 Budget Estimates), the overall magnitude of public resources available to the government in India has been grossly inadequate in comparison to several other countries. This has led to gross under-financing of public provisioning in the country in social sectors (like, education, health, water and sanitation, nutrition etc.) and almost complete absence of social security measures by government for people in the unorganised sector (who constitute a large majority of the population). Hence, it is very difficult for most observers of public policy in the country (like, development policy analysts, academics, policymakers, legislators, media, and civil society activists) to ignore the huge magnitudes of tax revenue involved in the estimates of revenue foregone due to exemptions.

As a result, many people have focused on the key finding in the Statement of revenue foregone, which is that: the total magnitude of tax revenue foregone due to exemptions/deductions/incentives in the Central government tax system is estimated (by the Union Ministry of Finance) to be Rs. 5.33 lakh crore in 2011-12 and Rs. 5.73 lakh crore in 2012-13. What it implies is that – the estimated amount of additional tax revenue that could have been collected by the Union Government, if all exemptions/deductions/incentives (both in direct and indirect taxes in the Central tax system) had been eliminated, is a staggering 5.9% of GDP for 2011-12 and 5.7% of GDP for 2012-13.

The actual magnitude of revenue that would get collected if all exemptions in the Central tax system are eliminated could certainly be less than the above stated figures of around 6% of GDP, since the estimation by the Finance Ministry is based on some assumptions (that are inevitable for such an exercise of estimation); however, the actual revenue potential associated with elimination of tax exemptions cannot be small.

We can also observe in Table 1 that the total estimated amount of revenue foregone had increased to the level of 7.4% of GDP for the years 2008-09 and 2009-10, before it fell to its earlier level of 6% of GDP in 2010-11. The higher magnitudes of revenue foregone in 2008-09 and 2009-10 are clearly due to the additional exemptions in the Central tax system given by the government in those two years, which were meant to tackle the impact of the global economic recession on Indian economy. The revenue foregone figure has fallen to around 6% of GDP in the subsequent years, as the Union Government withdrew its fiscal stimulus package starting with the Union Budget for 2010-11.

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1 Indian Public Finance Statistics 2011-12, Ministry of Finance, Govt. of India
Chart 1 shows the tax category-wise revenue foregone figures as proportions of total revenue foregone due to exemptions in the Central tax system in the financial year 2011-12.

**Chart 1: Revenue Foregone (in Corporate Income Tax, Personal Income Tax, Excise Duty and Customs Duty) as % of Total Revenue Foregone in financial year 2011-12**

![Chart 1: Revenue Foregone](image)

*Source: Compiled from Union Budget 2013-14, Ministry of Finance, Govt. of India*

Chart 2 shows the tax category-wise (projected) revenue foregone figures as proportions of total revenue foregone due to exemptions in the Central tax system in the financial year 2012-13.

**Chart 2: Projected Revenue Foregone (in Corporate Income Tax, Personal Income Tax, Excise Duty and Customs Duty) as % of Total Revenue Foregone in financial year 2012-13**

![Chart 2: Projected Revenue Foregone](image)

*Source: Compiled from Union Budget 2013-14, Ministry of Finance, Govt. of India*

We find that the proportion of tax revenue foregone is the highest (at 44% of total revenue foregone) in case of exemptions in Customs Duties, followed by an almost equally high proportion of revenue foregone (around 37%) in case of exemptions in Excise Duties. Exemptions in Corporate Income Tax have accounted for a much smaller 12% of the total revenue foregone, while that in Personal Income Tax have accounted for 8% of the total revenue foregone in the figures pertaining to financial year 2012-13.

However, given that the total magnitude of revenue foregone for 2012-13 is a stunning 5.7% of GDP, even 12% of this (i.e. the revenue foregone on account of exemptions in Corporate Income Tax) is 0.7% of GDP or approximately Rs. 68000 crore in absolute terms. This is a figure too high to ignore when we have to explore the
possibilities for the government to increase tax revenue. Moreover, in case of indirect taxes (like Customs Duties and Excise Duties), there is a concern that indirect taxes are not progressive as they affect the rich and the poor alike. Since indirect taxes are passed on to the ultimate consumers of goods or services, there is a likelihood that exemptions in some indirect taxes may actually lead to lower prices of goods or services, and also that some of the exemptions in indirect taxes may be meant for goods and services that are consumed mainly by the poorer sections of the population. Also, in India, almost two-third of the tax revenue collected (i.e. combined tax revenue of the Centre and States) is from indirect taxes and only about one-third of the tax revenue is from direct taxes.

Because of these concerns, it seems, the public discourse on revenue foregone due to exemptions in the Central tax system has focused a lot on exemptions being given to the corporate sector.

2.2- Revenue Foregone in respect of Corporate Income Tax

According to the Statement of Revenue Foregone under the Central Tax System, for the financial year 2011-12, the effective tax rates (ETRs) paid by both the manufacturing and service sectors (in the corporate sector) were much less than the statutory tax rate of 33.21%. While the ETR for the manufacturing sector was 24.83%, that for the service sector (in the corporate sector) was even less at 23.40%. The ETR for the entire sample of companies in the corporate sector was 24.10% (excluding dividend distribution tax). For the financial year 2012-13, the overall ETR for the entire sample of companies in the corporate sector is even less at 22.85%.

We must also note that, as per the Statement of Revenue Foregone under the Central Tax System, companies with higher levels of profits are paying lower ETR than those in the lower range of profits (Chart 3). For instance, companies making profits in the range of Rs. 0-1 crore paid an ETR of 26.26%, whereas companies making profits in the range of Greater than Rs. 500 crore paid an ETR of 21.67% (for the year 2012-13).

**Chart 3: Effective Corporate Income Tax Rate: Small vs. Large Companies (in per cent) [2012-13]**

![Effective Corporate Income Tax Rate Chart]

**Source:** Compiled from Statement of Revenue Foregone under the Central Tax System, Union Budget 2013-14, Ministry of Finance, Govt. of India

**Note:**

1. This graph shows different Effective Tax Rates (ETRs) (in %) paid by different companies of Corporate Sector (chosen as a group of sample companies from the entire corporate sector) for the financial year 2012-13. The horizontal axis shows range of different profit levels (profit before taxes) of companies. The vertical axis shows Effective Tax Rates (in %). It can be observed that lower level of profit making companies pay a higher ETR compared to higher profit making companies.

2. Effective Tax Rate (ETR) is a measure of actual tax payable from an industry relative to its Profit before Taxes (PBT). A lower ETR reflects companies are paying less tax relative to their profits. More formally, this is the ratio of total taxes paid (calculated for a particular sector/companies) to total profit (profit before taxes). In total taxes paid, surcharge and education cess are included, but dividend distribution tax (DDT) is excluded. It is expressed as a percentage. The standard formula for calculating ETR is: $ETR = \left[ \frac{\text{(Total taxes paid by a company + surcharge + education cess)}}{\text{Total Profit before Taxes}} \right] \times 100$
Although the number of companies in the higher profit ranges is also relatively less compared to the number of companies in the lower profit ranges, the largest profit-making companies (i.e., companies in the profit before tax or PBT range of greater than Rs. 500 crore) paid the lowest ETR (21.67%) for 2012-13. One possible reason for the deviation between the statutory tax rate (STR) and the effective tax rate (ETR) is the provision of various tax exemptions to the corporate sector (i.e. in respect of Corporate Income Tax).

It has been argued since long that large companies may benefit more from such exemptions and pay much less taxes than they are supposed to pay (Gupta 1981). We may also note here that, in the recent past, the Task Force on Direct Taxes (Kelkar Committee) had suggested a reduction of the STR and removal of exemptions; it had observed that the most direct way to raise the tax-GDP ratio for the country was to remove most of the plethora of exemptions and also emphasised that an effective tax policy should have minimum tax exemptions and incentives.\textsuperscript{8}

Atulan Guha has pointed out that there is a possibility that large companies may reduce their ETR through some unknown factors built in the political-administrative system (Guha 2007). According to him: “It may be that they (large companies) have greater power to lobby for obtaining favourable tax exemptions, which are otherwise insignificant in amount in relation to total tax exemptions, have the capacity to hire more efficient tax law experts who can reduce their tax burden, by utilizing these insignificant tax exemptions or they can buy tax officials who can reduce their tax burden by making lower assessments” (ibid., p. 1873).

In almost every Statement of Revenue Foregone document of the Ministry of Finance in the last few years, it has been recognised that the lowest effective tax rate (ETR) is paid by the IT Enabled & BPO service providers and Software Development Agencies. For instance, in the Statement of Revenue Foregone document of Union Budget 2008-09, it was stated that: “While the effective tax rate of almost all the industries is below the statutory level, it is the lowest for the IT Enabled Services providers & BPO Service Providers and Software Development Agencies at 7.36 per cent respectively. The two industries contributed 6.18 per cent of the total profits but only 2.08 per cent of the total taxes.”\textsuperscript{9}

Table 2 presents a comparison of the ETRs of some of the industries (in the Corporate Sector). It can be observed that the ETR for the IT Enabled & BPO service providers has been much lower than that for other industries; although, in the last two financial years, i.e. 2010-11 and 2011-12, the ETR paid by this industry has increased and crossed the 20% mark. Also, in the Statement of Revenue Foregone document of Union Budget 2012-13, it was shared that the ETRs for Diamond Cutting Businesses and Software Development Agencies were at 19.32% and 19.05% respectively, which were among the lowest.\textsuperscript{10}


\textsuperscript{9}Statement of Revenue Foregone document of Receipts Budget, 2008-2009, p. 47.

Table 2: Effective Tax Rate (including surcharge and education cess) for Sample Companies across Industry (in Corporate Sector) for financial years 2006-07 to 2011-12 (in percent)

<table>
<thead>
<tr>
<th>Ind. Financial Year</th>
<th>Automobile and Auto Parts</th>
<th>Engineering Goods</th>
<th>Printing and Publishing</th>
<th>Tobacco</th>
<th>IT Enabled Services, BPO Service providers</th>
</tr>
</thead>
<tbody>
<tr>
<td>2006-07</td>
<td>26.0</td>
<td>25.5</td>
<td>28.0</td>
<td>30.6</td>
<td>7.4</td>
</tr>
<tr>
<td>2007-08</td>
<td>24.0</td>
<td>30.0</td>
<td>31.0</td>
<td>25.0</td>
<td>15.0</td>
</tr>
<tr>
<td>2008-09</td>
<td>23.4</td>
<td>27.1</td>
<td>28.8</td>
<td>27.0</td>
<td>13.1</td>
</tr>
<tr>
<td>2009-10</td>
<td>25.1</td>
<td>27.6</td>
<td>30.5</td>
<td>28.0</td>
<td>15.1</td>
</tr>
<tr>
<td>2010-11</td>
<td>26.5</td>
<td>30.2</td>
<td>29.5</td>
<td>29.5</td>
<td>21.3</td>
</tr>
<tr>
<td>2011-12</td>
<td>21.2</td>
<td>29.0</td>
<td>29.0</td>
<td>28.0</td>
<td>24.3</td>
</tr>
</tbody>
</table>

*Note: Figures rounded to the nearest decimal.*

*Source: Compiled from Statement of Revenue Foregone, Union Budget (2008-09 to 2012-13), Ministry of Finance, Govt. of India*

Revenue foregone on account of deduction of export profits for STPI Units (software technology industries), Special Economic Zones (SEZs) and accelerated depreciation are substantial within the total revenue foregone in respect of Corporate Income Tax; in particular, depreciation allowance/accelerated depreciation is a dominant factor underlying this segment of tax revenue foregone. Deductions for Software Technology Parks (STPs), Special Economic Zones (SEZs), Diamond and Gold (precious stones & Jewellery), Mineral Fuels and Mineral Oils and the power sector and weighted deduction for expenditure on scientific research account for major chunks of the revenue foregone in respect of Corporate Income Tax.

Table 3: Major Tax Exemptions in Corporate Income Tax
[Financial Years: 2010-11 to 2012-13]

<table>
<thead>
<tr>
<th>Nature of Incentives</th>
<th>2010-11 (Revenue Foregone in Rs. Crore)</th>
<th>2011-12 (Revenue Foregone in Rs. Crore)</th>
<th>2012-13 (Projected Revenue Foregone in Rs. Crore)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Deduction of export profits of units located in SEZs (Section 10A and 10AA)</td>
<td>7432</td>
<td>10916</td>
<td>12033</td>
</tr>
<tr>
<td>Accelerated Depreciation (Section 32)</td>
<td>33243</td>
<td>34320</td>
<td>37831</td>
</tr>
<tr>
<td>Deduction of profits of undertakings engaged in generation, transmission and distribution of power (Section 80-IA)</td>
<td>7581</td>
<td>8301</td>
<td>9151</td>
</tr>
<tr>
<td>Deduction of profits of industrial undertakings derived from production of mineral oil and natural gas (Section 80-IB)</td>
<td>3626</td>
<td>7999</td>
<td>8817</td>
</tr>
</tbody>
</table>

*Source: Statement of Revenue Foregone, Union Budget (2012-13 and 2013-14), Ministry of Finance, Govt. of India*

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"This is the most important tax incentive for the corporate sector where government provides tax deductions based on the depreciation of fixed capital assets; companies are allowed to claim higher depreciation compared to depreciations under normal circumstances for a fixed number of years to avail such incentives."
The programmes relating to renewable energy were started in India in the 1980s, while a number of fiscal and financial incentives, like, accelerated depreciation, subsidised interest rates, capital subsidies, and low import tariffs, have been provided since the 1990s. Among these incentives, accelerated depreciation constitutes a substantial amount. It has been argued that such incentives are unsustainable in the long run in the absence of appropriate pricing policies, internalising costs of the environmental externalities, lack of R&D focus, better technology selection and supporting infrastructural facilities including training, operation and maintenance, monitoring etc."

Significant tax sops and other incentives, provided particularly in the Wind Energy sector, are said to have motivated substantial investments by corporates and High Net Worth Individuals in wind energy projects. The nature of investments in the sector/projects has, in fact, been largely motivated by the provision of accelerated depreciation allowances; and because of substantial capital requirement for investment in the sector, it remains confined to a group of big companies that have undermined competition and created some sort of a monopoly. For instance, it has been pointed out that “in Tamil Nadu, companies like Madras Cement, Tamil Nadu Newsprint and Paper Limited, Twentieth Century Finance Corporation Limited and dozens of others used this break to emerge as tax-free companies. A company that would otherwise need to pay, say, two crore rupees as income tax would simply install wind energy capacity worth the same amount, claim accelerated depreciation and end up paying absolutely no tax.”

It has also been argued that without appropriate infrastructural facilities, continuation of the provision of accelerated depreciation in this sector would entail net losses for the government. For instance, a number of wind mills are inoperative due to inadequate evacuation facilities. Almost 5000 million units (of energy) generated from wind mills were lost because of lack of evacuation facilities during 2010-2011. "Hence, it is argued that the provision of tax breaks on account of accelerated depreciation to the wind energy developers may have to be modified by the Income Tax Department."

There is a need to examine thoroughly the justifications for the tax exemptions / concessions given in the Special Economic Zones. It has been argued that the Special Economic Zones (SEZs) have actually turned into real estate zones instead of serving their primary objectives. The Parliamentary Standing Committee on Commerce has criticised the government for not establishing industries in almost half the SEZs set up since 2006 and giving the land to realtors, diverting fertile land of farmers." The Committee had pointed out that though land was acquired for Special Economic Zones, no industries have been set up in such lands; only 154 SEZs have become operational out of 389 notified, instead real estate business has become prosperous in the guise of SEZ.

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Several gems and jewellery units (which import European designer jewellery, targeted at the burgeoning market of wealthy Indian consumers, without paying any import duty) are taking advantage of the sops offered in SEZs. Reportedly, some gems and jewellery units operating in the Noida SEZ in the National Capital Region and Santacruz Electronics Export Processing Zone in Mumbai have been accused of abusing the license to import raw materials free of duty. There are even cases of designer jewellery being imported as raw materials when the exported items were ball bearings.²⁹

**Box 2: Special Economic Zones: the Manufacturing Industry in China and the IT Industry in India**

India embraced economic liberalisation in the early 1990s, which included provisioning of lucrative tax exemptions for the Information Technology (IT) sector. China had rolled out a similar process in 1978, which had included exemptions and incentives to its manufacturing industry. Gradually, China began offering tax exemptions to its manufacturing sector, reducing tax rates from 55 to 25 percent. Zero tax rate was applied to manufacturing industries for 2 years and 12.5 percent tax for another 3 years. India pursued a similar policy in Information Technology, Business Process Outsourcing and Knowledge Process Outsourcing (IT, BPO and KPO) sector with the advent of the liberalisation process in 1991. The sector was liberalised with the Software Technology Park of India (STPI) units scheme that provided IT companies a single-window agency for all business as well as a tax holiday for 10 years.

It is often argued that the Indian SEZ policy should be based on the Chinese model, whereas its effectiveness depends heavily upon size and infrastructural provisions (and also flexible labour laws, according to some) among other factors. Two important questions need to be addressed in this regard; one, is it required at all as the process of SEZ development in China too is controversial (Gopalakrishnan 2007); and, two, how to achieve the objectives of SEZ as enshrined in the SEZ Act, 2005.

If there is a need for SEZ, there is also a need to follow the necessary requirements for it to be effective—i.e. maintaining an optimal size, infrastructural facilities etc. Ideally, there should be a small number of SEZs, but each must have a certain size for successful operation. Chinese SEZs are much bigger in size but there are only five—Shenzhen, Zhuhai, Shantou, Hainan and Xiamen. On the other hand, India has more than 200 SEZs, which are too small in size to reap the benefits of economies of scale. That apart, the SEZs in India are not strategically located; while those in China are well-connected with ports, airports and roadways. **Better infrastructural facilities coupled with a superior supply chain management system should be a policy priority instead of huge tax incentives doled out for SEZs in India.** The tax incentives need to be project-specific instead of being under an overall incentive structure or long tax holidays.

Source: Compiled from http://www.seznews.com

### 2.3- Some Weaknesses in the Revenue Foregone Statement

The Finance Ministry’s estimation of tax revenue foregone due to exemptions in the Central tax system is based on the following assumptions:“

“(i) The estimates and projections are intended to indicate the potential revenue gain that would be realised by removing exemptions, deductions, weighted deductions and similar measures. The estimates are based on a


³⁰“Abuse of duty-free imports may lead to tighter regulation of SEZs” (Jan 27, 2010); The Financial Express, URL: http://www.financialexpress.com/news/abuse-of-duty-free-imports-may-lead-to-tighter-regulation-of-sezs/571868/2

short-term impact analysis. They are developed assuming that the underlying tax base would not be affected by removal of such measures. As the behaviour of economic agents, overall economic activity or other Government policies could change along with the elimination of the specific tax preference, the revenue implications could be different to that extent.

(ii) The cost of each tax concession is determined separately, assuming that all other tax provisions remain unchanged. Many of the tax concessions do, however, interact with each other. Therefore, the interactive impact of tax incentives could turn out to be different from the revenue foregone calculated by adding up the estimates and projections for each provision.™ (Emphasis has been added.)

Some of the observers have questioned the Finance Ministry’s estimates of tax revenue foregone due to exemptions, primarily on account of the above mentioned assumptions. The assumption that the underlying tax base (for any specific tax exemption) would not be affected by removal of the exemption is questionable. Likewise, the Revenue Foregone Statement itself mentions that many of the tax concessions may interact with each other in practice. However, it might be inevitable to make such assumptions in the process of estimation of potential revenue foregone due to exemptions.

Nonetheless, the Revenue Foregone Statement could include more explanations on the short term impact analysis on which the estimates are based. Also, it may be noted here that tax exemptions may have both short-term and long-term effects, and, in some cases, long-term effects of tax exemptions could be more important both in terms of tax revenues as well as their socio-economic impact.

Also, in order to remove certain ambiguities, more clarity is required on methodologies adopted in the estimation of revenue foregone with regard to indirect taxes. For instance, in the computation of revenue foregone for Excise Duty no correction is made for input taxes. To quote R. Kavita Rao (2013): “Central excise is a value added tax with provisions for input tax credit. In the case of exempt transactions, the taxpayer is not entitled to tax credit for any input taxes paid. Therefore, the net benefit from exemption in a value added tax is the tax payable on the value added. In the computation of revenue foregone for excise duty, however, no correction for input taxes had been made. The statement reports the full value of tax on the exempt transaction as the revenue foregone. It has been argued that on such transactions the extent of input taxes that remain embedded is not reported in any statement by the taxpayer, making it difficult for the reporting department to make such a correction. For the purposes of analysis, however, making such a correction is imperative.”

2.4- Some of the Specific Exemptions that should be Re-examined

Several of the exemptions in India’s Central tax system, pertaining to Personal Income Tax, Corporate Income Tax, Customs Duties and Excise Duties, may be justified on the basis of their socio-economic impact even now. However, given that the overall magnitude of revenue foregone due to exemptions is very high, and the country certainly needs to improve its tax revenue mobilization significantly, there is a need for a close scrutiny of the exemptions. Also, the arguments and information presented in the previous sections imply that the exemptions need to be minimised, carefully designed and justified with sound social and economic reasons; a cost-benefit analysis for each type of exemption should be carried out on a periodic basis as a measurement of their effectiveness with respect to their basic objectives.

In this context, it may be worthwhile to list out some specific exemptions in the Central tax system that should be re-examined. Some of these exemptions, shown in the following Table, account for the largest magnitudes of revenue foregone in their respective tax-categories.

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20 For related unambiguity in case of customs duty see Rao (2013).
### (I) Direct Taxes (Corporate, Non-Corporate and Individual Taxpayers)

#### (a) Corporate Sector:

<table>
<thead>
<tr>
<th>Exemption</th>
<th>Remarks</th>
</tr>
</thead>
<tbody>
<tr>
<td>[Projected revenue foregone in 2012-13]</td>
<td>The amount of revenue foregone on account of Accelerated Depreciation is the highest among all exemptions in respect of Corporate Income Tax.</td>
</tr>
<tr>
<td>Accelerated Depreciation (section 32) [Rs. 37831.7 Crore]</td>
<td>The Effective Tax Rate(ETR) paid by this sector is significantly lower compared to the overall share of profits of the Power sector in the sample of companies in the Corporate Sector.</td>
</tr>
<tr>
<td>Deduction of profits of undertakings engaged in generation, transmission and distribution of power (section 80-1A) [Rs. 9151.0 Crore]</td>
<td></td>
</tr>
<tr>
<td>Deduction of export profits of units located in SEZs (section 10A and 10AA) [Rs. 12033.1 Crore]</td>
<td>The amount of revenue foregone is substantial and the sector is vulnerable to round tripping practice of re-importing the same exportables for getting more deductions on export profits.</td>
</tr>
<tr>
<td>Deduction/weighted deduction for expenditure on scientific research [Rs. 6335.7 Crore]</td>
<td>Though it is sensitive, there may be a need to scrutinize closely the kind of research on which corporates are spending.</td>
</tr>
<tr>
<td>Deduction of profits of industrial undertakings derived from production of mineral oil (section 80-IB) [Rs. 8817.4 Crore]</td>
<td>Particularly in the non-fuel industries.</td>
</tr>
</tbody>
</table>

#### (b) Non-Corporate Sector [Firms/AOP/BOIs]

<table>
<thead>
<tr>
<th>Exemption</th>
<th>Remarks</th>
</tr>
</thead>
<tbody>
<tr>
<td>Deduction of profits of industrial undertakings derived from housing projects (section 80-IB) [Rs. 2787.6 Crore]</td>
<td>The Statement of Revenue Foregone, in the initial two years, provided some details for this sector with regard to the amount of revenue foregone. However, since then such details are not being provided.</td>
</tr>
<tr>
<td>Deduction of profits of cooperative societies (section 80P) [Rs. 1167.8 Crore]</td>
<td></td>
</tr>
<tr>
<td>Accelerated Depreciation (section 32) [Rs. 822.3 Crore]</td>
<td>Prone to misuse by taking tax advantages without genuine export promotion objectives.</td>
</tr>
<tr>
<td>Deduction of export profits of units located in SEZs (section 10A and 10AA) [Rs. 883.5 Crore]</td>
<td></td>
</tr>
</tbody>
</table>
(c) Individual Taxpayers

<table>
<thead>
<tr>
<th>Exemption</th>
<th>Remarks</th>
</tr>
</thead>
<tbody>
<tr>
<td>Deduction on account of certain investments and payments</td>
<td>Though it is sensitive, the amount of revenue foregone on this account is significant. The Direct Taxes Code — 2010 proposes to do away with some of the provisions of income tax exemption relating to investments and payments by individuals.</td>
</tr>
<tr>
<td>(section 80C) [Rs. 30661.7 Crore]</td>
<td></td>
</tr>
</tbody>
</table>

(ii) Indirect Taxes (Customs Duty, Excise Duty)

(a) Excise Duty: The Statement of Revenue Foregone does not provide any details for revenue foregone on account of exemptions in Excise Duties.
(b) Customs Duty

<table>
<thead>
<tr>
<th>Exemption</th>
<th>Remarks</th>
</tr>
</thead>
<tbody>
<tr>
<td>Precious stones, jewellery (Diamond and Gold) [Rs. 61035 Crore]</td>
<td>This accounts for the highest magnitude of revenue foregone among all items in respect of Customs Duties.</td>
</tr>
<tr>
<td></td>
<td>It has been argued that large imports of gold have aggravated India’s Current Account Deficit, whereas only a small portion of the gold imported contributes towards exports of gold jewellery.</td>
</tr>
<tr>
<td></td>
<td>Also, the relatively low level of ETR for this sector indicates that its Profit before taxes (PBT) are high relative to total income tax paid by this sector (the effective tax rate, for corporate tax, for Diamond cutting businesses was just 19.32% for the year 2011-12).</td>
</tr>
<tr>
<td>Mineral Fuels and mineral oils [Rs. 57752 Crore]</td>
<td>This too accounts for a very high magnitude of revenue foregone among all items in respect of Customs Duties.</td>
</tr>
</tbody>
</table>

Source: Statement of Revenue Foregone, Union Budget (2012-13 and 2013-14), Ministry of Finance, Govt. of India

Box 3: Tax Exemption: A Case Study

Tax Exemptions related to the Indian Premier League (IPL) –

From the Report of the Parliamentary Standing Committee on Finance (2010-11), Ministry of Finance, GoI (Thirty Eighth Report presented on 2 August, 2011)

The Parliamentary Standing Committee on Finance (2010-11) decided to examine this issue in detail as the Board of Control for Cricket in India (BCCI) sponsored Indian Premier League (IPL) drew strong criticisms with allegations of economic and financial wrong-doing, involving contravention of tax laws, foreign exchange law, anti-money laundering law, company law and RBI regulations. This case study focuses only on issues related to tax exemptions that the Committee has commented upon.

*Report can be accessed at: [http://164.100.47.134/isscommittee/Finance/38%20Report.pdf](http://164.100.47.134/isscommittee/Finance/38%20Report.pdf)*
BCCI & Tax Exemption

The Issue

- BCCI was granted exemption of income tax for the assessment years 2004-05 to 2006-07 to the tune of Rs. 225.28 crore on the basis of CBDT circular of 1984, which had clarified that promotion of sports is covered by the definition of a 'charitable' activity.
- However, the registration granted to BCCI for being involved in 'charitable activity' has been withdrawn on 28 December, 2009 with retrospective effect from the assessment year 2007-08.
- As a result, BCCI was assessed by the Income Tax Department for an income of Rs. 274.86 crore for the year 2007-08. BCCI has claimed exemption from tax to the tune of Rs. 377.33 crore and 216.64 crore for the years 2008-09 and 2009-10 on the ground of promoting cricket as a 'charitable' activity.
- At the time when the report (of the Parliamentary Standing Committee) was published, the Income Tax Department was in the process of scrutiny assessment for the year 2008-09 and the activities of BCCI during this year was being examined.

Committee's Response

- The Committee reported that they were 'astonished' that the Income Tax Department could not finalise the assessment of income of BCCI for the last three years even though a decision to withdraw tax exemption was taken with effect from June 1st, 2006.
- For the assessment year 2007-08, the Committee noted that although due cognizance of withdrawal of exemption was taken, resulting in a tax demand of Rs. 118 crore, only an amount of Rs. 92 crore had been realized from BCCI.
- The Committee concluded that while they are 'constrained to conclude that the Income Tax Department has been very lenient on BCCI', they recommended that the matter be thoroughly probed and an action taken report furnished to the Committee within one month of the presentation of the Report.
- The Committee also noted that the Income Tax Department has been quite 'inconsistent' in bringing BCCI into the taxability net and sought a thorough probe into the culpability of the tax officials concerned with granting exemptions and finalizing assessments in this case.

IPL & BCCI

The Issue

- For the IPL tournament, the BCCI had filed returns to the Income tax Department showing 'nil' income for the year 2008-09 and an income of Rs. 14.86 crore for the year 2009-10, while the gross revenue earned from IPL during the assessment year 2009-10, as per the Department of Revenue, was Rs. 661.78 crore.
- Further, IPL franchisees returned huge losses for the assessment years 2008-09, 2009-10 and 2010-11.
• The Central Board of Excise and Customs (CBEC) realized an amount of Rs. 94.32 crore by way of service tax together with interest of Rs. 91.63 lakh from IPL during the period 2007 to 2010. Further, as the BCCI-IPL were liable to pay service tax on franchisee fees, Business Consultancy Services, sale of space for advertisement, game right etc. a total of 102 show cause notices (as on 1 February, 2011) demanding service tax of Rs. 160.28 crore had been issued to them, out of which only Rs. 5 crore was paid.

Committee's Response
• The Committee noted that it was unable to understand why a paltry sum of Rs. 5 crore was deposited as service tax as against the demand of Rs. 160.28 crore.
• The Committee made clear that it expects all income tax assessments relating to BCCI-IPL as well as the franchisees and other entities connected with IPL for all the relevant assessment years are taken up as priority and finalized in a coordinated manner. The Committee was to be apprised of these assessments made and the quantum of taxes realized subsequently.

ICC World Cup
The Issue
• The Committee noted that tax exemption of about Rs. 45 crore was granted to the International Cricket Council (ICC) on the revenues generated from the recently concluded World Cup Cricket tournament.

Committee's Response
• The report states that the Committee is unconvinced whether the tax exemptions given to ICC was justified considering the World Cup received huge sponsorships and was supported generously by the corporate sector. They concluded that the tax exemption granted to ICC was 'devoid of merit' and that it should be reviewed by the Department of Revenue.

Conclusion: The report by the Standing Committee on Finance concluded by noting that the Ministry of Finance (Department of Revenue) should expedite finalization of the investigations on a fast track basis as well as devise a 'coherent and consistent' policy for the future whereby 'high profile money-spinning events such as the IPL are not kept out of the ambit of taxability'.

Source: This is compiled from the Report of the Parliamentary Standing Committee on Finance (2010-11), Ministry of Finance, Gol (Thirty Eighth Report presented on 2 August, 2011)
3. Recommendations on Tax Exemptions by Relevant Committees

In India, a number of Committees have been appointed at different points of time since Independence to examine relevant issues pertaining to taxation and recommend to the government appropriate policy measures with regard to the same. It would be useful here to take note of some of the recommendations pertaining to different types of tax exemptions, which have been made by such Committees appointed in recent times.

(i) Tax Reforms Committee (Chelliah Committee)

- It was argued during the early 1990s that the indirect tax structure in India had become extremely complicated, in particular the excise and customs duty structure, and that there were multiple rates and exemptions being provided without sound justifications.

- In August 1991, an expert committee was constituted by the Government of India (Gol) seeking suggestions with respect to the reforms required in indirect and direct taxes. The committee was headed by Raja J.Chelliah and was known popularly as the Tax Reforms Committee.

- The Committee proposed some major tax reforms, which went along the perspective of economic liberalisation that had been adopted by the Union Government since 1991.

- This Committee had observed that a simple tax system should only have a limited number of rates and exemptions/deductions and provide the least possible discretionary power to tax officials for interpreting the law."

- It was critical of the then existing import tariffs structure, which had multiplicity of statutory rates and a large number of exemptions/concessional rate notifications, making tax administration cumbersome; hence, it had proposed rationalisation of the same.

(ii) Advisory Group on Tax Policy and Tax Administration for the Tenth Plan (Shome Committee)

- This Committee made some recommendations pertaining to the exemptions prevailing in direct taxes. It pointed out that there was scope for reduction of a number of incentives and exemptions in direct taxes.

- The Committee pointed to a significant drawback of the prevailing exemption system that resulted in a regressive tax structure; to quote from its Interim Report: “Overall, the incentives are also iniquitous in that the manner in which they are offered tends to favour the richer tax payers. For example, deductions from income under Sections 10 and 80L and the provisions relating to rollover of capital gains tax favour upper bracket tax payers disproportionately.”

- In its Interim Report, the Committee recommended that the conditions for exemptions must be minimised.

- The Committee specifically pointed out the need for minimising exemptions with respect to customs duties and suggested that the number of export promotion schemes were also unnecessarily high and should be reduced."

- The Committee also suggested simplifying the nature, formulation and types of exemptions prevalent in case of excise duties.

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"For a detailed recommendations of Chelliah/Tax Reforms Committee, see the Book published by Academic Foundation, titled “Reports on India’s Tax Reforms”, pp.563-605


(iii) Task Force on Direct and Indirect Taxes, December 2002 (Kelkar Committee)

- The Committee under the chairmanship of Vijay Kelkar submitted its Report on direct and indirect taxes in December 2002. The panel on Direct Taxes pointed out that the tax system had become excessively complex and regressive due to the presence of contradictory tax exemptions.

- The Committee recognised that the most direct way to raise tax to GDP ratio was to remove most of the plethora of exemptions. To quote: “If efficient and feasible administration is an objective, the tax structure should comprise of low rates, few nominal rates, a broad base, minimal exemptions and incentives, no surcharges and, in cases of exceptions, clear guidelines. This is because a simple tax structure induces better tax administration.”

- The Committee pointed out that there are excessive tax exemptions in the corporate sector, which needed to be reduced. To quote, “The present scheme of corporate income tax is riddled with a large number of deductions and exemptions. As a result, the base is considerably lower than the book profit declared to shareholders. In effect, this has led to a non-transparent tax subsidy regime, complexity of the tax law, revenue loss, increased compliance cost and has encouraged rent seeking behaviour.”

- As a policy option, the Committee suggested corporate tax exemption could either be eliminated immediately with a provision of lower rates, or could be eliminated in a phased manner (maximum within three years).

- It also recognised that many of the exemptions were provided without sound economic reasons. It added that the pattern of exemptions was also not justified from socio-economic perspective. For instance, while substantial income and revenues were generated in the jewellery industry, the tax revenue generated from the industry was much lower compared to other sectors due to excessive deductions and exemptions.

- Moreover, the Committee had also observed that certain tax exemptions were not transparent and ambiguous, and, hence, were not amenable to auditing by the Comptroller and Auditor General.

- Regarding indirect taxes, the Committee emphasised that a number of exemptions in case of import tariffs and excise duties were irrational in the sense that these exemptions were based upon non-economic factors.

Thus, with regard to tax exemptions, all these committees (i.e. Chelliah, Shome and Kelkar committees) had recommended rationalisation and minimisation of the exemptions system pertaining not only to direct taxes but also indirect taxes, and stressed that tax exemptions should be justified with sound social and economic reasons.

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27 Both the Reports are available in the Ministry of Finance, Govt website. For the report on direct taxes, see the URL: finmin.nic.in/kelkar/Final_Report.pdf, and for indirect taxes see the URL: http://finmin.nic.in/kelkar/report.pdf.
29 For details see ibid, p.15-19.
30 For the recommendations in detail see the Consultation Paper “Task Force on Indirect Taxes” (October 2002), URL: http://finmin.nic.in/kelkar/report.pdf
4. Concluding Observations

In the context of the Central tax system in India, the available information and relevant arguments strongly suggest that exemptions need to be minimised, carefully designed and justified with sound social and economic reasons. There is a need to review the extent and nature of tax exemptions provided to Special Economic Zones (deduction of export profits of units located in SEZs), diamond and gold (precious stones and jewellery), mineral fuels and mineral oils and the power sector, among others. The policy measures by the government could focus more on infrastructure and communication facilities etc. instead of relying heavily on tax breaks. Tax breaks need to be project-specific, and should not be treated as a “cost-saving” source for corporations seeking sustained tax holidays. SEZs should be used as a strategic instrument specifically for export promotion purposes and not become a haven for other corporations seeking tax sops.

It may be worthwhile here to take note of the observations made in a report of the Organisation for Economic Cooperation and Development (OECD), with regard to tax incentives for investment: “In many countries, there is an absence of reliable data on actual investments made, direct and indirect benefits to the host economy and the cost of the incentives in terms of direct spending or revenue lost.” In this regard, the Report shares an interesting case study on Indonesian tax reforms (1984), which were aimed at reducing tax evasion and corruption, economic distortions and administrative costs while enhancing socio-economic equality. It is observed that the country followed a policy of reduced tax rates and broadening of the tax base, in which corporate tax rates were reduced from 45 to 35 percent and discriminatory tax preferences (tax holidays, accelerated depreciation, special investment allowances and preferential tax rates) were completely abolished. Initially, FDI inflow into the country declined a bit as a reaction to such bold policy measures but it gradually increased as the confidence of the investors for the economy was restored. In later years, the Indonesian government started providing tax concessions on selective basis, e.g., tax concessions on inward investments in the form of exemption from import duty on machineries, spare parts and capital goods.

In India, there have been some developments in the recent years towards a revision of some of the existing tax exemptions. In the Direct Taxes Code (DTC) Bill, which is being pursued by the Union Government as the major policy reform in direct taxes, there is a thrust for rationalization of exemptions and replacement of profit-linked tax incentives with investment-linked incentives (in case of Corporate Income Tax). As regards corporate tax exemptions, however, according to some economists, even after moving away from profit-linked incentives towards investment-linked incentives, the inequitable and regressive character of the tax structure might not change. Another positive development pertains to the imposition of Minimum Alternate Tax (MAT) on STPI units. The sector has been given a 10-year exemption, according to the SEZ Act, which expired in the financial year 2010. However, there is a lot that needs to be done with regard to a comprehensive review and rationalisation of the exemptions in the Central tax system.

There is a need for an in-depth industry-level review of the extent to which the anticipated benefits of tax exemptions are being fulfilled in certain industries, e.g. software development agencies, power and energy, and petroleum and petrochemical sector. Given that the effective tax rates (ETRs) for these are much lower, as reflected in the Union Budget documents.

In the Budget Speech for the 2009-10 Union Budget, the then Finance Minister had recognized that India's tax base continues to be low compared to other countries, mainly due to a plethora of exemptions in the Central government tax system. However, the government has not taken significant corrective measures in this regard in the last four Union Budgets.

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33Ibid, p.11.
34MAT refers to the minimum amount of tax, which is payable by corporates, if 10% of 'book profits' exceed tax on total income.
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**Accelerated Depreciation**: It is a practice followed by several companies to avail tax benefits by charging high depreciation of assets in the initial years of their operation. It provides them a way of deferring corporate income taxes by reducing taxable income in current years.

**Anti-Dumping Duty**: This is a tariff imposed to prevent dumping. Dumping is a strategy often used by domestic producers of a country to sell goods abroad at a price below that charged in their domestic market. It is illegal to dump certain products into some countries as they want to protect their own industries from such competition.

**Capital Gains Tax**: A tax imposed on capital gains accruing through sale of shares/property etc. In other words, Capital Gains Tax is a tax on the profits from the sale of 'capital assets' such as stocks and shares, land and buildings, businesses and valuable assets such as works of art. The nature of such taxes varies between countries and according to the nature of capital gains (i.e. short term or long term capital gains).

**Corporate Income Tax**: This is a tax levied on the income of Companies under the Income Tax Act, 1961.

**Customs Duties**: It is a tax levied on goods imported into the country as well as on goods exported from the country.

**Effective Tax Rate**: This is the ratio of total taxes paid (calculated for a particular sector/companies) to total profit (profit before taxes). In total taxes paid, surcharge and education cess are included, but dividend distribution tax (DDT) is excluded. It is expressed as a percentage. Following is the standard formula for calculating ETR.

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ETR = \left(\frac{\text{Total taxes paid by a company} + \text{surcharge} + \text{education cess} - \text{Dividend Distribution Tax}}{\text{Total Profit before Taxes}}\right) \times 100
\]

**Excise Duties**: It is a tax levied on those goods, which are manufactured in the country and are meant for domestic consumption.

**Externalities**: Externalities refer to situations when an activity of somebody creates enjoyment/disturbance for others. If an activity generates utilities/benefits for others, it is called “positive externalities”; conversely, it is termed “negative externalities” if it produces disutility like pollutant emissions by cars.

**Horizontal Equity**: This implies that the same treatment is provided to people in an identical situation. For instance, if two people earn Rs. 15,000 per month, they should both pay the same amount of income tax. Therefore, horizontal equity implies that there should not be any discrimination on grounds such as race, gender, different types of work. Horizontal equity is an important starting point for any tax system.

**Impact Analysis**: This is an evaluation of the pros and cons of pursuing a course of action taking account of all possible consequences of such an action. The nature of impact analysis can vary depending upon what kind of action is taken. In the context of an Economic Impact Analysis, such studies measure economic effects of the “shocks” to the system caused by climatological, environmental, physical, and other changes. This analysis attempts to simulate/replicate these impacts with mathematical equations (such as input-output models) that show linkages among various industries, economic sectors, and external factors.

**Inbound Investment**: Inbound investment is investment in a country from abroad. In India, for instance, inbound investment would refer to foreign investments made in the country. Similarly, Inward Investment is the investment of money in a country by companies from abroad.

**Infant Industry Argument**: This refers to an argument in favour of protecting the domestic industries through government backing, help and intervention from foreign competition, as domestic producers, at their early stage of business, may lack necessary skills and efficiency to compete with external producers. Therefore, domestic producers are usually protected through the imposition of high tariff barriers (and other related measures) on imported commodities similar in nature to those produced by them.


Loss Carry Forward: Loss carry forward is a technique used in accounting that allows a company to pay lower taxes than under normal circumstances. Such a mechanism allows investors/companies to carry their (reporting) losses forward for a specified number of years (usually 5-7 years). A legally specified loss to revenue ratio (with an upper limit) is allowed to carry forward. This method of tax benefits is particularly useful for companies whose projects are expected to make losses in the first couple of years as they try to increase production and penetrate markets.

Sales Tax: It is levied on the sale of a commodity, which is produced/imported and being sold for the first time.

Service Tax: It is a tax levied on services provided by a person and the responsibility of payment of the tax is cast on the service provider.

Special Economic Zones: Special Economic Zones (SEZs) are specified geographical areas where economic and other laws are deliberately made more free-market oriented than for other areas in order to promote certain kind of activities, which are supposed to be economically and socially beneficial for the country (for instance, employment generation/innovation etc.). Another objective is to increase FDIs, typically, of international business or MNCs. SEZs cover among others Free Trade Zones (FTZ), Export Processing Zones (EPZ), Industrial Parks/Industrial Estates (IE), Free Ports, Urban Enterprise Zones and others.

Tax Expenditure: The term “Tax Expenditure” is used to denote the cost of tax incentives/preferences/exemptions in terms of the potential tax revenue of the government lost (i.e., the estimated revenue foregone by the government that would have been generated if the tax incentives were not provided).

Tax Neutral Mergers: Some countries follow “tax neutral mergers”, where Mergers & Acquisitions (M&A) are free of any tax charges. Sometimes, the outstanding tax liability of a company that is to be acquired is taken into consideration while working on the valuation of the M&A.

Personal Income Tax: This is a tax on the income of individuals, firms etc. other than Companies, under the Income Tax Act, 1961. This head also includes other Taxes, mainly the ‘Securities Transaction Tax’, which is levied on transactions in listed securities undertaken on stock exchanges and in units of mutual funds.

Value Added Tax (VAT): VAT is a multi-stage tax, intended to tax every stage of sale of a good where some value has been added to the raw materials; but taxpayers do receive credit for tax already paid on the raw materials in earlier stages.

Venture Capital Investments: Private equity and venture capital are means to raise funds particularly for start-up firms. Private equity is a broad term referring primarily to non-public ownership equity securities that are not listed on a public exchange. Private equity encompasses both early stage (venture capital) and later stage (buy-out, expansion) investing. Venture capital is a means of equity financing for rapidly growing private companies. Venture capital firms invest funds on a professional basis, often focusing on a limited sector of specialisation (e.g., IT, infrastructure, health/life sciences, clean technology, etc.).

Vertical Equity: This implies that people with higher incomes should pay more tax. Vertical equity seeks to tax in a proportional or progressive way—people with more ability to pay should pay more tax.

Wealth Tax: This is a tax levied on the specified assets of certain persons including individuals and companies, under the Wealth Tax Act, 1957.

Withholding Tax: This is a tax deducted from a payment made to a person outside the country and is generally applied to investment incomes such as interests, dividends, royalties and license fees, in accordance with a Tax Treaty signed between two jurisdictions.
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