

Public Finance Quarterly

July-September 2009, Issue II

Editorial



Latha Ramanathan

Dear Readers,

Welcome to the second issue of quarterly newsletter of PwC's Public Finance (PF) Practice, 'Public Finance Quarterly'.

Public Finance is an arena which directly or indirectly touches and influences our lives. It can be through impact of various central and state government welfare schemes, amendments in policies and laws pertaining to direct and indirect taxes and/or through various monetary policies that have an impact on inflation and hence cost of living. Thus it helps to be well-informed of changes taking place in public finance space.

With this in consideration, the second issue of our newsletter continues to take further our endeavor to provide our readers with information and updates on developments, experiences and good practices in the PF domain.

In our inaugural issue, we had communicated about the revised guidelines issued by the Ministry of Finance, Government of India for preparation of Outcome Budget 2009-10. In 'Feature Article' section of this issue, we have analyzed these guidelines in terms of their pros and cons, along with the changes made in the Outcome Budget format.

As is known, Ministry of Finance has recently issued a draft of the Direct Tax Code, which is likely to be implemented in 2011. In this regard, we have presented a quick view of the proposed contours of the new tax code together with an examination of its possible impacts on business and individual taxpayers in our 'Pick of the Quarter' section.

In addition, key paper releases in public finance domain during the last quarter along with their reference links have been provided in our 'Round the Corner' section.

I would like to thank all our readers for their overwhelming support and response to our first issue. With your help and suggestions, we are continuously endeavoring to further improve this newsletter to ensure effective information sharing on PF issues. If you have an item to contribute for the next issue or want to subscribe to the newsletter, then please do not hesitate to contact the editorial team at latha.ramanathan@in.pwc.com. We look forward to your comments, suggestions, and contributions!

I hope you enjoy reading this issue and trust you will find a number of items that will prove to be of interest and use.

[Looking forward for your continuous support and association with "Public Finance Quarterly"](#)

Sincerely,

Latha Ramanathan

Executive Director & Head Public Finance

In this Issue:

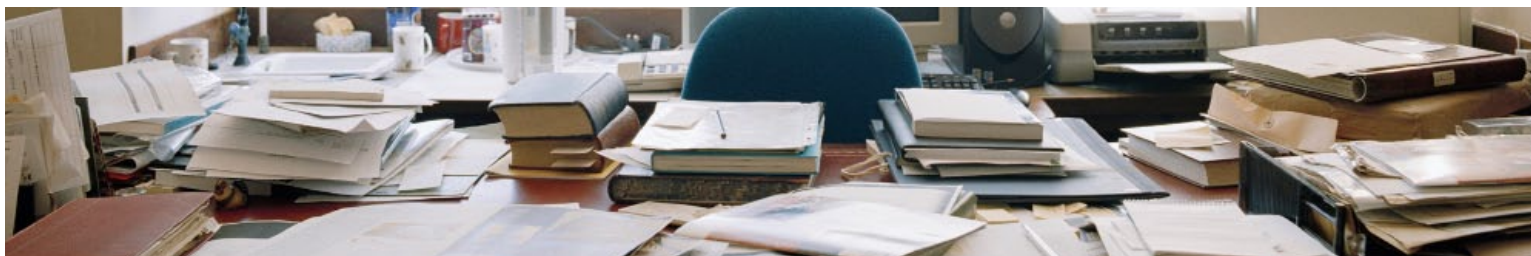
Round the Corner	03
Feature Article	05
Pick of the Quarter	09
PwC Updates	11
Memorable Experience-Field anecdote	12
Know Our People	12

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Round the Corner

Quarterly Stock of News Bytes and Releases



Releases

Public Financial Management Accountability Assessment, India–Himachal Pradesh

World Bank Report of June, 2009

The objective of this indicator-led analysis is to provide an integrated assessment of the Public Financial Management (PFM) system of the Government of Himachal Pradesh (GoHP). The analysis draws on the International Monetary Fund fiscal transparency code and other international standards. The set of thirty-one performance indicators developed for the assessment of state's PFM system covers:

- i. the performance of the PFM system in terms of actual expenditures and revenues by comparing them to the original approved budget, as well as the level of and changes in expenditure arrears;
- ii. transparency and comprehensiveness of the PFM system;
- iii. the performance of the key systems, processes and institutions in the budget cycle; and
- iv. the elements of donor practices which impact the performance of the PFM system.

Assessments are classified as A (excellent), B (good), C (opportunities for some improvement), and D (in need of improvement in some areas).

The analysis finds that the effective way to address the identified issues is in a strategic and sequential manner. Hence it not only identifies dimensions where opportunities exist for improvement in indicators, but also offers suggestions for their prioritization and sequencing. Dimensions identified as the areas for attention are:

- i. Revision of the HP Financial Rules and Budget Manual
- ii. Improvement of control environment in the State Treasuries;
- iii. Review of procurement rules; and
- iv. Adoption of a risk based approach towards functional internal audit process in all departments.

This is the second PFMA assessment at Sub National level in India, after Maharashtra.

Link: http://www-wds.worldbank.org/external/default/WDSPContentServer/WDSP/IB/2009/07/03/000334955_20090703015158/Rendered/PDF/486350ESW0IN0P101Official0Use0Only1.pdf

Technical Notes and Manuals: IMF Fiscal Affairs Department's Publication

The IMF recently launched a new series called Technical Notes and Manuals. The first three issues have been authored by the IMF's Fiscal Affairs Department. These notes and manuals aim at raising awareness among practitioners, officials and academics of contemporary fiscal topics; and improving the dissemination of FAD's TA advice. They deal with:

- i. A Basic Model of Performance-Based Budgeting
By Marc Robinson and Duncan Last
This technical note addresses the following main questions:
 - What are the characteristics of a basic model of performance-based budgeting?
 - How should low-income countries approach performance-based budgeting?
 - What preconditions should exist before starting PBB?
 - What forms of performance-based budgeting should low income countries avoid?

Link: <http://blog-pfm.imf.org/files/fad-technical-manual-1.pdf>

- ii. Transition to Accrual Accounting
By Abdul Khan and Stephen Mayes
This technical note addresses the following main questions:
 - What is accrual accounting?
 - What are the reasons for moving from cash to accrual accounting?
 - What are the differences between accrual accounting and accrual budgeting?
 - What are the main steps to be taken in moving from cash to accrual accounting?
 - What are the preconditions for introducing accrual accounting?
 - How should a move to accrual accounting be sequenced and managed in relation to the government's overall agenda for public management reform?

Link: <http://blog-pfm.imf.org/files/fad-technical-manual-2.pdf>

iii. Modernizing Cash Management

By Ian Lienert

The five sections of this note address the following main issues:

- What are the main objectives of modern cash management?
- What are good cash management practices in developed countries?
- What are the main features of the framework for short-term cash planning?
- What are the main challenges for improving cash management in low- and middle-income countries?
- How should cash management reforms be sequenced?

Link: <http://blog-pfm.imf.org/files/fad-technical-manual-3.pdf>

Pitfalls of Participatory Programs: Evidence from a Randomized Evaluation in Education in India

Poverty Action Lab Paper of August 2009, Author(s) -
Abhijit Banerjee, Rukmini Banerji, Esther Duflo, Rachel
Glennester, Stuti Khemani

Participation of beneficiaries in the monitoring of public services is increasingly seen as a key to improving their efficiency. In India, the current government flagship program on universal primary education organizes both locally elected leaders and parents of children enrolled in public schools into committees, and gives these groups powers over resource allocation, and monitoring and management of school performance. However, it was found in the baseline survey that people were not aware of the existence of these committees and their potential for improving education. Further this paper evaluated three different interventions to encourage beneficiaries' participation through these committees: providing information, training community members in a new testing tool, and training and organizing volunteers to hold remedial reading camps for illiterate children. The findings are that these interventions had no impact on community involvement in public schools, and no impact on teacher effort or learning outcomes in those schools.

However, the intervention that trained volunteers to teach children to read was found to have a large impact on activity outside public schools - local youths volunteered to be trained to teach, and children who attended these camps substantially improved their reading skills.

Link: http://www.povertyactionlab.org/papers/121_Updated_Pitfalls.pdf

India's Experience with Fiscal Rules: An Evaluation and the Way Forward

IMF Working Paper of August 2009, Author(s) -
Alejandro Sergio Simone and Petia Topalova

This paper examines India's experience with fiscal rules with a view to inform the design of a possible successor fiscal framework to the Fiscal Responsibility and Budget Management Act (FRBMA). Among several proposals to strengthen the FRBMA, a framework that focuses medium-term fiscal policy on debt sustainability by the use of a medium term debt target, and annual nominal expenditure growth rules is proposed. This approach tackles the deficit bias at its core and enables countercyclical fiscal policy through automatic stabilizers.

The message from the paper is that numerical targets should be supported by structural reform measures for both revenues and expenditures, while the coverage of the fiscal rules should be expanded.

Link: <http://www.imf.org/external/pubs/ft/wp/2009/wp09175.pdf>

Patterns of Inclusive Growth in Developing Asia: Insights from an Enhanced Growth- Poverty Elasticity Analysis

ADB Working Paper of August 2009

This research paper identifies key factors that explain the observed wide variation in patterns of inclusiveness of economic growth, which in itself is defined here as gross domestic product (GDP) growth that leads to significant poverty reduction in Asia. Factors that influence the degree of poverty reduction that accompanies economic growth (referred to as the poverty elasticity of growth or PEG) include the sectoral composition of the economy and its growth; the nature, size, and pattern of public investments (particularly on social services and agriculture); and quality of governance. PEG has been calculated for Asian countries as an arc elasticity over the 1990–1996 and 2000–2006 periods, and analyzed against available measures of the above-named factors from statistics compiled by ADB, World Bank, and UNDP. Pair-wise analyses using scatterplots, simple regressions, and multiple regressions have been employed to determine systematic relationships between the PEG and its likely determinants. Results affirmed the significant impact of quality of governance, public expenditures on social services, and contribution of agriculture to GDP growth, in that order of importance. There is likewise evidence that manufacturing growth has had a bearing on the inclusiveness of growth, especially in Southeast Asia in recent years. Results of the analysis also showed how dramatic differences in characterization of countries can result when a multidimensional poverty measure is employed rather than a unidimensional one based only on income or expenditure.

Link: <http://www.adbi.org/files/2009.08.12.wp145.patterns.inclusive.growth.dev.asia.pdf>

Feature Article

Gaining an insight into Public Finance Arena



Roadmap to Performance Based Budgeting in India

Present and Future Course for Union and State Governments

Performance Based Budget

Introduction

Performance based budgeting (PBB) can be defined as the budgetary process that attempts to incorporate performance information in the budget process. Performance information is the information on the components of different programs run by government departments to meet sectoral goals and objectives. This information provides the necessary knowledge on whether programs are being run efficiently and effectively. Performance information hence acts as a tool for evaluating performance of government departments.

There are several approaches under which performance information can be built into the budget process. This includes activity-based budgeting, performance budgeting, outcome based budgeting, program budgeting, and others. Integrating performance information into the budget process mainly involves a shift of focus from inputs (how much money will be spent on a program) to measurable outputs (what is achieved from the expenditure incurred) and outcomes (how the program/sectoral objective is met).

Countries which have incorporated performance information in their budgets have reported a number of benefits: sharper focus on results within government and greater understanding of how different programs contribute to government goals. At the same time, performance information also improves transparency, by providing greater information to legislatures and the public.

Brief History of PBB

Performance based budgeting has a long history in OECD countries, with most of them working on it for over ten years. The reasons behind such reforms have been several, for example, financial crises, pressure on the government to reduce expenditure, change in political administration. Denmark and Sweden embarked on performance budgeting during the economic crisis in the 1980s and early 1990s.

A decade later, the Asian financial crisis triggered similar reforms in South Korea. United Kingdom initiated performance budgeting in 1997 after the election of the Labour Party which introduced several budgetary reforms.

These countries have used different methods to institutionalize performance information into their budgetary systems. Some countries such as United States, have introduced reforms through legislation. However, legislation cannot guarantee reform without political and administrative support. Few other countries, such as Canada, have legislations as well as formal policy guidelines. UK, on the other hand, has simply used guidelines issued by the Central Ministries.

PBB Models

There are a number of models of performance based budgeting that use different mechanisms to link expenditure to results. Some have very sophisticated features and require the support of correspondingly sophisticated public management systems while others focus more on the basics.

The most basic form of performance based budgeting aims to link outputs and outcomes to budgetary expenditure. For effective implementation of this form of performance based budgeting, the objectives and expected outputs/outcomes from government expenditure need to be clearly stated in terms of measurable indicators. The budget process should also review these indicators from time to time for evaluating performance and deciding future budget allocations.

Apart from the basic model of performance based budgeting, a number of advanced performance-budgeting mechanisms have been adopted by some OECD countries. These include budgeting processes which set performance targets for all line ministries (e.g. UK Public Service Agreement) or rating of government program performance as 'effective', 'adequate',

'ineffective' etc. (e.g. U.S. Program Assessment Rating Tool). There are some approaches which treat line ministries like commercial businesses that are paid "prices" by the government for the services they deliver to the community. However, this approach has been successful only in specific-sectors or institutions (e.g. hospitals) and not when applied on government wide basis.

Path to PBB

In traditional line item budget, allocation is made by types of inputs (like salaries, equipments) and each year's budget is based on allocations in the previous year. Hence, decision making focuses on incremental allocations so as to ensure that expenditure is limited to the available resources. The major alternatives to incremental budget that have been proposed by public finance practitioners are 'Zero-Based Budgeting' (ZBB) and 'Planning, Programming and Budgeting System' (PPBS), also known as 'Program Budgeting'. The former involves reconsidering budgetary allocations in their entirety each year, using a zero base for each program. The latter involves focusing on the goals and objectives of budgetary expenditures and comparing different programs (and its associated costs) in terms of their success in producing outputs.

Line Item Budgeting to Program Budgeting

Program budgeting enables budget decision makers to assess the benefits and efficiency of programs relative to their costs. Program budgeting is, therefore, an element of performance based budgeting that is highly recommended for those countries that are trying to improve their budget processes and move to processes designed to better align spending decisions with expected performance.

The path to 'Program Budgeting' from 'Line Item Budgeting' primarily requires expenditure made by programs instead of by inputs. For this, the first step requires classification of different programs of the government on the basis of their objectives. How the program aims to achieve its objective (i.e. inputs and outputs) being stated along with development of performance indicators for the outputs. Finally, the programs have to be costed on the basis of inputs required to achieve the program objective. Hence, under 'Program Budgeting', the budget preparation process becomes program based.

These two budgeting processes are illustrated below.

Figure 1: Line Item Budgeting



Figure 2: Program Budgeting



Program Budgeting to PBB

After a government implements program budgeting, introduction of performance based budgeting will mainly require managerial accountability for program results. If program managers are to be held accountable for delivery of results, then they should be given greater flexibility to choose the input mix that can most efficiently deliver services. This requires a reduction of the large number of distinct limits imposed upon expenditure by inputs in traditional line item budgeting. Combined with this, administrative process flexibility will also be required. For example, governments should have the capacity to reduce civil service employment in low priority or ineffective program areas either through retirement schemes or redeployment.

Budgetary Reforms in India

Early attempts

Government of India embarked upon budgetary reforms to control public expenditure and reduce the growing budgetary deficit. For this, it turned to 'Zero Based Budgeting' (ZBB) to tone up financial management. On 10th July 1986, the Ministry of Finance issued a circular-cum-budget guideline to all ministries/ departments, and State Governments and Public Sector Undertakings, impressing upon them the need to apply ZBB to all schemes and programs with over Rs. 1 Crore outlay from the fiscal year 1987-88. For this purpose, a Central Monitoring Cell was formed.

The Finance Ministry had identified around 150 redundant and low priority schemes with estimated outlays of over Rs. 10 billion, which the Ministry wanted to eliminate. Among the state governments, Maharashtra implemented ZBB in 42 departments with the budget for 1987-88 reflecting a saving of Rs. 500 million through elimination or merger of several redundant, duplicative and low priority schemes.

However, ZBB in India has been implemented in the true sense only in the Department of Space. For the rest of the ministries the success can be termed negligible. Moreover, ZBB resulted in several operational issues as it is quite time consuming with all expenditures required to be thoroughly analyzed from zero base every year. With a very large number of ongoing programs running into thousands, undertaking such a task became infeasible.

Government of India has accepted performance budgeting as a tool for inculcating performance orientation and initiated the process of change, gradually and cautiously. This new approach has been introduced in all development departments in the Union Government. Several state governments have also introduced performance budgeting in a number of departments but the progress has not been satisfactory.

Current attempts of Government of India towards Outcome Based Budgeting (OBB)

Currently, Government of India is trying to implement Outcome Based Budgeting (OBB). This is a relatively new concept in budgetary process reform. Osborne and Gaebler have defined outcome budgeting as “A budget system that focuses on the outcomes of funded activity”. Osborne and Hutchison popularized the concept as ‘budgeting for outcomes’. Budgeting for Outcomes (BFO), challenges policy makers to determine the outcomes citizens value most, prioritize scarce resource allocation to produce these outcomes and re-evaluate the way the services are provided to the citizens.

Performance based budgeting is a necessary part of outcome based budgeting, but it is not the same thing. The former is concerned with the performance of any public program in terms of inputs to be provided under the program and expected outputs from it. It does not focus on the greater outcome from the program, which is the well-being of people. Hence, performance budgeting can be termed as an essential subset of outcome based budgeting.

In India, Outcome Budget has become an integral part of the budgeting process since 2005-06. Outcome Budget for any given year is prepared on the basis of the Regular Budget for that year, as a separate document by each Ministry/ Department in respect of all Demands/Appropriations controlled by it. Sub-targets for coverage of women, SC/ST and beneficiaries of North Eastern Region are required to be indicated separately in the Outcome Budget. A Guideline for preparation of Outcome Budget was released by GoI that has been subsequently revised.

Revised Guidelines for preparation of Outcome Budget 2009-10 have been released in May, 2009. As per the revised guidelines, Outcome Budget 2009-10 will broadly indicate physical dimensions of the financial budgets as also the actual physical performance in 2007-08, performance for the full preceding year of 2008-09 and the targeted performance during 2009-10. The Outcome Budget documents have to be laid before both the Houses of Parliament, after final approval of the Minister-in-charge, to ensure that the process is complete during the session when the regular budget is presented.

As required by the revised guidelines for preparation of Outcome Budget, every Ministry/Department presents its targeted and achieved outputs vis-à-vis any program in separate chapters in the Outcome Budget document.

The format of Tables as presented in Outcome Budget is shown below:

Table 1: Format for Outlays and Outcomes for Current Year

Name of Scheme/ Program	Obj.	Outlay 2009-10 (In Rs. Cr)		Quantifiable Deliverables/ Physical Outputs	Projected Outcome	Pro-cesses/ Timeline	Remark/ Risk Factors
1	2	3		4	5	6	7
		3 (i)	3 (ii)				
		Non Plan	Plan				
Scheme X							
Scheme Y							
Scheme Z							

Table 2: Format for Review of Past Performance

Name of Scheme/ Program	Obj.	Outlay 2008-09 (In Rs. Cr)		Quantifiable Deliverables/ Physical Outputs	Processes/ Timeline	Remark/ Risk Factors	Status as on 31st March, 2009
1	2	3		4	5	6	7
		3 (i)	3 (ii)				
		BE	RE				
Scheme X							
Scheme Y							
Scheme Z							

Observations on the Revised Guidelines for OBB

A study of the Revised Guidelines for OBB reveals the following issues that would need to be addressed by Gol in its subsequent revisions and updates to the Guidelines:

- Revised Guidelines for preparation of Outcome Budget 2009-10 requires performance for the full preceding year of 2008-09 to be included in the Outcome Budget. However, the timeline for Outcome Budget requires this process to be completed during the parliament session when the regular budget is presented. As the regular budget is presented generally in April, it is not possible to collect information on performance of programs up to 31st March for its presentation in the very next month. The performance therefore can be detailed only up to the 3rd quarter of previous financial year.
- Presentation of past and targeted outcomes in separate tables and in separate chapters makes it difficult to compare allocation for a program in the current year with those in the previous years at one go. To overcome this, a single table for capturing all data would be more helpful and the following suggested format for presentation could be considered.

Table 3: Suggested format for Outcome Budget

Name of Scheme/ Program	Obj.	Year	Outlay (In Rs. Cr)			Physical Outputs (up to Dec 31 for 2008-09)	Achievements/ Expected Outcomes	Processes/ Timeline	Reasons for under performance, if applicable	Remark/ Risk Factors
			Actual	RE	BE					
Scheme X		2007-2008	Y	N	N					
		2008-2009	N	Y	N					
		2009-2010	N	N	Y					
Scheme y		2007-2008	Y	N	N					
		2008-2009	N	Y	N					
		2009-2010	N	N	Y					

As can be seen from Table 3, for any scheme/program, current year as well as previous two years' data can be detailed in the same Table. For the current year, (shown as 2009-10 in Table 3), Budget Estimates (BE) represents the outlay. For the immediately preceding year, Revised Estimates should be stated as this provides a more updated account of expenditure. Actual expenditure should be stated for the year 2007-08. Physical outputs should be provided for the full year of 2007-08 and up to Dec 31 for the preceding year (as specified in the format). Along with physical outputs to be provided by the Department, past achievements and expected outcomes should also be mentioned. Reasons for under

performance wherever past achievements have fallen short of targets should also be provided. This would give an indicator of efficiency of the program in terms of its target achievements. Budget allocation for any given program in the current year can be based on previous year's performance in achieving the targets.

Conclusion

It is apparent from the above analysis that the need to provide a meaningful link between policy and budgeting has long been realized in India, but has also consistently proved elusive. The capacity to successfully carry out this linking of policies with programs through strategic planning mechanisms requires the skill to construct medium-term budgets. In medium term budgets, target results from each program are specified for the medium term and based on this, budgeting for the program is done every year. This as of now is taken care by Five Year Plans, which provide broad financial ceilings and likely outcomes that are to be achieved. But the issue is the robustness of link between 'outlays and inputs' and 'inputs and outputs' and finally 'outputs and outcomes'. Current efforts of OBB are an indication of the move from input based budgeting to output orientation in budgeting. Proper monitoring and accountability for outputs will be required to move from an outcome 'oriented' budgeting to outcome 'based' budgeting. A true Outcome Based Budgeting will involve measuring performance against indicators and linking allocation to performance. Certainly, this transformation from traditional budgeting procedures is likely to require a substantial effort in building capacity and the patience in managing the change process.

Pick of the Quarter

Sharing a Viewpoint



New Direct Tax Code: Walking on a Tight Rope

Tax reform is taking the taxes off things that have been taxed in the past and putting taxes on things that haven't been taxed before. -- Art Buchwald

With an almost five decades old Income Tax Act, 1961 subjected to over 5,000 amendments and a falling rate of growth in national tax collections, conditions could not have been riper for introduction of a new Direct Tax Code, as another major tax reform initiatives, along with promise for introduction of GST by next fiscal 2010. Targeted towards broadening the tax base through elimination of exemptions, the Code presents an opportunity to usher in a new tax regime of transparency and greater compliance.

As stated by the Union Finance Minister, Mr Pranab Mukherjee in the Foreword to the Code, the thrust of the Code is to improve efficiency and equity of the current tax system by eliminating distortions in the tax structure and introducing 'moderate' levels of taxation.

However, several proposed new changes have come under severe criticism in the public debate that ensued presentation of the draft Code by the Finance Minister. It has been argued that proposals like shifting the base for computation of Minimum Alternate Tax (MAT) from book profits to assets, capital gains taxation in case of non-residents; double tax avoidance agreements; General Anti-Avoidance Rules (GAAR); taxation of foreign companies; taxation of charitable institutions; and shift to EET system for taxation of savings will end up being counterproductive with their expected impact defeating the stated logic for their introduction.

This article restricts analyses of some of these issues to those having a direct bearing on individual taxpayers and the corporate sector.

An Individual's Perspective

In the current scenario, an employee's taxable income is directly proportional to the honesty of its employer in disclosing remunerations. Not surprisingly, dishonesty and non-disclosure of income tax have been rewarded in the form of lower tax payable in the present tax structure. In order to

address such issues and to ensure that all loopholes in the law are plugged, the Code proposes lowering of income tax rates and discontinuing most of the tax free perquisites. Following are the major changes recommended in the Code relating to personal taxation:

- Tax Exemption maintained at Rs 1.6 lakh income a year
- Income Tax slabs modified:
 - 10% tax on annual income of Rs 1.6 – 10 lakh
 - 20% tax on annual income over Rs 10 lakh up to 25 lakh
 - 30% tax on annual income beyond 25 lakh
- All perquisites and allowances such as leave travel, furnishings, entertainment expenses, conveyance, and medical to be added to income for taxation
- Savings up to 3 lakh to be exempted from income for taxation
- Under the proposed Exempt Exempt Tax (EET) system all withdrawals from saving instruments such as PF and PPF to attract tax on withdrawals
- Wealth tax limit raised to 50 crore from 30 lakh
- Financial securities like shares brought under wealth tax
- Tax on long term capital gains reintroduced.

Even such drastic changes in the income tax slabs have failed to bring cheer as the removal of tax rebates and savings incentives are being considered harsh. With inclusion of house rent allowance, medical and leave travel allowance, gross salary can be expected to go up substantially mitigating the impact of the more liberal tax slabs.

The biggest blow, however, has been dealt through the loss of attractive investments and saving avenues for individuals. By bringing long term capital gains on shares under the tax net, participation of retail investors in equities or equity-

oriented funds can be expected to be significantly dampened. Contributions to fixed deposits, interest and principal payment on housing loans, educational expenses of dependents, and a host of other forms of savings will no longer qualify as eligible for tax savings. Most importantly, the proposed EET (Exempt-Exempt-Tax) method of taxation will ensure that even the most favored saving instrument of the common man – the PPF – will not escape the tax net. Returns on investments in PPF will be taxable at the time of withdrawal or maturity. Thus under the EET system, investments will result in deferment of tax and not saving of tax, making permanent tax saving an impossibility.

The argument put forward in favor of EET system of taxation by the Government has been that it is internationally recognized as a fair and equitable way of taxation since it encourages savings and at the same time, follows a progressive approach to taxation. The counterargument to this is that while EET has indeed been adopted as a method of taxation of pensions in several developed countries, complimenting systems have been instituted to ensure that economic double taxation of income does not take place. Most of the EET implementing countries ensure that withdrawals from such pension funds are in the form of annuities. The principle of taxation of pension savings in these countries is as follows: pension savings should be taxed only limited to the amounts corresponding to the contributions that enjoyed tax relief when they were paid in. Thus, though annuities are subject to progressive taxation, the component of annuity corresponding to either:

- the financial returns accumulated by the pension fund, or
- the contributions that exceeded the tax relief threshold

is excluded from any further taxation. Moreover lump sum withdrawals from such funds are strictly discouraged as taxation becomes harsher in such cases. Given that similar systems and structures are not in place in India, cherry picking from successful international good practices may not give desired results and in fact may end up being counterproductive.

Another argument against the introduction of EET is that where investments are made out of income within the exempted limit (Rs 1.6 lakh), inequity will creep in when such investments are taxed on withdrawal.

The Corporate Perspective

For India Inc., the proposed Code presents a mixed bag of blessings and curses. The following points summarize the major changes proposed that are likely to have the maximum impact on our corporate sector:

- Corporate Tax rate to brought down to 25% against 30%
- Abolition of Securities Transaction Tax
- No distinction between short and long term capital gain tax
- Amalgamation and de-mergers to be tax neutral
- Business losses to be carried forward till fully adjusted
- Minimum Alternative Tax (MAT) on gross assets as against book profits
- Area based incentives to be replaced with incentives on investment
- Punishment for defaulters to be more severe.

In spite of a reduction in the corporate tax rate, concerns have been raised about whether implementation of these changes would result in a net increase in the tax burden on the corporate sector. The biggest worry has been the proposal to redesign MAT which seems to run counter to the objective of encouraging capital investment for productive growth.

Targeted at highly profitable companies, paying little or no tax due to availing of tax incentives, MAT based on the principle of taxation of presumptive income was introduced in India in 1983. After several amendments since then, in 2000 the Government made book profits as the base for imposition of MAT. Now the Discussion Paper on the proposed Code justifies the shift in MAT base from book profits to gross assets on the basis that such a shift 'will encourage optimal utilization of assets and thereby increase efficiency'.

Prima-facie, MAT would appear as a logical step to ensure that companies that otherwise would avoid paying their 'fair share' of taxes, also end up paying some amount of tax on income. However, a closer look will reveal that Minimum Alternate Tax (MAT) has some very far reaching implications. Economists all over the world have been debating on the efficacy of levying such type of a minimum tax primarily because MAT has the effect of reducing investment spending in several ways. Application of MAT on profitable companies results in a higher tax outflow than what would have been payable under regular assessment, and as a result the retained earnings available for investment activities goes down. The cash flow constraint becomes more relevant for companies at times when the capital markets are not doing well and the access to capital becomes tougher.

Apart from putting a strain on regular cash flows, MAT also discourages capital spending by raising the cost of capital or the base financial parameter which a project must meet before deciding to go ahead on the same.

Ironically, the Code proposes revamping of the MAT at a time when countries like the US are rethinking its very application. Recognising that Alternate Minimum Tax (AMT) as it is known in the United States) is having a severe adverse impact on corporate capital expenditure spending, President George Bush, in his economic stimulus proposal to the Congress, made a strong case for elimination of AMT. It was recognised that such a minimum tax was inhibiting investment and was diminishing the value of various investment incentives, such as accelerated depreciation.

Conclusion

To conclude, while the new direct tax code is truly a step in the right direction, certain key provisions would need to be debated upon. As an example, the EET method of taxation will only encourage individuals to under report their incomes in order to escape the tax net. Similarly, MAT on assets may adversely impact industrial growth by reducing incentives for the corporate sector to invest more.

The Government will need to adopt a flexible attitude on some of the key contentious issues to allow for adoption of the simplified Code and mitigate the risk of the Code being rejected altogether.

PwC Updates

PwC's contribution towards the sector



Know our Work

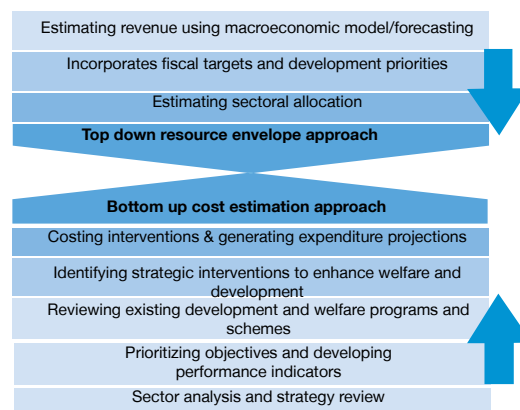
Medium Term Expenditure Framework (MTEF) - A tool for linking policy, planning & budgeting

The Public Finance practice of PwC, as Long Term Consultants under Strengthening Performance Management in Government Programme (SPMGP) for Government of Madhya Pradesh is involved in preparation of MTEF for five departments, namely Tribal Development, School Education, Water Resources, Public Works and Farmer's Welfare and Agriculture Development for the years 2008-09 and 2009-10. Based on this experience and leanings, a brief overview of MTEF as a concept, its process and benefits is presented in this segment.

The Concept: Medium Term Expenditure Framework (MTEF) is a public expenditure planning exercise that bridges the gap between long-term Five Year Plans and annual departmental budgeting exercise with sharp focus on result-oriented public expenditure. By linking sector specific plans and strategic interventions to sectoral budget, it serves to enhance efficiency and effectiveness in budget management. MTEF preparation is an initial step towards outcome based budgeting, with performance informed budgeting constituting the intermediate step. It is a multi-year rolling framework, usually for 3-5 years to be updated every year.

The Process: MTEF involves reconciliation of resource envelope estimated by top-down approach with bottom-up approach of cost estimation based on resource requirement for each administrative department.

- Estimation of resource envelope involves estimating revenue estimates of the government using fiscal targets and macroeconomic forecasting techniques. Sector allocation is then arrived at using government's priorities and developmental objectives.
- Undertaking sector reviews to identify priorities, programs, issues and concerns of the sector. Using appropriate performance indicators, existing development programs and schemes are analyzed and evaluated. Subsequently strategies and interventions are identified to resolve current issues and enhance welfare. Next, the cost implications of these interventions are estimated. After that, expenditure projections for the next 5 years are generated for attaining objectives of department.



- **Balancing the two approaches** is a critical step in formulating MTEF as it involves reconciliation of 'bottom up' inputs/ policy proposals/ interventions emanating from departments with preliminary departmental ceiling based on 'top down' estimate. Solving this optimization problem subject to the preliminary budget ceiling calls for exploration of various ways to reprioritize objectives. MTEF concludes with reallocation in line with finally agreed resource ceiling (if modified) in consultation with Finance Department and State Planning Commission.

The Benefits: If successfully applied and well implemented, MTEF:

- Raises resource consciousness and promotes more output and outcome focused approaches;
- Enhances predictability of resource flows by providing realistic projections of likely revenue and expenditure;
- Optimizes resource allocation by channelizing expenditure to programs and schemes found to be most effective and relevant to current issues and concerns;
- Facilitates program monitoring by assessing their effectiveness based on relevant performance indicators;
- Serves as an input in informing next round of policy plans/ decisions

Memorable Experience- Field anecdote

Dear Friends,

This is a short account of one of field experiences which happened during my early days in Chennai. Since I could not understand or speak Tamil, I had learned from one of my friend a phrase in Tamil “Tamil Teriya de”, which means that “I don’t know Tamil”. Being new in Chennai, on a fine evening, I decided to take a MTC bus for visiting the Marina beach. I went to the nearby bus stop, got into the bus which I thought would take me to my destination and made myself comfortable on a window seat.

Just as I was enjoying the view outside R K Salai, an elderly gentleman came and sat beside me. Being courteous, I passed a friendly smile to the gentleman and resumed viewing the sights. Soon, I found that the elderly man had put his hands on my shoulder and it seemed that he wanted to communicate something across. Getting my attention, he said something in Tamil, which of course I couldn’t understand. However, I was prepared for the situation and thought to use my master weapon, the phrase I had mugged up, to save myself. Acting smart, I said “Teriya De”, meaning I don’t know and turned towards the window appreciating myself on my smartness. Just then, I again heard the elderly man saying something in Tamil with the volume of his voice a little raised. I again patiently repeated the only words of the language that I had learned that time. His voice sounded even louder this time. I couldn’t understand the situation and started wondering whether the gentleman understands Tamil.

I looked around in the bus and found laughing faces. I started wondering if the friend had pulled a joke on me and possibly the phrase meant something else! I then noticed that the elderly man was pointing to his wrist and talking agitatedly with a raised voice. Taking clue of the gesture, I got the hang of the situation and realized that the gentleman was asking me to tell him the time.

Here I was wearing a watch and saying I don’t know! That day I realized that little knowledge can actually be very dangerous.

That was a memorable experience that taught me a nice lesson and leaves a smile on my face every time it passes my mind.

Ranen Banerjee

Know our People



Ranen Banerjee

Senior Manager, Public Finance, PwC

Ranen is a Senior Manager in PricewaterhouseCoopers Pvt Ltd, India. He has extensive experience of working with Public Sector and Government Departments in India, Bangladesh, Nepal, Sri Lanka, UAE, Maldives, Indonesia and Vietnam in areas covering Budget Reform, Expenditure Management, Public Resource Management, Fiscal Management Reforms and Restructuring of PSEs.

Job Experience

Ranen started focusing on Public Finance projects from 2001 and has been instrumental in the growth of the Public Finance practice within the Government Reforms and Infrastructure Development (GRID) SBU. In his professional carrier of 12 years, he has worked with several Government departments at national and sub-national levels on projects funded by ADB, DfID, JBIC, KfW and the World Bank. Some of the key clients handled by him in India are State Governments of Madhya Pradesh, West Bengal, Orissa, Assam and Uttar Pradesh.

Ranen is presently managing the long term consultancy assignment under the DFID supported Strengthening Performance Management in Government programme in Madhya Pradesh, India. He is guiding and supervising the development of Medium Term Expenditure Frameworks (MTEF) for 5 departments viz. Agriculture, School Education, Tribal Welfare, Water Resources and Public Works Department and is also coordinating the development of integrated macro-economic model for Madhya Pradesh. Concurrently, he is also directing and coordinating the Assam Governance and Public Resource Management Sub Program (II) supported by Asian Development Bank (ADB). The program involves assisting GoA in developing and institutionalizing outcome-based budgeting, establishing debt management unit, limiting its committed expenditures on pensions and salaries and strengthening capacity of Government officials.

He recently successfully concluded a two and half year Fiscal Management Reform Program undertaken by Ministry of Finance and Planning, Government of Sri Lanka. He was the Resident Project Manager for this assignment whereby he supported the key institutions responsible for public finance across various activities in order to improve fiscal performance and strengthened the development of new systems and procedures, which enhanced capacity, efficiency, and effectiveness of the revenue and budget administrations. He has worked on study of Agency Functions and their structures within Ministry of Finance in Indonesia and in developing a Mission and Vision for the State Treasury in Vietnam.

Ranen has undertaken several assignments involving assessing fiduciary risk inherent in the working of the Public Finance Management systems in government departments including Departments of Health and Family Welfare, Women and Child Development, Education and various central and state Government Programs.

Public Finance Practice

The Public Finance Practice of Government Reforms and Infrastructure Development (GRID) SBU of PwC in India has been closely working with clients in public sector and at all levels of Government as well as key donors such as DfID, JBIC, World Bank and ADB. A large dedicated team of full time professionals and associates provide services in areas that include public expenditure management, revenue administration, budgetary policy development, financial restructuring, performance improvement, institutional strengthening & capacity building, accounting & financial management systems, human resource development.

PwC has been providing advisory services to Governments, Multilateral and Private Sector Clients in the area of public finance. The work has broadly included, budget reform, revenue augmentation strategies, automation/computerization, and debt management. Most of these projects included training and capacity building of the Government counterparts working with PF team on the specific modules. In addition, the team has gained a lot of traction in the PEFA/FRA area with many assignments across south Asia.



Training Programme organised for Government of Madhya Pradesh on Econometric Forecasting Techniques

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