ECONOMIC INFIRMITIES WILL CONTINUE UNDER THE UNION BUDGET 1996-97

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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

ECONOMIC INFIRMITIES WILL CONTINUE UNDER THE UNION BUDGET (1996-97)

by

H. P. Ranina*

The Union Finance Minister, Mr. P. Chidambaram, in his maiden Budget Speech, has taken an approach so as to ensure that criticism from the parties supporting his Government is minimal. His stress on working within the framework of the Common Minimum Programme permeates throughout his Budget Speech.

There is no doubt that the Finance Minister has made every possible attempt to please the farmers' lobby and step up expenditure on rural development, for which an additional expenditure of more than Rs. 1,000 crore has been provided. There is a whopping increase of almost Rs. 1,700 crore in respect of social services, the bulk of such additional amount going to education.

His emphasis has been in three broad areas - (1) stabilising the fiscal imbalance; (2) poverty alleviation; and (3) promoting infrastructural development.

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* Mr. Ranina is an eminent authority on taxation and renowned author of several books. The text is based on a public lecture in Mumbai under the auspices of the Forum of Free Enterprise and several other organisations.

FISCAL DEFICIT

Towards the first goal, the Finance Minister has sought to restrain the budgetary deficit to Rs. 6,578 Crore, which is almost 5% of the Gross Domestic Product. To what extent he succeeds in doing so, remains to be seen.

In this context, it may be pointed out that when his predecessor, Dr. Manmohan Singh, estimated the deficit for 1995-96 at Rs. 5,000 crore when he introduced his Budget in February 1995, the actual budgetary deficit has increased by more than 50% and is estimated to be Rs. 7,600 crore for the preceding financial year. Hence, it remains to be seen whether Mr. Chidambaram will be able to maintain the budgetary deficit to the figure which he has arrived at.

A reading of the Budget papers shows that the customs duty accounted for the financial year 1996-97 is Rs. 44,435 crore, which is almost Rs. 15,000 crore more than what was budgeted for by his predecessor for 1995-96. Such an increase in collection of customs duty by almost 50% may not actually materialise, despite the 2% all round increase in customs duty. Perhaps, the Finance Minister has been too optimistic on the buoyancy of customs duty collection and if this optimism does not pay off, the budgetary deficit is definitely going to be much higher than projected, leading to serious doubts about fiscal discipline being maintained.

The best news is that he has decided to appoint a high level expenditure management and reforms Commission which is supposed to give its report within four months.

POVERTY ALLEVIATION PROGRAMMES

On the second objective of poverty alleviation, full marks must be given to the Finance Minister as he has left no stone unturned to provide adequately for schemes for the benefit of the vulnerable sections of society, specially those in the rural areas. However, the main challenge which he will hereafter face is to ensure that the money which he has earmarked reaches the sections of society for whom it is meant and that leakages are avoided. His predecessor had also made announcements of various schemes, but the implementation thereof has been lagging behind and no worthwhile benefit has been reaped by the beneficiaries of those schemes.

It has also to be seen whether, as a result of implementing scores of such schemes, the bureaucratic network would be increased. The Government is already spending almost Rs. 20,000 crore on salaries, allowances and pension for Central Government officers and staff. In this context, it has to be pointed out that the Finance Minister has budgeted for almost Rs. 4,000 crore in addition to what was budgeted for in 1995-96 to cover the cost of general services, including tax collection and external affairs.

INFRASTRUCTURE DEVELOPMENT

The third objective of promoting infrastructural development is undoubtedly the crying need of the hour. When the requirement of resources in this area is around Rs. 2,00,000 crore, the proposal of setting up the Infrastructure Development Finance Company with an allocation of Rs. 1,000 crore will only scratch the surface of the problem.

To what extent the IDFC will induce investors to invest in infrastructural projects has not been outlined by the Finance Minister. Likewise, his allotment of Rs. 200 crore to the National Highway Authority to enable it to leverage resources, will hardly make any impact in solving the problem of constructing 10,000 Kms. of national highways.

The figures for investment are indeed mind-boggling. A network of six-lane expressways estimated at Rs. 12 crore per kilometre, would require Rs. 120,000 crore if a 10,000 Kms. network is to be put in place, connecting every major industrial and agricultural hub to the ports of India. Upgradation of ports and establishment of new ones require another Rs. 45,000 crore. Power generation would easily absorb Rs. 60,000 crore, despite other projects coming up in the private sector. Upgradation of telecommunication facilities and expanding the network would require a minimum investment of Rs. 25,000 crore.

DEVELOPMENT FUND

Hence, over the next fifteen years, a whopping amount of Rs. 250,000 crore would be necessary for ensuring that infrastructure is remotely comparable to world standards. The Finance Minister has merely scratched the surface of the problem by taking the first step towards the establishment of the Infrastructure Development Finance Company with an authorised capital of Rs. 5,000 crore of which Rs. 500 crore would be contributed from budgetary resources and Rs. 500 crore by the Reserve Bank of India.

However, a finance company has a limited role to play. It can only act as a catalyst to promote investment in this sector. Even if the capital is leveraged substantially and borrowings are attracted at low international rates, about Rs. 25,000 crore would be mopped up over the next five years. This is woefully inadequate, having regard to the aforesaid quantum of funds.

If the expressway projects have to be set in motion, the first step in that direction would be to make a serious attempt to acquire land in the earmarked areas where the expressways are to be constructed. This can only be done by the Government in view of the powers it has under the Land Acquisition Act. A substantial amount of resources have, therefore, to be allocated for land acquisition. In fact, it is estimated that 35-40% of the cost of an expressway would go in land acquisition.

Apart from allocating Rs. 200 crore to the National Highway Authority for strengthening the existing highways, no allocation has been made for land acquisition in respect of the expressway project. Perhaps, the Finance Minister has deferred this to his February 1997 Budget.

The country needs large investments in the area of public health and irrigation. In order to attract commercial enterprises to operate such facilities, the Finance Bill, 1996, proposes to extend the benefit of tax holiday to other infrastructure facilities like water supply projects, irrigation systems, sanitation and sewerage systems.

At best, the aforesaid provisions will help the Government to begin the process of infrastructure development. However, it will be a very small beginning. The crying need of the hour is to start infrastructural development on a war-footing by taking up projects selectively where there is maximum need for ensuring the movement of goods and materials, and for power in deficit areas. The surface Transport Ministry and the Power Ministry also have to swing into action immediately, whether it is for carrying out feasibility studies or for inviting international tenders from contractors.

It has to be emphasized that the entire prospect of attracting U.S. $ 10 billion a year by way of foreign direct investment, as promised by the United Front Government, will hinge on infrastructural projects. Any slackening in the implementation of these projects would mean a fall in foreign direct investments, which without the infrastructural projects would bring in no more than U.S. $ 3-3.5 billion per annum in the next two years.

MINIMUM ALTERNATIVE TAX

The proposed section 115-JA which is meant to levy a Minimum Alternative Tax on limited companies is a totally regressive step. In the first place, it is discriminatory as the tax on book profits will not apply to sole proprietors, partnership firms and other non-corporate assessees. Further, it will have the effect of penalising companies which work in tandem with national priorities laid down by the Government itself, namely, export promotion, scientific research and development, new industries being set up in backward and notified areas, and generally those who plough back their profits in creation of additional productive assets.

In fact, this proposal will adversely affect such existing units because it will whittle down the effect of the existing provisions of sections 80-HHC, 35, 80-IA, etc. Conceptually, zero-tax companies have come into existence at the instance of the Government itself which has consciously decided to prescribe one rate of depreciation under the Companies Act, 1956 and another under the Income-tax Rules, 1962. But for this, zero-tax companies would not exist. Hence, it is economically unsound and morally unjustifiable to now levy a minimum tax only on companies which have set up their businesses to conform to national priorities.

LIQUIDITY CRUNCH

The biggest problem facing industry today, and which is having a deleterious effect on its growth, is the paucity of capital both for financing new assets as well as for working capital requirements. Even if money supply is expanded during the coming months, the Government's appetite for borrowing is so great that a substantial part of the new money supply will be absorbed by it. Hence, industry and business ventures will continue to be starved of funds for their legitimate needs and interest rates will continue to rule at the preposterously high level of 20%, making some of the ventures unviable.

To compound this problem, it is now proposed by amending section 43-B of the Income-tax Act to disallow interest payable to scheduled banks in the year in which such interest accrues and is due. In other words, even where the business unit follows the mercantile system of accounting, the interest will become deductible only on cash basis in the year of payment. This amendment will also lead to litigation, because it will be difficult for a businessman or company to prove that interest is actually paid where a running cash credit account is operated.

NO INCENTIVES FOR SAVINGS

While the rate of savings has come down drastically in the last few years from 24% to about 19%, no worthwhile benefit is given to individuals to increase their ability to save. A very small change made in the first slap of income-tax by reducing the rate from 20% to 15% will have no effect in boosting the savings rate. The new scheme to be framed by the Life Insurance Corporation of India for enabling a person to earn a pension after he reaches the age of 60, will only benefit those who are under 30 years.

The taxability of amounts received under the Keyman Insurance Scheme will also have a dampening effect on savings. An Insurance Scheme is one of the important measures for mopping up savings, and it is for this reason that amounts received on maturity of insurance policies have so far been exempted. The exception now proposed to be made for taxing maturity proceeds for the Keyman Insurance Policy, on the ground that the premium was deductible to the payer, will make this savings scheme unattractive.

CAPITAL MARKET REVIVAL

It is a well-known fact that the capital market currently is totally driven by foreign institutional investors. This is for the simple reason that they alone are investing funds, whereas individual investors have remained shy of investing, partly on account of the liquidity problems facing the economy and partly due to the dim prospects of capital appreciation despite companies coming up with encouraging results and better performances.

Investor confidence is one of the important factors which is globally recognised as a barometer of the capital market's performance. Whenever investor confidence falls, the share market takes a bearish trend, but when the confidence of investors is on the upbeat, buoyancy in the market becomes inevitable.

EXEMPTING DIVIDENDS

The Finance Minister could have easily changed the mood of investors by coming up with certain measures which would have involved very little sacrifice in revenues. The abolition of tax on dividends would have done wonders in galvanising the capital markets in India, and this move was specially justifiable with the Government introducing the Minimum Alternative Tax on companies to ensure that every company contributes a certain amount by way of corporate tax to the Exchequer. The double taxation of the same income, in view of the corporate tax and the tax on dividends, is economically unsound and morally indefensible.

The loss of revenue by exempting dividends from tax would not be more than Rs. 75 crore, considering the fact that, at present, the largest Indian players, namely, the Unit Trust of India and approved mutual funds have exemption from tax on their dividend income. Finance and investment companies also get the benefit of intercorporate dividend relief under section 80-M of the Income-tax Act and, therefore, do not pay the tax. Most foreign institutional investors keep the tax burden very low by taking the Mauritian route.

Hence, it is only the individual investors who have to pay the tax and the small ones get the benefit of section 80-L of the Act upto Rs. 10,000/- per annum. Thus, the actual tax-paying population on dividends is negligible, and, therefore, the loss of tax if dividends are made exempt would be minimal. However, it would have a tremendous impact in changing the investors' confidence in the capital market. It would also ensure that investors from smaller towns and semi-rural areas would invest a part of their savings in the capital market.

CAPITAL GAINS EXEMPTION

Further, the rationalisation of the capital gains tax provisions by allowing reinvestment of sale proceeds in acquisition of shares and debentures listed on the stock markets would have brought about a seachange in investor confidence levels. Instead of doing that, the introduction of the new privisions — sections 54-EA and 54-EB — would only mean diversion of sale proceeds of long-term capital assets towards investment in notified bonds, debentures and specified assets.

Such assets are obviously going to be those which are under the control of the Government or governmental institutions. One such bond which is likely to be notified by the Government for this purpose would be an instrument brought out by the newly set up infrastructure Development Finance Company.

Hence, it is apparent that there will be substantial diversion of funds from the capital market to the new instruments which the Government will bring out in order to monopolise the savings of the people. Possibly, the bonds will be made even more attractive by providing exemption of interest. In course of time, the list of specified assets will be increased to ensure flow of funds to the socially-oriented sectors.

The only pro-market proposal of the Finance Minister is to permit foreign institutional investors to increase their holdings from 5% to 10% in a particular company, subject to the overall ceiling of 24%. The reduction in the rate of long-term capital gains tax for domestic companies from 30% to 20% will help investment and finance companies to a limited extent.

NON-VOTING SHARES

The other measure proposed by the Finance Minister is to meet the long-standing demand of Indian industrialists, namely, the right to issue non-voting shares. The important point is that these shares are not going to be popular with the average investor for the simple reason that the share price of these shares will always be less than the price of the normal shares issued by the same company. This is for the obvious reason that in case of a management take-over, the non-voting shares would have no role to play.

Further, foreign institutional investors have not taken kindly to this proposal because their experience in other countries has shown that this instrument is utterly unpopular with investors. In fact, it would only increase the liquidity of the scrip in the market, thereby dampening its price. The fall in the share market indices after the announcement of the Budget proposals is substantially attributable to foreign institutional investors unloading shares of those companies where there is a possibility of issue of non-voting shares.

INDIRECT TAXES

Sectorwise, the textile industry has gained the maximum out of the indirect tax proposals, since the rate of excise duty on polyester filament yarn is reduced to 40%. The extension of the MODVAT credit to fabrics would also be helpful. The recategorisation of duty structure on motor vehicle industry should help the automobile sector, which will also benefit from the reduction in import duties on steel products.

The electronic goods industry and manufacturers of computers will also gain as a result of the drastic reduction in customs duty. Reduction in the peak rate of duty from 50% to 40% on pharmaceutical products as well as on organic and inorganic chemicals would also help certain publicly listed companies.

The increase in raw material costs and freight rates will hurt the steel industry as a result of manufacturing costs going up. The same will be the impact on the cement industry, except that a reduction in import duty on non-coking coal will bring some relief.

Consumer durables, notably personal care items, and detergents will considerably benefit by the lower cost of raw material inputs on account of decrease in customs duty. Fortunately, most of the detergent manufacturers have passed on the benefit of lower duties to consumers.

OTHER MEASURES

In the medium-term scenario, the best news for the capital market is the setting up of the depository systems, which, in course of time, should bring about paperless trading. This factor will enthuse more and more individual investors, specially from the rural areas, to divert part of their savings to the capital market.

Unfortunately, the Finance Minister has made no attempt to tackle the problem of a growing public debt which will gobble up Rs. 60,000 crore of revenue expenditure in 1996-97 in the form of interest payments. Even the disinvestment proposal of PSU shares which is expected to fetch him Rs. 5,000 crore, will be utilised for socially-oriented schemes rather than repayment of debt which, in turn, would reduce the interest burden.

CONCLUSION

The Finance Minister was expected to come up with innovative measures to accelerate the rate of growth to bring it into double digits, as well as to raise non-tax revenues and reduce governmental expenditure. Apart from permitting companies to issue non-voting shares, nothing exciting has been proposed which would achieve the aforesaid objectives. The Government machinery will become even more flabby than before considering the number of schemes to be implemented. Tax evasion and generation of black money will also continue with no effective steps being proposed to curb them.

The Finance Minister has clearly an unfinished agenda not only for increasing the level of savings of the Indian people, but for accelerating industrial growth. His real test will be in February 1997 when he will have to come up with new innovative ideas to give the right fillip to the capital market and ensure a higher rate of savings for the people.

In the final analysis, Mr. Chidambaram will have to ensure that during his tenure the rate of industrial growth is sustained at the current level of 12% and that there is no negative trend in corporate performance.

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

— Eugene Black

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Published by M. R. PAI for the Forum of Free Enterprise, 235, Dr. D. N. Road, Mumbai 400 001, and Printed by S. V. Limaye at India Printing Works, 42, G. D. Ambekar Marg, India Printing House, Wadala, Mumbai 400 031.

15/Aug/1996