THE UNION BUDGET 1976-77

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By

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It is in the fitness of things that the first epoch-making Budget in the history of our Republic should be published in March 1976 which is the bicentennial month of the first classic on modern economics—Adam Smith's *The Wealth of Nations.*

It constitutes a landmark, since for the first time a Finance Minister has accepted, adumbrated and applied three basic principles:

(*a*) Realistic rates of taxation are far better than confiscatory rates, from every point of view. "The majority of Indian tax payers would prefer to abide by the law and pay taxes as due, provided the tax burden is reasonable." The Budget constitutes a clean shift from fiscal theology to fiscal rationalism. In that sense it is our first *modern* Budget.

(*b*) You cannot have social justice in a poor country like India without economic growth; and therefore, the accent has to be on *economic growth* with social justice.

(*c*) A dialogue with the interests affected is a desirable prelude to a growth-oriented Budget. A Budget should not be an annual scourge but should partake more of the nature of the presentation of annual accounts of a *partnership* between the Government and the people.

The Budget has rightly continued last year's emphasis on agriculture and power—as much as 24% and 18% respectively of the outlay are going to be on these two items in the coming year.

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The Budget is truly memorable for what it has done in the field of personal taxation. The Voluntary Disclosure Scheme which ended on 31st December 1975 resulted in a disclosure of income aggregating to Rs. 744 crores and of wealth aggregating to Rs. 834 crores. Some regard it as only a fraction of the black money in existence. This shows the extent to which excessive rates of taxation had destroyed public integrity. By contrast, when the rates of personal taxation were reduced for the financial year 1974-75 there was a substantially higher collection of income-tax than was budgeted for, despite complete stagnation in the economy. This year the rates of income-tax and wealth-tax have been lowered at all levels, the maximum marginal rate of income-tax being 66% as compared to the maximum marginal rate of 74.75% for the year 1965-66 which was uptil now the lowest in the history of our Republic. We should never revert again to the twenty-year regime of expropriatory taxation. As a result of the decreased rates of income-tax and wealth-tax, the tax burden will be reduced by Rs. 180—205 crores. Deducting from it the amount of Rs. 80 crores which will be siphoned off under the Compulsory Deposit Scheme, Rs. 100—125 crores will be left in the hands of citizens to spend or invest and thereby help the nation to fight recession. The most satisfactory part of the Budget is that our national character will no longer continue to be degraded and public morality corrupted by crippling personal taxation which is advocated by those who want to see private enterprise destroyed.

However, while the Budget will help to raise our national character, one is not sure that it will help to raise our national income.

A few essential facts which constitute the background to the Budget may first be looked at.

For 1975-76 the deficit estimated in the Budget last year was Rs. 247 crores, while the actual deficit is now stated to be Rs. 490 crores. This figure is arrived at after taking credit for foreign aid amounting to Rs. 366 crores plus Rs. 204 crores which has come from Iran for the

Kudremukh Project. (The much-vaunted goal of self-reliance is clearly not yet within our reach.) If these windfalls from abroad amounting to Rs. 570 crores are not taken into account, the deficit for the last year would exceed Rs. 1,000 crores.

For the year 1976-77 the budgeted deficit is Rs. 320 crores, but this is arrived at by providing that the payment for imported fertilizers will be financed by the banking system through the Food Corporation of India, whereas upto now the cost of such imports was treated as a Budget outgoing. Again, the Budget has taken credit for Rs. 480 crores, being the moiety of the additional dearness allowance which employees are required to deposit with the Government under the Additional Emoluments (Compulsory Deposit) Scheme. But for this amount of Rs. 480 crores and the fertilizer import bill of, say, Rs. 320 crores, the deficit for 1976-77 would be Rs. 1120 crores. But this amount of deficit we can take in our stride.

It is not as if the tax raising effort has slackened or is below the target. For 1976-77 the Central Budget has levied higher indirect taxes which will yield Rs. 80 crores, while the increase in post and telegraph rates will net Rs. 140 crores and the increase in railway freight Rs. 87 crores. Thus the new imposts will aggregate to Rs. 307 crores.

The draft Fifth Plan envisaged a tax effort which would raise an additional Rs. 4,300 crores for the Exchequer; but in the first two years of the Plan new imposts have been already levied which would yield Rs. 5,600 crores over the five-year period of the Plan. Thus, taxation is the first and only target of the Fifth Plan which we have already crossed—and three years in advance!

Even the work of a great creative mind like Wordsworth was unequal in quality:

> "Two voices are there: one is of the deep;
> And one is of an old half-witted sheep
> And Wordsworth, both are thine."

The Budget speaks with two voices—one of sweet reason in the field of personal taxation, and the other of severe rigidity in the field of corporate taxation.

To point out the shortcomings of the Budget is not to detract from the praise due to it for the good it has done.

First, the Budget continues the tradition of the *incredible instability* of our fiscal laws. A stable fiscal policy is to a nation what a stable family life is to an individual. Development rebate which was withdrawn in 1974 was replaced by initial depreciation which will now be replaced by investment allowance. Instead, it would have been much better to revive development rebate on which the law has crystallized over a period of twenty years. The chronic instability is underlined by the rationalisation of the tax structure being stated to be in the nature of an "experiment". The law is an experiment, as all life is an experiment; but experiments should not be so frequent, so short-sighted and so short-lived as to rob the law of that modicum of stability which is essential to healthy growth. The proposed scheme of excise relief in respect of increased production is, again, stated to be for only "one year in the first instance". The basis of assessment on non-residents is sought to be drastically changed even in respect of existing agreements—a subject to which we shall revert later. A Budget should ensure stability of the substantive law for an optimum period of five years and a minimum period of three years.

Secondly, in some important respects, it is an *unfinished Budget*. Last year's Budget Speech contained a promise that the Government would take action "quickly" regarding tax incentives, excise rebates and reliefs, loans on specially low rates of interest etc., which are absolutely essential for new investment in capital-intensive industries, but even this year's Budget has left the subject untouched. The Marathe Committee's Report was submitted to the Government many months ago, but it has remained in cold storage. The scheme for granting excise relief in respect of increased production, the scope and incidence of the

research and development cess and of the social security scheme for employees, as well as the scheme for companies depositing an amount equivalent to the surcharge with the Industrial Development Bank of India—yet remain to be worked out. In the absence of these details it is difficult to evaluate the impact of the Budget on the corporate sector.

Thirdly, the *time-consuming and energy-wasting complexity* of our fiscal laws continues to be the hallmark of the new amendments to the Income-tax Act proposed in this year's Budget. 200 years ago the thirteen Colonies entered upon a War of Independence to vindicate the principle "No taxation without representation", and became the United States of America. Today the principle adhered to by the Department is—No tax relief without litigation. The investment allowance which is introduced by the Finance Bill is set out in no less than seven pages. The layman can have no idea of the senseless waste of time and effort involved in coping with our tax laws. For instance, development rebate was introduced in 1955, one of the conditions for its allowance being the creation of a development rebate reserve in the assessee's accounts. Litigation went on and on, as regards the question—in which year should the development rebate reserve be created? It was only after 21 years that the Revenue finally accepted the position—in January 1976—that the development rebate reserve may be created in the year in which the development rebate is actually allowed against adequate profits, and need not be created in the year in which the assets are installed but there are no profits to absorb the development rebate. The shareholders of the Associated Cement Companies Ltd. (as of several other companies) have been waiting to get the fruits of the Tribunal's decision in favour of the Company regarding tax relief in respect of newly established undertakings, and about two decades have passed since the relevant assessment year in which the relief should have been given. The Revenue refused to accept the Tribunal's decision and has taken the matter on a reference to the High Court—a procedure which involves a guaranteed delay of ten years.

Fourthly, the Budget has done *nothing for export promotion*. India's repayment liabilities in foreign exchange will aggregate to at least one billion dollars by 1980 and it is difficult to see how we shall be able to meet those liabilities unless our export earnings are stepped up by vigorous imaginative measures. Brazil and Ireland increased vastly their foreign exchange earnings by exempting export profits wholly from taxation. And we would be well advised to follow the example.

Fifthly, the Budget is growth-oriented, but not sufficiently growth-oriented to be able to overcome the recession and accelerate growth particularly in the capital-intensive sector. The total industrial output of India is around Rs. 25,000 crores, of which at least 40%, i.e. Rs. 10,000 crores, is affected by the current recession. The excise relief of Rs. 50 crores amounts to only 0.5% of the output in the recession-hit industries. What was needed was an excise relief amounting to at least Rs. 200 crores.

A dispassionate examination of the measures proposed in the Budget to accelerate growth would show how inadequate the measures are. The best of the new incentives is the investment allowance. But the investment allowance will mean an additional saving of only Rs. 9-10 crores, as compared to initial depreciation, since initial depreciation was at 20% whereas investment allowance is at 25%. The abolition of the interest-tax on long-term loans made to the corporate sector would mean a reduction in interest charges of about Rs. 6-7 crores, while the changes in the surtax would spell a saving of Rs. 3-4 crores. Thus the total saving to the corporate sector would be no more than Rs. 18—21 crores.

The corporation tax is budgeted to reach the all-time high of Rs. 1025 crores in the new year. The abolition of the 5% surcharge would have meant a notional difference of only about Rs. 45 crores which would have been most probably made up by better performance of the corporate sector. To relieve companies of the surcharge on their depositing an equivalent amount with the Industrial

Development Bank of India for a period of years is only to give industry a post-dated cheque which cannot help it in its present financial difficulties. Further, this 5% will go to finance the loans to be given by IDBI to the private sector upon terms which provide for the right of conversion of a portion of the loan into equity at a subsequent date. Thus the private sector has been asked virtually to finance its own partial take-over.

The investment allowance can only help profitable enterprises, because it is only when there are taxable profits that the investment allowance can be claimed as a deduction and thereby the fiscal burden can be reduced. But investment allowance can never help those capital-intensive industries (like cement, paper, fertilizers and heavy chemicals) which are foredoomed to losses in the context of the present pricing policy and vertiginous capital costs. It is significant that no new undertaking in the field of cement and fertilizers has come up in India during the last five years. What is needed for new units in such capital-intensive industries is a total holiday from excise for, say, seven years, long-term loans at low rates of interest, and reduction in import duties on foreign capital equipment. Which is the other way in which new units in these sectors can possibly be made viable?

It is true that the proposed 31.6% increase in the Plan outlay will take the Plan expenditure to Rs. 7852 crores in 1976-77, and this is bound to have a beneficial effect on the national economy. But unlike crops, Plan outlay cannot have an immediate impact on the economy. Its flush effect can only come later.

In sum, the Budget would have been perfect if it had applied the same norms of realism and wisdom in the field of corporate taxation which it has in the field of personal taxation.

Because there is a law against retrenchment and lay-off, no one can have an idea as to the real employment situation in India today. While the law has rightly protected

the weaker sections of society from joblessness, it is clear that the economy cannot survive for long in a healthy state if it has to carry a man-power load in excess of its needs or its capacity to pay. Enforced employment is a sedative, not a cure.

Will the Budget revive the investment market? You don't need to be a congenital pessimist to have grave misgivings on this point. The Reserve Bank's Equity Share Price Index, taking 100 as the base in 1961-62, was 96.4 in 1975-76; while gold, with the same base figure stood at 450. After taking into account the factor of inflation, the figure of 100 in 1961-62 would be only 36 for equity shares in 1975-76, while it would be 169 for gold. This means that those who put their moneys to productive use and national purposes are more than four times worse off than those who kept them in unproductive form. The capital raised in the stock market *in real terms* has been, during the last two years, only one-third of what it was in 1961-62. About 4,000 licences are floating around today, waiting to meet the capital which can finance the licensed projects. They would need probably Rs. 2000 crores for their fruition. But our economic policies have unfortunately so dried up the investment market that raising money of this magnitude is truly beyond hope. Without the private investor, our mixed economy cannot survive but would become a solid State economy—if one may be forgiven a pun from the language of electronics.

The Budget contains some proposals by way of relief from wealth-tax for persons of Indian origin residing abroad who are willing to bring their foreign capital into India. We have failed to attract the large foreign exchange resources of persons of Indian origin residing abroad, mainly for two reasons. First, the reliefs we offer are too niggardly compared to what other countries offer, and secondly, we change our laws too often and without regard to the rights of persons who have arranged their affairs on the basis of the prevailing law. For Indians residing abroad to come back to India with their fortunes, is like entering into matrimony. It is easy to take the plunge but difficult to get out.

At least two measures could have been taken in this year's Budget to revive the investment market. First, it should have provided that no tax would be levied in respect of capital gains made on the sales of shares, if such capital gains are re-invested in other shares. Secondly, it should have increased the deduction in respect of dividend income from Rs. 3,000 to Rs. 6,000. That would have given the investment market a shot in the arm. The total revenues of the State would definitely increase, not decrease, by such reliefs which would have a stimulant effect on the entire economy. Most countries take a long time to learn this simple lesson. For instance, Sri Lanka, finding its economy reduced to shambles by an overdose of the wrong type of "socialist taxation" during the past years, has now increased the minimum taxable limit from Rs. 6,000 to Rs. 9,000 and reduced the maximum marginal rate of income-tax from 65% to 50%.

The Budget is happily so framed that it will not revive inflation. There is a Plimsoll line in deficit financing which depends upon a wide variety of circumstances, and the Budget does not transgress that line. The proposed deficit of Rs. 320 crores for the year 1976-77 amounts to only 2.4% of the total expenditure of the Central Government and constitutes only 0.5% of the national income—the lowest ratio of deficit to national income in the last 20 years. During the year 1975-76, the deficit amounted to 0.8% of the national income without any inflation; in fact prices fell. We have built up a buffer food-stock of 11 million tons which constitutes adequate insurance against the vagaries of the monsoon.

The one part of the Budget which is bound to be gravely detrimental to the national interest is that which embodies changes in the law relating to non-residents. Drastic amendments are proposed by the Finance Bill as regards the computation of the income of non-residents:

(*a*) Non-residents will not get a deduction even in respect of expenses which are legitimately incurred by them for the purpose of earning the taxable income in India. As regards royalties,

technical fees, etc. they will get no deduction for expenses in excess of 20% of the gross amount of the Indian income, if the agreement was made before 1st April 1976; while in respect of agreements made on or after that date, no deduction will at all be allowable in respect of any expenditure however bona fide and necessary.

(*b*) Income which does not accrue in India and which was not deemed to accrue in India upto now will hereafter be deemed to accrue in India by a fiction of law and be taxable accordingly; and this new rule will apply to contracts both pre-existing and future.

(*c*) New rates of taxes are fixed in respect of income which may not be income in the true commercial sense and which is not really taxable in India by any internationally accepted norms.

Such drastic changes are bound to cause apprehensions in the minds of foreign investors. If it is our policy to welcome foreign investment, one can only say that the Finance Bill will frustrate that policy to a large extent. The most disquieting feature of the proposed amendments is that they will apply to existing contracts—contracts which were entered into on the basis of faith in the principles of income-tax law which have been in operation for half a century. Besides, any foreign investor would hereafter take into account the unpredictable mutability of Indian tax laws and provide for a wider margin of profit to safeguard himself against the contingency of unforeseen changes of the same character in future years. This would put a heavier burden on the Indian entrepreneur and would ultimately result in a larger drain on our foreign exchange resources.

Particular mention deserves to be made of the proposed amendment to Section 9 of the Income-tax Act which is truly irrational. Under the proposed amendment, if an Indian borrows money while he is abroad for his personal purposes, Indian income-tax would be deductible from the interest paid abroad on such a loan, although the

entire transaction would take place outside India, the only link between the interest due to the foreign party and India being that the payer of the interest has his ordinary residence in India. Likewise, the amendment seeks to provide that if any Indian resident pays abroad any royalty or fee for technical services rendered to him abroad, Indian income-tax should be payable in respect of such royalty or fee, although the contract and its performance would be entirely abroad and there would be no link between the royalty or fee and India except that the payer would be a resident of India. The important point is that the amendment is not restricted in its operation to such income, royalty or fee as is remitted from India. No state has ever levied income-tax on incomes accruing and received abroad merely on the ground that the man paying the money in any part of the world is its national. If the Revenue can legitimately collect tax in such cases, it can equally levy a tax on a hotel in a foreign country where an Indian goes to stay or dine, or a foreign store where an Indian buys shirts, or a foreign physician or surgeon whose services are required by an Indian while abroad.

The aforesaid proposed amendments deeming foreign interest, royalty and technical fees to accrue in India are *ultra vires* the powers of Indian Parliament which can legislate only for the territory of India. As far as foreigners and foreign income are concerned, the well established principle affirmed by the Privy Council in *Wallace Brothers and Co. Ltd.* v *CIT* (1948 ITR 240 at 246) is that given a *sufficient* territorial connection or nexus between the person sought to be charged and the country seeking to tax him, income-tax may properly extend to that person in respect of his foreign income. The connection must be a *real* one and the liability sought to be imposed must be *pertinent* to that connection. This principle was reaffirmed by the Federal Court of India in *A. H. Wadia* v *CIT* (1949 ITR 63, 72-3) and *Governor-General in Council* v *Raleigh Investment Co. Ltd.* (1944 ITR 265, 278). The proposed amendments seek to charge a foreigner in respect of his income outside India only

because the payer happens to be an Indian resident. *But the nationality or residence of the payer, by itself and without anything more, can never afford a sufficient, real or pertinent territorial nexus to justify the levy of income-tax on a foreigner in respect of his income which has nothing to do with India.* If this part of the Bill is at all enacted into law and its scope and validity are questioned before a court of law, the only alternatives before the court would be either to strike down the provisions as *ultra vires* the legislative powers of Indian Parliament or alternatively to read down the provisions so as to restrict their scope only to those cases where on the facts an adequate nexus does exist between the foreigner's income and India. If the proposed amendments are to make sense, they must be modified and restricted in their scope to those cases where the interest, royalty or technical fee is remitted from India or where the contract to which they relate is performed in India.

The draftsman of the amendments has obviously overlooked not only the territorial limitation on Parliament's legislative competence but also the point that (*a*) the non-deduction of bona fide expenses in computing the taxable income of non-residents and (*b*) the taxation of foreign income which has no sufficient, real and pertinent connection with India, are both clearly against the letter and the spirit of various Tax Treaties entered into by India with foreign countries.

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