THE UNION BUDGET 1998-99 is a Brave Response to Challenging Circumstances

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"Free Enterprise was born with man and shall survive as long as man survives".

– A. D. Shroff
1899-1965
Founder-President
Forum of Free Enterprise

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by

H. P. RANINA *

The first Budget of the BJP-led Government has to be viewed in the light of the macro-economic situation as of April 1998. In some key areas the economy performed well, but in many others the "laggard effect" was clearly discernible.

Turning first to the positive aspects of the economy, total gross domestic savings reached an all time high of 26.1% of GDP at current market prices. The rise in domestic savings was primarily due to a rise in private savings. As a proportion of GDP, private savings increased from 23% in 1995-96 to a peak of 24.2% in 1996-97.

Gross domestic capital formation, as a proportion of GDP at current market prices has continued to surge ahead of gross domestic savings rate to attain a high of 27.3% in 1996-97. Similarly, gross domestic capital formation in real terms as a proportion of GDP at constant prices reached a level of 27.4% in 1996-97.

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* *The author is a noted tax expert. The text is based on a talk delivered at a public meeting under the auspices of Forum of Free Enterprise and other organisations in Mumbai on 3rd June, 1998.*

The performance of infrastructure services showed some improvement in 1997-98. Growth of electricity generation at 6.7% during April-February 1997-98 was higher than the 3.7% growth in the corresponding period of 1996-97, mainly due to a turnaround in hydroelectric generation.

The service sector comprising trade, hotels, transport and communication, financial services, business and public administration has shown a step up in growth to 8.9% in 1997-98. This, to a large extent, has been driven by a surge in the growth of public administration and defence from 6.6% in 1996-97 to 21.3% in 1997-98.

The annual rate of inflation, which was 6.7% at the start of 1997-98, had fallen to an eleven-year low of 3.4% by the end of August 1997. The concern that the increase in the administered prices of petroleum products and electricity during the year would lead to cost push inflation proved unfounded.

The balance of payments situation in 1997-98 remained sound. The current account deficit fell to about 1.0% of GDP in 1996-97 reflecting mainly the slow-down in industrial growth and investment and growth of net invisibles. In 1997-98, the current account deficit is expected to be about 1.5% of GDP, which is significantly less than the average deficit of about 2.3% of GDP during the Seventh Plan period.

"Invisible" receipts accelerated after 1992-93 and the buoyancy was sustained in 1996-97. The upsurge in invisible receipts has been led by the inflow of private

transfer receipts. Tourism receipts, in US dollar terms, have also risen at a rate of about 8.2% per annum during the four years ending with 1996-97. The inflow of invisible receipts in recent years has been augmented by a noteworthy improvement in software and technology related exports.

Despite a significant increase in travel payment and some increases in interest and dividend payments, the net surplus under invisibles has recorded a five-fold increase during the Eighth Plan. As a result, the net inflow under invisibles financed about 74% of the trade deficit in BOP in 1996-97, up from about 35% in 1992-93.

ADVERSE ECONOMIC TRENDS

The process of fiscal consolidation received a setback during 1997-98 with the Central Government's fiscal deficit reaching 6.1% of GDP, as against the budget target of 4.5%. Concomitantly, the primary deficit was 1.7% points of GDP higher than budgeted.

The deterioration in the fiscal deficit was primarily due to a tax revenue shortfall of Rs. 14,236 crore (net to Centre), and a shortfall of Rs.3,894 crore in disinvestment receipts. Both customs and excise revenues were well below the budget estimates, the former on account of both lower volume and unit price of imports, and the latter because of unexpectedly low industrial growth. However, total expenditure exceeded the Budget estimated by only Rs. 3,069 crore.

Overall economic growth of GDP has decelerated significantly to 5% in 1997-98 from 7.5% in 1996-97. There has also been a fall in the average rate of

inflation during 1996-97. The average rate of growth of the economy rose from 6% per annum in the Seventh Plan (1985-90) to 6.8% in the Eighth Plan (1992-97).

The demand slow-down in industry is attributable to several factors including the sharp deceleration in exports since 1996-97, substantial uncertainty in domestic and international environment, tightening of money-credit policies in 1995-96 and other cyclical factors. The reduction in the domestic investment-saving gap during 1996-97 and the low inflation rate during 1997-98 support such a demand side explanation.

Agricultural production in 1997-98 is likely to be lower than last year's record output especially of foodgrains and commercial crops. Foodgrain output will, however, be higher than in 1995-96. The production of foodgrains during 1997-98 is expected to be 195.1 million tonnes compared with 199.3 million tonnes during 1996-97, representing a decline of 2.6%.

Industrial production has grown by 4.2% in 1997-98. This is composed of a growth rate of 4.9% in mining, 3.6% in manufacturing and 6.8% in electricity. As per the use-based classification, intermediate goods and basic goods grew at 6.9% and 7.0% respectively, whereas consumer goods registered a growth rate of 4.6% and capital goods suffered a decline of 4%.

The capital market continued to remain dormant in 1997-98. Resource mobilisation from the primary market through public issues steadily declined to Rs. 14,276 crore in 1996-97 and further down to Rs. 4,570 crore in 1997-98. The secondary market witnessed net FII sales

for the first time in November 1997. Though net FII investment remained negative in December 1997 and January 1998, it was positive in both February and March 1998.

In spite of the sharp declaration in import growth, the trade deficit in 1996-97 widened by about $2.9 billion (BOP basis), because the growth of exports also decelerated sharply. The continued sluggishness in export growth for the second year in succession in 1997-98 is a cause for concern. Based on DGCI&S data, export growth, in US dollar terms, decelerated to 5.3% in 1996-97 and to 2.6% (provisional) in 1997-98 after three successive years of increase ranging from 18 to 21% per annum.

Having set out the prevailing economic scenario, it would be relevant to turn to some of the policy announcements of the Finance Minister. He has been extremely sensitive to the needs of the vulnerable sections of society. Apart from increasing the initial exemption limit, the standard deduction and the medical allowance, he has ensured that closure of unviable public sector enterprises will not hurt the working class who will be given substantial amounts by way of compensation.

The Finance (No.2) Bill, 1998, has made several provisions which are based on the recommendations of the Expert Group for drafting a new Income-tax Law which was appointed by the former Finance Minister, Mr. P. Chidambaram, in August 1996. Some of the salient recommendations which have been accepted in this year's Budget pertain to exemption of capital gains

in case of business reorganisations, allowing depreciation on intangible assets, exempting stock options from tax, giving immunity from interest and penalties where a tax-payer elects to avoid litigation.

No specific provision has been made to revive the somnolent capital market which will continue to remain sluggish. Debt instruments will continue to be favoured by investors for reasons of safety and security and for ensuring a fixed return on investments. This would be at the cost of the primary and secondary market in shares of listed companies.

The Finance Minister has taken a firm view in raising resources by increasing the customs duties, though this has been justified on the ground that it will protect Indian industry. While the rationalisation of the excise duty structure is long overdue and a new excise code is proposed to be introduced in the next Budget session, the restriction on set-off of Modvat benefit will impose a higher burden on industry.

The reform of the financial sector will help in strengthening the banks, which will ensure that the problems faced by banks in South East Asia do not surface in this country. The finest act of the Finance Minister in this year's Budget is to give the requisite boost to housing, infrastructure and the software industry. The abolition of the Gift-tax Act was long overdue, though the treatment of gifts as income militates against the basic premise for levy of income tax.

The expanding of the service tax base covering several professionals from business management consultants to

architects and chartered accountants, will be resented by a large section of professionals. If at all it is to be levied, the service tax should be administered by the Income-tax Department and not by the Excise Department as at present.

The opening up of the insurance sector to private entrepreneurs ought to have been done boldly rather than apologetically. It is imperative that foreign capital, technology and expertise are brought in so that better service is provided to the large universe of insurance policy holders.

The proposed abolition of the Foreign Exchange Regulation Act is long overdue. The introduction of the new Foreign Exchange Management Act and the Money Laundering Bill will ensure continuation of the policies adopted by the previous Government to bring laws in tandem with the needs of modern business exigencies.

SPECIFIC PROVISIONS FOR THE CORPORATE SECTOR

The Finance Minister has ensured a stable fiscal policy governing the industrial sector and, at the same time, tried to meet some of the pressing demands of industry. Some of the important measures are discussed below, one of which will particularly assist in reorganisation of business by proprietors and partnership firms.

Under the existing provisions of the Income-tax Act, 1961, business reorganisations have adverse tax implications. Transfer of assets attracts levy of capital gains tax. Similarly, carry forward of losses and

unabsorbed depreciation are not available to successor business entities.

The Expert Group set up in 1996, had recognised the need to encourage business reorganisations when they are in consonance with the objective of economic development and are not merely devices to secure a tax advantage.

The Bill proposes to allow tax benefits in case of business reorganisations where a firm is succeeded to by a company in the business carried on by it or a proprietary concern is succeeded by a company. The transfer of any building, machinery, plant, furniture or intangible assets to the company would not attract capital gains tax, subject to fulfilment of certain conditions.

The conditions are -

(i) all assets and liabilities of the firm become the assets and liabilities of the company,

(ii) the partners of the firm become the shareholders of the company in the same proportion in which they hold shares in the firm,

(iii) no consideration other than shares arises to the partners, and

(iv) the aggregate shareholding of the partners in the company is atleast 50% for a period of 5 years from the date of succession.

Similar conditions are also stipulated in the case of a

sole proprietary concern being succeeded by a company. The Bill provides for carry forward of business loss and unabsorbed depreciation to successor companies fulfilling the aforesaid conditions.

It is important to note that the aggregate depreciation allowable to the predecessor and successor would not exceed in any previous year the deduction calculated at the prescribed rates as if the re-organisation has not taken place.

Under the existing provisions, depreciation is allowable when building, plant, machinery or furniture is used by the assessee for the purposes of his business or profession. To widen the scope of section 32, it is provided that depreciation will also be allowed where intangible assets are owned wholly or partly by the assessee and are used by such assessee for the purposes of his business or profession. Intangible assets, such as know-how, patent rights, copyrights, trade marks, licences, franchises or any other business or commercial rights of the assessee will form a separate block of assets.

As and when any capital expenditure is incurred by an assessee on acquiring such intangible assets, the amount of such expenditure would be added to the block of intangible assets and depreciation would be claimed on the written down value at the end of the financial year.

Under section 80-IA, undertakings presently engaged in the commercial production of mineral oil are entitled to a 7 year tax holiday benefit. With a view to

encouraging oil refining within the country in view of the increased demand, it is proposed to extend the benefit of such tax holidays to undertakings engaged in refining of oil. This benefit would be available to such undertakings which commence production on or after 1st October, 1998.

Under the provisions of section 80-IA, roads, highways, bridges, airports, ports and rail system are regarded as infrastructure facilities and the undertakings engaged in providing or maintaining such infrastructure facilities are entitled to a tax holiday for 5 years and a deduction of 30% of profits for the next 5 years. These companies have the choice of availing of such benefits in any ten consecutive years out of the initial twelve years from the year in which they commence construction.

Under the provisions of section 80-IA of the Income-tax Act, a five-year tax holiday and a deduction of 25% (30% in the case of companies) of profits in the subsequent five years is allowed, inter-alia, to an undertaking engaged in the business of generation, or generation and distribution, of power. The undertaking under the existing provisions should start generating power on or before 31st March, 2000. The date is now extended to 31st March, 2003.

For encouraging industrialisation in industrially backward States, the Finance Act, 1993, had provided for a five-year tax holiday for industrial units set up in industrially backward States specified in the Eighth Schedule, which start manufacture or production during the period beginning on the 1st day of April, 1993 and ending on the 31st day of March, 1998.

The Bill proposes to extend the tax holiday to undertakings set up in industrially backward States as specified in the Eighth Schedule which start manufacture/production even after 31st March, 1998 but before 1st April, 2000.

Waste management is a major concern for planners in all countries. For effective waste management, the role of waste pickers of the informal sector who separate bio-degradable waste and assessees who actually collect, process and treat it, is significant in enabling local authorities in both urban and rural areas to provide better sanitation and hygiene to the populace.

The bio-degradable waste can be utilised for purposes of generating energy and also for preparing organic manure by composting, vermicompost and anaerobic digestion. With a view to providing benefits to assessees who are engaged in such activities, a deduction of 100% of income derived from such activity or an amount of Rs. five lakhs whichever is less, shall be allowed.

The existing provisions of the Income-tax Act provide various fiscal concessions to spur growth of business and industry. In order to encourage employers to generate more employment opportunities, it is proposed to insert a new section 80-JJAA to provide an incentive in the form of a special deduction against business profits of a company.

This deduction would be over and above the expenditure on wages or salary, which is otherwise allowable as business expenditure to the company. The quantum of deduction is proposed to be thirty percent

of the aggregate wages or salary paid to new workers provided the following conditions are satisfied.

In the case of a new undertaking, the number of workers should be atleast one hundred. In the case of an existing undertaking, having a minimum of atleast hundred employees, the total number of new employees should be atleast ten percent more than the existing number of employees. The deduction in such cases would be allowed at the rate of 30% of the additional wages paid to new workmen.

Tax holiday is provided to enterprises carrying on the business of developing, maintaining and operating any infrastructure facility under section 80-IA (4-A). It is now proposed that this deduction may be extended to housing projects approved by a prescribed authority under the scheme to be framed by the Central Government.

The issue relating to whether the value of closing stock of inputs, work-in-progress and finished goods must necessarily include the element for which MODVAT credit is available has been the matter of considerable litigation.

In order to ensure that the value of opening and closing stock reflects the correct position, it is proposed to insert a new section 145-A to clarify that while computing the value of the inventory as per the method of accounting regularly employed by the assessee, the same would include the amount of any tax, duty, cess or fees paid or liability incurred for the same under any law in force.

It would now be relevant to deal with provisions pertaining to individuals. While computing the income from house property, a deduction equal to one-fifth of the annual value of the property is allowed in respect of repairs and collection of rent from the property under section 24 (1) (i) of the Income-tax Act. Enhancement of this deduction would encourage better maintenance of the existing housing stock. Hence, the percentage of this deduction is increased to one-fourth of the annual value.

To provide an incentive for self-occupied housing, it is proposed that the allowance for interest paid on capital borrowed for construction, repairs, renewals, etc. of house property would be raised from fifteen thousand rupees to thirty thousand rupees per annum.

Under the existing provision, loss from house property is not allowed to be carried forward for set-off against income arising in subsequent years. It is proposed to insert a new section 71-B so that where the net result of computation under the head income from house property is a loss, then such loss will be adjusted against income under other heads in the same assessment year and any balance loss remaining would be allowed to be carried forward and set-off in subsequent assessment years upto a maximum of eight assessment years against income from house property.

It is proposed to reintroduce the deduction allowed under section 80-GG in respect of any expenditure incurred by an assessee in excess of 10% of his total income towards payment of rent in respect of any furnished or unfurnished accommodation occupied by him for the purpose of his own residence to the extent of Rs. 2,000 per month or 25% of his total income, whichever is less.

In order to have continuity, the proposed amendment will take effect from 1st April, 1998 and will, accordingly, apply in relation to the assessment year 1998-99 and subsequent years.

Under the existing provisions of section 16 of the Income-tax Act, standard deduction of a sum equal to 33-1/3% of the salary or Rs. 20,000, whichever is less, is allowed to an individual having income from salary.

With a view to minimising the hardship that is likely to be caused to employees and also pensioners who are receiving salary or pension in the income slab of Rs. 5,000 to Rs. 7,500 per month, the Bill proposes to raise the limit of standard deduction for assessees having salary income upto Rs. 1,00,000 from Rs.20,000 to Rs. 25,000.

Under the existing provisions, any sum paid by the employer in respect of any expenditure actually incurred by the employee on his medical treatment or treatment of any member of his family, other than the treatment referred to in clauses (i) and (ii) of the proviso to section 17 (2) of the Income-tax Act to the extent of ten thousand rupees is not included in the 'perquisite' of the employee. This limit is to be increased to rupees fifteen thousand.

A new scheme seeks to provide a quick and voluntary settlement of tax dues outstanding as on 31.3.1998, both in various direct tax enactments as well as indirect tax enactments by offering waiver of a part of the arrear taxes and interest and providing immunity against institution of prosecution and imposition of penalty. The assessee on his part should withdraw appeals pending before various appellate authorities and Courts.

The Scheme comes into force on 1st September, 1998 and ends on 31st December, 1998. It will have the following salient features :-

(i) The declarant would be required to pay tax at the rate of 30% (35% in the case of firms and companies) on the amount of income in dispute (in other than search and seizure cases).

(ii) Where tax arrears include income-tax, interest payable or penalty levied, the amount payable would be 30% of the disputed income (35% in the case of firms and companies).

(iii) Where tax arrears comprise only interest payable or penalty levied, the amount payable would be 50% of the tax arrears.

(iv) Where tax arrears includes the tax, interest or penalty determined in any assessment on the basis of search and seizure proceedings under section 132 or section 132-A of Income-tax Act, the amount payable would be 40% of the disputed income (45% in the case of firms and companies).

(v) In respect of arrears under Wealth-tax Act, the amount payable would be 1% of the disputed wealth where the tax arrears include Wealth-tax or interest and penalty levied in addition to Wealth-tax. Where tax arrears is only interest payable or penalty levied, 50% of such amount is to be paid. Where the tax arrears are determined on the basis of search and seizure proceedings under section 37-A or 37-B of the Wealth-tax Act, the tax

payable would be at the rate of 2% of the disputed wealth.

(vi) In respect of tax arrears payable under the Gift-tax Act, the amount payable would be 30% of the disputed value of the gift where the tax arrears includes Gift-tax or interest payable and penalty levied in addition to Gift-tax. Where tax arrears is only interest payable or penalty levied, 50% of such amount would be payable.

To conclude, the BJP-led Government's maiden budget proposals not only ensure continuance of all existing benefits but also provide for several new incentives which will be a boon to entrepreneurs, both Indian and foreign, who propose to invest in the core sector. The Finance Minister's day of triumph will come when his Budget proposals result in Indian industry once again reaching the 8% rate of growth, which, in turn, may lay the foundation for macro-economic stability.

What remains to be seen is whether the Government will be able to manage the economy effectively so as to blunt the impact of inflationary pressures. If inflation is kept in check and not allowed to rise beyond the rate of 6%, if industrial growth once again touches the 8% mark, if the fiscal deficit is restricted to no more than 5.5% of GDP, Mr. Yashwant Sinha would richly deserve the gratitude of the Nation for steering the economy through turbulent times.

The views expressed in this booklet are not necessarily those of the Forum of Free Enterprise.

"People must come to accept private enterprise not as a necessary evil, but as an affirmative good".

– Eugene Black

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