

Financial Management

26.1. CONCEPT AND DEFINITION

- During the life of a business enterprise, there are financial events that receive considerable attention. An issue of ordinary shares is an example.
- By concentrating on discernible financial events, discussions on finance of an enterprise have tended to look at the raising and deployment of finance.
Funds required for running the business are raised through a combination of direct revenue from sales, loans from banks, sales of securities and bonds, etc.
- Funds raised as above are deployed among competing uses within the enterprise's activities.
- *Financial Management* can be looked upon as the study of relationship between the raising of finance and the deployment of finance.
- *Financial Management* involves decisions pertaining to
 - (i) Investment (proposals) policies,
 - (ii) Methods of financing, and
 - (iii) Dividend decisions.
- (i) *Investment Policies* dictate the process associated with capital budgeting and expenditures. Proposals (to spend money) may involve expenditures such as on, product development, additional test facility, etc. All proposals received are ranked and (investment) decisions are taken whether to sanction money for these proposed ventures or not.
- (ii) A proper mix of short-and long-term financing is ensured in order to provide necessary funds for proposed ventures at a minimum risk to the enterprise.
- (iii) Dividend decisions affect the
 - (a) Amount paid to stockholders in cash. Stock-holders must get some benefit, otherwise they may sell their shares.
 - (b) Distribution of additional shares of stock, etc.
- Any valid study of financial management is necessarily concerned with financial dynamics; dynamics indicates an attempt of not using static theory for solving problems of continuous nature.
- Lastly, it may be said that the financial function of any business enterprise tries to maximize the value of that business to its owners.

26.2. PURPOSE OF INVESTMENT

In a business enterprise, money is invested for the following purposes:

- (i) To procure land, buildings or for making expansion of the existing plant.
- (ii) For getting raw material, machinery, instruments, tools etc.
- (iii) For purchasing material transporting vehicles.
- (iv) On water, power, gas and other supplies for running the enterprise.

- (v) For administrative and selling services.
- (vi) On development projects and diversification of products.
- (vii) For increasing company's manufacturing capability.
- (viii) Research work, e.g., on cost reduction, etc.
- (ix) For paying salaries of direct and indirect workers.
- (x) To organise the business.

26.3. TYPES OF CAPITAL

26.3.1 Capital

- Capital is the life-blood of a business enterprise.
- Capital is a universal lubricant which keeps enterprise dynamic.
- *Capital* designates physical sources when applied to production and (it means) money when applied to finance.
- Capital, in its meaning, covers all the elements (e.g., money, land, building, machinery, materials, etc.) a businessman needs to start an enterprise.
- Capital is the measure of the amount of resources of an enterprise.
- Capital develops products, keeps workers and machines at work, encourages management to make progress and create value.

26.3.2 Types of Capital

Capital may be of the following two types :

1. Fixed or Block capital.
 2. Working or Current Capital.
- *Fixed Capital* is associated with long term assets whereas *Working Capital* pertains to current operations.
 - For running an industry, two types of capital are needed. One for purchasing fixed assets such as land, building, machinery, etc. and is known as *fixed capital*, whereas the other which is required for day-to-day needs is labelled as *working capital*.

26.3.3. Fixed Capital

- When an industrial enterprise is started from the ground up it requires capital to make/purchase
Land,
Building,
Equipment and Machinery,
Tools, and
Furniture, etc.

Assets of this type are used over and over again for a number of years and are commonly termed *Fixed Capital*.

26.3.4. Working Capital

- Once fixed assets, e.g., building, equipment, machinery, etc., have been purchased, the enterprise needs funds to meet its day-to-day needs and expenditures such as
 - * Purchase of raw material and supplies.
 - * Payment of employee wages.
 - * Storage costs.

- * Advertisement and selling expenses.
- * Equipment and plant maintenance costs.
- * Transportation and shipping expenses.
- * Expenditures during the time lag between the sale of the products and payment for them.

Funds required to cover these costs are commonly called *working capital*.

For details refer article 26.4.

26.4. WORKING CAPITAL

Definition

- *Working Capital* refers to a firm's investment in short term assets—cash, short term securities, accounts receivable and inventories.
- *Net Working Capital* is defined as current assets minus current liabilities.
- *Working Capital management* refers to all aspects of the administration of both current assets and current liabilities.
- *Working capital* is needed in any business because of the time lag between paying for materials and operating costs, and getting the money back again (together with added profit) from the customer.

Sources of Working Capital

- (1) Funds from business operations.
- (2) Other incomes such as from dividends, transfer fees, donations, interest from investments made in other companies, etc.
- (3) Sale of non-current assets such as useless and obsolete plant and machinery.
- (4) Long-term borrowings.
- (5) Issue of additional equity capital or preference share capital.

Uses of Working Capital

1. Loss from business operations would decrease the working capital.
2. The purchase of non-current assets generally causes a decrease in current assets or increase in current liabilities. Therefore, it should appear as the use of funds.
3. The retirement of long-term liabilities such as payment to preference shareholders and debenture holders involves the use of cash.
4. Dividend to shareholders.
5. Interest to lenders.

26.5. SOURCES OF FINANCE

26.5.1 Introduction

- In order to start an industrial concern, i.e., to produce and to sell, there must be adequate finance for purchasing fixed assets (building, machinery, etc.), raw materials and other supplies.
- There should also be sufficient finance to meet day-to-day expenditures of the enterprise.
- Thus the very first question which arises before starting an industrial concern is how much finance will be needed and how it will be provided or from what source it will be procured.
- The sources of finance may be categorized as follows :

26.5.2 Internal Sources

1. Retained equity earnings.

2. Depreciation provisions.
3. Deferred taxation.
4. Personal funds saved or inherited.

26.5.3. External Sources

(a) Permanent or long term sources of finance

5. Savings.
6. Loans.
7. Share Capital.
8. Debentures.
9. Corporate bonds.
10. Public deposits.
11. Taking in partners.

(b) Medium term sources of finance

12. Bank loans.
13. Hire purchase.
14. Sale and lease back.
15. Equipment leasing.
16. Profit plow back.

(c) Short term sources of finance

17. Credit facilities.
18. Trade credit.

(d) Specialist Institutions

19. Industrial financial corporation.
 20. State financial corporation.
 21. Industrial development corporation.
 22. Insurance companies, etc.
- It should be noted that internal sources of finance or fund supply,
 - (i) provide more than half of the total funds available from all sources ; and
 - (ii) form a necessary and integral part of the continuing activity of a business.
 - Various internal and external sources of raising finance have been briefly discussed below :

1. Retained Equity Earnings

- This implies retaining the earnings of the shareholders for internal reinvestment. Every rupee retained is a rupee with-held from distribution to existing shareholders.
- While doing so, management must do something to maintain the interest of shareholders.

2. Depreciation Provisions

- Depreciation provisions represent the maintenance of a capital stock to replace the existing machinery when it becomes uneconomical to use.
- Depreciation provision is a major source of internally generated funds.

3. Deferred Taxation

- Due to the time-lag between the earning of profit and payment of the appropriate taxation, the funds, represented by the tax liability, are available for use.

4. Personal Funds Saved or Inherited

In order to win confidence of external financiers, it is very necessary that the would-be owner must have assets of his own to invest in the firm.

5. Savings

- People save a percentage of their salary for a 'rainy day'.
- With the money thus saved, people purchase life insurance, buy stocks and bonds, buy shares or deposit in a bank.
- Thus saved money is made available to business enterprises for further use and investment.
- It may be said that almost all capital for investment in business and industry comes from savings of people.

6. Loans

- Money can be borrowed from the following sources for starting or expanding the business,
 - (i) Friends and relations
 - (ii) Money lending institutions
 - (iii) Commercial and other banks, etc.
- When money is borrowed, it becomes obligatory that the interest should be paid in time and the loan be paid back on the mutually agreed date.

7. Shares

- Funds are collected by issuing shares to public.
- The number of authorized shares that can be issued and the value of each share is specified. This is decided on the basis of the capital to be collected by issuing shares.
- Shares are issued for raising funds either when starting a new concern or when it is decided to expand and improve upon the existing one.
- The main division of share capital is into :

1. Preference shares

- Preference shares, as the name implies, have some preferential rights over other types of shares, e.g., dividend is first paid on preference shares and then on ordinary shares.
- Preference shares are entitled to a fixed dividend out of the profit.
- If the company faces a difficult period and is unable to pay dividends, quite possible, the preference shareholders may exert their powers and take over control from ordinary shareholders. This happens when the preference dividends are in arrears.
- Preference shares may be further classed as
 - (a) *Cumulative preference shares.* They are entitled to a fixed annual dividend. If this full dividend cannot be paid in any year (because of less profits to company), the rest of deficit can be paid out of future profits, (i.e., profits of next year).
 - (b) *Non-cumulative preference shares.* They are entitled to a fixed annual dividend, but the shareholders cannot ask for arrears from future profits if in any year the company fails to make enough profits to pay fixed dividends for that year.

(c) *Participating preference shares*. They are entitled to a fixed annual dividend plus something from the surplus left after paying dividend to ordinary shareholders.

2. Ordinary shares

Ordinary shareholders are generally paid a higher rate of dividend than that of preference shareholders but they carry greater risks.

- Dividend on ordinary shares is paid only after doing so on preference shares.
- There is no limit of dividend in case of ordinary shares. Ordinary shareholders may get very high rewards in one prosperous year of increased business and no dividend if the business encounters a difficult period.
- The ordinary shares may sometimes be called as *Equity Shares* or *Equities*.

3. Deferred Shares

- Deferred shares are issued to founders or promoters of the business enterprise.
- Dividend on deferred shares is paid in the last, i.e., first of all, dividend on preference shares is distributed, then it is paid on ordinary shares and in the end whatever profit is left is shared by the deferred shareholders.

8. Debentures

- Business corporations having good record of earnings and favourable prospects of expansion, in search for outside (external) funds to support operations and growth, may raise capital by borrowing it on a formal document known as a *Debenture*.
- Debenture is a certificate of indebtedness issued by the corporation. A fixed rate interest is paid on debentures and the amount is repayable after the stated number of years.
- The essential relationship between the company and the (bond) debentureholder is that of debtor-creditor.
- Debentures are generally un-secured bonds which have no claim on any specific asset of the company but are backed by the earning power and general credit of the company as viewed by the investor. For this reason, only companies with a very good profit record and a high financial standing can hope to sell unsecured bonds or debentures.
- The issue of debentures can be a very useful method of raising finance at reasonable cost.
- *Characteristics of debentures and the difference from shares*

Debentures	Shares
1. A debentureholder is a creditor only and has no control over the affairs of the company.	1. A shareholder is an owner of the company, i.e., he has ownership interest in the company.
2. A fixed rate interest is paid on debentures.	2. Dividend is paid on shares.
3. Interest is paid whether the company runs in profit or loss.	3. It bases upon the type of share whether the annual dividend is paid or not, (depending upon the profit/loss incurred by the company).
4. A debentureholder gets his money back after the stated number of years.	4. Money of the shareholder is not refunded to him.
5. In the event of liquidation of the company, a debentureholder will get his money before the shareholder gets something.	

9. Corporate bonds

- Corporate bonds are of two types
 1. *Unsecured bonds* or *Debentures* as discussed above, and
 2. *Secured bonds*, in which case some form of claim on the assets of the corporation is tied if the corporation fails to pay interest to the investor or does not return his money back after the stated number of years.

Mortgage bonds are examples of secured bonds.

10. Public Deposits

- Public may be asked to deposit their money directly with the company for a fixed long/short period ranging from half a year to seven years.

11. Taking in partners

- Capital may be raised by adding partners in the business who are ready to invest in the firm.

12. Bank loans

- Short term loans are easily available from commercial and other banks on reasonable interest rates.

13. Hire purchase

- The hirer makes a deposit, he gets the machinery (goods), etc., he needs and then he pays a number of periodical money instalments. At the end of a period when all the instalments have been paid, the possession of the goods passes to the hirer.

14. Sale and lease back

- For getting funds, a company may sell some of its property to an investment company with a right to lease back at an agreed rent.

15. Equipment leasing

Many types of fixed assets such as land, equipment, machinery, etc., can be obtained on lease for a number of years on rental basis.

16. Profit plowback

The whole profit is not distributed to shareholders or owners as dividends, rather a portion of it is retained in the business and used to finance expansion and growth of the concern.

17. Credit facilities

A useful source of short-term finance is to obtain goods and services on credit.

18. Trade credit

Trade credit is the financial assistance available from other firms with whom the business has dealings. Most important are the suppliers of inventory which is constantly being replaced.

19. Special institutions

Finance may be obtained by borrowing from an
insurance company ;
investment company ;
industrial development corporation, etc.

4. Profitability Ratios

- These ratios tell the story about the firm's past profitability.
- Profitability ratios are:—

$$(a) \text{ Profit Margin} = \frac{\text{Net income}}{\text{Net Sales}}$$

The profit margin is an important ratio because it describes how well a rupee of sales is squeezed by the firm into profit.

$$(b) \text{ Return on assets} = \frac{\text{Net income}}{\text{Total Assets}}$$

The intent of this ratio is to measure how profitably the firm has used its assets.

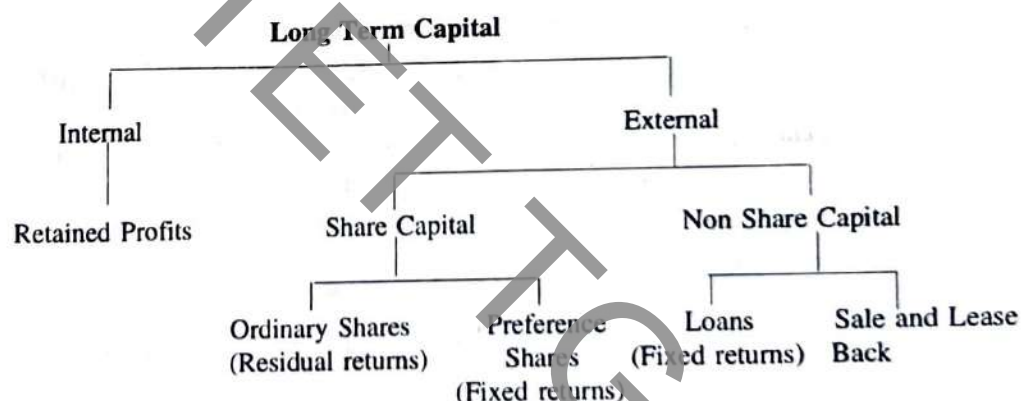
$$(c) \text{ Return on equity} = \frac{\text{Net income}}{\text{Equity}}$$

It indicates what kind of rate of return was earned on the book value of the owner's equity.

26.18 SOURCES OF FINANCE

Introduction

- The *business finance* is an activity concerned with raising and administering of funds used in business.
- The capital requirements of an industrial unit can be divided into three categories, namely
 1. Long term capital (Fig. 26.9)
 2. Medium term capital (Fig. 26.10)
 3. Short term capital (Fig. 26.11)



Legend : Can be of different types.

1. Deferred, Voting or Non-Voting.
2. Participating, Cumulative or Non-cumulative, Redeemable or Irredeemable.
3. Secured or Unsecured, Convertible or Non-convertible, Redeemable or Irredeemable.

Fig. 26.9 Methods of raising long term capital

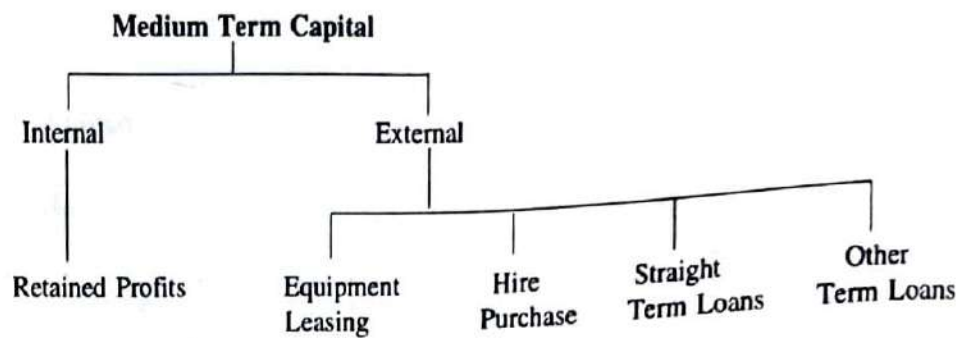


Fig. 26.10 Methods of raising medium term capital

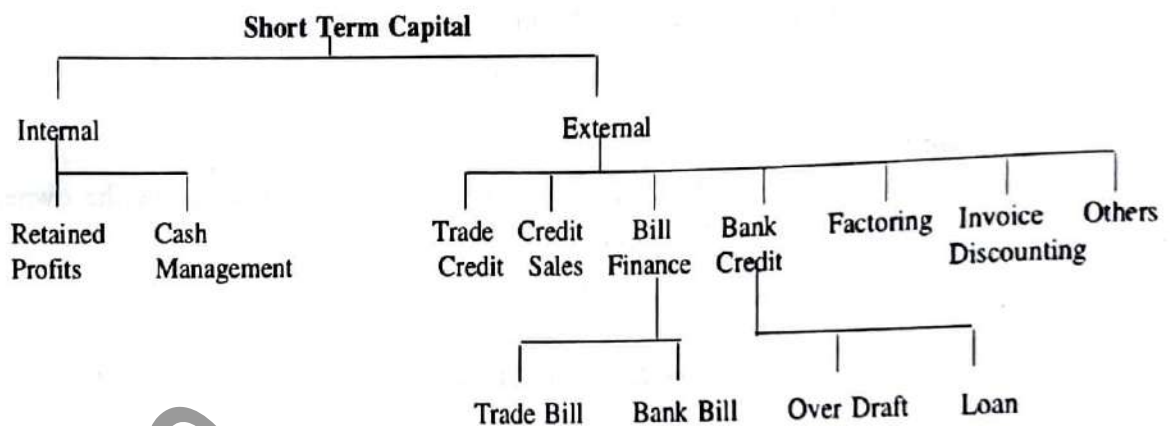


Fig. 26.11 Methods of raising short term capital

General sources of capital areas

- (1) *Private* – Individuals, family, friends
- (2) *Credit* – Suppliers
- (3) *Profits* – General reserves, special reserves
- (4) *Private sector institutions* – Banks, Insurance Companies, Industrial and Commercial Finance Corporation.
- (5) *Public Authorities* – Industry Act 1972, National Research and Development Corporation
- (6) *General Public* – New Issues
- (7) *Others* – Pension funds etc.

Time Periods

The time periods associated with the methods and sources of capital are:

1. Permanent and Long Term.
2. Medium Term.
3. Short Term.

There are no clear cut demarcating lines between these various periods of time but it is common, from the view of financial managers of firms, to associate them with the following periods :

1. *Permanent :* Finance that is not expected to be repaid as long as the business operates.
Long Term: Finance originally scheduled to be repaid over a period of five years or longer.
2. *Medium Term:* Finance to be repaid in more than one but less than five years.
3. *Short Term:* Finance originally scheduled for repayment in less than one year.

Which period is selected by the firm will depend upon a number of things such as the reason for which it is being used, the financial institutions providing the capital and the terms associated with the form of lending.

(1) *Long term funds are required for*

Fixed Assets — Land and Buildings
Factory and Machinery
Fixtures and Fittings

(2) *Medium term funds are required for*

Fixed Assets — Movable and Mobile
Furniture
Motor vehicles

(3) *Short term funds are required for*

Current Expenses — Direct and Indirect
production expenses
Current Assets — Raw material
Work in progress
stock.

(1) **Preference Shares**

- There are many varieties of these, each with differing rights and benefits. The holders of preference shares are usually entitled to a dividend at a fixed percentage out of profits in priority to any other class of shareholder and usually have preferential right to the return of their capital when a company is wound up. However, these shares rarely carry voting rights.

(2) **Debentures**

- These are not shares in the company and therefore the holder to a debenture is not an owner of the company. Debentures are basically securities which have been issued by the company in consideration for a loan. They carry fixed interest rates and give no right to voting in company meeting. Since debenture holders are creditors of the company they rank with other creditors before shareholders in the assets of the wound-up company.

(3) **Ordinary Shares**

- Holders of these shares have an equal right to share in the profits and the assets of a "wound up" company after prior claims of Preference shareholders and Debenture holders have been met. Normally these shares also carry voting rights.

- Whilst ordinary share capital tends to dominate the capital structure of the joint stock company the majority of companies in the U.K. have adopted other forms of capital. The basic reason for this is that the ordinary shareholder whilst accepting the risks of a company failure desires the best return possible on his investment. If the company can borrow money from other sources at low interest rates, the difference between the return the company makes by using that money and the interest they have to pay to borrow it, adds to the profits of the ordinary shareholder.
- Secondly, raising money by issuing securities which confer a variety of rights and benefits on the investor, will widen the appeal of such securities and improve the revenue raising prospects of the company. A brief sketch of some of these *other securities* and their characteristics follows :
- The **equity shareholders**, a term which signifies their being entitled to the equity of the business, i.e. the profits and assets remaining after the prior claims of all fixed interest bearing stocks have been met, may rightly expect voting powers which give them some say in the running of the business, but by various methods they are sometimes divested of this.

(4) Non-voting Ordinary shares

- The issue of non-voting shares is held by some to be justified in certain circumstances, *for example* where it is desired to retain control in the hands of the original shareholders. Capital transfer tax has caused problems in this respect when it has been necessary to sell certain shares in a company, and various schemes have been devised to overcome this; but if an issue of, say, one for one of non-voting shares is made, no disturbance of the original control need take place. It is also maintained that necessary capital may be obtained without the risk of a take-over bid, as the controlling shares may be retained while no incentive is given to buy up the non-voting shares.
- A *further justification* for the issue of *non-voting Ordinary shares* is claimed in that the market for the company's shares is widened.
It would seem that the objections raised outweigh the advantage claimed for such shares since they appear to be undemocratic, there being holders of equity share capital having to bear their shares of the risks but having little or no chance of exercising any power in the control of the company. Moreover, virtually complete control may be gained by a minority of the shareholders.

(5) Redeemable equity shares

- Redeemable equity shares may be issued which must be cancelled on redemption. The rules as to their redemption is as for redeemable preference shares. These could be useful to a company which desires to obtain capital for a certain project or projects in which the shareholders may participate in the increased profits. When the projects have repaid themselves, the shares may be redeemed.
- Although such shares may form only a small proportion of the total share capital they can prove very remunerative to the holders, as they may be entitled under the Articles to a very high rate of dividend. They may also confer the same voting rights as Ordinary shares or may be stated to be convertible to Ordinary shares after the lapse of a certain period.

(6) Stock

Fully paid shares may be converted into stock or stock units. Although stock may not be

issued directly, it has the advantage of allowing transfer fractionally, whereas shares must always be transferred in whole units and consequently according to their numbers. Since stock is not numbered, a considerable saving in clerical work is afforded by its use.

(7) Retained Profits

- In general, *internal funds* are a more important source of finance for small firms than for large, mainly because small firms are reluctant to seek finance from outside. Moreover smaller companies are not able to raise capital from outside sources easily. Nevertheless firms of all types and sizes *plough back profits into the business*. Prior to World War I the expansion of most firms came from *retained profits*. Since that time the rapid rise in taxation and the rapid pace of inflation have combined to make it more difficult for firms to rely on this method. Today, although less important, it still must be considered as being very important.

The term *retained profits*, as would be explained by an accountant, consists simply of the amount of net profit that has not been taken by taxation or used for the payment of dividends to shareholders.

- *Ploughing back profits*. An efficient company will usually ensure that not all its profits are distributed and adequate funds are ploughed back into the business by creating reserves or sinking funds for such matters as replacement of assets or acquisition of new ones.

Where reserves or sinking funds are set aside for specific purposes and not merely for strengthening the business as a whole, to ensure that such sums are available when required and to avoid their becoming absorbed in various assets of the business, they are usually invested outside the company and realised as and when required.

(8) Loan Capital

- Where capital is required but not of a permanent nature, it may be obtained by borrowing either on long term *loans* or for more immediate repayment.
- The most important method of raising capital on a long term basis is by means of *Debentures*.
- A Debenture is a document given by a company in acknowledgement of a debt, undertaking to repay the stated sum on or before a certain date, and in the meantime to pay interest at a fixed rate, usually in half-yearly intervals.

(a) "Simple" or "naked" Debentures

Such Debentures offer no charge on the assets of the company as security for the loan and in the event of winding up, the holders of such Debentures rank *pari passu* with ordinary unsecured creditors and can claim no priority or repayment.

(b) Mortgage Debentures

Debentures more usually give a charge over the assets of the company and in such a case are termed "Mortgage Debentures". The charge may be a fixed charge, that is, on certain assets of the company, or a floating charge. Not infrequently a charge may be conferred on some specified assets of the company in the form of a fixed charge, and in addition a floating charge may be given on the whole of the company's undertaking.

In the case of a fixed charge, the effect is to lease the property charged to the Debenture holders, so restricting the company's right to deal in the property in any way until such

time as the Debentures are redeemed.

Where a floating charge exists the property may be dealt with as if no such charge existed. If the company makes some default on a condition in the deed and action is taken by one or more of the Debenture holders to enforce the security, the charge crystallises, or in other words becomes fixed on the assets as they then exist.

(c) *Debenture stock*

Debenture stock constitutes, as do Debentures, evidence of a debt, but instead of each lender holding a separate bond he has a certificate entitling him to a specified portion of one loan.

(d) *Bearer Debentures*

Debentures payable to bearer are transferable by delivery and any bonafide transferee for value becomes the legal owner of them.

Debentures are frequently issued at a discount and may be redeemable at a premium.

(9) **Sale and Lease Back**

- Some companies own their premises whereas others operate in rented property and buildings. The former organisations have the opportunity to use this method to obtain finance; the latter do not.
- The normal procedure is for the firm to sell their factory or other property, for example, a warehouse or retail outlet, to an organisation who would undertake to lease back the property to the seller for a long period of time. The seller receives a sum of money which it intends to invest, and the purchaser receives the title to the property and a negotiated annual rental. The leases vary from a common period of 40 to 50 years and sometimes for much longer periods. Rents are reviewed and revised at intervals normally ranging from 5 to 7 years but usually never longer than 14 to 15 years.
- For this method it is essential, from the purchaser's point of view, that the property is an attractive investment. From the seller's point it may be attractive because the rental may be lower than the interest they would have to pay had they raised their capital from a mortgage debenture.
- If a company wishes to expand and to obtain immediate resources, this method of obtaining funds may be used, but it must always be borne in mind that the additional rental charges have to be met over a period of years when profits may fluctuate and the company's own position, from the point of view of fixed assets, is not so strong.
- **Some basic advantages associated with this method are :**
 1. The method can be used to obtain funds for other investment opportunities. The argument used is that the properties sold under this method do not make profits for the firm; that it is the turnover of working assets that makes the profits. Thus the sale and leasing back of non-profitable property to invest in more working assets enhances the expansion and profits of the firm.
 2. The firm is able to increase tax deductions and can, as a result, improve its cash flows.
 3. It is possible to raise more funds from the sale of a specific property than it could through mortgaging the property.
- **The disadvantages are :**
 1. The flexibility of the firm can be reduced if the lease does not allow them to modify the property.

2. At the termination of the lease any residual value remains with the owner.
3. The rental paid is a fixed charge against income.

For more information on the various aspects of leasing refer to the section on equipment leasing.

— *Sources of Sale and Lease Back*

Insurance companies, Property investment companies, pension funds, Finance houses etc.

(10) **Equipment Leasing**

- This method of obtaining finance is analogous to that of renting a property.
- The procedure employed is that the *financial institution* will purchase the asset desired by a *customer* from the supplier and then as the lessor (owner of the asset) will lease it to the customer (the lessee) in return for specified equal payments for a stated period of time. The initial lease is usually up to five years.

Source of equipment leasing

Mainly from finance houses, specialist leasing companies, leasing departments or subsidiaries of manufacturers.

(11) **Hire Purchase**

- Hire purchase is a method of obtaining finance from a financial company to purchase an equipment/machinery/vehicle etc., on medium length terms. The user can use the machinery without paying outright its price; rather he can earn out of the (use of) machinery and pay to the financial company in terms of hire purchase instalments.
- The procedure for hire purchase is similar to equipment leasing.
- The financial institution purchases the asset on behalf of the customer from the supplier (or dealer) and hires it to the customer. The finance provided is for a specified asset. A deposit is made by the customer and the balance due is spread by equal instalments at specified dates over a fixed period of time usually up to 5 years (or more even). The reason for the longer period of time is that the working life of the asset is longer than usual.
- The hire purchase company ensures itself security and reduces the risk it takes when entering into a hire purchase agreement by :
 - (i) Asking for a deposit, and
 - (ii) By shortening the period of time for repayments.Upon satisfactory completion of the payments the hirer is given the option to purchase the asset for a small sum, and in the majority of cases this is done. It is this option to purchase which is the main *difference* between *hire purchase* and *equipment leasing*.
- Small firms tend to hire purchase farm equipment, tractors, motor vehicles, machine tools, printing machines etc.
- *The advantages of hire purchase* are that (i) the customer has to make payments from revenue, it need not raise finance to purchase the asset (ii) the customer can conserve its financial resources, (iii) tax relief can be claimed in respect of annual (wear and tear) allowances, (iv) the hire has option to purchase the asset.

- *The disadvantages associated with hire purchase are that* (i) a down payment is required (ii) the cost is considered to be expensive. For example, the flat (interest) rate may be, say, 15%, but the true rate may be almost twice this rate (iii) the hirer has to maintain asset in good order etc.

Sources of hire purchase

Mainly from finance houses, specialist hire purchase companies.

To a lesser extent from associates, subsidiaries and departments of clearing banks and merchant banks.

Term Loans (Straight)

- A term loan refers to a method of lending whereby the lender advances a fixed sum of money at a fixed rate of interest to the customer and the sum is repaid by him by regular instalments over a fixed period or paid in full at a given date.
- *Advantages of term loans as compared to Bank overdrafts*
 - (1) Term loans are not withdrawn because of changes on which the borrower has no control such as credit squeeze. (overdrafts can be withdrawn).
 - (2) Term loans are agreed to a fixed period and are not reduced. (Bankers can ask that overdrafts be paid on demand).
 - (3) Little time is taken to negotiate agreements. (overdrafts may require renegotiation every 3 to 6 months).
 - (4) Payments are made from revenue.
 - (5) Normally more money can be raised than by the overdraft method.
 - (6) Tends to be cheaper than hire purchase or equipment leasing from the financial (rather than servicing) point of view.
 - (7) Ownership of the asset can be immediate, as opposed to hire purchase and equipment leasing.
 - (8) The asset can be used as security for raising additional finance.
- *Disadvantages associated with term loan*
 - (1) They are not cheap. The longer the period the greater the risk to the lender and this is reflected in the interest rates charged.
 - (2) They are more difficult than overdrafts to borrow. Lenders require a higher standard of credit worthiness.
 - (3) Term loans must be repaid regardless of the firm's business position.
 - (4) Repayments must be met on due date and thus lack the flexibility associated with overdrafts.
 - (5) Large repayments can create abnormal cash drain.

Sources of term loans (straight)

Clearing banks, Merchant banks, Finance houses etc.

Term Loans (others)

- These loans are other than straight term loans. In most respects they take the same form as straight term loans but vary in that the terms and conditions of the loan are tailored to fit the particular circumstances of each case.

Another difference is that the rates charged can change when they are reviewed every six months.

Sources of term loans (others)

Mainly secondary banks, for example, merchant banks.

Cash Management

- Cash is a commodity which businesses too often seek from external sources without first taking a closer look at home. Generally large companies have large cash resources and carefully manage their cash. Smaller companies are usually short of cash and generally are poor managers of their cash. There is a need for firms to improve their knowledge on cash collection and disbursement. This requires a thorough examination of the company's system of processing cash.
- Cash collection refers to ways of speeding up incoming cash and establishing procedures by which reductions in cost can be made. Getting invoices to customers as early as possible is one way to speed incoming cash.
- An invoice sent out early can result in cash being paid a day or more early and thus build up the cash available. When measured over the year the total sum available can be quite considerable. Cash in hand, discounts can be obtained, and less need to raise money from external sources are the results of the speed up in invoicing.
- Improvements in disbursing cash may also be possible. A cheque paid to your creditor may be delayed by a day or more without losing discounts or credit rating. Or, in drawing a cheque an analysis should be made on the time it takes to post it, the time it takes the post office to deliver it (the greater the distance the greater the time or the more obscure the location the greater the time?), the time taken by the creditor in handling the cheque before presentation to their bank and the time taken by the banks in clearing the cheque. Perhaps 4, 5 or more days use of this money may be available to your firm, but accurate clearing times must be established.
- *Positive cash management* means cash is available for use by your firm where before it was considered that it did not exist; *hidden cash*. The use of this cash creates savings throughout the year; savings are greater the larger the number of times invoices are sent to your customers in the year; the same idea applies to cheques sent to your suppliers. The result is that the minimum cash balance kept in your current account may not have to be as large as it was, and the amount of interest saved by not having to use external sources may be quite substantial.
- *Positive cash management* means that cash flows must be understood, cash and potential cash should be identified, and that cash should not be wasted, for example, holding unnecessary sums of cash in current accounts when it could be put to work and make money for the company.

Trade Credit

- Trade credit is a natural method of obtaining finance in that it arises from ordinary business transactions.
- Trade credit is an arrangement between a firm purchasing materials or supplies and its suppliers whereby the supplier delivers the goods and then agrees to defer payment of the debt. The supplier (creditor) shows this on his balance sheet in the form of a credit item whereas the receiver of the goods (debtor) will show it as a debit item on his balance sheet. It is quite normal for the deferment period to be around one month.

- Nearly every firm receives credit from its supplier and most give credit to their customers. The exception to this statement is in non-manufacturing firms especially those in the cash retail trade. To small and large firms the use of trade credit is an important source of working capital, but the extent to which it is given is mainly determined by the industry and not the size of firm. The importance of this method is that it is normally the largest single category of short term credit; even larger than Bank credit.
- Terms are usually arranged by the supplier to induce the customer to pay the debt before the due date. For example, a discount of 2% may be obtained if the debt is payable before 10 days, but between 11 and 30 days, the payment is net.

Advantages

- (1) Normally free from expenses (free of interest rate).
- (2) Flexible, convenient and informal.
- (3) Useful in promoting sales.
- (4) Can, with wise use, promote sound customer relations.

Disadvantages

- (1) Can be risky method. Control of firm can be lost, if the debtor fails to pay large debt to a single supplier.
- (2) Excessive credit given may force firm to borrow money.
- (3) Every debtor is a potential source of loss of cash. Bad debts.

Credit Sale

- A *credit sale* refers to the method of selling whereby the customer agrees to purchase goods and pay by instalments. Ownership of goods passes to the purchaser immediately. In the seller's books the purchaser becomes an unsecured debtor.
- This method is similar to hire purchase but possibly not so expensive. The *similarity to hire purchase* is that the goods are capital goods and the buyer enters into an agreement and agrees to pay off the debt in equal instalments. It *differs* from hire purchase in that the length of credit time is normally from about 6 months to a year and ownership is immediate.

Bill Finance

- The term *bill* refers to a *bill of exchange* which is nothing more than a special form of cheque which has been *post dated* usually 90 days forward. On occasion it could be for 30 days or even 180 days.
- In law, a bill is "an unconditional order in writing, addressed by one person to another, signed by the person giving it, requiring the person to whom it is addressed to pay on demand or at a fixed or determinate future time, a sum certain in money to or to the order of a specified person or to the bearer".
- *Bills can be classified* under two main headings
 - (1) Trade bills
 - (2) Bank bills
- The *Trade bill* relates to a bill drawn by a seller of goods (drawer) addressed to the buyer of goods (drawee) who, when receiving it, either writes across the face 'accepted' and signs it or pays a commission to a financial institution to accept it on his behalf. As soon as it has been accepted the person accepting it substitutes his credit for that of the drawer. He accepts liability to pay the bill on the due date.

- The *Bank bill* refers to a bill drawn by a person seeking finance to purchase goods and expecting to pay the bill on the due date.
- Trade bills are not normally as acceptable for discounting as are bank bills.

Bank Credit

- *Bank credit* refers to *overdrafts* and *short term bank loans*.
The source for bank credit are banks who rely for their funds largely from their depositors in the form of current and deposit accounts which can be withdrawn, respectively, on demand and very short notice.

- An *overdraft* is an agreement made by a banker whereby the bank agrees to honour cheques drawn on a *current account* up to a stated sum when that account has insufficient funds to meet such cheques. The rate of interest charged is on the amount of the total loan used.

For most companies (and individuals) it is the easiest and most convenient form of borrowing, and for many small businessmen, it is the most important external source of finance outside their normal trading activities.

- A *loan* for a short period of time is a method whereby the bank credits the customer's current account with a deposit to a stated amount for a given period of time (as may be arranged) for example, a year, nine months or for a shorter period.

The rate of interest charged, unlike the rates charged on overdrafts, is calculated on the total amount *provided*. Loans of this type are a cheap way of raising finance compared with many other methods, but, they are not as important nor so convenient (in terms of interest payments) as overdrafts.

Factoring

- *Factoring* refers to the purchase of a firm's book debts by a *factor*. The *factor* which is a specialised type of privately owned finance company that purchases accounts receivables, receives payments directly from the buyer of goods, quite unlike *invoice discounting*.

The only *common element* between factoring and invoice discounting is that they both are involved in the purchase of book debts.

- *Basically, there are two types of factoring*

(1) *Without recourse* — a method whereby the factor has no claim on his client, the seller of the receivables, should the factor not be able to obtain payment from the customer. Most factoring is of this type.

(2) *With recourse* — a method whereby the factor can claim payment from his client should the customer, who owes the debt, not pay.

- The factoring company combines book-keeping, credit insurance and the supply of finance; the latter being the main function.

Advantages

- Funds can be obtained almost immediately. Liabilities can be paid and cash accumulated.
- Debts can be paid promptly for the best possible cash discounts.
- The problem of the client's creditors urging debts be paid soonest are removed.
- The clients' credit image is improved.

Disadvantages

- (i) A restrictive method for most small firms.
- (ii) Arrangements are for an extended period and not for 2 or 3 months duration.
- (iii) The client uses a highly liquid asset as security.
- (iv) When invoices are large in number the administrative costs may be high.
- (v) A great deal of confidential business information is passed on to the factor.

Invoice Discounting

- Also known as *confidential invoice discounting*, because the discount firm makes no notification to the buyer of goods that the seller of the goods has borrowed money against their debt.

The discount firm has no contact with the buyer; the seller collects the debt and it is the seller the discount firm goes to, to collect the face value of the debt.

- Borrowing against receivables or book debt may be the answer for a company that is really in need of cash or for a company who has considerable amount of working capital tied up in receivables.

It is considered to be very expensive, so companies are often advised to exhaust other possible sources of finance first.

Advantages

- (1) Same as (i) to (iv) as mentioned under *factoring*.
- (2) The client's debtors are not informed of the financial arrangement.
- (3) It is flexible in that the client can discount his debts, up to an agreed limit, as and when he desires.

26.19 CAPITAL (Refer article 26.3 also)**Concept**

- Capital is an important factor of production.
- Capital is that part of *wealth* which helps in production of further wealth, e.g., seeds, machinery etc. An electric fan in the house is a *wealth* but a fan in an office or factory is a *capital*.
- Capital may be classified as
 - (i) *Physical capital*, like immovable property, seeds, fertilizers, business capital like goodwill of the firm etc.
 - (ii) *Financial capital* like bonds, shares, etc.

Features of Capital

- Capital is produced by man by saving wealth.
- Capital is a factor of production.
- Capital is transferable from one person/place to another.
- Constant use of capital leads to its depreciation.
- Capital is mobile as it can be moved from one occupation to another.
- Supply of capital as a factor of production can be easily increased or decreased.
- One has to toil hard to accumulate capital. It is man-made and not a free gift of the nature.
- Capital is the outcome of saving because saving when used in productive activities is called capital.

Types of Capital

- (1) *Fixed or block capital* — it is required to purchase building, machinery, tools etc.
- (2) *Working or current capital* — it is required to meet day-to-day needs and expenditures such as purchase of raw material, payment of employee wages etc. (refer page 26-2)

26.20 WORKING CAPITAL (Refer article 26.4 also)

Concept

- Working capital means *current assets*.
- *Current assets* means assets which can be converted into cash within an accounting year and includes cash, short term securities, bills receivable, stock etc.
- *Gross working capital* refers to the firm's total investment in current assets.
- *Net working capital* = current assets – current liabilities.
- The term *working capital* is commonly used for the capital which is required for day-to-day working in a business concern, such as for purchasing raw material, for meeting day-to-day expenditure on employee salaries, wages, rents, advertising etc. (Refer article 26.34)

Classification

Working capital may be classified as follows :

(1) *On the basis of concept*

Working capital may be classified as

- (i) Gross working capital
- (ii) Net working capital

These terms have been discussed above.

(2) *On the basis of periodicity of requirement*

Working capital may be

- (i) *Fixed or permanent working capital* —

Regular working capital
Reserve margin or Cushion working capital
- (ii) *Variable working capital* —

Seasonal working capital
Special working capital

Permanent (or Fixed) Working Capital

- This capital is permanently locked up in the current assets to carry out the business smoothly.
- This investment in current assets is of the permanent nature and will increase as the size of business expands.
- Permanent working capital is that minimum amount of investment in raw materials, work-in-process inventory, finished goods, stores and spares, accounts receivable and cash balance which a firm is required to have in order to carry on a desirable level of business activity.
- Such an amount cannot be reduced if the firm wants to carry on the business operations without interruption.
- It is that minimum amount which is absolutely essential throughout the year on a continuous basis for maintaining the circulation of current assets.

- *Minimum cash* is required for making payment of wages, salaries, and other expenses; *minimum stock* is required to maintain regular supplies and *minimum investment* in debtors is essential on account of credit sales according to the period of credit allowed to the customers.
- Since the requirement of *permanent or hard core working capital* is on a permanent basis, such working capital should be financed out of *long-term funds*.

Characteristics of permanent working capital

- (1) The size of permanent working capital grows with the growth of business.
- (2) It keeps on changing its form from one current asset to another.
- (3) As long as the firm is a going concern, working capital cannot be substantially reduced.

(a) Regular Working Capital

It is the minimum amount of liquid capital needed to keep up the circulation of the capital from cash to inventories, to receivable and again to cash.

This would include sufficient minimum bank balance to discount all bills, maintain adequate supply of raw materials etc.

(b) Reserve Margin or Cushion Working Capital

It is the *excess over the needs* or regular working capital that should be kept in reserve for *contingencies* that may arise at any time.

These *contingencies* include rising prices, strikes, special operations such as experiments with new products etc.

Variable Working Capital

- Variable working capital requires changes with the increase or decrease in the volume of production or business.
- Variable working capital can be classified as
 - (i) *Seasonal working capital*
 - (ii) *Special working capital*
- The working capital required to meet the *seasonal needs* of the industry or business is known as **seasonal working capital**. For example, if an enterprise is marketing woollen garments, it needs more money for that purpose during winter months than in summer season. Similar is the case with a factory business engaged in the production or marketing of coolers, refrigerators or air-conditioners. They are all Seasonal products.
- **Special working capital** is that part of the variable working capital which is meant for meeting the special business operations such as extensive marketing campaigns, experiments with products or methods of production etc.

The *distinction between fixed and variable working capital* is of great significance particularly in raising the funds for an enterprise. *Fixed working capital* should be raised in the same way as fixed capital is procured.

Variable working capital is procured out of short-term borrowings from the bank or from the public.

When it comes to types of startup **funding**, there are a lot of options to consider.

Startups in the early stages need to raise startup capital or funding to survive past the business idea (at minimum) but looking into all the types of funding can be overwhelming to a budding entrepreneur. If you've never heard about pre-seed funding, equity stake, or venture capital funds, we are going to dive into how to raise funds for startups, and the difference between all the funding sources out there.

So, what do all the types of startup funding mean? What are angel investors? How does series funding work? What does equity funding entail? What's the best way to land an investment from a venture capital firm? Is self-funding and crowdfunding actually legitimate? Is external startup funding the best option?

As Startups.com Founder and CEO Wil Schroter likes to say, "There's no 'fun' in funding." But it doesn't have to be terrifying, either. There are many different funding options to navigate in the early stages of a startup.

Let's explore the five most common types of startup funding sources, with links to more detailed explorations of each type of startup business funding here.

1. Series funding

Series funding is when a startup raises rounds of funds, each one higher than the next and each one increasing the value of the business. It's described alphabetically: **Series A, B, C, D, and E**.

Series A

Once a startup makes it through the pre-seed funding stage and it has some kind of traction — whether it's number of users, revenue, views, or any other key performance indicator (KPI) — they're ready to raise a Series A funding round.

The average Series A round is now \$9.3 million.

Series A startup funding usually comes from venture capital firms, although angel investors may also be involved. Additionally, more companies are using equity crowdfunding for their Series A.

Series A is a point at which many startups tend to fail. In a phenomenon known as "Series A crunch," even startups that are successful with their seed round often have trouble securing a Series A round.

Series B

A startup that reaches the point where they're ready to raise a Series B funding round has already found their product/market fit and needs help expanding.

The big question here is: Can you make your company work at scale? Can you go from 100 users to a 1,000? How about 1 million?

A Series B funding round now averages \$21 million. Companies can expect a valuation north of \$60 million.

Series B funding usually comes from venture capital firms, often the same investors who led the previous round. Because each round comes with a new valuation for the startup, previous investors often choose to reinvest in order to ensure that their piece of the pie is still significant.

Companies raising a series B funding round may also attract the interest of venture capital firms that invest in late-stage startups.

Series C

Companies that make it to the Series C stage of funding are doing very well and are ready to expand to new markets, acquire other businesses, or develop new products.

Series C is often the last round that a company raises, although some do go on to raise Series D and even Series E round — or beyond. However, it's more common that a Series C round is the final push to prepare a company for its IPO or an acquisition.

For its Series C, startups typically raise an average of \$26 million. Valuation of Series C companies often falls between \$100 million and \$120 million, although it's possible for companies to be worth much more, especially with the recent explosion funding valuation of “unicorn” startups.

Valuation at this stage is based on hard data points, like:

- How many customers does the company have?
- How much revenue has the company generated?
- What is the company's current and projected growth rate?

Series C funding typically comes from venture capital firms that invest in late-stage startups, private equity firms, banks, and even hedge funds.

Series D

"Series D funding is a little more complicated than the previous startup funding rounds. As mentioned, many companies finish raising capital during a Series C. However, there are a few reasons a company may choose to continue on to Series D.

1. Expansion Opportunities: Before opting to go IPO, a company might discover a new opportunity for expansion and just need another boost to get there. Many companies raise Series D rounds (or beyond) to increase their value before going public. Alternatively, some companies want to stay private for longer than was once common.

2. Down Round: When a company hasn't hit the expectations laid out after raising their Series C it's called a “down round.” It also refers to when a company raises money at a lower valuation than they raised in their previous round.

Series D rounds are typically funded by venture capitalists. The amount raised and valuations vary widely, especially because so few startups reach this stage.

Series E

If few companies make it to Series D, even fewer make it to a Series E. Companies that reach this point often raise for many of the reasons listed in the Series D round:

- They've failed to meet expectations

- They want to stay private longer
- They need a little more help before going public

2. Crowdfunding

Crowdfunding is a method of raising capital through the collective effort of friends, family, customers, and individual investors.

This approach taps into the collective efforts of a large pool of individuals — primarily online via social media and crowdfunding platforms — and leverages their networks for greater reach and exposure.

Crowdfunding is essentially the opposite of the mainstream approach to business finance. Traditionally, if a person wants to raise capital to start a serious business venture or launch a new product, they would need to pack up their , market research, and prototypes, and then shop their idea around to a limited pool of wealthy individuals or institutions.

These funding sources include:

- Banks
- Angel investors
- Venture Capitalists

This fundraising approach is like a funnel, with the entrepreneur and their pitch at the wide end and the audience of investors at the closed end. Fail to point that funnel at the right investor or firm at the right time, and that's time and money lost.

Crowdfunding platforms, on the other hand, turns that funnel on-end. By giving the entrepreneur a single platform to build, showcase, and share pitch resources, this approach dramatically streamlines the traditional business model.

Traditionally, entrepreneurs spend months sifting through their personal networks, vetting potential investors, and spending their own time and money to get in front of them.

With crowdfunding, it's much easier for entrepreneurs to raise money, get their opportunity in front of more interested parties and give them more ways to help grow the business, from investing thousands in exchange for **convertible debt** or equity to contributing \$20 in exchange for a first-run product or other rewards.

So, what are the options if you **can't raise any more funding**?

3. Loans

A small business startup loan is any type of loan that helps businesses with little to no traditional business loan history. It's one of many financing options for founders who are looking to either get started or improve their young companies.

Small business startup loan is an umbrella term under which a few different types of small business grants and financing fall.

Here's a general breakdown of the main types of various small business loans and startup loans you might run across as you're figuring out the best option for financing your startup.

1. SBA loans

An SBA small business loan is a loan that is backed by the Small Business Administration (SBA).

Founded in 1953, the SBA is a federal government program that provides support to small business owners in the form of mentorship, workshops, counseling, and small **business loans**

While the loans are backed by the SBA, they don't come directly from the SBA. You'll have to find a local lender who provides SBA loans in order to access the funding.

2. Credit cards

While not a traditional “loan,” many traditional business loans and credit cards are a great option for very early-stage startups who need help getting going.

Choose one with a 0% introductory APR, because that means that as long as you're able to pay off the balance each month (or at least by the end of the first year, which is when most credit cards' interest rates kick in), you're basically getting a free loan.

However, beware of high interest rates — and don't overestimate how quickly you'll be able to pay back a credit card. Once that introductory period is over, any balance you're carrying will likely come with a hefty interest rate.

3. Short term loans

Short-term loans are relatively small amounts of money that have to be paid back within three to 18 months.

They're often used as a stop-gap when a company is having cash flow problems, for emergencies, or to help companies take advantage of a new business opportunity.

4. Friends and family

Getting money — in the form of loans or investments — from family and friends is another one that doesn't fall under traditional “small business startup funding and loans.” But it's a common way for startup founders to get money from pre-seed funding to either start their companies or get help along the way.

Friends and family are a great source of early investment or loans — but it can be a tricky relationship to navigate.

It's common for people to feel like they can be casual and personal with these types of investments because their relationships with the investors are personal.

That's a mistake.

You should treat an investment or loan from friends and family as a professional addition to your personal savings and your existing personal relationships. It's a good idea to get a written contract stipulating the terms of the investment or loan and also to make it clear that it's very, very likely they won't get their money back if it's an investment.

4. Venture Capital

Venture capital investment is funding that's invested in startups and small businesses that are usually high-risk, but also have the potential for exponential growth.

The goal of venture capitalists is a very high return for the venture capital firm, usually in the form of an acquisition of the startup or an IPO.

Venture capital is a great option for startups that are looking to scale big — and quickly. Because the investments are fairly large, your startup has to be prepared to take that money and grow.

Venture Capitalists usually run by a handful of partners who have raised a large sum of money from a group of limited partners (LPs) to invest on their behalf.

The LPs are typically large institutions, like a State Teachers Retirement System or a university who are using the services of the VC to help generate big returns on their money.

The partners have a window of 7 to 10 years with which to make venture investments, and more importantly, generate a big return. Creating a big return in such a short span of time means that VCs must invest in deals that have a giant outcome.

These big outcomes not only provide great returns to the fund, they also help cover the losses of the high number of failures that high-risk investing attracts.

5. Angel Investors

Angel investors are typically high net-worth individuals who look to put relatively small amounts of money into startups, typically ranging from a few thousand dollars to as much as a million dollars.

Angel investors are often one of the more accessible forms of early-stage capital for an entrepreneur and as such are a critical part of the equity fundraising ecosystem.

The most beneficial aspect in working with an angel investor is that they can usually make an investment decision on their own. Not having to manage a partnership or corporate hierarchy of decision-making or financial advisor allows the angel investor to make bets that they feel comfortable with personally.

Often this is what an entrepreneur needs early in their startup's development.

Angels also tend to have subject matter expertise in a particular area, often where they have made money before. This helps the entrepreneur in a couple of huge ways.

First, they won't waste the entrepreneur's time asking uninformed questions because they already know the space.

Second, they tend to be well-connected in particular industries, so the value of their investment also includes the resources they can bring to help the venture in the future.

Unlike what the term may imply, an angel investor isn't a happy angel falling from the sky that is there to answer your dreams with a big fat check (although that sure would be nice).

Angel investors do not bail people out of personal or business credit problems. They do not make charity investments because an entrepreneur feels their idea is really important to the world. They

make investments to make a healthy return on their investment – rarely otherwise. Angel Investor Networks

Angels often band together to form angel investor networks. Since every angel has to sift through the same types of deals over and over, it helps to share deal flow and combine resources to find great deals.

Angel investor networks are really useful to entrepreneurs because they tend to have a more formalized process for reviewing new submissions and can also introduce the entrepreneur to a lot of new angels at once.

Think of working with an angel investor network as a way to broadcast your deal to a large number of qualified candidates all at once. In some cases, even if the network itself does not invest as a group, you may attract the attention of a particular angel in the network who decides to invest.

There is no definitive limit on how much funding what a single angel investor can invest, but a typical range would be from as little as \$5,000 to as much as \$5,000,000, although most angels tend to cap out around \$500,000.

Angels may also invest incrementally, offering you a small investment now with the opportunity to follow on at a later date with additional investment, typically when something important happens with the whole business plan.

SECRET

77

Budget and Budgetary Control

77.1. BUDGET

It is a tool of management for planning its future activities including estimate of sales, expenditure production etc. It is done for indicating the expected results of the business and the possible future line of action to be followed for the attainment of such results. Expected results are projected in financial terms or in other numerical terms like units of products, man hours, machine hours etc. Budgeting or Budget making may be defined as "a forecast of programme of operations based on expected operating efficiency."

Budget should be based on estimated future requirement for a definite period of time. It should be prepared by taking the help of previous statistical data. Thus, budgeting can be defined "as forecasting and preplanning for the next period using past experience, market trends and present position".

Budget provides predetermined standard of performance for the guidance of the efforts and activities in the business. As budgets provide standards of performance, they usually become the basis for control. Control used for the execution of budgets is what is called "budgetary control". Thus budgeting is concerned with the planning function of management, while "budgetary control" involves the function of controlling in the organisation.

Budgeting

Budgeting is an art of budget making. This implies forecasting and preplanning for the budget period on the basis of past statistical data, present trends and other related known present facts.

Budget as a means for Planning, Coordination and Control. Since planning is looking ahead and anticipate difficulties expected and their solution. Budget plans and forecast the expenditure and performance as regards production, sales, purchases, plant utilisation etc.

As coordination means weaving together the segments of the organisation so as to operate at the most efficient level and produce maximum profit. This is achieved as all the sections like sales, purchase, production, finance, personal etc. work together to achieve common goals as defined in the budget.

Controlling means by systematic appraisal of results to ensure that actual and operations coincide, and remedial actions are taken if there is any deviation. The budget means, by which plans are regularly compared with actual results regarding expenses and performances.

Objectives of Budgeting

It has the following main objectives :

- (i) To make periodical evaluation of management policies.
- (ii) To provide basis for examining the achievement of the industry.
- (iii) To provide check over expenditure in various departments.
- (iv) To make a programme for systematic development.
- (v) To decide basis for the expenditure of funds.
- (vi) To provide basis for checking of working of the concern by seeing their efficiency and economy.

Advantages of Budgeting

Budgeting in any concern is very essential, because it has some of the following important advantages :

- (i) Responsibility for the performance may be fixed. Therefore, it provides check over shifting of responsibility.
- (ii) By budgeting, financial position of the concern is made clear.
- (iii) A check on the performance and efficiency of the industry is provided.
- (iv) It improves management by providing check at all levels. Thus, it helps in improving efficiency.
- (v) It is essential to show budget while taking loan from banks so that they may know about the financial position of the concern.
- (vi) It helps in making the policies for the coming period.
- (vii) It is helpful to predetermine the price of product.

Budget Requisites

For budget preparation following considerations must be made :

(a) **Allotting Authority and Responsibility.** For proper budgeting suitable arrangements for allowing responsibility and authority are made. For this purpose a Budget Committee consisting of representatives from all the departments is formed. A Budget officer is appointed as co-ordinator. He is responsible for getting periodic reports from various departments and to see that all departments prepare estimates with sufficient supporting data.

(b) **Clearly defined Business Policies.** To prepare a good budget, it is essential to know about the business policies. After knowing the policies, budget is prepared considering their effects in each department.

(c) **Information about Forecast.** Information about the future activities of the business should be available to facilitate the budget preparation.

(d) **Cost Information.** While preparing budget all the information regarding costs are essential. Budget can only be prepared after knowing the manufacturing cost of product and other policies regarding margin of profit etc.

77.2. BUDGETING PRINCIPLES

Following principles should be adopted while budgeting for any kind of organisation, and for budgets of any kind :

- (a) Budget should be related to the organisational objectives, and should be linked with the organisational structure.
- (b) Budget should be flexible.
- (c) Budget should contain realistic estimates.
- (d) There should be norms, standards and productivity indices for inputs and outputs for the budget activity.
- (e) There should be a system of periodical, review and follow up.
- (f) For effective budgeting, management compliments and involvement of all concerned executives is necessary.

77.3. BUDGET CLASSIFICATION

Budgets (Basis)

<i>Flexibility</i>	<i>Mechanism</i>	<i>Functions</i>
1. Fixed budget 2. Variable budget	1. Appropriation budgeting 2. Performance budgeting 3. Zero Base budgeting	1. Master budget 2. Sales budget 3. Production budget 4. Financial budget 5. Capital Expenditure budget 6. Cash Budget 7. Material and Purchase budget 8. Labour budget

(A) On the basis of Flexibility

These are classified with reference to the approach adopted in their preparations :

1. Fixed budget. If the level of activity (capacity utilisation) can be fixed for a budget period, and if all the functional budgets are prepared based on this level of activity, then such a budgeting method is termed as fixed budgeting. In such budgeting no provision is made for any changes which might occur during the budget period.

2. Variable or Flexible budget. In the variable or flexible budgeting the level of activity (capacity utilisation) is variable. Where because of uncertainty of market, or material or skilled labour availability or machine capacity availability, it is not possible to fix up a level of activity during the budget period, variable budgeting is adopted. In such case different budgets are prepared for different levels of activity.

In flexible budgeting method, the budget for fixed costs is static (per unit production), but the budget for variable costs will vary with the level of activity (volume of production).

(B) On the basis of Mechanism

1. Appropriation Budgeting. This is mostly applicable to government departments, where output measurement of all the activities is difficult. Activities like health, education, agricul-

ture etc. are not susceptible to performance evaluation on an yearly basis. In such cases, maximum limit on expenditure for a given activity is fixed. This type of budget is also termed as a conventional budget.

In industry, appropriation budgeting is adopted in research and development, management training, and for some categories of administrative expenses.

This budget has following characteristics :

- (a) Oriented towards the financial or money aspects.
- (b) Emphasis is mainly on inputs like salaries, rent, stationary and not on the purpose of expenses.
- (c) Efforts are on exhausting the funds provided in the budget rather than on the performance or on the end results of the money spent.

2. Performance Budgeting. In short performance budgeting is a comprehensive operational document, conceived, presented and implemented in terms of functions, programmes and activities with their financial and physical aspects, closely interwoven.

The performance budget links physical targets with financial outlays, and presents for the next year. Its focus is on the work and the result expected of the money to be spent in the next year.

Performance budget serves the following purposes :

- (a) Correlates the physical and financial aspects of programmes and activities.
- (b) Brings together the annual objectives and the developmental plans.
- (c) Measures progress towards long term objectives as envisaged in the plan.
- (d) Improves budget formulation review and decision making at all levels of management in the organisation and thus serves as an effective instrument of planning and control for the managers.

Steps for developing performance budgeting system

- (i) Classify the total quantum of work in terms of functions, programmes and activities. A function is a broad grouping of operation that are directed towards the accomplishment of the goals or the objectives of the organisation. The programmes imply broad category with in function that identifies the end products. Activity is a division of a programme in terms of the nature of the work.
- (ii) Develop physical targets and financial resources required in terms of the function, programmes and activities. Establish also select work load factors like productivity indices and performance ratios, suitable for physical achievements.
- (iii) Devise an accounting system suitable for keeping records according to the function, programme and activity classification rather than the usual heads of expenditure.
- (iv) Have periodical reviews to see whether the performance is according to physical targets laid out and what is the financial variance.

3. Zero-Base Budgeting (Z.B.B.). Appropriation budgeting and performance budgeting is a planning process, and are primarily based on past years' records, and therefore based on the principle of 'incrementalism'. Zero Base Budgeting (Z.B.B.) on the other hand analyses each issue i.e. whether the current ongoing activity is efficient and effective, and whether it should be eliminated or changed. Thus it is required to justify the funds requirement for every activity.

(C) On the Basis of Functions

1. Master Budget. For large organisation, complete budget is very big. Therefore, a separate summary is prepared giving summaries about all the plans, policies and their effects over the business. The summarised budget of the entire concern is known as the "Master Budget". This outlines expected performances in different areas of the business. The object of the budget is to secure an overall co-ordination in the budgetary programme and accordingly it is utilized by the top management for exercising effective control over the business. First of all, departmental budgets are developed for integrating them into a master budget.

2. Sales Budget. This budget gives income from the products likely to be sold and the sales expenditure. Sales forecast can be done on the basis of the reports received from the salesman, who will give the approximate quantity of products likely to be sold in his area. Sales expenditure budget is prepared by estimating the expenses on advertising, market analysis, salesman's salaries, office expenses etc. for the budget period. Past records are very helpful for preparing sales budget.

The sales budget is the starting point in a budgetary programme since sales are basic activities which give shape to all other activities in a business. Sales and production are the basic activities of a manufacturing concern and all other activities play an auxiliary role in the business. Without planning sales, no future estimate can be made about auxiliary activities in the organisation. Even between two basic activities of sales and production, it is sales that regulate the flow of production in all businesses.

The primary objective of the business is good market standing and the market standing demands that sales should be placed as number one budget.

3. Production Budget. This budget is prepared to assure that demands of sales department can be met. It gives the time for producing and for despatching them. It also includes the expenditure likely to occur on the maintenance of these produced articles. It is prepared by considering sales demand and capacity of plant.

In addition to these production budget aims at securing economical manufacture of product and the maximum utilization of production facilities through a smooth operation. The cost of production is an important question in manufacturing and determines the effectiveness of planning efforts. The principal way of reducing costs is to secure the maximum utilization of production facilities and to obtain perfect co-ordination in their working relationships. This is just what is done in production budgeting.

4. Financial Budget. This budget gives the summary about the money to be received and spent during the budget period. The financial budget forecasts the profit and loss statement and the financial position of the concern at the end of the budget period. Thus, it helps the management for long term planning.

This budget is prepared for the use of top management members to know the profitability of a budgetary programme. This budget has no application in lower echelons of the organisation. Budgetary control cannot be exercised without the aid of the financial budget.

5. Capital Expenditure Budget. The capital expenditure budget is prepared with the object of making a planned and timely capital investment in the business. To ensure the availability of capital at the right time and to prevent disruption in the normal working of the enterprise, this budget maps out the future capital expenditure over a long period of time. Additional investments are required to be made in acquiring new equipments, machines and other production facilities by an enterprise. Capital expenditures in the year ahead are planned and provided for the preparation of this budget. Because of this budget all stresses and strains

are avoided and the enterprise is not forced to be caught unprepared for the situation.

6. Cash Budget. The cash budget is prepared for projecting the possible cash receipts and payments over the budget period. This budget analyses the cash position month by month or even week by week in some cases. The object of cash budget is to ensure a steady supply of funds for meeting day-to-day requirements of working capital and for paying current obligations of the business. The budget assists materially in making occasional heavy payments for the purchase of fixed assets, the disbursement of interest and dividend on the redemption of debentures and shares without causing any disturbance to the normal working of an enterprise.

Because of the advance estimate of cash position, the cash budget aids in timely raising of funds either through borrowing or through other means and utilizing surplus funds on the bulk purchase of materials or for short-term investment purpose.

7. Material and Purchases Budget. Material budget shows the monthwise quantities required for each major type of raw materials to produce the goods as per production budget. material quantities are assessed on the basis of past consumption records, or technical estimates.

Purchase budget is prepared with the help of material budget. It represents the quantities of the materials to be purchased (monthwise or quarterwise) and the estimated costs of the materials. Purchase budget helps in making purchase plans in accordance with established inventory procedures to purchase the required materials sufficiently in advance so that materials are available in time.

8. Direct Labour Budget. Direct labour budget shows the estimate of direct labour needed to carry out the budgeted output. It is breakdown for each department and gives periodwise labour requirement for each category of labour. The labour requirement is assessed on the basis of work study and other norms of the organisation. On the basis of standard wage rates for that category of workmen, total expenses needed on direct labour is estimated and indicated in the direct budget.

Other Budgets. In addition to the above, some other budgets are prepared in big industries. These may be training, research budgets etc.

77.4. BUDGET SUMMARIES

Three different documents such as (i) the master budget, (ii) the budget income statement and, (iii) the budget balance sheet are utilized for preparing a "Budget Summary". The master budget assembles together the anticipated results of all supporting budgets and includes sales targets, production targets and targets of other activities. The master budget alone, cannot show the profitability of budgetary programme. To ascertain the future income during the budget period, "Revenue and Expense" budget is developed in its proper form, both the trading results and net results are expressed in financial terms. Alternatively a separate income statement is required to be compiled for estimating the future income of the business. The revenue and expense budget is required to be related to the financial position of the business, as expressed in the balance sheet.

A budget balance sheet is prepared to show the expected variation in assets and liabilities caused by the result of budgetary programme. The budget balance sheet as well as the budget income statement is prepared from the data included in the "Master budget".

It means that "Master budget" is translated into an income statement and a balance sheet for the future and these three documents taken together form the budget summary for serving as a tool of top management control in the organisation.

77.5. BUDGETARY CONTROL

As we have already discussed the budget as an "estimate of future requirements about the activities of the concern for a particular period", therefore, a process known as Budgetary control is very helpful which is a "process of comparing the actual result with the corresponding budget data to know the actual cause of differences".

It can also be defined "as the process which keeps the actual standards as nearly as possible to the predetermined standard by strict supervision.

Budgetary control is useful to know about the extent of profits or losses being made.

Advantages. Budget and budgetary control has many advantages in the working of an industrial undertaking. Some of the important advantages are :

- (i) It clearly defines the goals of the business concern.
- (ii) It helps in making plans to attain these goals.
- (iii) It helps in determining the policies of the concern.
- (iv) It controls expenditure.
- (v) It gives in advance complete information regarding amount of capital needed for the budget period.
- (vi) It also helps to control the financial position of the undertaking.
- (vii) It helps management in controlling the causes of inefficiency.
- (viii) It promotes co-operation among different executives for determining future policies and plans.
- (ix) It acts as a tool for administration.
- (x) It helps to know that where executive action is required to obtain desired results.
- (xi) It helps in measuring the performance of each department of the concern.
- (xii) It centralises management control.

77.6. ESSENTIAL CONDITIONS FOR BUDGETARY CONTROL

These may be :

- | | |
|--|---------------------------------|
| (i) Focus on objectives | (ii) Consistent delegation |
| (iii) Proper targets | (iv) Appropriate period |
| (v) Communication of Planning promises | (vi) Provision for flexibility. |

(i) **Focus on Objectives.** Budgeting must be done in terms of objectives and policies of the concern. If objectives are not stressed in budgeting, it provides aimless efforts and implies no more than mere advance accounting of expected transactions in the business.

(ii) **Consistent Delegation.** Fixed duties and obligations are required to be allocated to individual managers at different levels of organisation for framing and executing budget. The overall budget is broken down into element parts in conformity with organizational components. By breaking down the budget into component parts, each management member can be informed about that part of the total budget for which he is accountable and when he is required to accomplish the work.

To secure necessary co-ordination between operations of two or more departments, departmental budgets are integrated and woven into a master budget for the concern as a whole.

(iii) **Proper Targets.** In matters of setting budget targets there should be adequate checks and safeguards against the adoption of too high or too low estimates. Both these extreme cases

of budget estimates create difficulties in the organisation and demoralize human beings of the enterprise. Utmost care must, therefore, be taken for fixing targets so that employee initiative and individual responsibility, can be aroused on the one hand and performance can be improved on the other hand.

(iv) **Appropriate Period.** Every business requires some short-term budgets as well as some long-term budgets. The sales budgets, the operating expenditure budgets, the revenue and expense budget and the cash budget are the usual short-term budgets. On the other hand, the capital expenditure budget, the research budget and the management training and development budget are the common long term budgets of a business.

Preparation of yearly budgets are recognised as short-term budgeting, while five yearly or ten yearly budgets are deemed as long-term budgeting. In short-term budgeting, a year is the common budget period. Budgets are prepared for a year and reviewed at yearly, six-monthly or quarterly intervals. In fact, budgeting is a continuous process and requires perfect harmonization between long-term and short-term budgets.

(v) **Communication of Planning Promises.** If departmental and subsidiary budgets are to be prepared and interpreted consistently throughout the organisation the communication of planning promises assumes importance. Subsidiary budgets which are mostly interrelated must be based on the same assumptions in planning for securing co-ordinated action.

(vi) **Provision for Flexibility.** There should be nothing rigid in budgeting and budgets must always be flexible to meet changed condition. Flexibility is one of the essential attributes of budgeting. This flexibility, however should not be taken by operating managers as an excuse for lowering their performances. Unless there are sufficient reasons, budgets should not be changed during their currency. Any alteration in budget figures must always be done at the highest level of management after thorough scrutiny.

Securing Flexibility in Budgeting

Uncertainty in customers demand, shortage of materials, labour disputes and priorities arising from government contracts have made business forecasting and the preparation of accurate budget a difficult matter. As a result, budgeting in many concerns is performed with some degree of flexibility, varying from the plan of revising budget estimates from month to month, to meet changing conditions to the highly developed programme of budget preparation which provides a series of budget estimates for different levels of sales and production which might be expected under varying circumstances during the budget period.

77.7. LIMITATIONS OF THE BUDGET

Too frequently too much is expected of a system of budgeting within a short period of time. It should be recognised that no budget is better than the people who operate it and people cannot be changed in their habits and interests over night. The idea of budgeting must be told and furthermore, it must be demonstrated. It may gain rapid acceptance and effectiveness in one department and only "half-hearted" acceptance in others. Some people will consider the budget as only a negative control and something to be resisted and postponed as-long as possible. Some will give "lip service" to the endorsement of the idea but know in their own minds that it cannot work in that department. The chances are that, it will not work in that department until the desire to make it work has been established. That desire cannot be forced. Budgeting, is an instrument of planning, control and co-ordination, and it must be co-operative budgeting. As such, time is an essential element.

26.8. FINANCIAL ACCOUNTING AND BOOK-KEEPING

26.8.1 Financial Accounting

- Financial accounting is concerned with external transactions *i.e.*, it records all dealings with outside the concern.

Purchase, sale, services, etc. whether for cash or credit are covered in financial accounting.

- *Financial accounting covers*

1. Cash accounts—cash receipts and payments.
2. Personal accounts—credit given and taken.
3. Real accounts—property bought and sold.
4. Nominal accounts—Expenses incurred.

- *Financial accounting meets following objectives*

1. Stock exchange requirements.
2. Legal requirements.
3. Tax requirements.
4. Safeguarding shareholders.
5. Dividend policy.

- *Financial accounting*

1. is a legal necessity ;
2. is vital for showing the indebtedness of a concern ;
3. serves as evidence of credit worthiness; and
4. serves as a report on Management's social obligations. It deals with matters of interest (such as wages, etc.) to workers and trade unions.

26.9. BOOK-KEEPING

Introduction and necessity of

- It is apparent that in the accounting department there is a large amount of routine work to be performed.
- Cash accounting must be strictly controlled and the various day books and ledgers must be entered.
- As the size of the business grows, no businessman can remember all his transactions and thus he realises the necessity of proper book-keeping.
- Book-keeping is also necessary in order to satisfy the income-tax authorities.
- Proper book-keeping or properly maintained business records show :
 - (i) All purchases, sales and returns in the financial year.
 - (ii) Quantity and value of goods available with the concern.
 - (iii) Transactions with creditors and debtors.
 - (iv) Information about assets and liabilities of the concern.
 - (v) Profit and loss accounts.
 - (vi) Cash available with the concern.
 - (vii) The financial soundness of the concern.

Definition of

Book-keeping may be defined as the art and science of recording all the dealings related to money, goods and services in a systematic manner so that any information pertaining to the business can be easily supplied to the management or the owner of the concern.

Systems of Book-keeping

The following two systems of book-keeping may be used :

1. Single entry system.
2. Double entry system.

1. Single Entry System

- Every transaction is between two persons or two concerns.
- Every transaction, thus, affects two accounts.
- Single entry system records only one side of the transaction and hence it does not provide complete information about a transaction.
- This system of book-keeping is not generally used.

2. Double Entry System

- Double entry system records both the sides of the transaction and thus provides complete information of the business transaction.
- The two sides of a business transaction are
 - (i) The credit side.
 - (ii) The debit side.
- In double entry system, the value of an asset will appear on the left hand side and the value of liability on the right hand side of an account.

26.10. SOME TERMS USED IN BOOK-KEEPING

1. **Capital** is amount of cash, fixed assets and other goods which one invests in a business.

2. Transaction

The monetary dealing between two persons or two parties is called a transaction.

3. Trade discount

It is a discount or a % deduction from the list price which a seller gives to the purchaser, for example 10 to 15% discount on the printed price of the book is available to a student who buys any book.

4. Drawing

Drawing implies the withdrawal of money by the owner from his business for his personal use.

5. Sales returns

When a customer who has purchased certain goods, returns some of them (due to some reason) to the firm, it is called sales returns.

The reason of return may be either the goods are defective or they are not in right quantity, etc.

6. Purchase returns

If a firm returns to the vendor the goods purchased from him (due to some reason), it is known as purchase returns.

7. Commission

It is a kind of a remuneration given by a firm to a person for his services rendered to the firm.

8. Cash and credit trade

- It is a *cash trade* when a person buys and sells goods for cash only.
- it is a *credit trade* when a person makes both cash and credit sales and purchases.

9. Debtor

One (person or firm) who owes money to others, *i.e.*, he has to pay money to others.

10. Creditor

One to whom others owe money, *i.e.*, he has to get money from others.

11. Bad debt

A bad debt is one which becomes irrecoverable, for some reason, for example if the debtor dies without leaving any property behind.

12. Turnover

Turnover implies the total (credit and cash) sales of a business.

13. Assets**14. Liabilities****26.11. ASSETS****Definition**

- Assets are the resources of the business enterprise, *e.g.*, properties, equipment, stocks, debtors, cash, etc.
- Assets thus, include both money and right to future services.

Types

Assets are conventionally classified on the balance sheet in three major categories, namely :

- (a) Current assets.
- (b) Fixed assets.
- (c) Other assets.

(a) Current assets

- Current assets include cash and other assets that, under normal business conditions, can be converted into cash within a short time frame (*i.e.*, 1 year or less).
- Current assets may be consumed in immediate day-to-day operations of the business.
- Current assets include :
 - (i) Cash in hand,
 - (ii) Cash in bank,
 - (iii) Notes receivable,
 - (iv) Investment,
 - (v) Debtors,
 - (vi) Accounts receivable,
 - (vii) All inventories, and
 - (viii) Funds in checking accounts.

(b) Fixed assets

- Fixed assets have relatively permanent existence and are not readily converted into cash.
- Fixed assets are held for the purpose of earning income and they are not sold in the course of trading.

- Fixed assets are used in the operations of business.
 - Fixed assets include :
 - (i) Land,
 - (ii) Building,
 - (iii) Equipment and machinery,
 - (iv) Furniture, and
 - (v) Transport vehicles.
 - (c) **Other assets**
 - Other assets are those which do not fall into either current assets or fixed assets categories.
 - Other assets include
 - (i) Patents,
 - (ii) Copyrights,
 - (iii) Franchises,
 - (iv) Goodwill,
 - (v) Investment in the securities of other companies which management intends to hold for a long time.
 - (vi) Investments in bond sinking funds.
 - (vii) investments in pension funds, etc.
- N.B.: i, ii, iii and iv above are called *Intangible assets* and v, vi, and vii are known as *Long-term investments*.

26.12. LIABILITIES

Definition

- Those from whom a business enterprise borrows are known as creditors. The creditors have a claim on the business enterprise until they are paid : these claims are termed *Liabilities*.
- Thus liabilities constitute claims against the business enterprise.

Types of

Liabilities may be categorised as

1. Current liabilities,
2. Fixed liabilities, and
3. Contingent liabilities.

1. Current liabilities

- Debts which are expected to be settled within 1 year or less are shown as current liabilities.
- Current liabilities include :
 - (i) A bank overdraft,
 - (ii) Short term loans,
 - (iii) Trade credit,
 - (iv) Notes payable,
 - (v) Wages of employees,
 - (vi) Unearned revenues, e.g., rent or interest received in advance.

2. **Fixed liabilities.** They are of three types :

- (i) *Owner's capital*, i.e., the amount owed by the business to the proprietors.
- (ii) *Long term debts* or loans to the business ; such as, in the case of a company, bonds, debentures, etc.

Long term debts fall due after more than one year in the future.

(iii) *Capital reserves*. Where amounts are allocated out of surpluses with a view to increase the permanent capital of the business, such allocations are credited to a *capital reserve* account which henceforth forms a part of the fixed capital of the concern.

3. Contingent liabilities

- A contingent liability arises if, for example, a person/firm becomes a party to a bill of exchange.
- The contingent liability becomes a real liability if the principle debtor or the acceptor of the bill fails to pay.
- Contingent liabilities include guarantees entered into by the business.
- Contingent liabilities are not entered in an account forming part of double entry system, but they have to be noted on the balance-sheet of limited companies.

26.13. THE JOURNAL AND THE LEDGER

Introduction

- Every business transaction is recorded on the same day (it takes place) in a book called the JOURNAL. Thus, a *journal* is simply a chronological listing of transactions. The journal constitutes the original record of transactions.
- A journal records many accounts related to many persons or firms and thus it is very difficult to trace easily the accounts/transactions related to one person/firm.
- From the journal, the transactions related to each person or firm are sorted out, classified, and entered in a book called LEDGER. Thus,

(i) Ledger contains the same information (as given in journal) but properly arranged according to each person/firm it is related to.

(ii) In other words, the ledger furnishes a record of transactions grouped according to accounts. Each account reveals the effect of all transactions involving that particular item.

(iii) The ledger is split into two halves: the debit (Dr.) side being on the left and the credit (Cr.) side on the right.

- Fig. 26.1 and 26.2 show an extract from a *journal* and a Ledger respectively.

Example 26.1: Record the following transactions, in a journal and then post the journal entries in the ledger of cash accounts, goods account and capital account.

Transactions

May 1, 1977	Opened a hardware shop with	Rs. 10,000
May 3, 1977	Brought grinding wheels worth	Rs. 6,000
May 5, 1977	Sold grinding wheels to 'A'	Rs. 4,000
May 6, 1977	Commission paid	Rs. 50
May 9, 1977	Paid to bank	Rs. 1,000
May 12, 1977	Shop rent paid	Rs. 300
May 14, 1977	Purchased conduit pipes	Rs. 3,000
May 16, 1977	Conduit pipes sold	Rs. 2,000
May 17, 1977	Bought welding electrodes	Rs. 1,000

Solution : (See Fig. 26.1 to 26.4)

- The transactions have been recorded in the journal (refer Fig. 26.1). The next step is to transfer the amounts to the respective ledger accounts through a process known as *Posting*. Posting is the process of sorting and collecting the journal entries to various accounts and their recording in the respective ledger accounts. Fig. 26.2 to 26.4 show respective ledgers.

26.14. TRIAL BALANCE

- After posting all journal entries into the ledger, a statement called *Trial Balance* is prepared to check the accuracy of posting into the ledger.
- Trial balance checks the arithmetical accuracy of the entries.
- Trial balance is simply a list of the accounts and their balances at any given date.
- Trial balance is used to test the equality of balances because at any time the debits and credits should be equal in value.
- Besides checking the accuracy of posting into the ledger, the trial balance prepares material for formulating financial statements such as profit and Loss Account and Balance Sheet.
- Fig. 26.5 shows *Trial Balance* prepared from the Ledgers (Fig. 26.2 to 26.4).

JOURNAL

Date 1977	Accounts	Ref. L.F.	Debit (Dr.) Rs.	Credit (Cr.) Rs.
May 1	Cash A/c Dr. To Capital A/c		10,000	10,000
May 3	Goods A/c Dr. To Cash A/c		6,000	6,000
May 5	Cash A/c Dr. To Goods A/c		4,000	4,000
May 6	Commission A/c Dr. To cash A/c		50	50
May 9	Bank A/c Dr. To cash A/c		1,000	1,000
May 12	Rent A/c Dr. To cash A/c		300	300
May 14	Goods A/c Dr. To cash A/c		3,000	3,000
May 16	Cash A/c Dr. To Goods A/c		2,000	2,000
May 17	Goods A/c Dr. To cash A/c		1,000	1,000
	Total		27,350	27,350

1. Ref. column is meant for recording the folio of the ledger on which particular account will appear.

Fig. 26.1

LEDGER-CASH ACCOUNT

Debit, Dr.			Credit, Cr.		
Date	Particulars	Amount Rs.	Date	Particulars	Amount Rs.
May 1	To Capital	10,000	May 3	By Goods	6,000
May 5	To Goods	4,000	May 6	By Commission	50
May 16	To Goods	2,000	May 9	By Bank	1,000
			May 12	By Rent	300
			May 14	By Goods	3,000
			May 17	By Goods	1,000
				By Balance c/d	4,650
		16,000			16,000

Fig. 26.2

LEDGER-GOODS ACCOUNT

Debit, Dr.			Credit, Cr.		
Date	Particulars	Amount Rs.	Date	Particulars	Amount Rs.
May 3	To Cash	6,000	May 5	By Cash	4,000
May 14	To Cash	3,000	May 16	By Cash	2,000
May 17	To Cash	1,000		By Balance c/d	4,000
		10,000			10,000

Fig. 26.3

LEDGER-CAPITAL ACCOUNT

Debit, Dr.			Credit, Cr.		
Date	Particulars	Amount Rs.	Date	Particulars	Amount Rs.
April 30	To Balance b/d	10,000	May 1	By Cash	10,000
		10,000			10,000

Fig 26.4

c/d Carried down
b/d Brought down

TRIAL BALANCE

<i>Ledger Account</i>	<i>Debit, Dr. Rs.</i>	<i>Credit, Cr. Rs.</i>
Cash Account	4,650 *	
Goods Account	4,000 **	
Capital Account		10,000
.....		
.....		
.....		
Total	Rs. Z	Rs. Z

* Balance of cash account.

** Balance of goods account-Refer Ledgers.

Fig. 26.5

— A trial balance discloses the following types of errors :

- (i) An item posted two times.
- (ii) A mistake in posting.
- (iii) A mistake in addition.
- (iv) An item left from being posted.
- (v) Money values wrongly recorded (i.e., Rs. 160.0 in place of Rs. 1,600).

— A trial balance will not disclose the following types of errors.

- (i) *Errors of Commission*—Errors in posting to wrong accounts or compensating errors (i.e., mistake of same amount on debit and credit side.)
- (ii) *Errors of Omission*—items completely omitted from the books of account.
- (iii) *Errors of principle*—errors due to lack of knowledge of accounting principles, i.e., treating revenue items as capital, etc.

26.15. TRADING ACCOUNT

- The trading account shows the gross profit or gross loss on trading for the period covered.
- The trading account shows debit on the left hand side and credit on the right hand side (refer Fig.26.6).
- The debit side includes opening stock, the purchase, direct expenses, etc.
- The credit side marks sales, closing stock, etc.
- The difference between debit and credit sides shows either gross profit or gross loss.
- Fig. 26.6 illustrates trading account.

TRADING ACCOUNT

Debit, Dr.			Credit, Cr.		
Date	Particulars	Amount Rs.	Date	Particulars	Amount Rs.
March 1, 1977	To Stock (opening)	10,000	March 20	By Sales	13,000
March 3	To purchase	6,000	March 25	Less returns from customers	(-)300
March 10	To wages	500			
March 15	To carriage & octroi	100	March 31, 1977	To stock (closing)	4500
	To gross profit	600			
		17,200			17,200

Fig. 26.6

26.16. FINANCIAL STATEMENT

Introduction and Significance

- Financial statement of a business enterprise constitutes the general purpose, external reports of that enterprise.
- Financial statements are prepared for both internal dissemination within the corporation and for external distribution to the shareholders, creditors, the government and others having an interest in the financial position of the corporation.
- Financial statements have *significance* because :
 - (i) They are of interest to managers, owners, the lenders, the employees, the creditors and almost everybody who is concerned with the business.
 - (ii) Many business decisions are made only after consulting the financial statements or after financially justifying the move.
- Financial statements usually include
 1. Income statements (or the profit and loss statement)
 2. Balance sheet.

Profit and Loss Statement

- Income statement or profit and loss statement is a statement of revenues and expenses for a specified period of time.
- The income statement reports the results of operations of a given period.
- The statement starts with a report of the income for the period, from which are deducted all the costs incurred as a result of operations.
- The net figure is the profit or loss for the period.
- Fig. 26.7 shows a simplified income statement or profit and loss account.

Balance Sheet

- A balance sheet is a statement showing the financial status of the company at any given time.
 - A balance sheet is a statement of assets, liabilities and capital (or net worth) at a specified date.
- In other words, the balance sheet shows a summary of the sources of the (business) enterprise resources and of the investment of those resources in various assets.
- Balance sheets are prepared at least annually but may be done so more often and on specific occasions when the need exists in connection with making decisions concerning large project investments, dividend distribution, etc.

Fig. 26.8 shows a simplified balance sheet.

A.B.C. Co.	
Income Statement	
Month Ended March 31, 1977	
Revenues :	
Sales	Rs. 50,000
Expenses :	
Cost of goods sold	Rs. 25000
Selling expenses	Rs. 8000
Administrative expenses	Rs. 10000
Total expenses	Rs. 43,000
Income tax	Rs. 5,000
Net income (or Net profit)	Rs. 38,000

Fig. 26.7. Profit and Loss Statement.

A.B.C. Co.			
Balance Sheet			
March 31, 1991			
LIABILITIES	Rs.	ASSETS	Rs.
Current Liabilities :		Current Assets :	
Creditors for expenses		Cash in hand	
Trade creditors		Cash at bank	
Bills payable		Bills receivable	
Bank overdraft		Debtors	
		Inventory	
Long-term Liabilities :		Investments :	
Long-term loan		Fixed assets :	
Mortgage on property		Furniture and fittings	
Owner equity		Plant and machinery	
Capital		Building	
Retained profits		Land	
		Goodwill	

Fig. 26.8 Balance Sheet of a Corporation

THE INDIAN TAX STRUCTURE

The Indian Constitution is quasi-federal and the country has a three-tier government: the Central government, the State governments and the local governments. As the local public authorities are directly under the State government, no separate allocation of taxation rights has been done to them. To avoid any dispute between the Centre and States in the field of taxation, the following constitutional provisions have been made:

1. Division of powers to levy taxes between the Centre and the States is quite unambiguous. In other words, there is no tax which can be levied by both the Centre and the States. Before the Constitutional (Eightieth Amendment) Act was passed in March 2000, the customs duties and the corporation tax were within the purview of the Central government and they accounted for about 50 per cent of its tax revenue. Now revenues from these taxes are to be shared between the Centre and the States along with other Central taxes and duties. The States have power to levy some other taxes and the revenue collection from them may be spent on their activities. The important taxes falling in this category are value added tax (VAT), State excise duties, land revenue, agricultural income tax and entertainment tax.

2. Some taxes were earlier levied by the Central government but their proceeds were divided between the Centre and the States. Union excise duties and taxes on income other than agricultural income belonged to this category. The basis on which these taxes were divided between the Centre and the States was recommended by the Finance Commission. Now these taxes do not constitute a separate category. Together with other Central taxes and duties they constitute a Central pool of tax revenue which is shared between the Centre and the States in accordance with the recommendations of the Finance Commission.

3. The power to levy and collect certain taxes is vested in the Centre, whereas their revenue proceeds are to be distributed among the States. Estate duty on property other than agricultural land, duty on railway freights and fares, terminal tax on goods and passengers carried by railways, sea or air, taxes on sale or purchase of newspapers and on advertisements therein belong to this category.

4. Though some taxes are levied by the Central government, the responsibility to collect them is of the State governments. Stamp duties other than included in the Union List and excise duties on drugs and cosmetics have been included in this category.

The present chapter is devoted to a discussion of the following issues related to the Indian tax structure:

- Tax burden in India
- Tax revenue of the Central and the State governments
- Taxes on income and wealth
- Indirect taxation
- Evaluation of Indian tax structure
- The tax reforms since 1991
- Appendix: Goods and Services Tax (GST)

TAX BURDEN IN INDIA

The easiest way to know the tax burden is to find out tax-GDP ratio. When the process of economic planning began in India in 1950-51, the tax-GDP ratio was as low as 6.3 per cent. It has risen over the years but continues to be abysmally low. For instance, it was only 17.2 per cent in 2015-16 (this includes both Central and State tax revenues). The corresponding tax-GDP ratio for OECD countries was 33 per cent in 2013. Purely in terms of tax-GDP ratio, India has always been substantially lower than the average of OECD economies, over a 50-year period spanning 1965 to 2014.¹ Among the emerging economies, Russia has the highest tax-GDP ratio of over 36 per cent, followed by Brazil with over 33 per cent and South Africa with 25 per cent.² In fact, as pointed out recently by Thomas Piketty, India's overall tax revenues are very small for the size of its economy.

Some economists point out that an economy's tax-GDP ratio is or should be, a function of its per capita GDP, and hence it is misleading to compare India with those much wealthier. However, as pointed out by Praveen Chakravarty and Vivek Dehejia, the theoretical basis for such as assertion is debatable, and empirical evidence for

this is also lacking. While India's own tax-GDP ratio has increased over 50 years with increasing per capita GDP, superficially supporting the theory, this fact hides more than it reveals, if one breaks the time period of study into two quarters-century periods. In the 25-year period from 1965 to 1990, India's tax-GDP ratio increased steadily from 10 per cent to 16 per cent while India's GDP increased 2.8 fold. In the subsequent 26-year period from 1991 to 2016, India's tax-GDP ratio stayed roughly constant between 16 per cent and 17 per cent, while GDP increased 4.5 fold. It is puzzling to note that *"just as India broke away from its cliched Hindu rate of growth post the 1991 economic reforms to grow much more rapidly, its tax-to-GDP ratio stayed constant, belying those who would have predicted an increase"*.³

The tax revenue has recorded a considerable increase during the planning period. However, because of large scale poverty in the country, the base of direct taxes is very small. In addition, an important source of income is still out of the income tax. The agricultural income has been exempted from the Union income tax and the States are not inclined to levy it though they have statutory powers to do so. The government must take note of the fact that during the planning period a new class of large and big farmers has emerged and its income still remains untaxed. Also, India has a sizeable black income. Estimates by GPI (Global

Financial Integrity) Report shows that the size of India's black economy was as high as \$ 640.7 billion in 2008 which was 50 per cent of its GDP.³ Obviously, whole of this black income is concentrated in the hands of the richest who do not pay any tax on it. The government should muster courage to haul up this politically influential group of tax evaders.

TAX REVENUE OF THE CENTRAL GOVERNMENT

The total tax revenue of the Central government in 1970-71 was ₹ 2,451 crore. Of this, the share of direct taxes was ₹ 511 crore (i.e., 20.8 per cent) while the share of indirect taxes was ₹ 1,940 crore (i.e., 79.2 per cent). This shows that only *one-fifth* of the tax revenue was contributed by direct taxes. The share of direct taxes fell further to 16.1 per cent in 1990-91. However, on account of recent tax reforms, the share of direct taxes in total tax revenue has increased – it was 36.3 per cent in 2000-01 and 59.5 per cent in 2009-10. In 2015-16, direct taxes contributed ₹ 4,70,146 crore which was 49.6 per cent of the total tax revenue of ₹ 9,47,508 crore.

Direct and Indirect Taxes of Central Government

Table 50.1 presents information on revenue receipts from different direct and indirect taxes to the Central

Table 50.1
Direct and Indirect Taxes of the Central Government

Year	Tax revenue (net)	Direct tax	of which Personal income tax	Corporation tax	Indirect tax (net)	of which Excise duties (net)	Customs duties
1970-71	2451	511	114	371	1940	1369	524
1980-81	9358	1893	438	1311	7465	3723	3409
1985-86	21140	3698	665	2865	17442	7331	9526
1990-91	42978	6903	1250	5335	36075	14100	20644
1995-96	81939	22287	4318	16487	59652	22176	35757
1999-2000	128271	41436	9131	30692	86836	34944	48419
2000-01	136658	49651	23766	25177	87007	49758	34163
2001-02	133532	47703	22106	25133	85828	54469	28340
2002-03	158544	61612	27779	33893	96932	62388	31898
2003-04	186982	76590	30765	45706	110392	70245	34586
2004-05	224798	95944	35443	60289	128854	77241	41811
2005-06	270264	120692	45538	75187	149572	86642	46645
2006-07	351182	169738	62707	106701	181444	92651	62819
2007-08	439547	231574	86563	144660	207972	96178	75382
2008-09	443319	248152	86985	160797	195169	81872	69217
2009-10	456536	271623	94532	176797	184913	84383	60223
2010-11	569868	313501	102441	209115	256367	110222	97598
2011-12	629764	343310	118224	227411	286454	116226	105614
2012-13	741877	396585	140438	255570	345292	141245	115890
2013-14	815854	455829	169408	285742	360025	137975	121059
2014-15	903615	500531	188336	311453	403085	153709	127994
2015-16	947508	470146	181835	288305	477363	219000	127482

Source: Reserve Bank of India, *Handbook of Statistics on the Indian Economy*, 2015-16 (Mumbai, 2016), Table 100, p. 166.

government. From a review of this table, we can arrive at the following conclusions:

1. The share of personal income tax in total direct tax revenue was 22.3 per cent in 1970-71 (₹ 114 crore out of ₹ 511 crore). It fell to 18.1 per cent in 1990-91 but rose to as high as 46.3 per cent in 2001-02. In 2015-16, the share of personal income tax in total direct tax revenue was 38.7 per cent (₹ 1,81,835 crore out of ₹ 4,70,146 crore). The share of corporation tax in total direct tax revenue was 72.6 per cent in 1970-71 (₹ 371 crore out of ₹ 511 crore) and 61.3 per cent in 2015-16 (₹ 2,88,305 crore out of ₹ 4,70,146 crore).

2. Of the total indirect tax revenue of ₹ 1,940 crore in 1970-71, excise duties contributed ₹ 1,369 crore which comes to 70.6 per cent. Their share fell to only 39.1 per cent in 1990-91 but rose subsequently to 57.2 per cent in 2000-01 and further to as high as 63.6 per cent in 2003-04. However, it fell thereafter and stood at 45.9 per cent in 2015-16 (₹ 2,19,000 crore out of ₹ 4,77,363 crore). A glance at the table shows that excise duties/collections fell in absolute terms in 2008-09 — from ₹ 96,178 crore in 2007-08 to ₹ 81,872 crore in 2008-09. This was due to economic slowdown in the economy during the year 2008-09 which had a negative impact on corporate activity.

3. Calculation on Table 50.1 shows that customs duties accounted for 27.0 per cent of indirect tax revenue in 1970-71 (₹ 524 crore out of ₹ 1,940 crore). Their share in indirect tax revenue rose to 57.2 per cent in 1990-91 and 59.9 per cent in 1995-96. However, the share of customs duties in total indirect tax revenue was only 26.7 per cent in 2015-16 (₹ 1,27,482 crore out of ₹ 4,77,363 crore). The relative decline in customs duties in recent years is due to substantial reductions in duty rates.

4. It can be calculated from Table 50.1 that the relative share of personal income tax, corporation tax, excise duties and customs duties in total tax revenue in 1970-71 was 4.6 per cent, 15.1 per cent, 55.8 per cent and 21.4 per cent respectively. **Thus, more than half of the tax revenue was contributed by excise duties.** Considerable changes in the relative contribution of these taxes have taken place over the years. For instance, the relative shares of these taxes in total tax revenue in 1990-91 were 2.9 per cent, 12.4 per cent, 32.8 per cent and 48.0 per cent respectively. This shows that **customs duties became the most important source of tax revenue and contributed almost half of the total tax revenue in 1990-91.** However, as the process of import liberalisation gathered momentum in the post-economic reform period and, as a result, import duties were slashed, the share of customs duties in total tax receipts has tended to decline. In 2015-16 the relative shares of these taxes in total tax revenue was as follows —

personal income tax 19.2 per cent, corporation tax 30.4 per cent, excise duties 23.1 per cent and customs duties 13.4 per cent. Thus, **the most important contributor to tax revenue now is the corporation tax.** This is mainly due to the rising incomes of the corporate sector in recent years following economic liberalisation.

TAX REVENUE OF THE STATE GOVERNMENTS

The principal tax revenue sources of the State governments are the share of the States in the Central taxes and duties, commercial taxes, land revenue, stamp duties and registration fees, and the State excise duties on alcohol and other narcotics. Of all commercial taxes, sales tax has been the most important. However, this tax has now been replaced by Value Added Tax (VAT). Taxes on motor spirit and vehicles, entertainment tax and duties on electricity are other commercial taxes. For a long time, land revenue was an important source of revenue of the States. Until the beginning of the World War II, States raised nearly 35 per cent of the revenue from this source. Thereafter, its importance has considerably declined. Land revenue by its nature is an inelastic tax and thus over the years revenue proceeds from this source have not increased much. Thus, its contribution to States' tax revenue declined from 9 per cent in 1967-68 to 0.8 per cent in 2006-07. Due to stress on prohibition in the country, the revenue collection from the excise duty on alcoholic liquors and narcotics has not increased to the maximum possible level. In 2014-15, State excise duties accounted for 8.0 per cent of the total tax revenue of the States. Reliance of the States on sales tax had considerably increased over the years. In 2013-14, this tax had accounted for 44.1 per cent of the State governments' tax revenue (₹ 5,21,853 crore out of ₹ 11,83,086 crore). The share of States in Central taxes in 2014-15 was ₹ 3,66,216 crore (which was 31.0 per cent of the total tax revenue of the States). In other words, sales tax and share of States in Central taxes together accounted for 75.1 per cent (*i.e., three-fourths*) of the total tax revenue of the States in 2014-15.

TAXES ON INCOME AND WEALTH

In India, taxes levied on income and wealth by the Central government alone are important. Though the State governments have the power to levy a tax on agricultural incomes, yet in practice this tax has not developed as a major source of revenue of the States. **The Central government levies a number of taxes on income and wealth of which**

(from the point of view of the revenue proceeds) only personal income tax and corporation tax are important.

Personal Income Tax

Personal income tax is levied on the incomes of individuals, Hindu families, unregistered firms and other associations of people. For taxation purpose income from all sources is added. However, apart from the deduction of necessary professional expenditures, rebate on account of life insurance premium, provident fund, etc., was earlier allowed. This rebate was, however, abolished in the Budget for 2005-06.

Like all other countries, India has a progressive income tax. Before 1974-75, the marginal rate for income tax in this country was 97.75 per cent which was the highest in the world. One negative ramification of such a high marginal tax rate was that income tax became replete with exemptions, allowances, deductions and incentives.⁵ On the recommendation of the Direct Taxes Enquiry Committee, the marginal rate for income tax was brought down to 77 per cent which was subsequently reduced to 50 per cent as part of long-term fiscal strategy. The marginal rate for income tax was brought down to 40 per cent in the budget for 1992-93, and further to 30 per cent in the budget for 1997-98. The tax rates have been reduced at other levels also. Thus, the degree of the progressivity of the schedule has been considerably reduced. Reduction in tax rates at all levels has been by and large commended in the country. *Extraordinarily high tax rates in the past were highly unrealistic. They failed to reduce economic disparities. On the contrary, they put a high premium on tax evasion and, in practice, became a major factor in the growth of black money.* The Chelliah Committee had also favoured significant reductions in tax rates at all levels. This approach seems to be influenced by the Laffer Effect which implies that a reduction in the rate of taxation leads to more than proportionate increase in tax yield.

Apart from the purpose of raising revenue for the government, the income tax can also be used for pursuing some other objectives such as growth, economic stability and redistribution of income. However, J. Mirrlees has in his classic paper noted that optimal tax rates tended to be rather low (less than 20-25) per cent. He thus concluded that the income tax is perhaps a less potent instrument of redistribution than might be expected.⁶ Some economists, however, doubt the validity of Mirrlees's findings. They still believe that income tax can be used as a tool of income redistribution without involving high incentive cost of taxing income.

For realising the objectives as stated above, income tax should not only be levied in a progressive manner but its

tax base should also be wide enough and the proceeds should show a tendency to increase sufficiently in response to rise in the national income. Unfortunately in this country, the base of income tax is very narrow. The base of income tax was further narrowed by a large number of deductions and reliefs which the government allowed at different times. The most important of these were in the following areas:

- (a) savings, especially in government-sponsored savings schemes, mutual funds and insurance companies;
- (b) fringe benefits, in both private and public sectors, comprising employer provided housing, transport, medical and other facilities;
- (c) capital gains on assets held longer than one year;
- (d) charitable contributions to specified charitable trusts.

Taxpayers in both higher and middle income groups benefited from these deductions and reliefs and, in the process, the base of income tax narrowed drastically. *In India, income tax also lacks built-inflexibility. Thus, its effectiveness as a tool of economic management is rather limited.* Moreover, income tax in this country clearly violates the canon of equity by completely exempting agricultural incomes. Due to this particular provision, *income tax has failed to play any positive role in redistributing income* in the countryside. In India, income tax cannot be relied upon for realising even economic stability. Due to its narrow base and lack of flexibility, manipulations in its rates would have little impact on the effective demand. Under these circumstances, income tax has hardly any role to play as an anti-inflationary measure in this country. To sum up, *income tax in its existing form is essentially a means to collect revenue and as a fiscal instrument its relevance is limited.*

Corporation Tax

Corporation tax is levied on the incomes of registered companies and corporations. The rationale for the corporation tax is that a joint stock company has a separate entity, and thus a separate tax different from personal income tax has to be levied on its income. Until 1960-61, corporations were taxed in a partial sense. A corporation was required to pay income tax on behalf of its shareholders on dividends paid to them, and each shareholder got a credit to this effect. Since 1960-61, corporations are being treated as independent entities and shareholders are no longer allowed any credit against their individual tax liabilities.

Though corporate incomes are being taxed at a flat rate, there were provisions for various kinds of rebates and exemptions. In order to give incentive to development activity in the industrial sector, a system of development rebate was introduced in 1955 in place of initial depreciation allowance. Between 1974 and 1976 development rebate was withdrawn and the system of initial depreciation allowance

was reintroduced. This arrangement was, however, short-lived, as in the Budget for 1976-77 a system of investment allowance on the pattern of development rebate was provided. Over the years, corporation tax base remained eroded on account of various rebates, exemptions and allowances. In the Budget for 1990-91 the investment allowance and the Investment Deposit Account Scheme were withdrawn but the corporate enterprises were compensated by lowering down the rate of corporation tax. However, in the Budget for 1991-92 the rates of corporation tax was raised. The Chelliah Committee had recommended that the corporation tax rate should be brought down to 40 per cent. This was implemented in the Budget for 1994-95. The Budget for 1997-98 reduced the rate of corporation tax to 35 per cent. In the Budget for 2005-06, the corporate tax rate was reduced from 35 to 30 per cent. While presenting Union Budget for the year 2015-16, the Finance Minister proposed to reduce the corporate tax rate from 30 per cent to 25 per cent over a period, accompanied by rationalisation and removal of various tax exemptions and incentives. In the Union Budget 2017-18, the Finance Minister reduced the corporate tax to 25 per cent for medium and small enterprises with annual turnover of less than ₹ 50 crore.

About four-and-a-half decades ago commenting on the structure of the corporation tax Raja J. Chelliah had remarked, "The present structure of company taxation in India is unnecessarily complicated, illogical and devoid of any sound principle".⁷ He had approvingly quoted Nicholas Kaldor, "The company taxation in provisions of India (perhaps even more than that of other countries) are apt to strike a detached observer as a perfect maze of unnecessary complications, the accretion over years of futile endeavour to reconcile fundamentally contradictory objectives."⁸ This situation has persisted over the years. Hence, for example, certain provisions of the corporation tax act as incentives to investors, whereas some others nullify their effects. Further, if some provisions exercise checks on companies which make attempts to evade the tax, they also adversely affect capital formation in the private corporate sector. Companies often take undue advantages of the provisions relating to rebates and exemptions. These exemptions have been provided to induce investment activity and thereby economic development, but companies generally use them to evade the tax. Over the years, too many changes have been made in the system of corporation tax and, therefore, it is rather difficult to say anything about their effectiveness.

The Chelliah Committee recommended elimination of most of the incentives except those meant for promoting savings and exports. In India, the justification for incentive provisions in the tax laws has been widely questioned because over the years several prosperous companies paying

handsome dividends have been getting away without paying any corporation tax. Amaresh Bagchi points out that "the liberal depreciation provisions granting 100 per cent depreciation to several items of assets has facilitated tax avoidance and enabled companies to reduce their taxable profits to zero or near zero."⁹ Therefore, there is a strong case for eliminating incentive provisions which in fact have become legitimate devices to evade the corporation tax. 'Zero-tax' companies now require firm handling. This has been done by levying a minimum alternative tax (MAT).¹⁰

Taxes on Wealth and Capital

Taxes which have been levied on wealth and capital are mainly three: estate duty, annual tax on wealth and gift tax.

Estate Duty was first introduced in India in 1953. It was levied on total property passing on the death of a person. The whole property of the deceased constituted the estate and was considered liable to pay estate duty. Agricultural land in States which had agreed to a legislation to this effect was included in the estate and was subject to this duty. Agricultural land in other States was not subject to estate duty, its value, however, was added to the value of the estate for determining the rate of estate duty to be levied on other property.

In anticipation of death some people gifted their property to their heirs. The purpose in all such cases was to avoid the estate duty. In order to check avoidance of the estate duty in this manner, the Estate Duty Act, 1953, contained a provision whereby all property transferred in anticipation of death could be treated as part of the estate passing on death. From the point of view of proceeds, the estate duty was a minor source of revenue. Hence, the *Central government decided to abolish it with effect from April 1, 1985.*

An Annual Tax on Wealth was first introduced in May 1957 on the recommendations of Kaldor. It is levied on the excess of net wealth over exemption of individuals, joint Hindu families and companies. For assessing the net value of wealth, net obligations are deducted from its market value. Certain properties such as agricultural land and balances of provident fund and life insurance have been exempted from this tax. Accepting the recommendations of the Chelliah Committee, the government has now exempted productive assets, such as shares, bonds, bank deposits etc. Like estate duty, *wealth tax has also been a minor source of revenue.*

A Gift Tax was first introduced in 1958. It was treated as complementary to the estate duty and annual tax on wealth. The gift tax was leviable on all donations except the ones given by the charitable institutions, government companies and private companies. Certain exemptions were

made. Notable among these were donations to recognised charitable institutions, gifts to women dependents at the time of their marriage and gifts to wife. ***Gift tax has been abolished on gifts made on or after October 1, 1998.***

How far taxes on capital and wealth in India are justified on the basis of equity, their economic effects and administrative efficiency is a moot question. According to Kaldor, a tax on income alone fails to satisfy the canon of equity. Taxable capacity of an individual depends both on his income and wealth. Therefore, a tax on wealth in addition to a tax on income is more in accordance with the canon of equity than a single tax on income or on wealth. Levying of estate duty is also just. From the point of view of their economic effects, none of the three taxes exercises adverse effects on ability and willingness to work and save. Further, these taxes do not discourage investment activity in any way. Hence if there are no clear favourable effects of these taxes on productive activity, then there are no adverse effects either. Assessment of the value of an estate or some other wealth is, however, a difficult task, and overcoming of attendant administrative problems in levying these taxes does not seem to be easy.

INDIRECT TAXATION

The principal indirect taxes levied in India are customs duties, excise duties, service tax and sales tax or VAT. Under the Constitution, the Central government has exclusive power to levy customs duties and excise duties on commodities other than alcoholic liquors and narcotics. From a modest beginning in 1994-95, services tax has grown into a significant source of revenue. The States have been allocated exclusive jurisdiction over the excise on alcoholic liquors and taxes on sale or purchase of goods, except newspapers.

Customs Duties

While using its constitutional powers the ***Central government now levies duties on both imports and exports.*** From revenue point of view, the importance of export duty is limited. Over the years both export and import duties have not only been a source of revenue, they have also been employed as an instrument to regulate foreign trade. Precisely for this reason it has been a practice on the part of the Central government to provide information about the purpose of each import duty in the budget.

Import duties in India are generally levied on ad valorem basis which implies that they are determined as a certain percentage of the price of the commodity. On some commodities specific import duties, i.e., per unit taxes on imports have been levied either singly or in addition

to *ad valorem* duties. Due to their strategic importance in the country's economic development, imports of machinery and essential raw materials have been taxed lightly. As compared to import duties, export duties are less important from revenue as well as foreign trade regulation point of view.

Customs duties perform two major functions. First, like any other tax they raise revenue needed by the government, and second they regulate foreign trade of the country, more particularly the imports. In pursuance of these objectives ***during the pre-tax reform period, India had become a country with the highest level of customs tariff*** in the world, with basic duties supplemented by 'auxiliary' and additional or countervailing duties. The maximum rate of duty was as high as 300 per cent. Commenting on the structure of customs duties Amaresh Bagchi writes, "The rate structure was marked also by wide dispersal among commodities and numerous exemptions rendering the system of foreign trade taxes extremely complex and economically irrational. In many instances, similar products were taxed at different rates, and even the same product was subjected to varying rates depending on its use. The effective rates of protection (ERP) also varied widely across industries (often effected through administrative modifications), and some sectors enjoyed unduly high levels of protection while for some like capital goods industries the ERP was low or even negative."¹¹ Thus, structure of customs duties was dictated not by considerations of revenue alone. It was without doubt irrational and constituted an impediment to growth and thus called for drastic reform.

Even before the Tax Reform Committee, 1991 suggested significant reform measures, the government had realised the need to reform the structure of customs duties with a view to reduce the role of quantitative restrictions on imports and place increasing reliance on tariffs to regulate imports. It was stated in the Long Term Fiscal Policy of 1985 (LTFP), "The move in this direction should increase revenues, encourage less import-intensive forms of production, moderate the unjustifiably high protection granted by quantitative restrictions to certain industries and reduce the delays and uncertainties associated with the administration of import licensing."¹² The LTFP also considered it necessary to distinguish between the following broad categories of imports: (1) Capital goods; (2) Raw materials; (3) Other intermediate goods (including components and so called "universal intermediates"; (4) Essential consumer goods (e.g., foodgrains, edible oils and life saving drugs); and (5) Non-essential consumer goods.

In carrying out tariff rationalisation, there is a strong case for subjecting all categories of imports to the same rate of tariff. This simplified system has important merits. ***First***, it will eliminate unnecessary confusion which prevails in

case of multiplicity of rates. So the uniform rate system is convenient to both trade and industry and the customs administration. **Second**, it will prevent opportunities to evade taxes which arise from misclassifications of imports in the system of multiplicity of rates. Third, a single nominal rate of import duty would provide effective protection at a uniform rate. However, at India's present state of development a uniform system of nominal tariff rates for capital goods, intermediate products and other commodities may not immediately be feasible. Therefore, while rationalising the structure of customs tariffs a distinction has been made between capital goods, intermediates, components and other finished products. On the basis of the recommendations of the Chelliah Committee, import duties have been substantially reduced and in the Budget for 2006-07 the peak tariff level of import duties was lowered to 12.5 per cent. **The peak tariff level of import duties was further lowered to 10 per cent in the Budget for 2007-08.** Sukumar Mukhopadhyay, however, points out that what is called the peak rate in Indian budgets is essentially the median rate which applies to most of the items.¹³

There has been a sharp reduction in the effective rates of protection too as a result of the tariff reforms involving steep fall in the rates of import duties. But, as was expected, lowering of import duties had an adverse effect on the Central government's revenue collections. As a proportion of GDP, revenue from customs declined to only 0.9 per cent of GDP in 2015-16. Thus, the government has to find alternative sources that can make up for the revenue loss from the drastic reduction in the rates of import tariffs.

Excise Duties

An excise duty is in true sense a commodity tax because it is levied on production and has absolutely no connection with its actual sale. Thus in its form, it is very much different from a sales tax. However, from the point of view of tax shifting and the determination of incidence, there is little difference between an excise duty and a sales tax.

Excise duties on commodities other than alcoholic liquors and narcotics are levied by the Central government. Until the mid-1930s, excise duties were levied only on 5 commodities. Since then the number of commodities on which the Central government levies excise duties has steadily increased and now the list is quite comprehensive. Revenue collection from excise duties has registered a really spectacular increase during the planning period. Although the Central government has levied heavy excise duties on luxury commodities, revenue proceeds from them are not much. Major revenue collection even now is from excise duties on textiles, sugar, tea, tobacco, cement and such other necessary articles. Hence, over the years, levying of

excise duties on an increasing scale has resulted in the dilution of the progressivity of the tax structure.

At present, excise duties are levied by the Central government in a number of forms. This obviously complicates the tax structure and makes it difficult to assess the final burden. In view of this problem the government has not only converted many of the specific duties into *ad valorem* rates but the number of rate categories for Central excise duties has also been reduced. Over the past few years, the number of exemption notifications have been brought down drastically. The government has also decided not to grant special or *ad hoc* exemptions in future except under very special circumstances.

Taxation of inputs, such as raw materials, components and other intermediates has a number of limitations. It very often distorts the production structure, results in 'cascading' of taxes and does not allow correct assessment of the tax incidence. Therefore, the government now intends to remove these defects of the central excise system by progressively relieving inputs from excise and countervailing duties. An ideal system to realise this objective would be to adopt value added taxation (VAT). However, on account of some formidable practical difficulties in this country, the Government proposed to introduce it in a phased manner. For instance, it initially levied a modified system of VAT (MODVAT) which is broadly revenue neutral. The government had no intention to provide substantial reliefs on excise. However, it has been in favour of having a rationalised structure of excise duties. It has, therefore, restructured Central excise duties in the light of the recommendations made by the Chelliah Committee.

The Budget for 1994-95 introduced major reforms in the excise tax structure as part of the government's programme of modernising the country's tax system. The principal features of this restructuring were: (i) Extension of MODVAT to capital goods and petroleum products; (ii) Shift in the bulk of excise taxation from specific to *ad valorem* rates which assured much greater built-in buoyancy of revenues; (iii) reduction in total number of *ad valorem* tax rates to about half the existing number which was a major step towards simplicity and transparency; (iv) continuing the process of lowering rates when they were unduly high; (v) application of uniform rates for similar commodities to the extent possible with a view to reduce classification problems, scope for misuse and widespread litigation; (vi) removal of complicated price list procedure; and (vii) reduction of the number of special exemption notifications.

These reform measures were expected to promote growth of manufacturing output and employment. They made tax administration easier and less discretionary and

also reduced the scope for misclassification, disputes and evasion. They increased revenue elasticity and paved the way for an eventual adoption of a Value Added Tax (VAT). In the Budget for 2000-01, the Finance Minister replaced the multiple MODVAT system by a single Central Value Added Tax (CENVAT).

In the wake of the global financial crisis in 2008-09, the standard rate of excise duty for non-petroleum goods was reduced from 14 per cent to 8 per cent in a phased manner. This rate was raised from 8 per cent to 10 per cent in Budget 2010-11. The standard rate of excise duty was raised from 10 per cent to 12 per cent in Union Budget for 2012-13. The current standard ad valorem rate of duty of excise (CENVAT) is 12.36 per cent.

States' Excise Duties

The States have exclusive jurisdiction over the excise duties on alcohol and narcotics. It is an easy source of revenue and possible revenue proceeds from this source are high. In some States, heavy excise duty on alcohol has been used to discourage its consumption. In some other States policy of prohibition has been adopted and the governments have preferred to bear the loss of revenue for realising a socially desirable purpose. Prohibition has always been a controversial subject in India. Its criticism is made not because its merits as a measure of social welfare are not recognised, but because its implementation has been found rather difficult. Wherever prohibition has been introduced, illegal production of liquor has continued under the patronage of corrupt administration, while the government has suffered heavy loss of revenue. Mainly due to these reasons, some States have not introduced prohibition.

Service Tax

Service tax was introduced in 1994-95 on three services — telephone services, general insurance and share broking. Since then, every year the net has been widened by including more and more services under the tax net. As a result, the number of assesseees has increased considerably over the years and so has been the revenue from this tax. The revenue from service tax has increased considerably from ₹ 2,613 crore in 2000-01 to ₹ 97,579 crore in 2011-12 and further to ₹ 2.1 lakh crore in 2015-16. The rate of service tax in the Union Budget 2008-09 was kept at 12 per cent. In 2012-13, the government came out with a negative list of services with around 20 categories under it (these were kept out of the service tax net). The Union Budget for 2015-16 increased the rate of service tax from 12 per cent to 14 per cent. From November 15, 2015, an additional Swachh Bharat cess got added at the rate of 0.5 per cent, which left the service tax at 14.5 per cent. The Union Budget 2016-17 imposed a cess, called the Krishi Kalyan Cess, at 0.5 per cent on all

taxable services, to finance initiatives relating to improvement of agriculture and welfare of farmers. Thus, effective June 1, 2016, the applicable service tax became 15.0 per cent.

The main reasons for the imposition of the service tax have been as follows:

1. The growth in the service sector during the period of last one decade or so has been spectacular. Now services account for 59 per cent of GDP. At the same time, their contribution to the government exchequer has not at all been commensurate. *In 2015-16, revenue from service tax accounted for 14.4 per cent of Union gross tax revenue.*

2. Considerations of efficiency and equity also strongly govern the inclusion of services under taxation. With discriminatory taxation of goods and services, efficiency in resource allocation is bound to suffer. This is because resources move from taxed to non-taxed sectors. In the absence of service taxation, equity suffers since services are consumed more by the high income households.

3. If services are not taxed, traders cannot claim VAT on their service inputs. This is likely to cause cascading, distort choice and encourage business to develop in-house services.

Value Added Tax (VAT)

Rationale for VAT. The Indirect Taxation Enquiry Committee was constituted in July 1976, under the chairmanship of L.K. Jha for suggesting reforms in the indirect taxation system. The Jha Committee found that the country's indirect tax structure as a whole was progressive, but there was little integration between individual indirect taxes. According to the Jha Committee, each indirect tax was levied independently of other indirect taxes. Moreover, these taxes lacked built-in flexibility and every time when revenue collections had to be increased, upward revision in the tax rates was done. India's indirect tax structure was by and large uncertain and complex and its administration was difficult.

The Committee recommended both short-term as well as long-term measures for reforming indirect taxation system. *In its opinion, ad valorem taxes are superior to specific taxes due to their higher income elasticity.* The Jha Committee thus recommended introduction of *ad valorem* taxes as far as possible. It also favoured exemption of inputs from indirect taxes. It favoured integration in the indirect tax structure and suggested that the excise duties and sales tax should be replaced by a single commodity tax. It was proposed that this tax should be levied by the Central government and proceeds divided between the Centre and the States. However, this proposal did not find favour with the States as they were unwilling to surrender their power to levy a sales tax. In respect of sales tax, the States were

completely autonomous and acceptance of this proposal would have meant surrender of their right to levy this tax.

However, on theoretical grounds, the Indirect Taxation Enquiry Committee argued that a value added tax (VAT) is the best of all indirect taxes. This view is echoed by many tax policy experts. According to Parthasarathi Shome, VAT is better because of two reasons, "First, the VAT has a self-monitoring mechanism which assists tax administration. Second, the VAT, if appropriately structured, eliminates distortions in decisions by producers that arise from taxation of imports."¹⁴ Moreover, since VAT collects revenue in different stages, it has a higher revenue potential. On practical (administrative) grounds, however, the imposition of VAT was considered problematic as a system of VAT requires levying of a tax on the value added at each stage of production.

Introduction of State Value Added Tax. Despite the above-mentioned administrative problems, the Empowered Committee (EC) of State Finance Ministers in its meeting held on June 18, 2004, arrived at a broad consensus to introduce VAT from April 1, 2005. Accordingly, VAT has been introduced by all States/UTs except for the UTs of Andaman and Nicobar Islands and Lakshadweep. *The State level VAT being implemented presently has replaced the erstwhile sales tax system of the States.*

It may be mentioned here that since sales tax/VAT is a State subject, the role of the Central government is merely as a facilitator to ensure successful implementation of VAT. A compensation formula was worked out in consultation with the States, for providing compensation to them, during 2005-06, 2006-07 and 2007-08, for any loss on account of

introduction of VAT and compensation has been released according to this formula.

Through its deliberations over the years, the Empowered Committee has finalised a design of VAT to be adopted by the States, which seeks to retain certain essential features commonly across States while, at the same time, providing a measure of flexibility to the States to enable them to meet their local requirements. The salient features of the VAT design finalised by the Empowered Committee are given in Box 50.1.

EVALUATION OF INDIAN TAX STRUCTURE

India's tax structure is quite extensive. Now almost every conceivable direct and indirect tax is levied in this country. In terms of the ratios of tax proceeds to GDP, India is one of the modestly taxed countries. And, if today the government feels that its resources are inadequate and it has no choice but to have recourse to public debt and deficit financing, it is mainly due to its colossal unproductive expenditure and complete indifference to the canon of economy.

As far as the tax structure is concerned, its following features are notable:

1. Tax buoyancy. Tax buoyancy is a measure of the responsiveness of tax receipts with respect to GDP or National Income. *A tax is buoyant when revenues increase by more than 1 per cent for a 1 per cent increase in GDP.* A study conducted by the National Institute of Public

Box 50.1

Salient Features of the VAT Design

- The rates of VAT on various commodities shall be uniform for all the States/UTs. *There are two basic rates of 4 per cent and 12.5 per cent, besides an exempt category and a special rate of 1 per cent for a few selected items.* The items of basic necessities and goods of local importance (upto 10 items) have been put in the 0 per cent or the exempted schedule. Gold, silver and precious stones have been put in the 1 per cent schedule. The 4 per cent rate applies to other essential items and industrial inputs. The 12.5 per cent rate is residual rate of VAT applicable to commodities not covered by other schedules. There is also a category with 20 per cent floor rate of tax, but the commodities listed in this schedule will not be VATable. This category covers items like motor spirit (petrol, diesel and aviation turbine fuel), liquor etc.
- There is provision for eliminating the multiplicity of taxes. In fact, several State taxes on purchase or sale of goods (excluding entry tax in lieu of octroi) have been subsumed in VAT or made VATable.
- Provision has been made for allowing 'Input Tax Credit' (ITC). However, since the VAT being implemented is intra-State VAT only and does not cover inter-State sale transactions, the ITC will not be available on inter-State purchases.
- Exports will be zero-rated, and at the same time, credit will be given for all taxes on inputs/purchases, related to such exports.
- There are provisions to make the system more business-friendly. These include provision for self-assessment by the dealers, provision of a threshold limit for registration of dealers in terms of annual turnover of ₹ 5 lakh, and provision for composition of tax liability upto annual turnover limit of ₹ 50 lakh.
- States have been allowed to continue with the existing industrial incentives, without breaking the VAT chain. However, no fresh sales tax/VAT-based incentives are permitted.

Source: Government of India, *Economic Survey*, 2007-08 (Delhi, 2008), Box 3.4, p. 55.

Finance and Policy (NIPFP) estimated buoyancy of India's tax system for the period 1970-71 to 1983-84. The study revealed that the buoyancy of total tax revenue was greater than unity (1.21) over the period.¹⁵ The Reserve Bank estimated the tax buoyancies for the period 1981-1993 and 1981-2001. According to these estimates, tax buoyancy of direct taxes was 1.19 for the period 1981-2001 as compared with 1.07 for the pre-tax reforms period, 1981-1993. However, the buoyancy of indirect taxes dipped considerably to 0.88 from 1.07 in the corresponding period.¹⁶ According to *Economic Survey* 2012-13, in the post FRBM period (i.e., the post 2003-04 period), both direct and indirect taxes remained buoyant except in the crisis years (2008-09 and 2009-10) and 2011-12. During 2011-12, both direct and indirect tax revenues grew at a lower rate than what the Budget Estimates envisaged as well as the 2010-11 growth rate mainly on account of economic slowdown, weak market sentiment, slow investment growth, global uncertainty, and persistent high inflation. This led to a sharp fall in tax buoyancy in 2011-12. The decline was more in corporate taxes than personal income taxes. During the period, direct tax buoyancy (ratio of direct taxes growth to nominal GDP growth) also declined and was less than 1. According to *Economic Survey* 2012-13, this could be due to lower profitability of corporations considering higher inflation.¹⁷ Tax buoyancy was 0.73 in 2013-14 which improved to 0.89 in 2014-15.¹⁸

2. Regressive tax system. The consensus view in modern public economics is that a tax system with a preponderance of indirect taxes is regressive since the marginal impact of indirect taxes on the economically weaker sections of society is far greater. India's direct-to-indirect tax ratio (Centre and State combined) was roughly 39 : 61 in 2014-15. This is in contrast to most OECD economies where the ratio is the exact opposite, 67 : 33 per cent in favour of direct taxes. In the 50-year period 1965-2014, India's direct-to-indirect tax ratio has swung from a low of 13 : 87 to its current high of 39 : 61. For the OECD nations, throughout this 50-year period, the direct-to-indirect tax ratio has remained roughly constant in the range of 65 : 35.

Superiority of direct taxes is established both in terms of efficiency and equity, while indirect taxes are inferior. Both left and right, prefer direct to indirect taxes, the former for reasons of progressivity and the latter for reasons of minimizing inefficiency. If indirect taxes must be used, perhaps because of some constitutional or political economy constraint on the level of income or wealth taxes that a government may levy, then ideally they should be minimally distorting – in effect by mimicking the effects of a direct tax. According to Praveen Chakravarty and Vivek Dehejia, *an example of a 'good' indirect tax is a single rate goods*

and service tax (GST) with no exemptions. Such a tax distorts individuals' labour supply and savings choices, like direct income and wealth taxes, but does not distort the economy's structure of production or consumption, as most indirect taxes, such as trade tariffs, do. The 'worst' taxes are sector-specific excise duties with high tax rates – such as taxes on petroleum, alcohol and tobacco – which are maximally distorting to the economy and maximally regressive. However, since these taxes are convenient to use to grab a lot of revenue, they are very popular in most of the developing countries (including India).¹⁹ This makes their tax system regressive.

3. Administrative efficiency. The Indian tax system is not administratively efficient. Both direct and indirect taxes are highly complex, and thus provide enough opportunities to unscrupulous elements to avoid as well as evade taxes. The Indian tax system also violates the canons of simplicity and certainty. Moreover, *there are definitional defects in India's tax system which give elaborate powers to tax authorities to interpret tax laws according to their whims and fancies. This has resulted in widespread corruption in various tax departments.*

Taxation in India is being used as a fiscal tool. Therefore, the government uses various taxes for influencing allocation of resources, inducing capital formation and reducing the regional and personal disparities. In its attempt to achieve so many objectives through taxation, the government has not succeeded much in realising any of these objectives, but in its endeavour to do so the administrative efficiency has gone down. It is now generally recognised that in order to tone up the tax administration various tax laws ought to be simplified. The government has already taken initiatives in this direction.

4. Multiplicity of tax laws and lack of integration. There is multiplicity of direct and indirect taxes in India. For example, the tax on income and the annual wealth tax may be placed in the category of direct taxes. It is often suggested that they should be integrated into a single direct tax. The Budget for 2009-10 proposed the adoption of a Direct Taxes Code. The Code seeks to consolidate and amend the law relating to all direct taxes, that is income tax, dividend distribution tax and wealth tax so as to establish an economically efficient effective and equitable direct tax system which will facilitate voluntary compliance and help increase the tax-GDP ratio. All the direct taxes have been brought under a single code and compliance procedures unified, which will eventually pave the way for a single unified taxpayer reporting system.

Indirect taxes have also lacked integration. The excise duties have been levied primarily by the Union government, the sales tax by the States and the Octroi by local bodies.

According to the Indirect Taxation Enquiry Committee, there is little coordination among them. In its opinion, octroi is unnecessary and should be abolished and excise duties and sales tax should be replaced by Value Added Tax (VAT). The Chelliah Committee had also recommended the introduction of VAT. The government has initiated measures in this direction. At the Central level, Central Value Added Tax (CENVAT) and at the State level, State Value Added Tax (SVAT) have been introduced. The Central sales tax is also being planned to be phased out. It is to be replaced by Goods and Service Tax (GST).

5. Inter-sectoral imbalances in the tax structure.

There are grave inter-sectoral imbalances in India's tax structure as agricultural incomes are tax free. Not only farmers, even companies investing in the agricultural sector are exempt from paying taxes. In a study published recently, Kavita Rao and D.P. Sengupta have estimated that over 50 companies reported agricultural incomes of over ₹ 100 crore in 2009-10 with their total agricultural income amounting to ₹ 31,313 crore. In addition, there are many large farmers who have acquired considerable wealth in recent times through agricultural operations and/or sale of land. However, because of political considerations (as farmers are a huge vote bank), State governments have shown no inclination to tax agricultural incomes as they do not wish to be seen as anti-farmer. In their study, Rao and Sengupta have estimated that in 2007-08, taxing agricultural income on a par with other incomes would have yielded revenue of around ₹ 50,000 crore (equal to 1.2 per cent of GDP) and this would have boosted State revenues by roughly 19 per cent.²⁰ It may also be pointed out here that taxing agricultural incomes will not hurt farmers who are in distress as is often feared. This is because even if agricultural income is subject to income tax, a substantial section of the farmers – the small and marginal ones – will remain outside the tax net simply because their incomes are likely to be below the basic exemption limit of ₹ 2,50,000 per annum that is extended to all tax payers in India.

6. The burden of tax exemptions. A large number of tax exemptions have been provided over the years on various grounds like promoting economic growth; skill upgradation; balanced regional growth; dispersal of industries; neutralisation of disadvantages on account of scale of operation and location; and incentives to priority sectors including infrastructure. This results in huge revenue losses. The aggregate revenue foregone from Central taxes (both direct and indirect) was ₹ 5.66 lakh crore for 2012-13 (which was 5.6 per cent of GDP) and ₹ 5.73 lakh crore in 2013-14 (which was 5.0 per cent of GDP).²¹

Not only the huge amounts of revenue foregone on account of tax exemptions reduce the resources with the

government, they also distort resource allocation and stunt productivity. In addition, they create various legal complexities, classification disputes and a whole class of rent seekers who try for their perpetuation. It is, accordingly, necessary to subject the tax exemptions to a sunset clause.

7. Equity. The Indian tax system has not adequately served the objective of equity. Because of the various exemptions and concessions, the principle of equal treatment to equals is violated. Two persons with identical incomes pay different taxes due to exemptions of and concessions on income from some sources or uses. As correctly pointed out by M. Govind Rao, the redistribution in taxation has to be mainly achieved through the direct tax system. However, even as the share of direct taxes in total tax revenue has shown an increase over the years, its impact on overall redistribution is negligible.²² To illustrate, only 3.65 crore individuals of a nation of more than 125 crore people filed income tax returns during assessment year 2014-15. This is just 3 per cent of the population. Moreover, of the 3.65 crore individuals who filed income tax returns, there were only 5.5 lakh people who paid income tax of more than ₹ 5 lakh and they accounted for 57 per cent of the total tax kitty. This essentially means that *only 1.5 per cent of those filing returns are contributing to 57 per cent of tax kitty.* The number of tax payers with incomes more than ₹ 1 crore in the year was only 48,417.

THE TAX REFORMS SINCE 1991

Recommendations of Tax Reforms Committee (1991) and Task Forces (2002)

The Tax Reforms Committee was constituted under the Chairmanship of Raja J. Chelliah in 1991 (and is, therefore, also known as Chelliah Committee) to examine the existing tax structure in the country and make appropriate recommendations to reform it. In its report, the Committee recommended far-reaching changes in the tax system to remove loopholes besides making it more efficient from the point of view of raising revenue. It also stressed the need of rationality and stability in the tax structure. According to the Committee, *ad hoc* changes in tax system from year to year undermine rationality and create complications. *The Committee was in favour of making tax system and laws relating to taxes quite simple. In a simple tax system, there would be limited number of rates, and only a few exemptions and deductions. Further, it would give little discretionary power to the tax officials for interpreting the law.* The Committee was also of the view that the prevailing methods of tax administration need to be modernised and tax enforcement visibly improved. As far as particular taxes

are concerned, some of the important recommendations of the Chelliah Committee were as follows: (i) lowering of income tax rates with a narrower spread between the entry rate and maximum marginal rate, and a minimum number of incentives; (ii) reducing the corporate tax rate to 40 per cent and abolition of the surcharge; (iii) changes in the tax treatment of long-term capital gains (the Committee argued that the prevailing tax treatment of long-term capital gains was not correct because the deductions allowed in computing taxable gain was not related to the period of time for which the assets were held. It also did not take into account the inflation that might have occurred over time. The Committee suggested the adoption of a system of indexation to take care of this problem); (iv) reducing the tax rates for foreign companies and bringing down the differential between the tax rates on domestic and foreign companies to around 7.5 percentage points (in no case, the differential should exceed 10 percentage points); (v) avoiding the system of subjecting the income of both partnership firms as well as the partners as this practice amounted to double taxation; (vi) making a distinction between productive and non-productive assets for the purpose of levying wealth tax (the Committee took the view that by exempting productive assets such as shares, securities, bonds, bank deposits, etc. from wealth tax, the government could encourage investment in them); (vii) excise duties should be *ad valorem* and more items should be brought under them (the Committee argued that *ad valorem* duties are preferable to specific duties as they ensure buoyancy in revenue on account of increase in prices); and (viii) in the field of customs duties, the Chelliah Committee recommended reduction in the general level of tariffs, a reduction in the dispersion of the tariff rates and a rationalisation of the system with the abolition of numerous end-use exemptions and concessions.

In 2002, two Task Forces ('Task Force on Direct Taxes' and 'Task Force on Indirect Taxes') were set up under the Chairmanship of Vijay L. Kelkar. These Task Forces made several recommendations for simplification and rationalisation of direct and indirect taxes. The Kelkar Committee (as the two Task Forces can be jointly referred to as) argued that a tax system should balance the requirements of (i) equity, (ii) ease of collection, and (iii) fostering the efficiency in resource allocation. The Committee, in the interests of efficient tax administration, opined that a fairer tax structure should comprise of: (i) lower rates of taxation, (ii) a few nominal rates, (iii) a broad base, (iv) minimum tax exemptions and incentives, (v) no surcharges, and (vi) clearly articulated exemptions. As far as particular taxes are concerned, some of the important recommendations of the Task Forces were as follows:

1. Personal income tax: (i) increase in exemption limit to ₹ 1 lakh with a higher exemption limit for widows and senior citizens; (ii) only two slabs of tax rates – 20 per cent upto ₹ 4 lakh and 30 per cent for income above ₹ 4 lakh; (iii) elimination of standard deduction and tax incentives under Sections 88, 80C and interest income under Section 10.

2. Corporate income tax: (i) reduction in tax rate to 30 per cent for domestic companies and to 35 per cent for foreign companies; (ii) reduction in general rate of depreciation for plant and machinery from 25 per cent to 15 per cent; (iii) elimination of the Minimum Alternate Tax (MAT); (iv) long-term capital gains be aggregated with other incomes and subjected to taxation at the nominal rates; and (v) removal of exemptions under several Sections.

The Committee also recommended the abolition of wealth tax.

3. Excise duties: (i) all levies should be reviewed and replaced by only one levy, namely, CENVAT (i.e., Central Value Added Tax); (ii) zero excise duty on life saving drugs and equipment, security items, food items and agricultural products; varying rates of duties on several other specified products; (iii) all exemptions to be removed on the textile sector except for handloom woven fabrics and certified as khadi; (iv) duty exemption in respect of small-scale sector to be extended only to small units with a turnover of upto ₹ 50 lakh; (v) uniformity in all State legislations, procedures and documentation relating to VAT; and (vi) extension of service tax in a comprehensive manner leaving out only a few services by including them in the negative list.

4. Customs duties: (i) multiplicity of levies to be reduced to 3, i.e., basic customs duty, additional duty and anti-dumping duties; (ii) zero customs duty on items like life saving drugs and equipment, sovereign imports and imports by RBI; varying rates of duties on several other specified products; (iii) duty reduction to the level of 5-10 per cent should start after the introduction of State level VAT; (iv) a higher duty rate upto 150 per cent on specified agricultural products and demerit goods; and (v) all exemptions should be removed except in the case of life saving drugs, goods of security and strategic interest, goods for relief and charitable purposes and international obligations including contracts.

Implementation of the Recommendations

The Government of India has been implementing the recommendations of the Chelliah Committee and the two Task Forces over the years in a phased manner. The major changes which have already been made in the direct and indirect tax policies are stated below:

1. Personal income tax has been restructured with lower taxes and fewer slabs. In 1992-93, personal income tax slabs were down to three – 20, 30 and 40 per cent. In 1997-98, these rates were brought down further to 10, 20 and 30 per cent. These rates continue till date although surcharge and cess have been imposed on them in different years to generate additional revenue.

2. The corporate tax rate was reduced to 40 per cent in 1994-95, 35 per cent in 1997-98 and to 30 per cent in 2005-06.

3. While moderating these rates, the challenge has been to also moderate tax incentives. These included, in the case of personal income tax, tax preferences and concessions for savings, housing, retirement benefits, investment in and returns from certain types of financial assets, investment in retirement schemes, and income of charitable trusts.²³ A significant move towards moderating tax preferences in personal income tax was made in 2005-06 with the phasing out of the tax rebate on these investments and allowing them instead as a deduction from taxable income subject to a cap.

Major tax incentives in the case of corporates have been profit linked deductions for specified sectors and for businesses located in underdeveloped areas. To broaden the tax base for corporates by moderating the effect of tax incentives, a minimum alternate tax (MAT) was introduced in 1996-97.

4. Capital gains from sale of listed equities (held for more than a year by an investor) have been exempted from tax, both for domestic and international investors.

5. The reforms in excise duties have been guided by the need to simplify the rate structure, to give some relief on articles of mass consumption, help the domestic capital goods industry so as to increase its competitiveness and also reduce capital costs, assist industries suffering from depressed demand conditions and to provide relief to small-scale industry. The excise duty structure was rationalised to a single rate CENVAT (Central Value Added Tax) in 2000-01.

6. Customs duties have been reduced considerably in the recent years both as a result of the recommendations of the Chelliah Committee and Kelkar Committee and the international obligations following multilateral negotiations under WTO. In the Union Budget for 2007-08, the peak level of customs duty was scaled down to 10 per cent.

7. Service tax was introduced in 1994-95. In this year, a 5 per cent Union service tax was levied on three specified services, namely, telephone, general insurance and stock brokerage. Over the years, many new services have been added to the list and the rate of tax has also been

hiked. The service tax is now levied on all services except a negative list.

8. Both, the Chelliah Committee and the Kelkar Committee had recommended a number of measures for improving the tax administration. In the post-1991 reform period, a number of steps have been undertaken in this direction. Information technology has been deployed extensively to reduce physical interface between the tax payer and the tax department. With the automation of all major locations, customs administration works almost entirely on the electronic data interchange (EDI) system now. Filing of import and export documents, and their processing and tracking is conducted electronically. The adoption of ACES (Automated Central Excise and Service Tax) for excise duties and service tax has simplified the process of registration, return filing, and tax payments all of which can be transacted electronically. Self-assessment of tax liability by a tax payer followed by risk-based selection for audit or scrutiny is the mode of tax collection for all these taxes. Internal work processes have also been improved and revamped to impart greater efficiency in key processes, such as audit and scrutiny.²⁴

APPENDIX TO CHAPTER 50: GOODS AND SERVICES TAX

Goods and services tax (GST) is a tax levied when a consumer buys a good or service. It is meant to be a single, comprehensive tax that will subsume all the other indirect taxes on consumption like service tax, etc. Thus, GST is to be a single national uniform tax levied across India on all goods and services. The objective is to end the regime of multiple taxes on goods and services and bring them under one rate. India's indirect tax system has been mired in multi-layered taxes levied by the Centre and State governments at different stages of the supply chain such as excise duty, octroi, Central sales tax (CST) and value added tax (VAT), among others. In GST, all these are to be subsumed under a single regime. Thus, GST changes the system from being production-based taxation to being consumption-based.

Benefits of GST

GST has been envisaged as an efficient tax system, neutral in its application and distributionally attractive. The advantages are: (i) wider tax base, necessary for lowering tax rates and eliminating classification disputes; (ii) elimination of multiplicity of taxes and their cascading effects; (iii) rationalisation of tax structure and simplification of compliance procedures; (iv) harmonisation of Centre and State tax administrations, which would reduce duplication

and compliance costs; and (v) automation of compliance procedures to reduce errors and increase efficiency.

In India, GST is proposed to have a 'dual' structure, which means it will have two components – the Central GST and the State GST. Thus, both the Centre and the States will have separate powers to legislate and administer their respective taxes. This is necessary because India is a federal country and the States have been assigned the powers to levy and collect taxes through appropriate legislation. Both the levels of government have distinct responsibilities to perform according to the division of powers prescribed in the Constitution for which they need to raise resources. A dual GST will conform to fiscal federalism.

The GST structure would follow the destination principle. Accordingly, imports would be subject to GST, while exports would be zero-rated. In the case of inter-State transactions within India, State tax would apply in the State of destination as opposed to that of origin.

The Constitution Amendment Bill for GST

The salient features of the GST Constitutional Amendment Bill are as follows:

- Insertion of a new Article 246A conferring simultaneous power to the Union and the State legislatures to legislate on GST.
- Insertion of a new Article 279A for the creation of a Goods and Services Tax Council, which will be a joint forum of the Centre and the States. This Council would function under the chairmanship of the Union Finance Minister and shall have State Finance Ministers as members.
- Central taxes like central excise duty, additional excise duties, service tax, additional customs duty, and special additional duty of customs, etc. will be subsumed in GST.
- At the State level, taxes like VAT/sales tax, Central sales tax, entertainment tax, octroi and entry tax, purchase tax and luxury tax, etc. would be subsumed in GST.
- The Centre will compensate States for loss of revenue arising on account of implementation of the GST for a period upto five years (the compensation will be on a tapering basis, *i.e.*, 100 per cent for first three years, 75 per cent in the fourth year and 50 per cent in the fifth year).
- All goods and services, except alcoholic liquor for human consumption, will be brought under the purview of GST. However, it has also been provided that petroleum and petroleum products shall not be

subject to the levy of GST till notified at a future date on the recommendation of the GST Council. The present taxes levied by the States and the Centre on petroleum and petroleum products, *i.e.*, sales tax/VAT, Central sales tax (CST) and excise duty only, will continue to be levied in the interim period.

- Both Centre and States will simultaneously levy GST across the value chain. The Centre would levy and collect Central Goods and Services Tax (CGST), and States would levy and collect the State Goods and Services Tax (SGST) on all transactions within a State.
- The Centre would levy and collect the Integrated Goods and Services Tax (IGST) on all inter-State supply of goods and services. There will be seamless flow of input tax credit from one State to another. Proceeds of IGST will be apportioned among the States.
- GST is a destination-based tax. All SGST on the final product will ordinarily accrue to the consuming State.
- GST rates will be uniform across the country. However, to give some fiscal autonomy to the Centre and States, there will be a provision of a narrow tax band over and above the floor rates of CGST and SGST.
- It is proposed to levy a non-VATable additional tax of not more than 1 per cent on supply of goods in the course of inter-State trade or commerce for a period not exceeding 2 years, or further such period as recommended by the GST Council. This additional tax on supply of goods shall be assigned to the States from where such supplies originate.
- The term 'services' is proposed to be exhaustively defined as 'anything other than goods'.

The revised draft of model GST law, which was made public in November 2016, provides for a maximum rate of tax under the new regime at 14 per cent (14 per cent Central GST and an equal State GST, taking the total to 28 per cent). A four-slab rate structure was proposed – from zero to 28 per cent. The structure proposed the GST at zero per cent on a host of goods and services, including food, health and educational services, and at 28 per cent on luxury items, such as fast-moving consumer goods and consumer durables. On consumption of ultra-luxury items and demerit goods, such as big cars and tobacco products, it proposes imposition of cess over and above a 28 per cent GST rate. The GST is proposed to be levied at 5 per cent, 12 per cent or 18 per cent on the remaining goods and services.

In a meeting held on March 16, 2017, the GST Council agreed on fixing the ceiling on cess that would be imposed under the new regime to fund compensation to States for any revenue loss, with luxury cars, soft drinks and mineral water facing up to 15 per cent levy on top of the 28 per cent GST rate (this means that the total tax incidence on these items cannot be more than 43 per cent). The Council opted to levy cess on five category of products – pan masala, chewing tobacco and cigarettes, luxury cars, aerated drinks and mineral water, and coal and lignite – to create a fund with a corpus of around ₹ 50,000 crore for meeting a potential liability (cess on cigarettes was kept at 290 per cent). It kept the option of adding more items to the list later. The cess would be applicable for five years, the period for which the Centre has committed to compensate the States for potential revenue losses. This period can be extended by the GST Council.

Lok Sabha passed the four bills related to GST – Central GST Bill, the Integrated GST Bill, the Union Territories GST Bill and the Compensation Law – on March 29, 2017. These bills were also approved by the Rajya Sabha on April 6, 2017 paving the way for the roll out of a nationwide goods and services tax.

NOTES

1. Praveen Chakravarty and Vivek Dehejia, "India is an Outlier in Its Tax Policy", *Mint*, February 23, 2016, p. 31.
2. M. Govind Rao, "Public Finance: Development, Equity and Political Economy", in Bimal Jalan and Pulapre Balkrishnan (ed.), *Politics Trumps Economics* (New Delhi, 2014), pp. 174-5.
3. Praveen Chakravarty and Vivek Dehejia, *op. cit.*, p. 31.
4. GFI, *The Drivers and Dynamics of Illicit Financial Flows from India: 1948-2000* (November 2010), Appendix Table 8, p. 67.
5. Parthasarathi Shome, *India's Fiscal Matters* (New Delhi, 2002), p. 188.
6. J. Mirrlees, "An Exploration in the Theory of Optimum Income Taxation", *Review of Economic Studies*, 38, pp. 175-208.
7. Raja J. Chelliah, *Fiscal Policy in Underdeveloped Countries* (London, 1969), p. 122.

8. *Ibid.*, p. 122.
9. Amaresh Bagchi, "Strengthening Direct Taxes — Some Suggestions", *Economic and Political Weekly*, February 18, 1995, p. 384.
10. In the past, a large number of companies showed book profits on their profit and loss account and at the same time, distributed huge dividends. However, these companies did not pay any tax to the government as they reported either nil or negative income under provisions of the Income Tax Act. Thus, these companies were showing book profits and declaring dividends to their shareholders but were not paying any tax (thus they came to be known as 'zero tax' companies). In order to bring such companies under the Income Tax net, Section 115JA was introduced from assessment year 1997-98. Now, all companies having book profits under the Companies Act have to pay a minimum alternate tax (MAT). Thus, MAT is a way of making companies pay a minimum amount of tax. MAT rate was 18.5 per cent of book profits in the Union Budget 2011-12.
11. Amaresh Bagchi, "Taxation of Goods and Services in India: An Overview" in Sudipto Mundle, *Public Finance — Policy Issues for India* (Delhi, 1997), pp. 113-4.
12. Government of India, *Long Term Fiscal Policy*, (Delhi, 1985), p. 40.
13. Sukumar Mukhopadhyay, "No Method in the Largesse", *Business Standard*, March 1/2, 2003, p. 14.
14. Parthasarathi Shome, *op. cit.*, p. 154.
15. Shankar Acharya, "India's Fiscal Policy," in Robert E.B. Lucas and Gustav F. Papanek (eds.), *The Indian Economy* (Delhi, 1988), Table 14.2, p. 312, Original Source, The National Institute of Public Finance and Policy, New Delhi.
16. Reserve Bank of India, *Report on Currency and Finance 2001-02* (Mumbai, 2003), Table 4.3, p. IV-10.
17. Government of India, *Economic Survey 2012-13* (Delhi, 2013), pp. 59-60.
18. Reserve Bank of India, *Annual Report 2014-15* (Mumbai, 2015), Table II.12, p. 44.
19. Praveen Chakravarty and Vivek Dehejia, *op. cit.*, p. 31.
20. Ishan Bakshi, "Making a Case for Taxing Farm Incomes", *Business Standard*, April 12, 2016, p. 21.
21. Government of India, *Economic Survey 2014-15* (Delhi, 2015), Volume II, p. 31.
22. M Govind Rao, *op. cit.*, p. 176.
23. Sunil Mitra, Ashutosh Dixit and Vivek Johri, "Tax System and Reform", in Kaushik Basu and Annemie Maertens (ed.), *The New Oxford Companion to Economics in India* (New Delhi, 2012), p. 681.
24. *Ibid.*, p. 683.