

The Budget Outlook, 2005

With the announcement of the Union Budget by the Finance Ministry on February 28, 2005, and introduction of several reforms, there is a discussion going on in various quarters of industry and business on the viability of these decisions and their contribution to economic growth and achievement of specified objectives. In this debate, we try to put forth the opinions of some experts on these ticklish issues.

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Union Budget 2005 announced that the fringe benefits to the employees will now be taxable in the hands of the company at the rate of 30%. How do you perceive the government's move in this regard? Will it not result in the reduction of benefits provided to employees in the long run?

Sundar Sankaran: Lower tax rates would be good for the economy as a whole. If we want tax rates to go down, then tax avoidance through payment structuring has to be plugged. When one party gets a tax break on some expenditure, it should be a taxable income in the hands of the recipient. The Fringe Benefit Tax (FBT) is a step towards implementing this principle. It may appear unfair in a micro sense, but it is good in a macro sense.

Atul Sarma: The budget proposal of FBT has valid theoretical justification: Treating equals as equals irrespective of types of income, in cash or in kind. It will undoubtedly reduce a part of benefits provided to employees as it would be, if money equivalent of the fringe benefit is paid. It may however, introduce some complexity in tax implementation.

Ashok Banerjee: The FBT is a poorly thought out and difficult to implement provision in the budget. The Finance Minister's argument that employees, around the world, are taxed on Cost to Company (CTC) basis and hence should similarly be taxed in India fails to realize that the incidence of FBT would only increase such CTC. Also, it would be very difficult to prove which expenses are meant for business purposes and which would figure as fringe benefits. Salary and

Note: The views expressed by the participants are their own, and do not necessarily represent the views of the organizations they are associated with.

other associated benefits paid/offered by a company to its employee(s) are genuine business expenses and hence logically the company should rather get tax benefit on such expenses. Hence, FBT might invite the old regime of unnecessary intervention by income tax authorities on the slightest pretext which will lead to consequent harassment of corporate assesseees.

D Tripathi Rao: The FBT neither strictly follows the canons of taxation nor is it clear in its intent. While tax reforms in the post 90s aimed at procedural simplification, FBT is a contrarious move, which will make tax calculations quite mischievous. Is one going to club (sales) promotional and other 'face-lift' expenditures of the company along with the add-on perks and allowances given to the employee as FBT? Therefore, the question remains how would you identify in transactional space where essential benefits end and fringe benefits begin, provided by the employer. In the end, it may land up as a tax to the employee not to the employer if the later successfully shifts the final incidence on the former or the employer prunes the add-on benefits. Though, it should be acknowledged that since the introduction of tax deducted at source system, the corporate houses indulged in practicing what is called as 'Cost to Company' (CTC) benefit from tax exemption, which includes all the fringe benefits such as, free meal, palatial office space, chauffeur driven car and etc., given to the employee. Thus, companies can avoid paying tax by showing much of these dolled out benefits as cost to the company. From a policy point of view, if tax revenue maximization is the objective, better ways of doing it can be explored including bringing more and more areas in to tax net, ala, agriculture.

Tarun Das: This proposed tax is for the employer to pay. It will cause confusion – it already has. Perhaps, a review will enable the tax to be simple in form and administration so as to avoid disputes and litigation. I would have preferred the corporate tax rate to remain where it was and not FBT.

Banks and the common man are strongly opposing the government's decision to impose a cash withdrawal tax at the rate of 0.1% on the withdrawal of Rs.10,000 or more on a single day from an account. Is it the protest or the government's move which is justified?

Sundar Sankaran: How many of us withdraw Rs. 10,000 per day? And on how many occasions? It will not hurt the predominant majority. What might be required is a provision for emergencies e.g., withdrawals above Rs. 10,000 in a day could be still exempted up to Rs. 300,000 of such withdrawals during a year. In a way, the 0.1% withdrawal tax would operate as an expenditure tax. Trust the Finance Minister to raise the tax rate in the next budget, once the country accepts this new tax!

If we want tax rates to go down, then tax avoidance through payment structuring has to be plugged

– Sundar Sankaran

Atul Sarma: Tax on cash withdrawal intended to curb black money will not meet the desired outcome. A large part of black income is invested in gold and urban property. Eventually, the incidence of the tax would fall on those who have already paid income tax or those who are outside the tax network.

Ashok Banerjee: This recommendation is already under review and there are reports that the threshold limit may be significantly raised or the withdrawal of cash from savings bank account may not attract the 'cash withdrawal tax'. But the moot point is this, is it a mean way of raising revenue? Although, our Finance Minister says that this provision is aimed at unearthing black money and would be used as audit trail, the fact of the matter is that an estimate shows that the government can easily collect around Rs. 3,000 cr through this tax. Hence, it is more a revenue enhancing measure than a compliance measure. The cash withdrawal tax would also create operational hazard. It is well-known that many companies withdraw large amount of cash at the beginning of each month for salary disbursement. Such withdrawals are for genuine business purposes and hence it would be highly illogical to charge tax on these cash withdrawals.

D Tripathi Rao: The government decision to impose a cash withdrawal tax at the rate of 0.1% on the withdrawal of Rs. 10,000 or more on a single day has two fold aims: One of promotion of cashless economy through financial innovation – cheque-based, credit- and debit-card-based transactions and e-commerce, and the other of unraveling hidden black economy. However, given the nascent stage of financial development in India, it is impossible to think about a quick transition to a cashless economy. Unlike, the developed countries, more than 90% of the business carried out by the unorganized sector or non-incorporated business sector and much of the informational and technological advantage is yet to diffuse in to the vast rural India. Therefore, the payment made for the host of services rendered by manual laborers, housemaids, cook, barber and milkman are done through cash in India. Moreover, well defined property rights and legal institutions are preconditions for a cashless economy. Whereas, unraveling the black economy, tax on cash withdrawal as a policy choice is far off the mark.

Tarun Das: The purpose of this tax, i.e., to address the issue of black money is not something to be questioned. Whether it will serve its purpose is the main question. Will it lead to people keeping money in cash rather than putting it in a bank account?

In your opinion, how will the recent budget affect the current bearish fixed income market in the medium to long-run? Do you think the current trend is temporary or is it going to last long?

Sundar Sankaran: The government has been talking of a stable interest rate regime for the next six months. But it would really depend on two factors – inflation and government borrowings. Inflation in India is more of cost push type. Petrol price increases could feed in a moderate inflation. Price rise of 5% appears to have been factored into the debt markets. Government borrowings might be less of a concern, so long as foreign currency flows into the Indian system – through FDI, FII investments or export earnings - remain robust. The bottom line is that I would bet on the equity markets this year, not the debt market.

Atul Sarma: The fixed income market behavior essentially depends on the price situation. If price stability could be maintained, there need not be any adverse impact.

Ashok Banerjee: The budget contains favorable provisions to boost our fixed income market. Certain enabling provisions such as the emphasis on infrastructure, removal of SLR/CRR restrictions, creation of SPV to raise long term loans to fund infrastructure projects etc. should send positive signals to the fixed income markets. These provisions and the benign interest rates may increase the bond prices and hence generate investors' interest in the long-run.

D Tripathi Rao: The recent budget does not augur positively to the already set in current bearish trend in the fixed income market. In coming days, macroeconomic developments will determine it.

How favorable is the present budget from the point of view of foreign investment? What could be the rationale of the government in allowing FDIs into mining and pension fund sectors? Don't you think it is apt to keep these sectors strictly under government control?

Sundar Sankaran: We may need to view mining and pension funds differently. Mining is a key feeder industry, which has been lacking smart capital and technology. The government lacks the resources to spare. If we open it to the Indian private sector, but keep foreign investment out, then inefficiencies will creep in. Foreign investment might enhance the "smartness" in the industry. A national mining policy could be a framework within which this operates.

Tax on cash withdrawal intended to curb black money will not meet the desired outcome

– Atul Sarma

As regards pension funds, let us recognize that government control is not an insurance against frauds. Indeed, a government controlled sector could lead to institutions that are "too big to fail", with the resultant impact of government bail outs if there is a problem. Instead, let us operate on the basis of licensing the "just and fit". Competition amongst them would take the pension sector to the size that it needs to have.

Atul Sarma: There is nothing that should dampen the upturn of the FDI. On the contrary, the relaxation in regard to entry of FDI in the construction sector should give some impetus.

Ashok Banerjee: The government's intention to allow more FDI in sectors like Banking, Mining and Pension Funds, has already attracted enough criticism. However, we have observed that FDIs in Telecom and Insurance Sectors have not done any harm to the domestic players as well as the public at large. Rather such investments have increased competition in the industry leading to lowering of prices to the benefit of ultimate consumers. Hence, the issue is not the FDI in newer sectors per se, but the adverse consequences of such investments. Sector like mining requires three things urgently – a) massive investment; b) latest technology; and c) professional management. It is expected that FDI in mining would meet these three requirements. In order to ensure that there is level playing field and no abuse of market power, the government needs to put a proper regulator in place.

D Tripati Rao: Similar to the proposal for allowing mutual fund industry for FDI, the finance ministry is mulling over the option of a variable foreign direct investment cap for pension fund managers having a magnitude of \$50 mn investment. The rationale is that global fund managers have better expertise – the technical know-how, in handling large funds with better asset-liability management practices, information processing abilities and can withstand contingent shock since they are exposed to diversified portfolio on a global scale. Of course, the flip side is that being susceptible to external shocks they can import financial instability very easily to the domestic markets. And often indulge in speculative tendencies jeopardizing growth. A limited participation partnering along with domestic fund managers after a careful scrutiny and well laid financial prudence parameters under the watchful eye of a strong and independent regulatory authority could be an option.

FDIs have increased competition in the industry leading to lowering of prices to the benefit of ultimate consumers

– Ashok Banerjee

Tarun Das: The Budget is FDI positive though there is nothing specific in it. In any case, the Budget is not the place for FDI announcements. FDI in Mining will be very helpful. India needs to modernize and upgrade its Mining Industry especially in terms of technology. FDI will help. FDI in Pension Funds is not an issue. In any case, India always starts with FDI caps and the process is gradual.

Do you think that the increase in surcharge from 2.5% to 10% with an additional 2% education cess has defeated the government's objective of reducing the corporate tax rate from 35% to 30%?

Sundar Sankaran: Yes, I agree. The effective tax rate of the corporate sector has not gone down.

Atul Sarma: The increase in the surcharge by 10% with respect to corporate income need not neutralize the benefit of reduction in corporate tax from 35 to 30% to a wide spectrum of companies.

Ashok Banerjee: The Finance Minister has tinkered with the corporate tax rate by lowering the rate of depreciation, increasing the surcharge and retaining the education cess. However, it should not be denied that Indian Corporate Sector has reported impressive performance during the current year – both in the domestic and international markets. Hence, Corporate India should not have asked for tax concessions in the current year's budget.

D Tripati Rao: The government expenditure incurred in providing basic amenities, be it education, health and social security, must come from general tax revenues. A surcharge is a 'transitory levy' in exceptional circumstances such as national calamities or having a particular purpose and levied for a very specific period. It is by no means to acquire a permanent feature.

Now, the companies who have reported income of more than 8.5 lakhs will be levied surcharge. But since the surcharge is levied at the margin, i.e., surcharge levied on taxable income, therefore, even after additional surcharge, bigger companies will still benefit from reduction in the corporate tax from 35% to 30%. Though, in addition to the surcharge and education cess, the benefits are nullified to some extent by the reduction of exemption amount for depreciation.

Tarun Das: Yes and no. The Education cess is an earmarked fund similar to the highway/road construction fund. What is important is to ensure proper utilization and application. The increase in surcharge certainly negates. The reduction in the rate, compounded by the Fringe Benefits Tax. Simplicity is important in the tax regime. Better to have a single rate without surcharges or exemptions.

□ Union budget 2005 is stated to be the "budget for the common man". Do you think the budget will be able to please the common man yet impress the rating agencies such as S&P with the fiscal improvements it is likely to bring in?

Sundar Sankaran: The budget is weak on fiscal improvements. Therefore it cannot impress the rating agencies. 'Budget for common man' syndrome is inevitable with fractured mandates and shorter tenures of government. In case we want 'budget for economy' then let us vote in governments with strong majority. It can be any party. They all learn to be responsible when in power. Look at the left front in Calcutta. Power without responsibility, as is happening at the centre, is a worry. Therefore, the solution lies in the political system, not the budget.

The budgetary framework appears to enhance supply side by lowering corporate tax rates and infrastructure provisioning

— D Tripati Rao

Atul Sarma: The budget thrust on sectors such as agriculture, rural and infrastructure development should enhance growth and efficiency. However, fiscal balance still remains very fragile. At the same time, the allocation of funds is usually not commensurate with outcome.

Ashok Banerjee: The major thrust of the current year's budget is in agriculture and social sectors with significant budgetary allocation for rural infrastructure, education, health etc. The burden of achieving this objective is to be borne by all the stake holders—Government, Corporate Sector, and the common man. However, the major concern lies in the implementation of projects in social sector and the possible slippages. A disciplined investment and close monitoring of utilization of funds would be the only way to ensure better fiscal responsibility. Such an approach might even earn accolades from international rating agencies.

D Tripati Rao: The Budget 2005 has been received with applause cutting across corporates for reduction in tax rates, salaried class for raising the income tax slab, increased allocation towards agricultural and rural infrastructure, higher expenditure on education and health, and special emphasis on women and other weaker sections. The media has been unanimous in its verdict on the present budget: 'It has something to offer for every one.' The budgetary framework on the one hand appears to enhance supply side by lowering corporate tax rates and infrastructure provisioning, while in the other hand, it wants to sustain growth by augmenting demand by increasing the income tax exemption slabs and government outlays for many a rural upliftment programs and by providing adequate credit provisioning to small farmers.

However, the rating agencies such as, S&P are cautiously optimistic for obvious reasons on the grounds of fiscal health and the government's silence over disinvestments program. On the fiscal side, though fiscal deficit is marginally lower than the previous year, it has failed to meet the FRBM target as the Finance Minister quite candidly reasoned Tsunami and other effects. The funding of large amount of total government borrowing slated this year is going to be a major issue. Also, the nominal GDP estimates reported in Economic Survey implicitly assumes a higher order of inflation—more than 6.5%. And the recent hardening of international crude oil prices with domestic correction may further add to the rising inflationary trend. This has already seen an upward pressure on nominal interest rates.

Tarun Das: The budget attempts to address the agricultural and rural economy and infrastructure sectors. Both these will help the common man enormously. It will also add to GDP growth, raise revenues and please the investor community and capital markets. It is a Budget which should be welcomed by the rating agencies also.

□ The government has introduced significant changes in the taxation of individuals and corporations. Are these projections for tax revenues reasonable? If not, what do you think could be the impact of shortfall in tax collections on the economy?

Sundar Sankaran: Budget is an estimate. With new taxes, it is even more difficult to predict corrections. Let us give credit to the Finance Minister for his innovations. I am sure he is capable enough to implement course corrections during the year to avoid nasty surprises at the end.

Atul Sarma: The realization of the projected tax revenue would essentially depend on growth. If the growth of the economy as projected is realized, tax buoyancy should make up for the revenue loss from tax reduction.

Ashok Banerjee: The budget estimates more than 30% increase in both income tax and corporate tax revenue during 2005-2006 (as compared to revised estimate of 2004-2005). On the individual tax front, the rationalization of tax rates would lower the tax revenue. The service tax net has been widened. But the increase in revenue through service tax is only pegged at 24%. The proposed effective corporate tax rate has actually not been reduced and hence corporate tax collection coupled with FBT would increase during 2005-2006. Overall, there could be a shortfall in the tax collections. This might aggravate the fiscal deficit numbers.

D Tripathi Rao: The rationalization and reduction of tax rates borrows its intellectual heritage from the supply side economies. The developed economies, in the short run, calibrate tax rates to turn the business cycles upward by augmenting pent-up demand. But our experience of mobilization which means generating higher tax revenues by lowering tax rates, the laffer-curve effect, is far off the mark. The estimated tax revenues has underlying assumption that the expected decrease in customs collection can be more than compensated by excise collections with sustained industrial growth of the order beyond 8-9% together with higher imports. But one could conjecture that tax revenues may fall short than the estimated amount, thus widening the fiscal deficit further.

Tarun Das: If GDP growth is at 7 to 8% and the potential is 9 to 10%, then the revenue projections can be achieved. As of now, 2005/6 looks very positive with manufacturing and services on a high growth path. ♦

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