STUDY ON UNACCOUNTED INCOME / WEALTH BOTH INSIDE AND OUTSIDE THE COUNTRY

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DRAFT REPORT

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PREFACE

The subject of unaccounted income and wealth has in the recent year's evoked considerable interest in academia as well as policy circles. Popular print-media articles have gradually formulated a generalised perception that unaccounted income in any economy is rising. In the event of this perception being true the massive circulation of unaccounted income could pose a big threat to a country's economy. A growing or otherwise parallel economy has enough potential to undermine the entire fiscal structure of a country. It may lead to huge losses in tax revenues to the government and has a debilitating effect on the institutions of governance and formulation of public policy in the country.

In case of Indian economy the phenomenon of parallel/shadow/black economy has been there in existence almost since the beginning of the second Five Year Plan. Many experts and committees have studied this phenomenon and suggested measures to control it and gradually eradicate it.

Central Board of Direct Taxes (CBDT), Department of Revenue, Ministry of Finance, Government of India, New Delhi, awarded National Institute of Financial Management (NIFM), Faridabad, an autonomous body under the Department of Expenditure, Ministry of Finance, Government of India, a study on generation and / accumulation of 'unaccounted income / wealth both inside and outside the country' vide letter no. F. No. 414 / 58 / 2009 / IT (Inv.I), dated March 17, 2011

The Terms of Reference (ToR) for this study are as follows:

a) To assess/survey unaccounted income and wealth both inside and outside the country
b) To profile the nature of activities engendering money laundering both inside and outside the country with its ramifications on national security.
c) To identify important sectors of economy in which unaccounted money is generated and examine causes and conditions that result in generation of unaccounted money.
d) To examine the methods employed in generation of unaccounted money and conversion of the same into accounted money.
e) To suggest ways and means for detection and prevention of unaccounted money and bringing the same into the mainstream of economy.
f) To suggest methods to be employed for bringing to tax unaccounted money kept outside India.
g) To estimate the quantum of non-payment of tax due to evasion by registered corporate bodies.

These terms of reference are wide ranging and are quite exhaustive. NIFM has attempted to concentrate justifiably on all the terms of reference. However, the issues of quantification of the unaccounted income in India have received more attention.

In this study we have attempted estimation of the so called elusive phenomenon of unaccounted income and analysed its various dimensions. Econometric models and techniques have been applied in order to estimate the size of the shadow economy. In order to have insights on the other terms of references the study team had interactions with the experts / officers of various agencies / departments / ministries / organisations and stakeholders. The methods and techniques employed to meet the above included observations and interactive discussions; interviewing the link-nets; focus group discussions (FGD); back-up/back-end questionnaire; qualitative data analysis techniques and content analysis.

The outcome of the research study is presented in the six chapters corresponding to the various terms of reference. Chapter 1 of the report focuses on trying to understand the phenomenon by first defining it. In the next Chapter empirical estimates of the size of the shadow economy using various approaches and models along with the theoretical background are presented and some policy conclusions are drawn. An insight into the various reasons which lead to the origination of the black economy and about the main causes of the shadow economy in some of the sectors prone to black money (Realty, Securities, Manufacturing and Diamond) is provided in Chapter 3.

India faces a range of money laundering and terrorist financing risks. In Chapter 4 the perspective of money laundering and various *modus operandi* have been discussed. Generation of Black Money and its flight outside the country are concerns of the tax administration, financial institutions as well as the regulatory bodies of the country. It is important not only to stop the capital flight outside the country, but also to find out ways and means to bring back money to tax which is stashed abroad. Suggestions with reference to various methods to bring to tax money stashed outside the country, based on international experiences are discussed in Chapter 5. The estimation of quantum of tax evasion by registered corporate bodies and reasons for tax evasion and avoidance are discussed in Chapter 6 of the report. The suggestions with reference to each of the terms of reference have been covered as part of each of the chapters.

It is observed that there is considerable ambiguity concerning the exact nature of the phenomenon of parallel economy. The results of the study conducted by NIFM are based on numerous assumptions and approximations, each of which could attract detailed discussion. As an empirical work these platform for debate, but the fact remains that dealing with the concept of unaccounted income presents a definitive challenge. It is intuitively clear that unaccounted income stems from those activities that are out of sight, from the tax administrators. While some are out of sight on account of judgemental errors, majority of the activities are actually designed for remaining concealed. It is fairly difficult even to describe what cannot be seen, let alone measure it. The task at hand, however, has been to do both. Moreover, absence of and /or non –availability of reliable data makes the task even more difficult. In general the estimations of the shadow economy/ underground economy are volatile and quiet often one finds it too difficult to really claim to be confident of the full reliability of one's estimates of unaccounted income.

Most views contained in this report are based on large number of informal interviews conducted with senior revenue officials and policy makers at the centre and in the states, businessmen, and associations of workers representatives, civil society organizations, academics and experts. It may be difficult to assess the reliability of such information but it would be certainly worth gathering and analysing this information.

We hope the findings and analysis in this draft report will be useful.

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December 03, 2012

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The study was carried out under the overall guidance from a Steering Committee. The members of this committee comprises of Shri Rajiv Agarwal, former Secretary to the Government of India, Department of Consumer Affairs, Ministry of Consumer Affairs and Public Distribution System, Government of India, Dr. Pronab Sen, Principal Advisor, Planning Commission of India, Dr. U. K Sen, IRS, Chairman CAIB & Special Secretary, Department of Revenue (*Retired*), Shri M. Lakshminarayanan, Partner /Tax Deloitte Haskins &Sells, Shri Lalit Srivastava, Banking Ombudsman (Retd.), Reserve Bank of India and Shri G. P Gupta, Former Director, NIFM, Ex-Officio Member and Convenor. At every stage of the project, they helped us with critical comments, responded to our findings and also provided us with valuable insights and suggestions about how to move forward.

The study team members are grateful to Shri M. P. Varshney IRS, Chief Commissioner of Income Tax (Retired) Dr. Arup Mitra (Professor, Institute of Economic Growth, New Delhi), Shri Ashok Arya, IRS (C&CE) Ex-Addl. DG, NACEN, Faridabad, for their continued guidance , comments and stimulating criticism on earlier drafts.

We got immensely benefitted from discussions and extensive series of consultations with senior officials from various ministries and government departments, industry persons, members of civil society, academics, practitioners and policy-makers. We would like to express our special thanks to all of them for their generous contributions.

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The Fellow research students of NIFM made important scholarly contributions throughout the period of report study. We are very appreciative of their dedication and commitment of time. We are also thankful to Sudharshan Reddy Paramati, Research Assistant for his excellent research assistance and Rakesh Erazuth Mohandas from IBM India Pvt. Ltd., for his graphical support.

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EXECUTIVE SUMMARY

The present study has been commissioned by Central Board of Direct Taxes, Ministry of Finance, Government of India.

In this study, we undertook the task of collecting available data on the parallel economy in India to determine its development and size over an extended period of time. The study attempts a modest effort to understand the phenomenon by defining it and then seeks to grasp the severity of the situation by trying to estimate the size of parallel economy.

Some of the sectors of the economy where unaccounted income is generated have been studied in order to examine the causes and conditions that result in the generation and the conversion of same into accounted money. The study report also covers some aspects of money laundering with its ramifications on national security. Estimates of quantum of non-payment of taxes by registered corporate bodies have been prepared and reasons examined thereof. In the last section of the study report, various methods and concerted efforts to bring unaccounted tax funds stashed abroad have been examined.

Unaccounted Income: Definition and Estimates

Unaccounted income[1] is a multi-dimensional phenomenon and its definition would depend on the context in which it is being used. In this study, we have followed a narrow definition: "Unaccounted Income is the income from those economic activities that circumvent or otherwise avoid government regulation and taxation." This definition attempts to cover all illegal economic activities and income from some legal economic activities where tax is evaded.

The very nature of the shadow economy makes its measurement a challenge. In this report we have employed several alternative methods for gauging the size of the unaccounted income in India.

The first method used in the study is an indirect approach namely, 'the currency demand approach'. The approach works on the consideration that there is an excess increase in currency demand, which is unexplained by the conventional macroeconomic factors but could be attributed to the tax burden that force people to work in the underground economy. The trend of shadow economy as a percentage of GDP is estimated and subsequently size of unaccounted income at current prices is estimated.

The estimates using this approach indicate that barring a few years the size of the shadow economy varies between 30 to 40 percent of the India's GDP, which is quite substantial. Further,

[1]The unaccounted income commonly spoken as black money is known by different names: informal, unofficial, irregular, second, underground, subterranean, hidden, invisible, unrecorded or shadow economy. In the study these terms have been used interchangeably.

at current price the size of the unaccounted income is estimated to be around ₹ 30,000,00 crore (Thirty Lakh Crore) in 2010.

The second method used is the Multiple Indicators Multiple Causes (MIMIC) method. This approach captures the dimension of the underground economy and is popularly known as structural equation modeling (SEM). The MIMIC approach explicitly considers several causes, as well as the multiple effects of the shadow economy. The methodology makes use of the associations between the observable causes and the observable effects of an unobserved variable, in this case the unaccounted or shadow economy, to estimate the unobserved factor itself.

Two variants of MIMIC model, covering variables related to taxation, government efficiency, economic crime, macroeconomic fundamentals etc. have been employed. The overall findings clearly indicate that, for the period under study (1970-2010) the size of the shadow economy in India in terms of share of GDP is found to be evidently declining.

In the 1971-72, the estimated size was 33% of the country's GDP, which declines to 17% in 1990-91; it had further declined to 7% in 2010-11. However, in absolute terms the overall size of the shadow economy at the current price has increased from ₹ 16,424 crore in 1971-72 to ₹ 96,982 crore in 1991-92, which reached to ₹ 5,473,11 crore in 2010-11. Overall, the model perhaps indicates that reforms in various sectors, i.e. taxation and regulatory sides, have helped reduce the relative size of the shadow or the underground economy.

Another estimate using Dynamic Mimic Model approach has also been attempted. The findings show that that firstly, taxes are crucial for shadow economy growth in India. Second, economic crime has positive and sizable effects on the growth of shadow economy. Third, the important elections have positive spillover effects on the shadow economy. Fourth, labor market transformation is also crucially related to growth of underground economy. Overall a declining trend of shadow economy in terms of share of GDP except for few years, i.e. 1979-80 and 1987-88 is observed. It is also observed that in initial years (1971-72 to 1974-75) and last years (2007-08 to 2010-11) the size is by and large persisting. Focusing on overall size at the current prices indicates that shadow economy has increased from ₹ 16,424 crores of 1971-72 to ₹ 1,15,315 crores in 1990-91, which further increased to ₹ 7,72,263 crores in 2010-11. Overall the model indicates for declining trend of shadow economy in India, which confirms the robustness and reliability of our results using structural modelling.The size was above 30% in early 1970's, which decreased to around 7 to 15% of GDP in 2010-11.

Finally, using the household survey data, it is attempted to estimate personal income tax evasion using the direct approach in post reform period. Results of the analysis indicate that the tax evasion has seen phenomenal decline in the period of two decades of reform. Tax evasion was as high as 75.33% (of total personal income tax collection) in 1993-94, which reduced to 72.58% in 1999-00 and 70.44% in 2004-05. There has been impressive decline in 2009-10 to the level of 58.90%. Results also reveal that high tax evading states for the study period include Assam, Andhra Pradesh, Haryana, Kerala, Punjab, Orissa, and Jammu & Kashmir. Tax evasion is observed to be as high as 90% in some cases.

These results should be interpreted carefully. The various models used to estimate the unaccounted income in an economy have their own assumptions. Many of these assumptions are open to debate. The definition of shadow economy varies according to inclusion or exclusion of certain variables. In general the estimations of shadow economy or the underground economy are vulnerable and quiet often no one can really claim to be confident of the full reliability of its estimates.

Our currency models have focused on tax sensitive components of the economy, where currency is the prime mode of transaction. Therefore, it is likely that our currency model also captures a small part of the informal economy, which is also unaccounted in the formal income accounting. Therefore, a relatively large estimate using currency model makes sense. Our MIMIC models cover relatively large areas of the economy, which include several tax components, criminal sector, political illegal funding during elections and labour market. Despite having a broader coverage of the economy, the estimates are rather accurate and relatively lower mainly because it has not covered parts of informal economy unlike as in the currency model. Overall, our empirical results are satisfactory and indicate that the share of the unaccounted income has been decreasing in the recent years, however, absolute size is showing upward trend in the study period.

Sectors Vulnerable to Unaccounted Income: Causes and Conditions

There are some sectors in the economy that are more vulnerable to unaccounted income as a large proportion of it is generated and invested in these sectors.

Sectoral Identification

A three step approach was used to identify the major sectors where the unaccounted money is generated and/or invested. Firstly, with a view to get some broad insights and to gather some set of impressions, a large number of informal interviews with businessmen, tax practitioners, civil servants and other experts were pursued. Then, two set of research instruments (for Direct and Indirect taxes) were designed and half day workshops at the various commissionorates were conducted across the country (Kolkata, Delhi, Mumbai, Jaipur, Chennai, Coimbatore, Patna and Meerut). Focus group meetings with industry associations and chambers of commerce were also undertaken.

The survey results indicated that the sectors where unaccounted income is found to be highest included real estate, mining, pan masala, gutkka and tobacco industry, bullion and commodity markets, film industry, educational institutes and professionals. The other sectors namely securities market and manufacturing also showed high incidence of unaccounted income.

The study attempts at analysing the major causes and conditions leading to generation of black money in the real estate, manufacturing, securities sector and diamond industry.

Unaccounted Money in the Urban Real Estate Sector

The real estate market in India, at present is widely known and acknowledged as extremely inefficient and opaque. There is easy absorption and generation of black money in this sector.

Land allotment/ purchase of land in auction from the government is the initial activity in the sector that gives rise to confusion and corruption. Conversion of land use is another issue where discretion is exercised. After acquisition of land, the builder has to decide the nature of construction and also to seek various permissions and licences from government agencies. The generation of unaccounted money in the building construction can also be attributed to flexible interpretation of Floor Space Index (FSI), sharp accountancy practices using percentage of completion method for revenue recognition, inflation of expenses and extracting wrong tax concessions.

The informal interviews with the brokers and builders in fourteen cities gave an idea about the market prices of the property. It was observed in many cases that the value adopted by the stamp valuation authority in form of circle rates is much lesser than the fair market value of the properties on the date of transfer. Large disparities and variations have been noted in different parts of the country.

The suggested reforms in the real estate sector can be classified into two major heads. Reforms to bring about increased transparency, check tax evasion, underreporting of transactions and to ensure better compliance. Secondly to suggest measures to combat money laundering in the sector. These include suggestions for constitution of a regulatory authority; rationalising circle rates with market rates; rationalization of stamp duty; automated and single-window clearance; including real estate in goods and service tax; eliminating 'percentage of completion' method; posting records online; capacity building and use of advanced tools like data mining generation of suspicious activity reports to spot tax fraud and money laundering.

Unaccounted income in the Manufacturing sector

Field survey reports indicated that the major evasion prone industries are Iron & Steel, Gutkha / Pan Masala, Khaini, Bidi, Copper and articles thereof, Cement and pharmaceuticals. Further, the manufacturing units availing area based exemption notifications were also found to be prone to evasion.

One day workshops were conducted in CBEC Commissionorates offices in 5 cities namely Mumbai, Delhi, Meerut, Chennai and Coimbotore and the responses gathered. Non-filing of tax returns; not declaring income/underreporting income; and the over-claiming of expenses by businesses and corporations, trade mispricing false claiming of tax exemptions and deductions were rated high on the gravity scale by the respondents. Some of the other methods of tax evasion as pointed by the respondents and also as disclosed in the various reports of the revenue department included: non maintenance of books of accounts, undervaluation of stocks, non-payment of advance tax and non-filing of return of income, personal drawing from the company which attracts provisions of deemed dividend u/s *ƒ* (22) (e) of Income tax Act; 1961 ,Group Companies utilizing their accumulated profit for benefit of the individuals and other companies/ concerns of the group; incomplete books of accounts and wrong claim-of

exemption u/s 10A of the Income Tax Act, 1961. Misuse of SSI Exemption has also been highlighted in the survey. Large scale manipulation in prices, to evade the customs duties was also observed as a method for generation of unaccounted money.

During the survey it was also intended to seek the opinion of the experts on the ways to check the unaccounted income in areas of direct and indirect taxes. Most of the respondents considered weak enforcement of tax laws, failing standards and value system and cost of tax evasion being lesser than cost of compliance being the primary reasons for evasion of taxes. An important suggestion for improvement of the state of affairs is implementation of Goods and Services Tax (GST). GST would facilitate greater vertical equity in fiscal federalism, reduce cascading nature of commodity taxes and through shift to value addition as the basis for assessment, it will unify the market for goods and services.

In defining options for further reform, the starting point is the basic structure of the tax. The corporate tax regime in India has a higher base rate, set off with sector specific tax incentives (exemptions/deductions). Wide ranging exemption is a problem with excise as well as custom duties. One of the most important base-broadening measures therefore, should be to reduce the exemptions. The structure should be stimulus friendly and lead both to a wider tax net and a payer friendly system.

Unaccounted Income in the Indian Securities Markets

The findings and observations gathered during the survey pointed apparently to an array of methods for converting unaccounted income into accounted income in the securities market with the different techniques customized to varied situations and needs of the individual/corporates/ firm etc. Arranging for hawala loans, buying book entries and admission of share premium is the most common method utilized for conversion of black money into white money. It is followed by the method of using tax havens and bringing back the unaccounted money as share capital or loans. As per the survey results Benami transactions, getting gifts from abroad and bogus long term capital gains are also utilized invariably for conversion of unaccounted income. As long term capital gains of shares sold through recognized Stock Exchange on payment of Securities Transaction Tax (STT) are not subjected to tax, many a times business income is disguised as capital gains to take advantage of the wide gap in tax rate between the long term capital gains and business profit. Another active method of tax avoidance is through Mauritius Route. Foreign portfolio investors and other categories of investors have to pay a short-term capital gains tax of 10% in India if they sell shares within an year of purchase. They are, however, exempt from paying long term capital gains tax as local investors if they sell the shares after one year of purchase. But by routing their investments from Mauritius, foreign portfolio investors do not have to pay even the short-term capital gains tax by virtue of Indo-Mauritius tax treaty.

Unaccounted income in the Indian Diamond Industry

Results of the survey reveal that the most common methods of suppression of profits and generation of unaccounted income in this trade include

- suppression of the value of closing stock and stock manipulation;
- understatement of yield;
- inflation of labour expenses;
- overstatement of rejection;
- bogus purchases through accommodation bills;
- unaccounted trading;
- family controlled; and
- dabba system

It has been observed that most of the transactions in this sector go unreported which make the sector all the more vulnerable. It is suggested that more law enforcement measures are required to be devoted to curb abuses in the diamond trade. Coordination between Income Tax and the Customs department may also facilitate better monitoring of in case of evasion by unaccounted trading and accommodation bills. As suggested in the white paper if any unexplained bullion is found during course of search , mandatory penalty @300% u/s 271 (1)c should be imposed. Where high value rough diamonds are purchased and still a higher rejection is being claimed, verification of physical stock of rejection with reference to what is shown in books is also suggested by the study.

Money laundering nature of activities and ramifications to national security

The terms of reference of the study relating to profiling the nature of activities engendering money laundering both inside and outside the country with its ramifications on national security are discussed in this section of the report. As a preliminary initiative the meaning of the term money laundering has been conceptualised and later an attempt is made to understand the various modi operandi.
The review of related literature and discussion with the various stakeholders thereof on money laundering revealed that tax evasion and slush funds are the strong bases for the process of money laundering. Availability of easy unaccounted money in any part of the world fuels activities of terrorists, drug dealers, illegal arms dealers and other criminals to operate and expand their criminal enterprises.

Certain locations, more prone to ML activities were identified for gathering primary information. During the course of discussions with experts, senior officials of revenue and enforcement agencies and steering committee members it was indicated that the following are the prominent activities at International Bordering States of India that involve in activities engendering ML: drug trafficking; smuggling of Gold / Electronic goods; false declaration of goods under export/import as part of organised crime to obtain illegally certain benefits given by the government to promote business; human trafficking; cyber fraud; identity theft and illegal control of bank accounts; counterfeiting of Indian currency (FICN) and related smuggling; counterfeited credit/value cards; trafficking in wild life products; theft of objects having cultural significance and smuggling of such products to foreign countries; arms and ammunition; white collar crime; corruption and bribery; illegal liquor / alcohol trading; Hawala; extortions; and cattle smuggling. Such activities engender ML with its ramification to national security through following sectors: Trading; Gems & Jewellery; Entertainment Industry; Electoral Financing;

Terrorism Financing; Sports; and Non-Profit Organisation (NPO) / Non-Government Organisations (NGO) / Foundation / Trusts / Charitable Organisations.

The interactions with the various enforcement agencies, reporting and non-reporting institutions pointed towards the gaps and need for improvements especially capacity building. It was also observed that prevention, detection and suppression on money laundering have been very modest and needs to be made more effective.

Methods to be employed for bringing to tax unaccounted money kept outside India

In the latter section of the study, various methods for bringing to tax money stashed outside the country have been examined. Diverse experience of various countries and various methods adopted in this regard has been briefly discussed in this section of the report. The role of multinational companies and the setting up of out-fits in tax havens as shell companies, taking the advantage of the regulatory environment is highlighted. Some of the measures which the government, have resorted to in the past, and can avail of in the future are also discussed in the report. A particular reference is made to Offshore Voluntary Disclosure Scheme which the government can resort to, in bring unaccounted money to the mainstream and the modus to be followed is highlighted. Taking the precedence of earlier voluntary Disclosure Scheme, certain lessons that can be learnt and shortcomings which can be improved upon are stated. The Whistleblower Scheme with its advantages and shortcomings as adapted in USA and the lessons that can be learnt in for adopting in India have also been examined.

The generation of illicit flows has grown multifold and it needs to be tackled in ways more than one. In that effort, other measures like anonymous withholding tax and its shortcomings also find part of the report. No measure can be successful without the co-operation of other countries and in that regard the need of proper information sharing under Double Tax Avoidance Agreements and Tax Information Exchange Agreements with various tax heavens in perspective has been discussed.

Measures adopted are not one time, but need continuous improvement, hence provision for Voluntary Disclosure Provisions on an on-going basis are suggested. In the report, the role of society in curbing any unlawful activity and instilling virtues of tax compliance among young minds is also emphasized.

Estimation of the quantum of Non-Payment of tax due to evasion by Registered Corporate Bodies

Government sources of tax revenue are various and amongst them corporate tax forms a crucial part of it. In this section of the report we have analyzed various issues related to the corporate tax India. A review of the related literature indicates that companies usually evade tax by not filing return of income or suppressing their profits by fabricating its financial statements in a variety of different ways. Our analysis in this section has shown that on one hand corporate tax revenue has increasing at very high rate but on the other hand the corporate tax buoyancy has been relatively low. It is also quantified that a large number of corporates though registered

with the ministry of corporate affairs, yet are not filing their return of investment with the income tax department, which seems to be a serious concern for the tax authority.

Using the structural equation modeling, we estimate the corporate tax evasion, which is indicated that corporate tax evasion in the country is quite sizable. It has increased from 18.5% of corporate tax revenue in 2004-05 to 32% in 2010-11. An index of shadow income in the corporate sector is developed and it reveals that the shadow economy has increased sharply and steadily.

ABBREVIATIONS

ABN	Australian Business Number
ABR	Australian Business Register
ADB	Asian Development Bank
AML	Anti-Money Laundering
APG	Asia Pacific Group on Money Laundering
ARS	Africa Revenue Service
ASDU	Audit Surveillance and Detection Unit
ASYCUDA	The Automated System for Customs Data
ATO	Australian Taxation Office
ATO	Australian Taxation Office
BCA	Business Council of Australia
CAG	Comptroller and Auditor General
CAGR	Compound Annual Growth Rate
CBDT	Central Board of Direct Tax
CBEC	Central Board Of Excise and Customs
CBEC-IND	Central Board of Excise and Customs – India
CBI	Central Bureau of Investigation
CCR	Canonical Cointegrating Regression
CDD	Customer Due Diligence
CDF	Currency Declaration Forms
CEIB-IND	Central Economic Intelligence Bureau – India
CENVAT	Central Value Added Tax
CFC	Controlled Foreign Corporation
CGTR	Central Government tax revenue
CMIE	Centre for Monitoring Indian Economy
CPCs	Centralised Processing Centres
CPD	Cut and Polished Diamonds
CPI	Consumer Price Index
CRA	Canada Revenue Agency
CrPC	Code of Criminal Procedure
CSO	Central Statistics Office
CTR	Cash Transaction Report
DEPB	Duty Entitlement Pass Book
GCEI	Directorate General of Central Excise Intelligence
DGIR	Director General of Inland Revenue
DOLS	Dynamic Ordinary Least Squares
DPO	Departure Prohibition Order
DRI	Directorate of Revenue Intelligence
DRI-IND	Directorate of Revenue Intelligence – India
DTAA	Double Taxation Avoidance Agreements
DTC	Diamond trading Company
DTC	Direct Tax Code
DYMIMIC	Dynamic Multiple Indicators Multiple Causes
EAG	Eurasian Group on Combating Money Laundering and Financing of Terrorism
ECM	Error Correction Model
ED	Directorate of Enforcement

EOU	Export Oriented Units
EPZ	Export Processing Unit
ESAAMLG	Eastern and South African Anti-Money Laundering Group
ETR	Effective tax rate
ETR	employ effective tax rate
FATA	Financial Action Task Force
FATC	Foreign Account Tax Compliance Act
FATF	Financial Action Task Force
FDI	Foreign Direct Investment
FEMA	Foreign Exchange Management Act
FERA	Foreign Exchange Regulation Act
FGD	Focus Group Discussions
FICN	Counterfeiting of Indian currency
FII	Foreign Institutional Investor
FIU-IND	Financial Intelligence Unit India
FMOLS	Fully Modified Ordinary Least Squares
FSI	Floor Space Index
FTZ	Free Trade Zones
GAAR	General Anti-Avoidance Rules
GDPFC	GDP at factor cost
GDR	Global Depository Notes
GIABA	Inter-Governmental Group of Action Against Money Laundering in West Africa
GST	Goods and service Tax
GST	Goods and Services Tax
HMRC	HM Revenue & Customs
HUF	Hindu Undivided Family
IFRS	International Financial Reporting Standards
IMF	International Monetary Fund
IMoLIN-Austria	International Money Laundering Information Networks
IRA	Internal Revenue Act
IRAS	Inland Revenue Agency of Singapore
IRDA	Insurance Regulation and Development Authority
IRS	Internal Revenue Service
IT	Information technology
ITA	Income Tax Act
ITAT	Income Tax Appellate Tribunal
ITR	Income Tax Return
IU	Intelligence Unit
JITSIC	Joint International Tax Shelter Information Centre
KFR	Kidnapping for ransom
KYC	Know Your Customer
LOPPS	Licit Opiate/Psychotropic Pharmaceuticals
LTCG	Long Term Capital Gain
MCA	Ministry of Corporate affairs
MHA	Ministry of Home Affairs
MIMIC	Multiple Indicators Multiple Causes
ML	Money Laundering
MOU	Memorandum of Understanding

MPCE	monthly per capita expenditure
MRA	Malawi Revenue Authority
NADT	National Academy of Direct Taxes
NAS	National account statistics
NCAER	National Centre of Applied Economic Research
NCB-IND	Narcotics Control Bureau – India
NCIC	National Construction Industry Council
NCO	National Occupation Codes
NCRB-IND	National Crime Records Bureau – India
NDF	New Disclosure Facility
NDPS	Narcotic Drugs and Psychotropic Substances Act
NEFT	National Electronic Funds Transfer
NGO	Non-Government Organisations
NIR	New Zealand Inland Revenue
NPO	Non-Profit Organisation
NRA	National Roads Authority
NRI	Non- reporting Institutions
NSDL	National Science Digital Library
NSSO	National Sample Survey Organisation
ODF	Optional Disclosure Facility
OECD	Organisation for Economic Co-operation and Development
OLS	Ordinary Least Squares
OVDI	Off shore Voluntary Disclosure Initiative
OVDP	Offshore Voluntary Disclosure Program
PAN	Permanent Account Number
PBT	Profit Before tax
PE	Permanent establishments
PMAL	Prevention of Money Laundering Act
PN	Participatory Notes
R&D	Research and Development
RBI	Reserve Bank of India
RI	Reporting Institutions
RMSEA	Root Mean Square Error
ROI	Return of Income
RTD	Road Traffic Directorate
RTI	Right to Information Act
SAARs	specific anti-avoidance rules
SC	Supreme Court
SE	Shadow Economy
SEBI	Securities and Exchange Board of India
SEM	structural equation modelling
SEZ	Special Economic Zones
SMS	Short Messaging System
SSCL	Social Security and Customs legislation
SSI	Small Scale Industry
STPI	Software Technology Parks of India
STR	Suspicious Transaction Report

STT	Securities Transaction Tax
TCU	Tax Compliance Unit
TDR	Transfer of development rights
TIEA	Tax Information Exchange Agreement
TIN	Tax Information network
TOC	Transnational Organised Crime
TOIT	Taxation of International Transactions
TRA	Tanzania Revenue Authority
UAPA	Unlawful Activities (Prevention) Act
UNODC	United Nations Office on Drugs and Crime
VAT	Value added Tax
VAT	Value Added Tax
VDP	Voluntary Disclosures Program
VIT	Vehicle Income Tax
WPI	Wholesale Price Index
ZRA	Zambia Revenue Authority

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Chapter - 1

UNACCOUNTED INCOME IN INDIA: AN INTRODUCTION

1 UNACCOUNTED INCOME IN INDIA: AN INTRODUCTION

Background and Introduction

Adjudging by popular media discussion in the recent years, probably no economic issue has covered more space than Black Money. The unaccounted income commonly spoken as black money is income from the parallel economy and is known by different names: *informal, unofficial, irregular, second, underground, subterranean, hidden, invisible, unrecorded* or *shadow economy*. The unaccounted or black economy means different things to different people. Definitions are almost as numerous as the multitude of names which have been applied to the phenomenon. Some definitions focus on tax losses, others emphasize on the shortcomings in the traditional measurement of GDP, while others would encompass a much broader range of economic activities. It is noteworthy that in this study we have used all the above terms.

The parallel / underground / shadow / black economy has been in existence as long as its legitimate counterpart. The difference is that the government has any number of methods for tracking the exchange of goods, services and currency in an above-board economy, but very few ways of tracking the activities of an underground economy. Gathering information about underground economic activity(-ies) is difficult, because no one engaged in such activity(-ies) wants to be identified. However, in order to truly understand any economy, we need to know both that is recorded and the one that is hidden. Obtaining accurate statistics about the allocation of a country's resources in the shadow economy is important for making effective economic policy decisions.

Before analysing the issue, *firstly* it is important and relevant to understand why there is a need to study this issue. Policymakers are generally concerned about the rise of the unaccounted income in the country. There are several reasons which make the estimation of accurate size and trend of the shadow economy important for the policy purpose.

Among the most important are:

- The unaccounted economy reduces the size of potential state revenue. The result can be a vicious circle of an increase in the budget deficits or tax rates, additional growth of the shadow economy, and may impact social welfare in general.
- To formulate effective monetary, labor and fiscal policy, it is crucial to know the level of precision in the estimates of key statistics of the economy, such as, *output, price-level* and *unemployment*. Given that these statistics are employed to generate economic policies, inaccurate figures may lead to inappropriate policy responses (see Fleming et al., 2003). Therefore, efforts are made to supplement official national accounts statistics with estimates of unaccounted economic activity.
- The effects of a growing unaccounted economy on the official one must also be considered. On the one hand, a prospering shadow economy may attract (domestic and foreign) workers away from the official economy and create competition for official firms. On the other hand, at least two-thirds of the income earned in the shadow economy is immediately spent in the official economy, thus having a positive effect on the official economy (Schneider and Enste, 2000).
- Some unaccounted economy activities, *i.e.,* illicit trade in narcotics and arms trading, are hurtful not only for economy, but also hazardous for society.

Scope and Definition of Unaccounted Economy

Feige had in 1990 identified four specific types of underground economic activities, illegal, unreported, unrecorded and informal and explored their nature, interrelationships and relevance for different economic issues. The metric for measuring the dimensions of each underground activity is the aggregate income generated by the activity. These different types of economies have been shown in Table 1.1.

(i) Illegal economy: The illegal economy consists of the income produced by those economic activities pursued in violation of legal statutes defining the scope of legitimate forms of commerce. Participants of illegal economy engage in the production and distribution of prohibited goods and services.

(ii) Unreported economy: The unreported economy consists of those economic activities that circumvent or evade the institutionally established fiscal rules as codified in the tax code. A summary measure of the unreported economy is the amount of income that should be reported to the tax authority but is not. A complementary measure of the unreported economy is the "tax gap," *namely*, the difference between the amount of tax revenues due to the fiscal authority and the amount of tax revenue actually collected. The "tax gap" measure takes account of the appropriate marginal tax rate, as well as non-compliance with the rules concerning deductions from and adjustments to reportable income. The size and growth of unreported income and the tax gap affect the size of budget deficits, the government debt and tax reform policies. Tax evasion is a peculiar problem for developing nations whose already weakened fiscal authority must now shift a greater burden of revenue collection to monetary policy. Inflation is a major contributor to political instability of developing nations, with its dramatic consequences for allocation and distribution.

(iii) Unrecorded economy: The unrecorded economy consists of those economic activities that circumvent the institutional rules that define the reporting requirements of government statistical agencies. A summary measure of the unrecorded economy is the amount of unrecorded income, namely the amount of income that should (under existing rules and conventions) be recorded in national accounting systems (e.g., national income and product accounts) but is not. Unrecorded income represents a discrepancy between total income / output and the actual amount of income or output captured or enumerated by the statistical accounting system. The importance of estimating the size and rate of change of unrecorded income cannot be overemphasized. Any effort to evaluate the programmatic effects of policy changes designed to implement the overall development process must have accurate inter-

temporal estimates of the actual level of overall economic activity. One particularly important component of unrecorded economic activity in developing nations is household production.

(iv) Informal economy: The term informal economy has been used so frequently and inconsistently in the development literature that it also requires some consideration. Following the classification system suggested by the new institutional economics, the informal economy comprises those economic activities that circumvent the costs and are excluded from the benefits and rights incorporated in the laws and administrative rules covering property relationships, commercial licensing, labor contracts, torts, financial credit and social security systems. A summary measure of informal economy is the income generated by economic agents that operate informally.

Table 1.1:

Types of underground economic activities: Illegal, Unreported, Unrecorded and Informal

	Definition	**Activities**
Illegal Economy	Totality of the revenues that are generated by those economic activities that violate the legal status of legitimate forms of trade.	Illegal activities such as illegal drugs dealing, black market of currency exchange, money laundering, unlicensed money lending, illegal gambling, pornography etc.
Unreported Economy	Totality of economic activities that escape or avoid fiscal rules as they are defined in fiscal codes.	Unreported revenue either from legal sources or illegal sources.
Unrecorded Economy	Activities that avoid institutional conventions that define the necessary requirements for the report to governmental agencies for statistics.	House hold activities -
Informal Economy	Economic activities that avoid costs and excluded from the rights and benefits that come along with leasing, work contracts, loan and social security.	Revenue that generated by economic agents that operate informally.

Source: *Feige, 1997; Rădulescu, Propescu and Matei, 2010*

The unaccounted economy has been conceived as "assets or resources that have neither been reported to the public authorities at the time of their generation nor disclosed at any point of time during their possession"[2].

The hidden economy is also defined as

> *"the economic activity generating factor incomes which cannot be estimated from the regular statistical sources used to compile the income measure of gross domestic product"* (Macafee, 1980).
>
> "*The aggregate of incomes which should have been reported to tax authorities but were not (in principle this includes incomes from illegal activities); and (ii) the extent to which estimates of national income and output are biased downwards because of such non-reporting (or under-reporting) of incomes and output*" (Acharya, 1983).

NIPFP, in its 1985 report on *Some Aspects of Black Economy*, defined black income as

> "*the aggregates of incomes which are taxable but not reported to the tax authorities*". Black/unaccounted incomes are "*the extent to which estimates of national income and output are biased downwards because of deliberate, false reporting of incomes, output and transactions for reasons of tax evasion, flouting of other economic controls and relative motives*".

Thus, in addition to income earned through illegal means, the term black money would also include legal income that is concealed from public authorities:

- to evade payment of taxes (income tax, excise duty, sales tax, stamp duty, etc.);
- to evade payment of other statutory contributions;
- to evade compliance with the provisions of industrial laws such as the Industrial Dispute Act 1947, Minimum Wages Act 1948, Payment of Bonus Act 1936, Factories Act 1948 and Contract Labour (Regulation and Abolition) Act 1970; and/or
- to evade compliance with other laws and administrative procedures.

> "*The hidden economy is the unrecorded national income. The unrecorded national income is calculated as the difference between the potential national income for the given currency in circulation and the recorded*

[2]The White Paper produced by Ministry of Finance, GOI, 2011

> *national income. This definition of the hidden economy suggests that, in principle, it is larger than the tax evaded income*" (Bhattacharya, 1999).

Frey and Schneider (2000) related the underground economy to officially measured national income. It comprises all presently not recorded productive (*i.e.,* value-adding) activities which should be in the national product (GNP). This definition allows to compare and to add the underground economy to GNP.

> "*Besides these illegal practices, underground economy also includes income generated through legitimate cash-based or non-cash-based activities such as online trade and bartering services*" (Zhuge et. al, 2009; Schneider and Enste, 2000).
>
> *The underground economy consists of activities such as, illegal drugs dealing, smuggling, money laundering, unlicensed money lending, illegal gambling, and other illegal activities"*(Amir et al., 2009; Smith and Christau, 2008).

Our definition in this study

As discussed earlier unaccounted income is multi-dimensional and as such its definition would depend on the context in which it is being used. The terms like *underground, black, hidden, invisible, shadow* and *unaccounted* are used interchangeably in this study. We, however, attempt to follow a narrow definition:

> "Unaccounted Income is the income from those economic activities that circumvent or otherwise avoid government regulation and taxation."

This definition attempts to cover all illegal economic activities, *i.e., trade with stolen goods; drug dealing, manufacturing; prostitution; gambling; smuggling; fraud; and like others*, non-monetary illegal economic activities, *i.e.*, *Barter of drugs, stolen goods, smuggling, theft for own use*, *and like others*. We also cover income from legal economic activities where tax is evaded, *i.e. Unreported income from self-employment; wages, salaries and assets from unreported work related to legal services and goods*.

Chapter - 2

UNACCOUNTED INCOME AND ITS ESTIMATION

2 UNACCOUNTED INCOME AND ITS ESTIMATION

2.1 Estimating Unaccounted Income: A Taxonomy

Background and Introduction

Given that shadow economy by its very nature is hidden from or unregistered by the state, estimating its size is a potentially perplexing and difficult task. Just as the definitions of the shadow economy or the non-observed economy vary greatly, so do the methods of estimating its size. It is widely accepted by scholars estimating the shadow economy (SE) is a "minefield". "*Whatever methodology one adopts in a situation of this kind, assumptions must be made and data issues must be resolved, and many of these assumption and issues are open to debate*" (Giles and Tedds, 2002b). In general, the estimations of shadow economy or the underground economy are vulnerable and quiet often no one can really claim to be confident of the full reliability of its estimates.

Estimating the size of the 'unaccounted' economy is of considerable importance from a macroeconomic policy-making standpoint. The scale of the unaccounted economy varies from country to country and state to state. It also varies widely over the business cycle, and considering the revenue gap, it may results in considerable burdens on the economy and on society by reducing the welfare expenditure. Starting from the work by Feige (1979, 1982) and by Tanzi (1980, 1983), there have been many research studies utilizing a range of approaches to measure the size of the unaccounted economy in various countries. Interest in this topic has been invigorated, as is evidenced by such contributions as Bhattacharyya (1990), Pissarides and Weber (1989), Eliat and Zinnes (2002) and Vuletin (2008), for example. Recent works by Chaudhuri, Schneider,

Chattopadhyay (2006) using MIMIC modeling, generates an historical evidence of 'hidden' real output in Indian states and moreover, Global Financial Integrity (GFI) (2010) estimates illicit flows from India, which renewed the interest on this topic in India.

The average estimated size of the shadow economy varies from 12 percent of registered GDP for OECD members to 23 percent for transition economies and to 39 percent for developing countries (see for example, Schneider, 2000).

The size of the underground economy is important for many reasons. *First*, a significant amount of underground economy represents a considerable amount of tax evasion, representing a large potential tax revenue source. *Second*, the measurement of some macroeconomic variables, *such as,* the growth of GDP, the level of unemployment, and the size of the tax base, can be distorted significantly by the existence of a sizeable underground economy. *Third*, the existence of such an economy might have a significant implication for the macroeconomic business cycle in general.

Methods to Measure Size of Unaccounted Economy

Many methods have been used to measure the size of the unaccounted economy[3]. Methodologies of calculating the size of the Underground Economy may be classified into three categories:

(i) direct;
(ii) indirect; and
(iii) model-based.

Direct Methods

Two kinds of such methods exist:

[3] For a detailed review, see Schneider and Enste (2000) and OECD Handbook (2002), Vuletin (2008).

(i) the auditing of tax returns (e.g. Thomas, 1992); and

(ii) the questionnaire surveys (e.g. Williams, 2006).

Direct Method includes Survey Methods in which a range of micro approaches use surveys and samples based on voluntary replies, or tax auditing and other compliance methods to measure the shadow economy (*e.g.,* Isanchen and Strom, 1985; Witte, 1987; Mogensen *et al*, 1995; Ivan-Ungureanu and Pop, 1996 and Feige, 1996). While providing details about the structure of the unaccounted economy, the results are sensitive to the way the questionnaire is designed and formulated and the respondents' willingness to cooperate. Therefore, surveys are unlikely to capture all informal activities (Vuletin, 2008). To estimate the personal tax evasion, some studies, for instance, *e.g.,* NIPFP, 1985; Pissarides and Weber 1989; Merz and Wolff, 1993; Fiorio and D'Amuri, 2005; Marino andZizza, 2010; Hurst *et al*. (2011) used household survey data. The main assumption is that taxpayers who do not comply or declare their income or hide part of their income from tax authorities might consider declaring a more correct figure to a household interviewer.

Indirect Methods

The "indirect" methods try to determine the size of the unaccounted income by measuring the "traces" that it leaves in official statistics. They are often called "indicator" approaches and use mainly macroeconomic data. These include:

(i) approaches based on the discrepancy between national expenditure and income statistics;

(ii) approaches based on the discrepancy between the official and actual labour force;

(iii) the "electricity consumption" approach Kauffman and Kaliberda (1996) and Eliat and Zinnes (2002); and

(iv) different variants of monetary and currency approach of Feige (1979),and Cagan (1958) and others.

A brief description of **indirect methods** is provided below:

I. **Fiscal approach:** In this approach, independent estimates of taxable income are compared with the actual incomes assessed for taxation. The income actually assessed for taxation is usually lower than the income estimated. Usually, the independent estimate of the tax base starts from income information contained in the national accounts statistics. In Indian studies, Kaldor (1956) was an early exponent of this approach. The same method has been used by Chopra (1982) to estimate a time series of unaccounted income in India from 1960-61 to 1976-77. This methodology was also used by Wanchoo Committee Report (YEAR?) to obtain more updated estimates of tax-evaded income in India. The same approach has also been used in developed countries like United States (Kenadian; 1982 and Park; 1981, 1983) and United Kingdom (O'Higgins; 1982).

II. **Monetary and currency approach:** The monetary approaches rest on the assumed stability in the relationship of various money stock aggregates to each other and to the total of income or transactions in the economy and attribute departures from the norm values to the growth of unaccounted income in the economy. The three variants of the monetary approach have become quite common:

- The first was pioneered by Gutmann (1977) for U.S in 1976. He picked a base year when the size of the unaccounted economy was assumed to be negligible, took the currency to demand deposits ratio for that year to be a fixed norm and attributed all subsequent increase in this ratio to the disproportionately growing demand for cash to finance transactions in a growing unaccounted economy. In the Indian context the currency to deposits ratio was observed to be falling since 1950; application of the Gutmann method yields gibberish results, such as a "negative black economy" in many of the years since 1952-53. A critique of Gutmann's method as applied to India is provided by Sandesara (1983b).
- Another monetary variant was deployed by Feige (1979) in U.S for 1976. He started with a base year when the underground economy was assumed to be

non-existent, estimated the ratio of total monetised transactions (by cheque and by currency) to total nominal GNP for that year, and attributed any subsequent increase in this ratio to the growth of the unaccounted economy.

- Yet another class of monetary approach suggested by Cagan (1958) and developed by Tanzi (1980, 1983). It involves specifying and estimating a currency demand equation with a tax variable included among the independent, explanatory variables. The estimated relationship between change in taxes and in currency demand is then used to estimate the scale of unaccounted income. The assumption being that the growth of tax-evaded income is associated with growing requirements for cash.

III. **Physical input approach:** The physical input approach seeks to identify a stable relationship between the use of physical inputs and national output in the economy. Here, one starts with an intermediate input, which is widely used throughout the economy and for which the aggregate output and consumption data are deemed reliable. The next step is to estimate a relationship between national (or sectoral) output and the use of input, making due allowances for changes in technology and output mix. To the extent that the consumption of the input cannot be explained in terms of growth in officially measured GNP and other relevant variables, *such as* changes in technology and output mix, to that extent the residual consumption is attributed to the unaccounted economy. Gupta and Mehta (1982) have generated estimates of the unreported economy based on trends in the consumption of electric power in the Indian economy. They have made a novel and intriguing attempt to apply a physical input approach to estimating the size of the unreported economy but their study is vulnerable to many questions and doubts.

IV. **Labour Market approach:** In this approach the growth in shadow economy is estimated on the basis of the decline in labour participation in the official economy, assuming the labourforce has a constant participation rate overall. For example, this approach has been used mainly by researchers in Italy (Contini;

1981, 1982), where the official labourforce participation rate has declined drastically since the late 1950's, while unofficial surveys have estimated participation rates much higher than the official ones in recent years, suggesting that growing numbers of Italians are finding gainful employment in activities not reported to the authorities. Given an estimate of the underground labourforce and one of average value added per worker, it is easy to compute an estimate of the size of unaccounted economy. The relevance of the same to India is limited because of the numerous difficulties with employment data. This approach has been used in the studies *like* Denison (1982), Ahn and Rica (1997), Del Boca (1981), O'Neill (1983).

V. **National Accounts approach:** This approach relies on the fact that a country's GNP is frequently estimated independently from both income and expenditure sides. Typically, the estimate from the income side is somewhat lower than that from the expenditure side. In UK, it has been hypothesized (Macafee, 1960) that the discrepancy constitutes a measure of unaccounted incomes, which escape national output accounting from the income side but are caught by the expenditure side estimates. This approach hinges crucially on independence of the national income estimates from the income and expenditure sides. In countries like India, where such independence is not complete, the approach cannot be effectively applied. Furthermore, this approach cannot deal with those black economy activities which escape national accounting from both the income and expenditure, sides. An alternative national accounting approach estimating the unaccounted economy is to scrutinize the national account estimates of value added for each sector and gauge the probable extent to which underreporting of outputs, prices and values might be imparting a downward bias to these estimates. Some work along these lines has been done by Ghosh *et al.* (1981).

Model Methods

The Model based method namely the "Multiple Indicators, Multiple Causes" (MIMIC) approach of Frey and Weck-Hanneman (1984) is based on the statistical theory of latent variables (Structural Equation Modelling).The MIMIC approach explicitly considers several causes, as well as the multiple effects of the shadow economy. The methodology makes use of the associations between the observable causes and the observable effects of an unobserved variable, in this case the underground economy, to estimate the unobserved factor itself (Dell'Anno, 2007, Loayza, 1997). The underlying idea is that we can use measurements of both the causal and the indicator variables in a time frame to infer the movements of the shadow economy. This gives an ordinal measure of shadow economy.

The detailed review of related literature in Indian context is given in Annexure 2.1.

Size of the Parallel Economy

In the following sections of the study attempts are made to estimate the size and trend of the shadow economy in India using various approaches.

Any exercise estimating the size of the domestic parallel economy yields such a gigantic figure, that, even after all possible normalization and moderation, the irreducible number that remains, makes it plain that the problem is one of the most daunting ones faced by the government.

We, therefore, should accept that the scale of the parallel economy is a gigantic one, and move on to examine the possible measures that can be undertaken to create an economic environment that ensures better compliance of fiscal laws and foreign exchange regulations.

2.2 Currency Demand Approach

Background and Introduction

A widely applied way to measure the size of the shadow economy is the "Monetary method" or the "Currency approach". In this approach undeclared, under-declared, non-measured and under-registered transactions incurred to avoid the burden of taxes but non-market activities are included in the concept of the shadow economy. It is assumed that cash is used to make transactions that agents want to keep hidden from official records and it is essentially based on the computation of discrepancies between declared income and the income implied by the observed currency demand.

Transactions of cash are difficult to be traced. Other assets are registered in financial institutions and their uses are recorded in such a way that transactions can be easily inspected. If the amount of currency used to make hidden transactions can be estimated, then this amount could be multiplied by the income-velocity of money to get a measure of the size of the shadow economy. This approach is the most popular among all mainly because of its presumed simplicity. There are three different techniques used to identify the size of the black economy through monetary variables.

Gutmann Approach

The first is the constant rate approach. It was pioneered by Gutmann (1977), for the U.S in 1976. He picked a base year when the size of the unaccounted economy was assumed to be negligible. His strategy required the following assumptions:

(i) high taxes and government regulations are the main causes of the existence of a shadow sector;

(ii) only cash is used to make transactions in the shadow economy;

(iii) the ratio of currency to demand deposits, C/D, is only influenced by changes in taxes and regulations, and

(iv) there was some point in time in the past when no shadow economy existed.

As the ratio C/D of that period should have prevailed except for changes in taxes and regulations, each increase in C/D is directly linked to the extra currency used in the shadow economy. The method assumes that the income-velocity of circulation, v, is equal for the registered and the hidden economies; hence the size of the hidden sector is v times the extra currency.

Fiege Approach

Another monetary variant was deployed by Feige (1979). He started with a base year when the underground economy was assumed to be non-existent and estimated the ratio of total monetised transactions (by cheque and by currency) to total nominal GNP for that year, and attributes any subsequent increase in this ratio to the growth of the unaccounted economy.

In the Indian context Gupta and Gupta (1982) followed the methodology used by Feige which relied on the standard Fisherian identity[4]to estimate India's unofficial economy on a yearly basis for the period 1967 to 1978.

A crucial assumption made in Gupta and Gupta's method relates to the constancy of the ratio of total monetized transactions (PT) to total nominal income (Y). If this ratio changes over time, for reasons other than the growth of a black economy, then the estimates for black economy are undermined. There can be several reasons for the change in the transaction/income ratio. One can be the monetization of the economy, i.e., the increasing monetization increases this ratio also. Second, with development, the density of inter-industry transactions normally increases or, in other words, the input-output matrix for the economy gradually fills up. Thus, the growth of inter-industry transactions, and hence of total transactions can be expected to be more rapid than the growth of nominal value added and thus, this ratio of transactions to income is expected

[4]

to increase. Third, Gupta's study have themselves pointed out that economic development will normally be associated with disproportionately higher growth in purely financial transactions, reflecting growing diversification and sophistication in financial and capital markets. This would tend to increase the ratio of transactions to income over time. Fourth, in an economy with a growing proportion of transfer payments, the ratio of transactions for nominal value added can be expected to increase over time.

Tanzi Approach

Neither Gutmann (1977) nor Feige (1979) used econometric estimates of the demand for currency. They reckoned the amount of money held to finance hidden transactions in reference to a past point in the time in which it was postulated, no shadow economy existed. The size of the hidden sector is then obtained, multiplying the income-velocity of circulation—assumed to be equal for the registered and the shadow economies—by that amount of money. The work by Tanzi (1982, 1983) and all the papers based using Tanzi's method use econometric estimates of the demand for currency. This approach recognizes that the income-velocity depends not only on variables that induce economic agents to make hidden transactions but also on income and the opportunity cost of holding cash. The estimated equation of the demand for currency is useful to get the extra cash held by economic agents to finance hidden transactions without postulating that there was some past time in which no shadow economy existed. It is again assumed that the income-velocity of circulation for registered and hidden transactions is same so the size of the shadow economy is measured by multiplying the extra cash by that income-velocity of circulation.

With this method, the demand for money or cash holdings are estimated econometrically twice, one with a relevant tax variable and another without it. The difference between the estimations is attributed to the size of black economy. According to this approach, the size of the black economy increases as the rate of tax

burden increases. It is also assumed that the velocity of money is the same both in the formal and the informal economy.

The model of Tanzi (1983) takes variables, such as weighted average tax rate, proportion of wages and salaries in national income, interest rate on savings deposits, and per capita income as a function of the ratio of currency in circulation to broad money. The model assumes that cash or currency in circulation is a crucial indicator of underground economic activities. The second important assumption of the model is related to the velocity of money. It is assumed that the velocity of money is the same in both official as well as unofficial economy. The third important consideration of the model is related to tax burden. It is assumed that high tax rate is what mainly drives activities in underground economy. People in the country opt to work in the underground economy to avoid high tax burden. In order, to find out the size of the underground economy, (i.e. excess money in money demand), the currency demand equation should be estimated over time (see Thomas, 1999 and Bhattacharyya, 1999 for a detailed criticism of the assumptions of currency demand model).

As discussed, the approach works on the consideration that there is an excess increase in currency demand, which is unexplained by the conventional macroeconomic factors but could be attributed to the rising tax burden and other factors (licensing and regulation) that force people to work in the underground economy. The size and evolution of the shadow economy can be initially estimated by comparing the development of currency when taxes and government regulations are at their lowest values, with the development of currency at the current (higher) levels of taxation and regulations. In the next step, assuming the same income velocity for currency in the shadow economy as for money (as measured by narrow or broad money) in the official economy, the size of the underground economy can be computed. Earlier version of this currency demand equation is severely criticized by Thomas (1999), Giles (1999a, b) and Bhattacharyya (1999) and their research attempted to improve the models in several accounts, i.e. specifications and utilization of sound econometric techniques.

Criticism of Tanzi's Approach

The commonly raised objections to this method as listed by Schneider and Enste (2000) are:

(i) All transactions of the shadow economy are not necessarily paid in cash.

(ii) Most studies using this approach mainly consider only one particular factor, the tax burden, as a cause of the shadow economy. But some other important factors, for instance, regulation, taxpayers' attitude towards the state and tax morality, are not considered. This is perhaps because there is absence of reliable data for most countries on these issues. Furthermore, since most of the countries have made significant progress in reforming their taxation policy, regulation and licensing seem to be more likely reason of generation of black income.

(iii) Gillian Garcia (1978), Park (1979), and Feige (1996) have argued that increase/decrease in currency demand are mainly due to a slowdown/boom in demand deposits, rather than due to activities in the black economy, at least in case of the United States. Also, Tanzi's model is criticized on grounds of selection of crucial variables, stability of empirical models and model specification (e.g. Feige, 1986, 1997; Frey and Pommerehne, 1984; Thomas, 1986, 1992, 1999).

(iv) Another criticism of this approach is the assumption of the same velocity of money in both types of economies, i.e. official and unofficial.

(v) Assumption that there is no shadow economy in the base year is also not valid, and relaxing the assumption would again imply an upward adjustment of the figures as pursued in most of the studies already undertaken.

(vi) Finally, the model estimation is subject to violation of time series properties and there is a high likelihood of spurious findings.

NIFM estimate of Shadow Economy using Currency Approach

In-spite of the above commonly raised objections to the third monetary approach we have tried to estimate shadow economy through this approach mainly because of its wide acceptability and also because in India currency is the predominant medium of exchange for informal transactions. In the earlier studies time series properties, structural breaks and sensitivity to units of measurement were widely ignored. Our analysis has suitably taken care of these issues while employing the econometric techniques. Also in our analysis we have utilized several alternative specifications and techniques to find out the consistency and robustness of the results using advanced econometric tools.

The model used to estimate the magnitude of the second economy is specified as follows:

$$Y_t = \alpha + \beta_1 X_t + \beta_2 Z_t + e_t \quad (1)$$

where Y, the dependent variable, may represent the ratio of currency in circulation to demand deposits, to money supply. Y may also represent real currency holdings, that is, cash in public hands deflated by the general consumer price index. X is a vector of explanatory variables traditionally considered to be the major determinants of Y; Z is a vector of variables that stimulates underground economic activity; e is the stochastic disturbance term and t indicates time period.

When the variables that stimulate the underground economy actively are assigned their respective lowest historical values or zero, then the regression equation yields the estimate of the demand for currency pertaining to the economy. It is then possible to estimate currency holdings with or without the underground or second economy. The

difference gives an estimate of the currency held in the second economy which, when multiplied by the income velocity of money, gives an indication of the size of the second economy.

Following Bagchwa and Naho (1995), the demand for currency equation for India is specified as:

$$\ln(C/p)_t = \alpha + \beta_1 \ln\left(\frac{\text{Tax}}{\text{GDP}}\right)_t + \beta_2 IR_t + \beta_3 \ln \text{WPI}_t + \beta_4 \ln \text{Percapita GDP}_t + \beta_5 \ln\left(\frac{\text{Expenditure}}{\text{GDP}}\right)_t + \beta_6 \ln(\text{DOMCRDT/GDP}) + \text{e}_t \quad (1.1)$$

While following Tanzi (1983), the demand for currency equation for India is specified as:

$$\ln(C/M3)_t = \alpha + \beta_1 \ln\left(\frac{\text{Tax}}{\text{GDP}}\right)_t + \beta_2 IR_t + \beta_3 \ln \text{WPI}_t + \beta_4 \ln \text{Percapita GDP}_t + \beta_5 \ln\left(\frac{\text{Expenditure}}{\text{GDP}}\right)_t + \beta_6 \ln(\text{DOMCRDT/GDP}) + \text{e}_t \quad (1.2)$$

Where $\frac{C}{p}$= real currency holding, i.e. Nominal currency deflated by CPI-IW. Currency includes the sum of currency demanded for both the regular economy, Cr, and for the underground economy, Cu.

$\frac{\text{Tax}}{\text{GDP}}$= Tax revenue divided by GDP at current price

Cr = Currency Regular

Cu= Currency Underground

IR = Interest rate (Commercial banks' average deposit rate)

WPI= Wholesale Price Index

Per-capita GDP= Per capita real GDP

$\frac{\text{DOMCRD}}{\text{GDP}}$= Total domestic credit by banking sector divided by GDP at current price

e = stochastic error term

$\beta's$ are parameters to be estimated and *ln* indicates for conversion of the data in logarithm.

These data series are culled from Handbook of Statistics on Indian Economy, 2011 provided by RBI for the period 1970-2009.

Empirical Methodology and Estimation Results

The first step of this process involves a test for stationarity[5] to know the order of integration of the variables. For this purpose we carried out the Augmented Dickey-Fuller (ADF) test for unit roots and also the Ng and Perron (2001) test.

Once the order of each variable is determined, the co-integration analysis is performed to ascertain whether the time series of these variables display a stationary process in a linear combination. However, considering the structural economic transformation in the country, it is important and relevant to test structural break in our empirical system before testing the co-integration. Structural change implies that the value of the coefficients does not remain same in a model, over the entire time period. It happens due to policy changes, emergence of a crisis or for a variety of other reasons. We have used most basic econometric procedure for testing structural change or break and the results of the test indicate for three breaks in the system of equation 1.1 which are in

[5]A stationary time series data is one whose statistical properties such as mean, variance, autocorrelation, etc. are all constant over time. A stationarized series is comparatively easy to predict. Another important reason for testing and trying to stationarize a time series data is to be able to obtain meaningful sample statistics such as means, variances, and correlations with other variables. The analysis based on such statistics is useful as descriptors of future behavior only if the series is stationary. For example, if the series is consistently increasing over time as in the case of non-stationarity of the data, the sample mean and variance will grow with the size of the sample, and it will be always underestimated the mean and variance. For this reason the stationary test is required to be carried out and caution should be taken if - data is used in regression models fitted (for details see Engle and Granger, 1987).

years 1991, 1997 and 2002, while in equation 1.2, it is indicated for 1997 (details of econometric tests and explanation given in appendix).

After establishing the co-integration relationship among variables we proceed to estimate both the demand for currency equations.

We initially employ Ordinary Least Squares (OLS) for the analysis. However, we cannot deny the fact that the macroeconomic variables which are used in the model exhibit the problem of endogeneity and they are subject of unit root problem (as we have shown). Therefore, Fully Modified Ordinary Least Squares (FMOLS) method developed by Philips and Hansen (1990) is used for the estimation. For robustness check, we also employ Park's (1992) Canonical Cointegrating Regression (CCR).

We initiate the analysis of the model based on equations 1.1 in which real currency is dependent variable. We utilize a range of estimators for the analysis purpose. We begin this using the ordinary least square (OLS) estimator. Within the broad framework of the general functional form, alternative variables and proxies were used during trial estimations. We drop domestic credit variable from the model on the basis of our initial trial of the model. Subsequently, we introduce the dummy variables (for periods: 1991-2009, 1997-2009 and 2002-2009) in the equation based on our finding of structural breaks. It is noteworthy that ideally we should have divided the sample in sub-samples on basis of structural breaks findings, but considering already small sample size, we prefer to overcome the problem by inclusion of the period dummies. Results of the estimation based on OLS regression reported in column 1 of Table 2.1, which suggest that Interest rate; price variable, Per-capita GDP and Expenditure/GDP are statistically significant. All three Dummy variables are also found be significant. Surprisingly, our focus variable 'tax' is not appeared to be statistically significant at any acceptable level. Subsequently, we utilize CCR estimator for the analysis of equation 2.2. Our results are very similar to that of OLS except for tax and expenditure variable (see column 2 of Table 2.1). Taxation variable is now turned out be significant, while expenditure variable

could not pass the statistical significant test. Finally, in order to improve the results and to achieve the robustness of the results we utilize the FMOLS estimator to analyze the equation 1.1 and results of the estimation are presented in column 3 of Table 2.2 As expected the results using this estimator are most consistent. We find all variables including dummies are statistically significant at 5 or 10% level. Signs of the variables are found to be at expected theoretical lines and robust. Goodness of fit statistics indicates that model is very well fitted. Thus we pick up the results of the FMOLS estimate for further perusal.

Table 2.1:			
Estimation of Demand of Currency			
Dependent Variable: Ln (Real currency)			
	1	2	3
Ln (Tax/GDP)	0.099544 (1.220793)	0.135353* (1.766874)	0.120795* (1.927713)
Interest rate	-0.050253** (-5.311520)	-0.053550** (-5.903603)	-0.052721** (-7.333679)
Ln (WPI)	0.578273** (5.814985)	0.549748** (6.270210)	0.557549** (7.197079)
Ln (Per-capita GDP)	0.777740** (3.298561)	0.920492** (4.348880)	0.868305** (4.747654)
Ln (Expenditure/GDP)	0.235810** (1.334619)	0.272337 (1.644386)	0.094265* (1.922775)
Dummy 91	0.119292** (4.206056)	0.129614** (4.751749)	0.128579** (5.809226)
Dummy 97	-0.152494** (-3.827423)	-0.168175** (-4.702889)	-0.165901** (-5.400856)
Dummy 02	-0.068929** (-2.323908)	-0.091271** (-3.170556)	-0.079778** (-3.546503)
Constant	1.070780** (3.910651)	0.809872** (3.226676)	0.660716** (2.812913)
R^2	0.994246	0.993327	0.993786
Durbin-Watson stat	1.449369	1.574630	1.543711
Estimator	OLS	CCR	FMOLS

Notes:

1. *CCR: Canonical Cointegrating Regression*
2. *** and * denote significant at 5% and 10%.*
3. *SE is parenthesis.*

Now we shift our attention to the analysis of the model based on equation 1.2. In this model, ratio of currency and money supply is considered as dependent variable. Here

also we utilize several alternative estimators to arrive at robust results. Thus, like the previous analysis, we first utilize the ordinary least square method (OLS). For deciding of broad framework of the model, several alternative variables and proxies were tested during trial estimations. Subsequently, we introduce the dummy variables (for period: 1997-2009) in the equation based on our finding of structural breaks. The model reduction was achieved by dropping insignificant coefficients judged on the basis of the statistical significance and backed by existing theoretical consideration. Results of the estimation based on OLS regression reported in column 1 of Table 2.2, which suggest that all variables Tax/GDP, Interest rate, price variable, Per-capita GDP, DOMCRDT/GDP and Expenditure/GDP are found to be statistically significant. Our dummy variables inclusion is also justified as it is found be statistically significant. Our focus variable 'tax' is appeared to be statistically significant and has a favorable sign. Subsequently, we utilize CCR estimator for the analysis of equation 1.2. Our results are very similar to that of OLS for all the variables (see column 2 of Table 2.2). Next we employ DOLS estimator for the analysis of equation 1.2. Again our results are very similar to that of other estimators for all the variables, however, estimated sign of tax variable here is inconsistent and thus we cannot accept the DOLS results (see column 3 of Table 2.2). Finally, in order to improve the results and to achieve the robustness of the results we utilize the FMOLS estimator to analyze equation 1.2 and results of the estimation are presented in column 4 of Table 2.2. As expected the results using this estimator are consistent. We find all variables including dummies are statistically significant at 5 or 10% level. Signs of the variables are also appeared to be at expected theoretical lines and robust. Goodness of fit statistics indicates that model is very well fitted. Thus we pick up the results of the FMOLS estimate for further perusal.

Table 2.2:
Estimation of Demand of Currency

Dependent Variable: Ln (CURRENCY/M3)				
	1	2	3	4
Ln (Tax/GDP)	0.079477** (2.449706)	0.069997** (3.530274)	-0.050437 (-1.172059)	0.073433** (4.306876)
Interest rate	-0.007153** (-3.168096)	-0.006246** (-3.712014)	0.002600 (0.748426)	-0.006252** (-4.070422)
Ln (WPI)	-0.181570** (-6.432904)	-0.196304** (-8.888725)	-0.318995** (-8.923972)	-0.194293** (-9.560451)
Ln (Per-capita GDP)	0.193278** (5.122646)	0.217233** (3.980495)	0.645080** (5.798847)	0.212529** (4.164590)
Ln (Expenditure/GDP)	-0.309672** (-4.426704)	-0.303476** (-7.218701)	0.142448 (1.376819)	-0.306842** (-8.192462)
Ln (DOMCREDIT/GDP)	-0.221929** (-9.672883)	-0.215373** (-16.26975)	-0.222052** (-10.57341)	-0.215744** (-17.55421)
Dummy 97	-0.038360** (-2.654333)	-0.036010** (-4.107735)	-0.033965* (-1.908392)	-0.035755** (-4.711024)
Constant	-0.042618 (-0.492828)	-0.022729 (-0.382816)	-0.455218** (-4.045215)	-0.023754 (-0.449858)
R^2	0.992765	0.991589	0.999239	0.991589
Durbin-Watson stat	1.886416	1.879994	2.170394	1.871713
Estimator	OLS	CCR	DOLS	FMOLS

Notes:
1. *CCR: Canonical Cointegrating Regression*
2. *** and * denote significant at 5% and 10%.*
3. *SE is parenthesis.*

Calculating the Size of the Shadow Economy

Calculating the Size using equation 1.1

We now compute the series of 'illegal money' over the period for which we have data. The yearly estimates of the second economy are as follows. First, the values expressed in terms of logarithm are converted into level form. Then results of the FMOLS estimate first solved to obtain values for the total amount of cash circulating in the economy as a whole over the period. Denote this series as C_t (where t represents 1970, 1971, 1972, 1973, 1974, ..., 2009).

In the next step, the total tax is set equal to zero[6], to show a scenario where there will be no incentive to participate in the hidden economy. Solving the model, with taxation equal to zero, yields therefore the value of currency for recorded sector. We denote this solution C_{Rt}, (where t represents t=1970, 1971, 1972, 1973, ..., 2009.

Assuming that the velocity of 'illegal' money is the same as that of legal money, an estimate of the value added attributable to hidden economic activity is obtained by multiplying illegal money by the velocity of money. The velocity of money V_t is obtained by dividing nominal income by legal money:

$$\boldsymbol{V_t = \frac{Y_t P_t}{C_{RT}}}$$

where, t represents t =1970, 1971, ..., 2009.

Where $\mathrm{Y_t}$ and is income taken in terms of GDP and $\mathrm{P_t}$ is price index (CPI-IW). Assuming that velocities in both the official and the shadow economy are the same, the shadow economy GDP was obtained as the product of estimated nominal illegal currency. Thus, the estimate of the amount of income (nominal) attributable to shadow economy is then computed as:

$$\mathrm{Y_{Ht}} = (\mathrm{C_t}\text{-}\mathrm{C_{Rt}}) \times \mathrm{V_t}$$

t =1970, 1971, ..., 2009.

Calculating the Size using equation 1.2

Now the estimates of the underground economy based on equation 1.2 are derived as follows. For each year, based on the estimated parameters of FMOLS results of equation 1.2, the predicted level of the currency ratio C/M3 is calculated by using the preceding regression equations. Then, given the actual figure of the M3 for that year, the predicted level of currency holdings (C_t) can be calculated. Then we followed similar procedure as of equation 1.1.

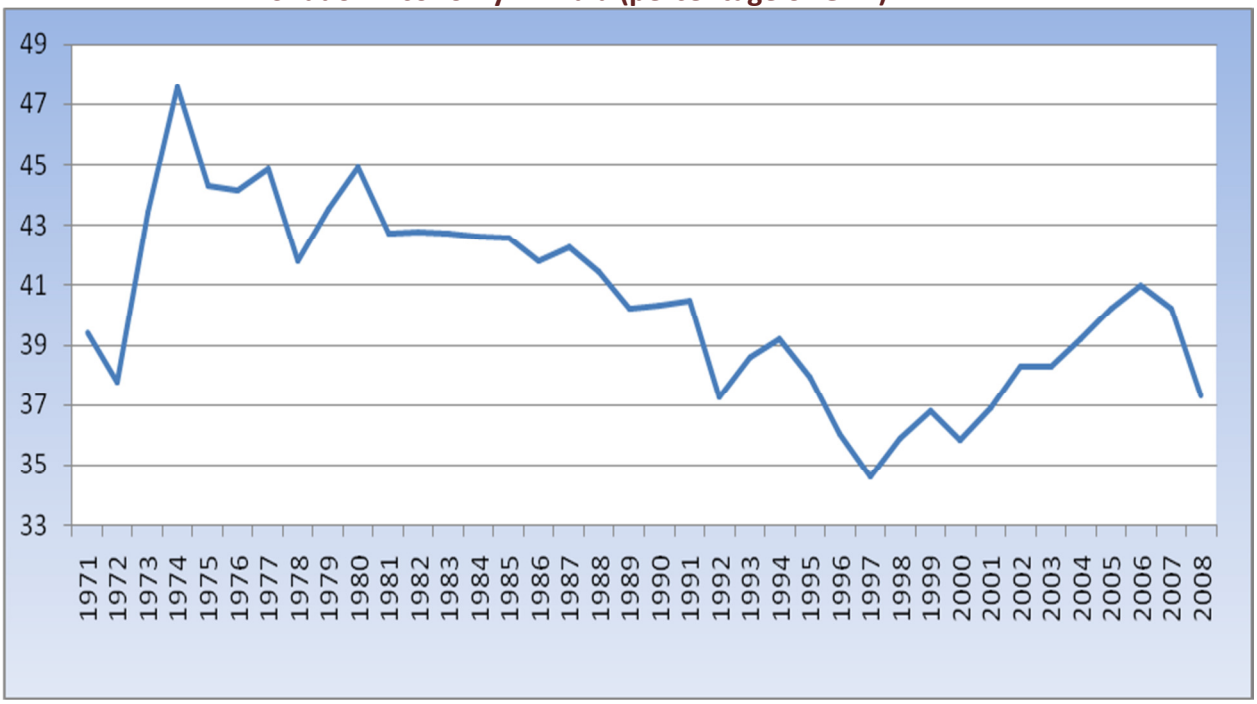
[6]Some studies, i.e. Bagchwa and Naho (1995), use lowest value of tax variable instead of zero. Considering the type of data of tax we have used it is proper to use zero value of tax than the lowest value.

The resulting yearly estimates of the black-economy based on real currency model (equation 1.1) show a relatively large size in terms of percentage of GDP. The estimates are shown in Figure 2.1. It was 38% in 1971 which rose to 47% in 1974. After that it starts declining however not very sharply till 1978. After this period the country had witnessed again an increasing trend in black money and it reached to 45% in 1980. After that the share of black-economy constantly declined, barring 1993 and 1994, till 1997. Nevertheless, after reaching at lowest point (below 35%) in 1997, it has started picking up again till 2006. In the last two years of the analysis, a declining trend is observed. Comparison of percentage growth of the black economy with official economy in real terms (see Figure 2.2), illustrates that the former economy growth is always more volatile than the latter.

Focusing on the nominal value of the black economy at the current market price (the estimates are shown in Figure 2.3), it is estimated that it was ₹ 19313 crore in 1971, increased to ₹ 63272 crore, which is more than three times in a decade. In the eve of the economic reform initiatives it becomes ₹ 229161 crore which again is more than three and half times higher than the value of 1980. In the year 2000, it is assessed to be ₹ 773536 crore and finally in the last observed year (in 2009), it has reached to ₹ 2972621 crore, which is approximately four times higher in just nine years.

Figure 2.1:

Shadow Economy in India (percentage of GDP)

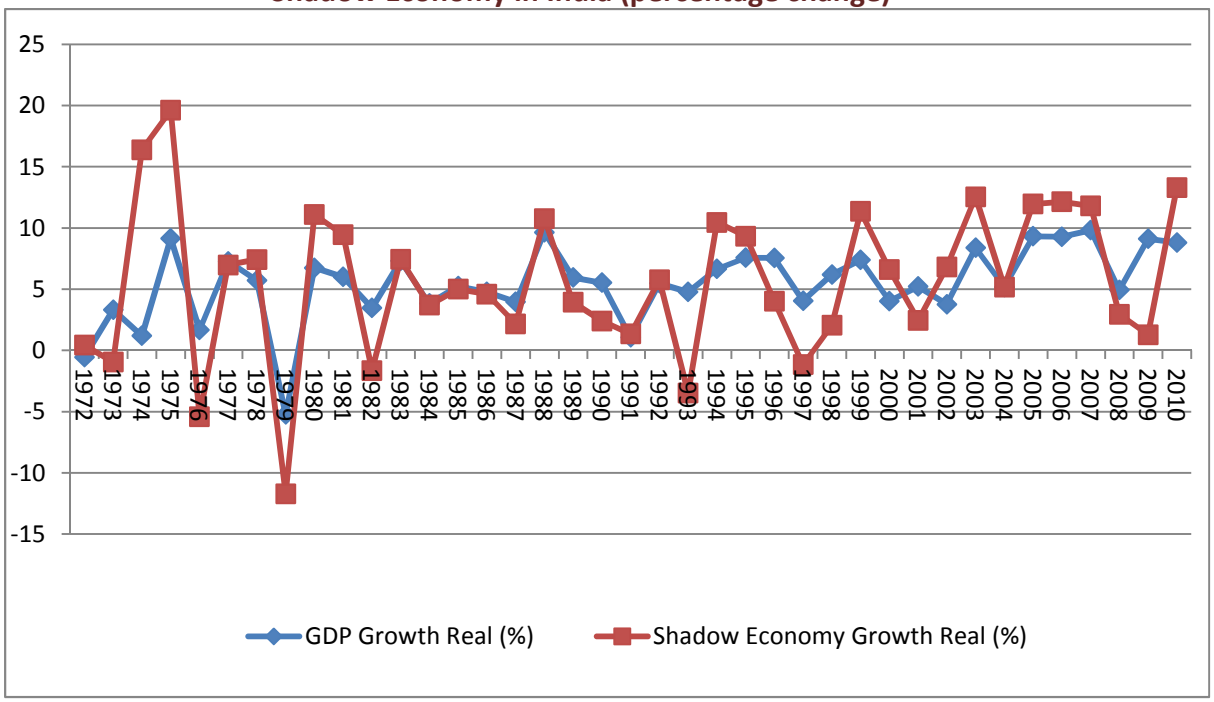


Source: *own calculation*

Notes: *estimated based on the real currency model (equation1.1)*

Figure 2.2:

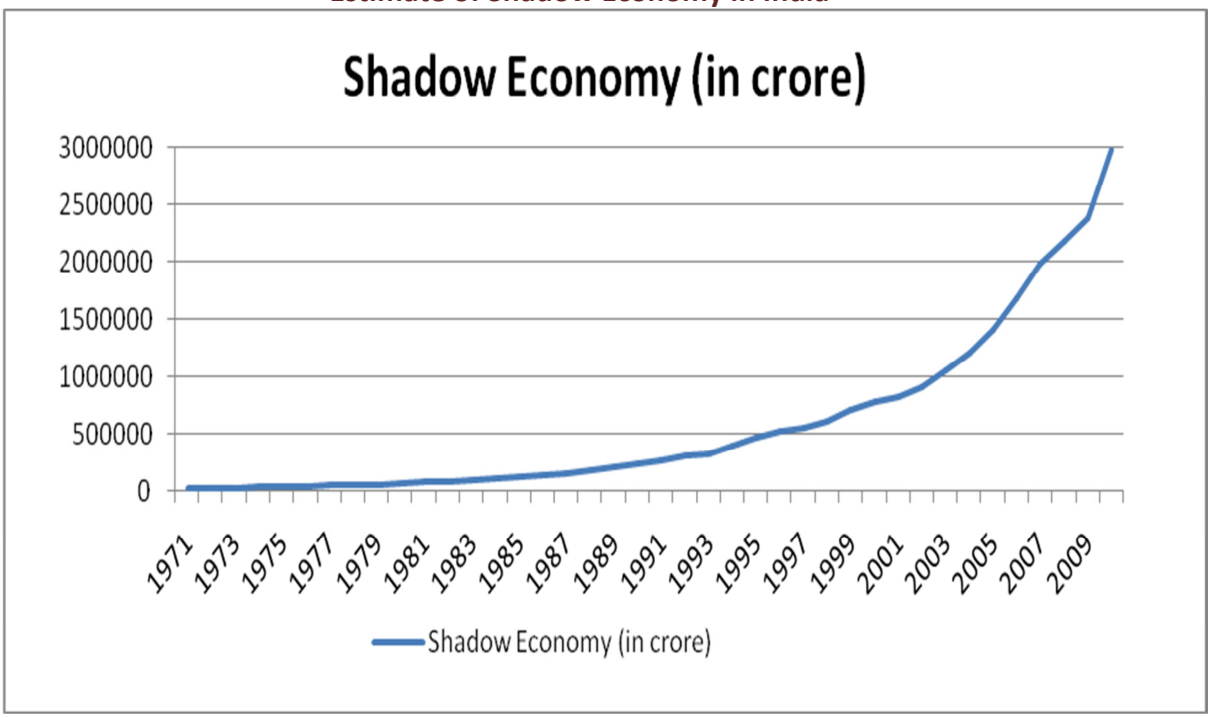
Shadow Economy in India (percentage change)



Source: *own calculation*

Notes: *estimated based on the real currency model (equation 11)*

Figure 2.3:
Estimate of Shadow Economy in India

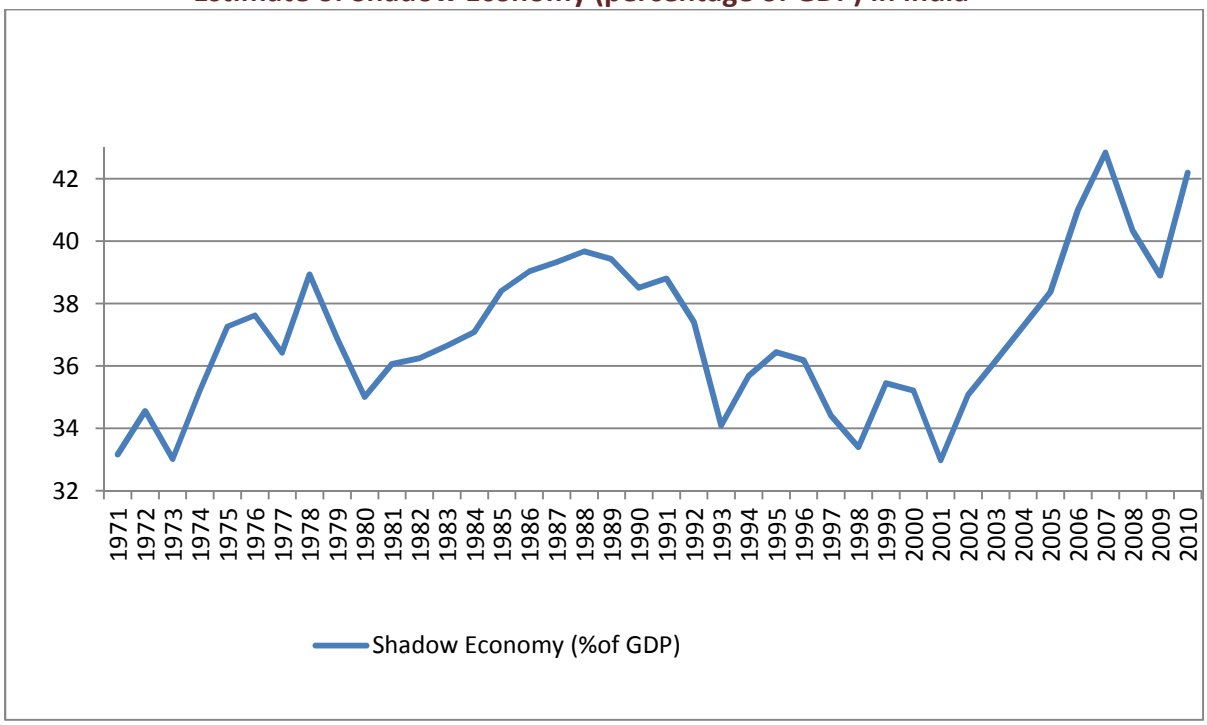


Source: *own calculation*
Notes: *estimate based on the real currency model (equation 1.1)*

Now we discuss estimation based on equation 1.2. Figure 2.4 and 2.5 report the estimated shadow economy in terms of values (at current market price) and as percentage of GDP, respectively. The estimates show that the underground economy grew from about ₹ 16424 crore in 1971 and it is ₹ 43364 crore in 1978, which is around three times higher in merely seven years period. In this duration, In terms of percentage share of official GDP, it has increased from 33% to 39%. After that in next two years, the economy had witnessed a declining trend of the black economy in terms of GDP, but picked up sharply after that to reach about 40% of the official economy of the country in 1988.It is witnessed lowest of 33% of official GDP in 2001, but surprisingly moved to 43% in 2007. In the last observed year, 2010, it is assessed to be ₹ 3228163crore, gone up nearly twenty times higher in the last two decades.

Figure 2.4:

Estimate of Shadow Economy (percentage of GDP) in India

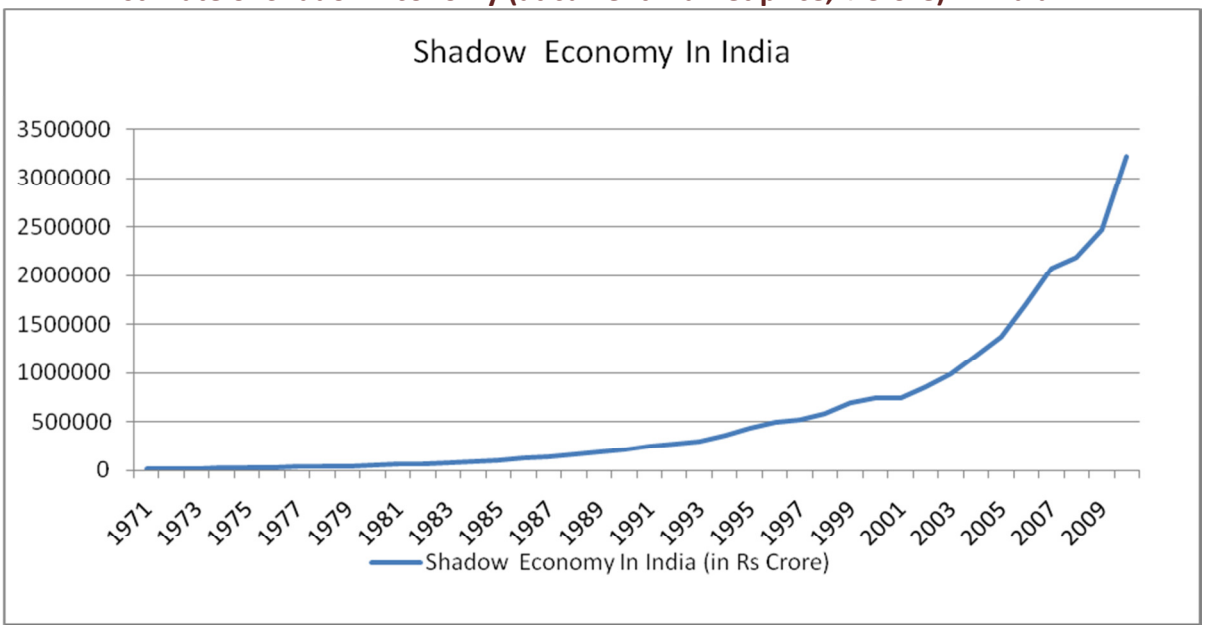


Source: *Own calculation*

Notes:*estimated based on the Currency/M3 model (equation 1.2)*

Figure2.5:

Estimate of Shadow Economy (at current market price, ₹ Crore) in India



Source:*own calculation*

Notes: *estimated based on the currency/M3 model (equation 1.2)*

2.3 Multiple Indicators Multiple Causes (MIMIC) Approach

Background and Introduction

In this section the Multiple Indicators Multiple Causes (MIMIC) approach is employed to estimate the underground economy in India. This approach captures the dimension of the underground economy to be a "latent variable"[7]and is popularly known as structural equation modeling (SEM). All other methods e.g., electricity consumption, money or cash demand, consider only one indicator. However, often there are several manifestations or symptoms of the shadow economy showing up simultaneously. The MIMIC approach explicitly considers several causes, as well as the multiple effects of the shadow economy. The methodology makes use of the associations between the observable causes and the observable effects of an unobserved variable, in this case the unaccounted or shadow economy, to estimate the unobserved factor itself.

Highly popular models of monetary approach mainly consider taxation as a cause of black money generation in the economy. However, the underground economy has causal effects on external, production, labor, and money markets. The MIMIC model approach explicitly captures the causes of the shadow economy and the effects on the important sectors of the economy. The empirical method of MIMIC is based on the statistical theory of unobserved variables, which considers multiple causes and multiple indicators of the phenomenon. A factor-analytic approach is used to measure the hidden economy as an unobserved variable over time. The unknown coefficients are estimated in a set of structural equations within which the unobserved variable cannot be measured directly (see Aigner, Schneider, and Ghosh 1988).

The MIMIC approach is preferred over the other methods to calculate the size of the shadow economy in the Indian context mainly because of the following reasons:

[7]Latent variables are variables that are not directly observed but are rather inferred (through an econometrics model) from other observed variables.

- Lack of availability of data in using tax auditing, labour force discrepancies and other similar survey-based information for estimating shadow economy in the Indian case.
- Standard literature has shown that MIMIC approach yields very reliable estimate of the shadow economy (e.g., see for review Schneider, 2005). For example, the technique has been employed by Vuletin (2008) for 32 Latin American and Caribbean countries in the early 2000s, Dell'Anno, Gómez-Antonio and Pardo (2007) in three Mediterranean countries, namely France, Spain and Greece, Pickhard and Pons (2006) for Germany, Macias and Cazzavillan (2008) for Mexico, Schneider, Buehnb and Montenegro (2011) for a large number of countries.

Against this background, we now attempt to estimate the trend and size of the underground economy for India. Despite popularity of this model it has not been widely applied by many in the Indian case. Chattopadhyay et al., (2006) has attempted to investigate the size of the hidden economy in Indian states over the period 1974/75 to 1995/96. Schneider, Buehnb, Montenegro (2010) have utilized MIMIC method to estimate the shadow economy in India in the cross country framework. In this study we employ MIMIC to estimate shadow economy in India at the country level. There are many limitations for variable selection at state level as has been pointed out in both the earlier studies on India. It is noteworthy that results of MIMIC framework are highly sensitive to selection of the variables.

Also, very often, MIMIC models are applied to time series data to arrive at estimates of the size and development of the shadow economy over time. However, the macroeconomic variables, which are commonly used, do not satisfy the underlying assumption of stationarity and this may lead to the problem of spurious regression results. We have taken care of this issue by using the Dynamic MIMIC model.

MIMIC model firstly proposed by Joreskog and Goldberger (1975) is a particular type of linear structural equation model in which there exists a single latent variable, which is

caused by a set of determining factors and whose existence is reflected in a series of indicators. In these models, the shadow economy is considered as a linear combination of a set of observable causes. The unknown coefficients are estimated using a set of structural equations.

As with the other approaches also, there are a number of shortcomings associated with the use of the MIMIC approach.

(i) It is not assured that the estimates produced by the MIMIC model will precisely reflect participation in the shadow economy, since the causes and indicators may in fact also be driving or be driven by other economic phenomena (see Giles and Tedds, 2002).

(ii) The MIMIC model does not produce an estimate of the shadow economy that can be expressed, for example, as a percentage of GDP: rather, the approach produces an index of estimated shadow economic activity. In order to obtain an absolute size of the shadow economy, the model requires a benchmark estimate derived from an alternative methodology. Typically, the currency demand approach is used to provide this benchmark.

(iii) It is often not easy to use variables that are difficult to measure. For example, the degree of government regulation has an impact on shadow economy activities, but constructing reliable estimates of such variables is not a straightforward process.

(iv) The meaning of the latent variable depends completely on how correctly, precisely and comprehensively the causal and indicator variables correspond to the intended semantic content of the latent variable".

In order to construct the model, a set of exogenous determinants of the size of the shadow economy are used and another set of variables is employed indicating the size and capturing the effects of the shadow economy.

Determinants

As determinants of the shadow economy, the following variables are included:

a. **Tax burden:**According to the relevant academic literature, tax burden is considered as an important determinant of shadow economy. It is generally observed that an increase in the tax burden provides a strong incentive to work in the unofficial market, and thus a positive sign is to be expected. In all MIMIC applications this variable is included as a cause of the underground economy and has historically always exercised a direct effect on the shadow economy. Within the econometric framework, the tax burden is measured as the total share of all taxes in GDP. This indicator has also been disaggregated into different partial proxies such as direct and indirect taxes as a percentage of GDP, in order to test if all the components of the tax burden have the same effect or not on the shadow economy.

Theoretical analysis holds that direct taxes are more visible than indirect taxes, because indirect taxes suffer from fiscal opacity. A positive sign in all the components of tax burden is to be expected, but it is greater in the case of direct taxes.

In this study, we have included three important tax indicators: personal income tax/GDP ratio, corporate income tax/GDP ratio and indirect tax to GDP ratio.

b. **Public Sector/Government:**The size of the public sector usually serves as an indicator of efficiency. To a larger extent the quality and quantity of publicly provided goods and services depend on the efficiency of the public sector. Excessive regulation is believed to be a key factor encouraging rent seeking behaviour as well as delaying procedures and services, and laying the bases for corruption in the government sector.The provision of public sector services is also a crucial causal variable of people's decision to work or not work in the shadow economy (see also Schneider, Buehn, Montenegro, 2010). To capture this effect, we have followed Chaudhuri, Schneider, Chattopadhyay (2006), and utilize government expenditure to GDP ratio (Expenditure/GDP).

c. **Price Index:** Following Giles (1999) and Vuletin (2008), we include price index in our model, which covers the issue of price rise to allow for the upward "creep" of tax brackets, and the associated incentive for taxpayers to engage in unaccounted activities. A more pervasive effect of inflation is that, as it tends to be uneven across sectors, it alters the income distribution, and this may induce disrespect for tax law. The higher the inflation, the larger is the expected size of the shadow economy. We include CPI-Industrial workers Index as a measure of price index in the model.

d. **Economic crime:** Crime and shadow economy are closely related and increasing criminal activities increase the size of the shadow economy in the country. Considering this viewpoint, we include the total reported economic crime in the country. We especially focus on economic aspects of the crime as it should have higher level of correlation with shadow economy than other types of crime. We expect positive effect of this variable on the shadow economy.

e. **Democratic Election:** In India, it is widely believed that during elections (in order to choose the public representatives) contesting candidates often spend more than the prescribed limit. Often it is seen that business sector, fund election spending which in turn may encourage unaccounted income and wealth generation. Thus, we include election as a dummy in our structural equation.

f. **Economic reforms:** In early 1990s, economic reforms were initiated. The reform process, which is still continuing, has touched policies and regulations in most of the areas of the Indian economy, viz. taxation, trade and licensing etc. General opinion is divided, on one side it is argued that rationalization of tax rate, abolition of tough licensing and better regulation have helped reducing black money generation. On the other hand, some argue that reform initiatives have expanded the economic activities. The licensing and regulation reforms are still pending in some core areas and thus the situation may result in greater black money generation.

g. **Labor market transition:** Schneider (2011) argues economic opportunities, the overall situation of the labor market, unemployment rate, and regulation related to labor market and transition in the labor market, are crucial for the shadow economy and especially the shadow labor force. Studies of Saint-Paul (1996) and Fugazzaand Jacques (2001) have also shown crucial link between taxation and labor market condition. Considering these viewpoints and recognizing the lack of standard labor data in the Indian case, we set to utilize a ratio of private to public workers in organized sector. The variable is expected to capture two factors (i) transition in the labor market; and (ii) privatization of labor sector in the Indian economy.

Indicators

a. **National Income:** An increase in the size of the shadow economy may cause productive factors to move from the official economy to the shadow economy. Thus, the growth in official GDP may decline (Frey and Weck-Hannemann, 1984; Kaufmann and Kaliberda, 1996; Loayza, 1996; Eilat and Zinnes, 2000; Dell 'Anno, 2003; and Dell 'Anno and Schneider, 2004). However, some authors argue that in the expansion phase of the economic cycle the shadow economy also grows, as it satisfies part of the demand which is not covered by the official economy (Adam and Ginsburgh, 1985; Tedds, 1998; Giles, 1999b; Giles and Tedds, 2002; and Chatterjee et al., 2003). Thus, the expected sign for this indicator is ambiguous. Specifically, following Dell'Anno, Gómez-Antonio, Pardo (2007), we have used real GDP data to capture this effect in our empirical model

b. **Money Supply:** This indicator is the basis of the monetary approach for quantifying the size of the shadow economy. The hypothesis assumes that the shadow economy has a close link with the level of money supply and currency (see currency model section for detailed discussion on the theoretical and empirical linkage). Its expected sign will therefore be positive. This indicator is the one which has been used to establish the scale variable, which by convention

is fixed at unity. We consider ratio of Broad money supply to GDP (M3/GDP) for this purpose.

c. **Consumption of electrical energy:** Some authors have used 'physical' methods to quantify the level of the shadow economy. The procedure consists of estimating the electricity consumption necessary to produce the level of GDP declared in the economy, and assume that any excess is an indicator of the electricity consumed by undeclared activities (see electricity model section for detailed discussion on the theoretical and empirical linkage). Consequently, the expected sign will be positive. We have utilized data of per cap electricity consumption in our empirical model.

Against the above theoretical and empirical discussion, we specify a benchmark model for the empirical analysis, which is shown in Figure 5.1. It is noteworthy that using these variables we form several alternative empirical models in order to choose an appropriate model for computation of the shadow economy in India.

Figure 2.6

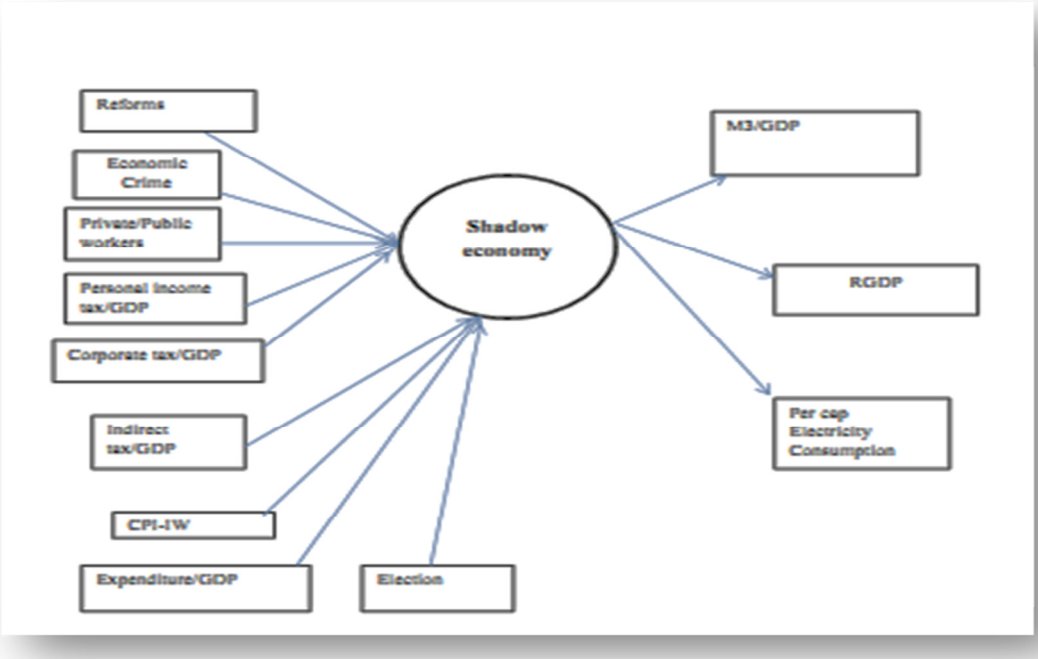


Table 2.3:		
Data Description		
Variable	**Definition**	**Data Source**
Economic Crime	Total economic crime in India	Crime in India Statistics (various issues) National Crime Records Bureau Ministry of Home Affairs Government of India
Private/Public workers	Ratio of employment in Organized Private sector to Public Sector	Quarterly Employment Review (various issues), Directorate General of Employment & Training Ministry of Labour Government of India
Private/Public workers	Ratio of employment in Organized Private sector to Public Sector	Quarterly Employment Review (various issues), Directorate General of Employment & Training Ministry of Labour Government of India
Personal income tax/GDP	Ratio of Personal income tax revenue to GDP	Personal income tax Indian Public Finance Statistic (various issues), Ministry of Finance Government of India
Corporate tax/GDP	Ratio of Corporate income tax revenue to GDP	Corporate income tax: Indian Public Finance Statistics (various issues), Ministry of Finance Government of India
Indirect tax/GDP	Ratio of Indirect tax revenue to GDP	Indirect tax: : Indian Public Finance Statistics (various issues), Ministry of Finance Government of India
CPI-IW	Consumer Price Index (CPI) for Industrial Workers	Handbook of statistics on the Indian economy(various issues), published by Reserve Bank of India (RBI)
Expenditure/GDP	Total central government expenditure	Indian Public Finance Statistics (various issues), Ministry of Finance Government of India
Election Dummy	Lok Sabha and Important assembly election year dummy	From various sources
Reform period	1991-2010= 1, otherwise 0	
M3/GDP	Broad Money (M3) to GDP (MP)	Handbook of statistics on the Indian economy(various issues), published by Reserve Bank of India (RBI)
RGDP	GDP at Market Prices (MP) deflated by GDP Deflator	Central Statistics Office (CSO), Ministry of Statistics and Programme Implementation
Per cap Electricity Consumption	Per capita Electricity Consumption	World development Indicators, 2011, The World Bank

MIMIC Estimation Results

This section estimates the structural model which will help calculate the changes in the size of the shadow economy in India over the period 1971-72 to 2009-10. The variables employed as cause and as indicators of the shadow economy are presented in Figure 5.1. The structural model provides ordinal estimations of the shadow economy, which, if suitably calibrated with the exogenous estimations of the monetary model described in the previous section, allow the evolution of the shadow economy to be traced.

The column A of Table 2.4 reports the causal variables, M3/GDP and Real GDP are considered as indicator variables. Results of the analysis indicate that all tax variables, i.e. Personal income tax/GDP, Corporate tax/GDP and Indirect tax/GDP are statistically significant at 5% level. The estimated coefficient of corporate tax/GDP is found to be largest and positive. Surprisingly, the coefficient of Indirect tax/GDP is found to be negative in this model. Subsequently, in the next columns (2 to 7), we report results of the models in which some other important causes, i.e. economic crime, price index (CPI-IW), Expenditure/GDP, Election year dummy and reform period dummy, are included. Results related to tax variables are very mixed. Personal income tax/GDP and Corporate tax/GDP have positive coefficients and quite large as expected, however, statistically insignificant though. On the other hand, Indirect tax/GDP, which is statistically significant in all cases, is found to have a negative sign. Economic crime is found to be significant and positive in most of the cases, which make sense as theoretically it should have a positive effect. Results regarding Price index is also on the expected line and it is found be significant and positive wherever it is included. Findings related to results of election and government expenditure are very mixed; nevertheless, they fail to pass the statistical test. Finally, reform period dummy is also included in the model, which is found to be positive and statistically significant. To judge the goodness of fit of the estimated empirical models, we employ the root mean square error of approximation (RMSEA).This test statistics has an advantage of less sensitivity to sample size (e.g., see Fan et al., 1999). By convention, the model is considered to have good-fit if the RMSEA is less than or equal to 0.05. The test statistics indicates that Model 2 (reported in

Column 2 of the table) is most appropriate among all the estimated equations. Results of Likelihood ratio test of the model versus saturated and of the baseline versus saturated also validate the results of the RMSEA.[8]

Using the estimated results based on column 2 of Table 2.4, we estimate the size and evolution of India's shadow or underground economy. The first step of this process is to compute the ordinal index. This index is then transformed into a cardinal series using our currency model results for the starting year. Finally, taking these into account, estimates of the shadow economy are derived using Bajada and Schneider's (2005) calibration methodology. Figure 2.5 shows the computed size of the underground economy in the country, while Figure 2.8 illustrates the results as a percentage of GDP. Overall these results illustrate a sharp declining trend of the shadow economy in terms of share of GDP except for the years, 1979-80. In the 1971-72, the estimated size was 33% of the country's GDP, which declines to 17% in 1990-91; it had further declined to 7% in 2010-11. However, in absolute terms the overall size of the shadow economy at the current price has increased from ₹ 16424 crore in 1971-72 to ₹ 96982 crore in 1991-92, which reached to ₹ 547311 crore in 2010-11. Overall, the model perhaps indicates that reforms in various sectors, i.e. taxation and regulatory sides, have helped reduce the relative size of the shadow or the underground economy.

Table 2.4:

MIMIC Model Results

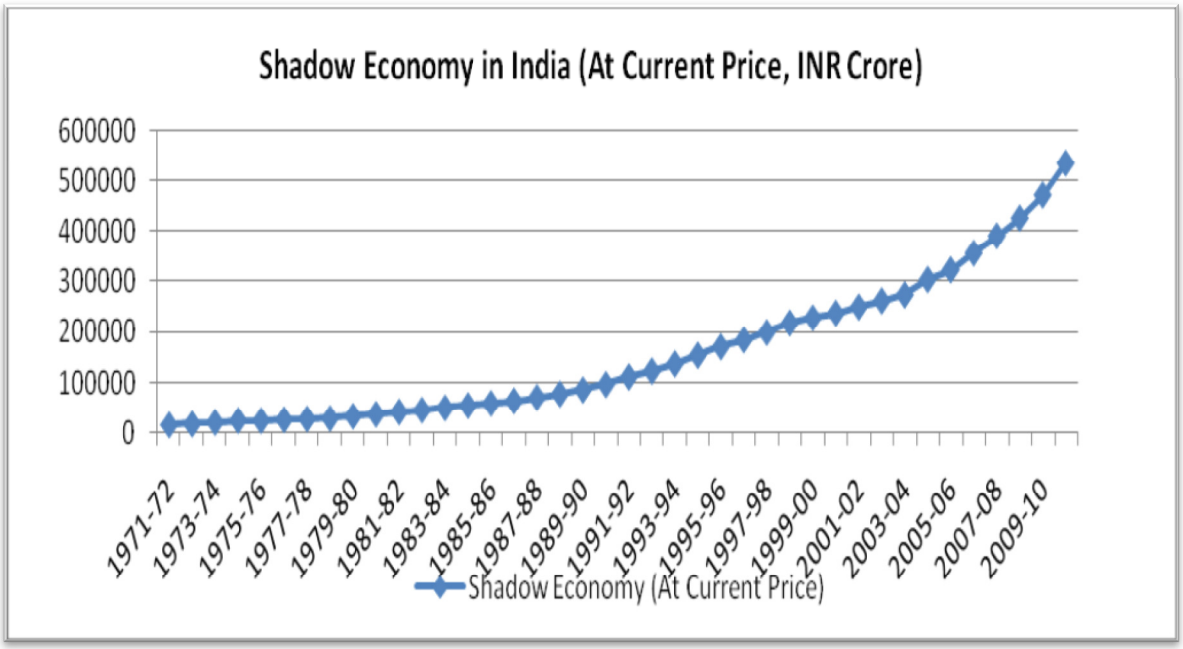
A	1	2	3	4	5	6	7
Cause variables							
Economic Crime		-.0000614 (.0001003)	.0006953** (.0001348)	.0007225** (.0001677)	.0008355** (.0001495)	-.0000569 (.0001678)	.0005208** (.0001624)
Private/Public workers	-.5057586 (.368351)	-.2054683** (.0536805)	-.4886084** (.1916407)	-.4493647** (.2155425)	-.5462534 ** (.1634374)	-.0368666 (.0897669)	-.299616** (.1233626)
Personal income tax/GDP	10.50442** (3.896149)	4.043226** (1.27206)	3.031748 (1.45368)	.7774738 (1.771719)	1.209478 (1.494884)	1.052167 (1.317165)	1.693105 (1.00333)

[8] This test is a goodness-of-fit test in badness-of-fit units; a significant result implies that there maybe missing paths in the model's specification. More specifically, the null hypothesis of this testis that the fitted covariance matrix and mean vector of the observed variables are equal to the matrixand vector observed in the population as measured by the sample. Results of Likelihood ratio test of baseline versus saturated is not reported in the text to conserve the space, however, provided on demand.

Corporate tax/GDP	20.88106** (2.718235)	4.359458** (1.431031)	4.197195** (2.621288)	3.993863 (3.164432)	2.947283 (2.725822)	.87 14479 (2.35393)	4.64884 (3.350609)
Indirect tax/GDP	-2.79589** (2.330457)	-.8430214** (.3366991)	-5.187168** (1.456978)	-4.951749** (1.593812)	-3.442686** (1.044496)	-1.805778** (1.02612)	-4.847808** (1.29754)
CPI-IW		0.3296147** (.0362038)				.3463237** (.0581885)	
Expenditure/ GDP			.6760457 (.5548044)	.4858398 (.5838414)		-.0898377 (.200765)	.7872308 (.4819897)
Election Dummy				.5838414 (1.447064)	-1.046532 (1.212184)	-2.037268 (1.35619)	.0859526 (1.220863)
Reform period							8.133197** (1.932096)
Indicator variables							
M3/GDP	1	1	1	1	1	1	1
RGDP	47611.51** (47611.51)	48320.67** (2063.336)	50032.63 ** (2286.281)	50325.61** (2083.067)	50895.58 (2329.095)	50092.83** (1940.568)	49144.53 (2238.504)
Per cap Electricity Consumption							9751.535 (380.7828)
LR test (χ^2)	63.31 (0.0423)	40.76 (0.1201)	80.03 (0.011)	87.92 (0.0012)	73.11 (0.0022)	165.79 (0.0013)	172.14 (0.0023)
RMSEA	0.1533	0.0432	0.1469	0.1462	0.1446	0.1559	0.1347

Note:
1. SE is in parentheses,
2. LR test is Likelihood ratio test of model vs. saturated,
3. Likelihood ratio test baseline vs. saturated of yield similar results as of model vs. saturated (it is not reported here)

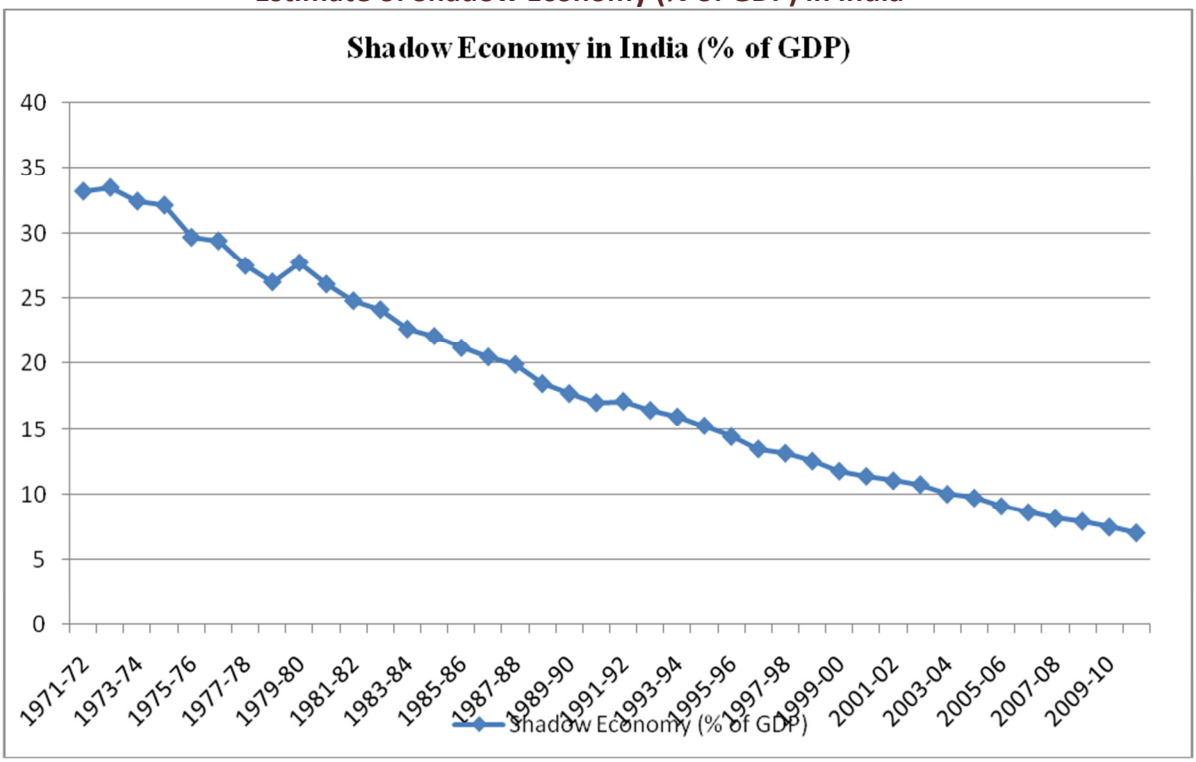
Figure 2.7:
Estimate of Shadow Economy in India (at current price, ₹ crore)



Source: *Own Calculation*

Figure 2.8:

Estimate of Shadow Economy (% of GDP) in India



Source: *Own Calculation*

2.4 Dynamic MIMIC Model

In most of the studies, MIMIC models are applied to time series data to estimate the size and intensity of the underground economy over time. As most macroeconomic variables do not satisfy the underlying assumption of stationarity, the problem of spurious regressions may arise. Researchers usually overcome this problem by transforming the time series into stationary ones, employing a difference operator. Alternatively, one could estimate an error correction model (ECM) if the variables are co-integrated and a stationary long run relationship exists between them. This approach has become popular in applied economics in recent years. The MIMIC model in first difference[9]s is referred to as the DYMIMIC model (Aigner et al., 1988). In the DYMIMIC model, the data's long run information is lost if the variables are used in their first differences, albeit they are co-integrated. Retaining this information may help to improve estimates of the shadow economy. The authors are not aware of any study for the Indian economy that tests for co-integration in the variables and makes use of their long run equilibrium relationships in MIMIC model estimation.

Empirical Analysis and Results

To set the stage for the DYMIMIC, the order of integration of the variables is initially determined using the ADF test. The testing procedures are based on the null hypothesis that a unit root exists in the autoregressive representation of the series. The test fails to reject the null hypothesis of a unit root for each of the series in level. First differences of log level of these series are stationary, suggesting that all series are integrated of order one, 1(1) (see Table 2.5).

Since the order of the stationary (1) is the same for all variables, the Engle and Granger two-step (for detailed discussion, see Hall, 1986) approach test is applied for finding the order of co-integration. For this purpose, it is required to estimate least square regressions with variables in levels, where the particular indicator is the dependent

9

variable and the causes are the independent variables. Thus, the regression equations are:

$$RGDP_t = \beta_1 \frac{\text{Personalincometax}}{\text{GDP}} + \beta_2 \frac{\text{Corporatetax}}{\text{GDP}} + \beta_3 \frac{\text{Indirecttax}}{\text{GDP}} + \beta_4 \frac{\text{Private}}{\text{Public}} \text{workers} +$$

β_5CPI-IW+ β_6Economic Crime+ $\beta_7 \frac{\text{Expenditure}}{\text{GDP}}$ + e1……d.m.1

$$M3/GDP_t = \beta_1 \frac{\text{Personalincometax}}{\text{GDP}} + \beta_2 \frac{\text{Corporatetax}}{\text{GDP}} + \beta_3 \frac{\text{Indirecttax}}{\text{GDP}} + \beta_4 \frac{\text{Private}}{\text{Public}} \text{workers} +$$

β_5CPI-IW+β_6Economic Crime+ $\beta_7 \frac{\text{Expenditure}}{\text{GDP}}$ + e2…… d.m.2

Where all variables as explained earlier (see also Table 5. 1) and e1 and e2 are stochastic residuals.

Because all variables are deviations from their means, no constant is included in the regression equations. Next we analyze the assumed co-integration relationship's residuals e1 and e2 using the ADF test. If the causes are cointegrated with the indicators, we expect the ADF test to reject the null hypothesis of a unit root against the alternative for both error terms e1 and e2. As presented in Table 2.5 we can in fact reject the null hypothesis for both residuals at conventional significance levels. We therefore, conclude that the causes are cointegrated with each indicator.

Table 2.5:

Test of Stationarity

Variable (cause)	ADF (at level)	Lag Length	ADF (at 1st Difference)	Lag Length
Economic Crime	3.895220	0	-4.432284**	0
Private/Public workers	-2.365571	0	-4.562895**	0
Personal income tax/GDP	-0.542930	0	-6.467013**	0
Corporate tax/GDP	0.9753	0	-4.942329**	0
Indirect tax/GDP	-0.821528	1	-5.583572**	0
CPI-IW	3.450188 t	9	-3.340629 t *	8
Expenditure/GDP	-2.900930	4	-3.272619**	4
RGDP	11.65692t	0	-4.294873 t **	0
M3/GDP	0.674766	*0*	-4.487680**	*0*

Notes:

1. p-values are MacKinnon (1996) one-sided p-values.

*2. ** and * denote significant at 5% and 10%, respectively.*

3. Optimal number of lag is determined by based on SIC criterion, 4. Superscript t indicates linear trend inclusion.

Table 2.6:		
Analysis of Cointegration Between Causes and Indicators		
Variable (cause)	RGDP	M3/GDP
Economic Crime	0.07098*	0.0482**
Private/Public workers	0.05044*	0.05937*
Personal income tax/GDP	0.0334**	0.0008**
Corporate tax/GDP	0.0000**	0.0690**
Indirect tax/GDP	0.09294*	0.04169**
CPI-IW	0.0000**	0.0000**
Expenditure/GDP	0.08407*	0.0002**
Adjusted R-squared	0.994888	0.974858
t-statistic for Residual (p-value)	*-3.4091** (0.0165)*	*-4.7882** (0.0004)*

Notes:
1. The critical values of the ADF test's t-statistic are taken from Engle and Yoo (1987).
2. The order of the autoregressive correction has been chosen using the SIC criterion.
3. The null hypothesis of a unit root is rejected at the 5% level for both residuals (e1 and e2).
4. The p-values of the parameter estimators are given in parenthesis.
*5. ** and * denote significant at 5% and 10%, respectively.*

The confirmation of both cointegration relationships permits the estimation of a short run equilibrium MIMIC model for the size and development of the shadow economy according to equation (d.m.1&2). In both equations, we consider first difference of the variables. Results of the short run equilibrium without including the long run error correction terms e1 and e2 from both cointegration relationships (see Columns 1 of Table 2.6) suggest that all tax variables are statistically significant i.e. Personal income tax/GDP, Corporate tax/GDP and Indirect tax/GDP. Their signs are as expected except in the case of Indirect tax, where it is negative. These results are similar to our MIMIC model estimates. The sign of coefficient of economic crime is found to be positive and statistically significant at 5% level. Price index is estimated to be negative and statistically significant. The Coefficient Private /Public worker, which is kept in the model to capture the transformation in the labor market, is also found to be significant and positive. For government sector, we include the coefficient Expenditure/GDP, which is

found be significant and positive. Election dummy, perceived as an important cause of black money generation is found to be sizable and statistically significant at 10% level. Results of goodness of fit (LR test and RMSEA) also indicate that the model fits very well. In order to estimate not only the relative size of the parameters but also their levels, it is necessary to fix a scale for the unobservable latent variable. A convenient way to determine the relative magnitude of the variables is to set the coefficient of one of the measurement model's indicator variables to non-zero. Here, we fix the coefficient of the variable M3/GDP for both equations.

Now we return to the results of the short run equilibrium by including the long run error correction terms e1 and e2 from both the cointegration relationships, reported in Column 2 of Table 2.7. Except Indirect tax/GDP, we fail to find any other tax variable statistically significant. Most of the variables except price index did not turn out to be statistically significant. Only one cointegration relationship (e1) is found be statistically significant. Results of goodness of fit (LR test and RMSEA) also indicate poor fit of the model. Thus we decided not to focus on this equation any further. The estimates of the shadow economy are based on equation 2.

Now we summarize our findings at this stage. First, taxes are crucial for shadow economy growth in India. Second, economic crime has positive and sizable effects on the growth of shadow economy. Third, the important elections have positive spillover effects on the shadow economy. Fourth, labor market transformation is also crucially related to growth of underground economy. Finally, inclusion of the long run error correction term does not provide encouraging results.

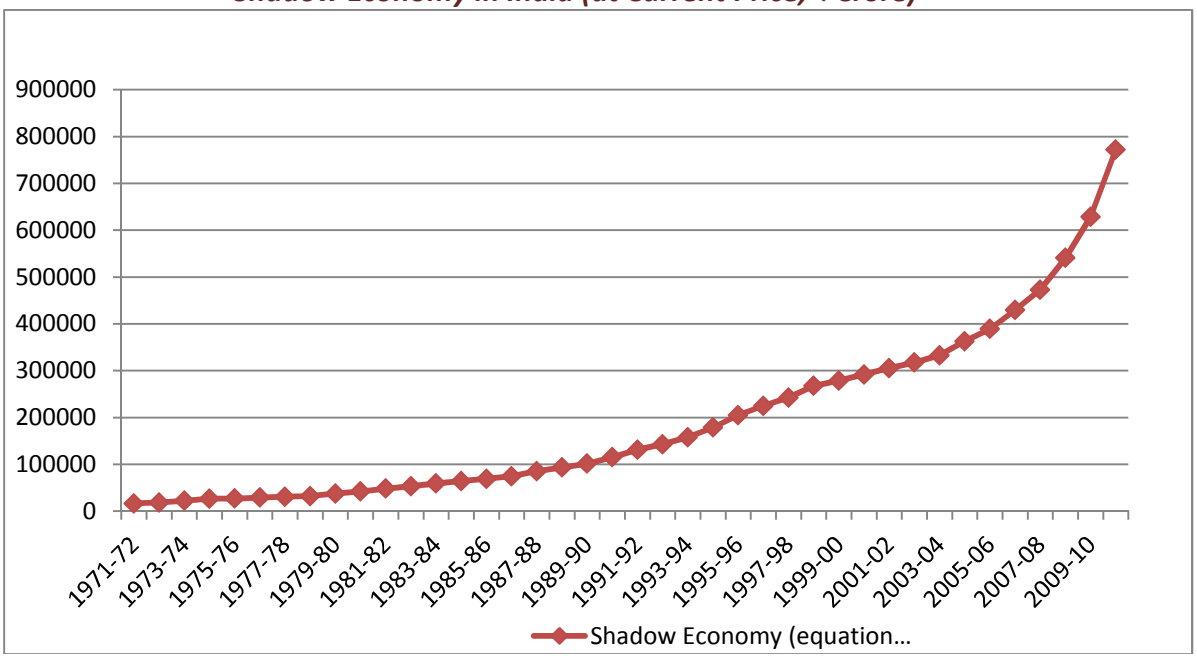
Using the estimated results based on column 1 of Table 2.7, we estimate the size and evolution of India's underground economy. The first step of this process is to compute the ordinal index. This index is then transformed into a cardinal series using our currency model results for the starting year. Figure 2.9 gives the computed size of the underground economy in the country, while Figure 2.10 illustrates the results as percentage of GDP.

Overall these results illustrate a declining trend in terms of share of GDP except for few years, i.e. 1979-80 and 1987-88. It is also observed that in initial years (1971-72 to 1974-75) and last years (2007-08 to 2010-11) the size is by and large persisting. Focusing on overall size at the current prices indicates that shadow economy has increased from ₹ 16424 crores of 19971-72 to ₹ 115315 crores in 1990-91, which further increased to ₹ 772263 crores in 2010-11. Overall the model indicates for declining trend of shadow economy in India, which confirms the robustness and reliability of our results using structural modeling.

Table 2.7:		
Dynamic MIMIC Model Results		
	1 (equation 1)	2 (equation 2)
Cause		
Δ Economic Crime	0.0003775** (0.0002146)	0.0006841 (0.0009615)
Δ Private/Public workers	0.6324627* (0.3011019)	0.5075481 (2.767437)
Δ Personal income tax/GDP	4.814869* (2.631533)	5.842163 (2.913387)
Δ Corporate tax/GDP	3.799737* (2.585676)	0.2449447 (21.08295)
Δ Indirect tax/GDP	-3.44598** (1.26947)	-6.685011** (2.046766)
Δ CPI-IW	-0.784836** (0.1346617)	-1.294443** (.2504809)
Δ Expenditure/GDP	1.163733** (0.5078364)	1.630423 (2.31235)
Δ Election Dummy	1.469283* (0.755281)	2.498879 (3.134014)
e1		0.0000239** (0.0000115)
e2		0.230908 (1.056278)
Indicator		
M3/GDP	1	1
RGDP	-10929.65** (6943.364)	-8099.8 (7302.584)
LR test (χ^2)	32.667	137.79
RMSEA	0.00	0.452
Note: *1. SE is in parentheses,* *2. LR test is Likelihood ratio test of model vs. saturated,*		

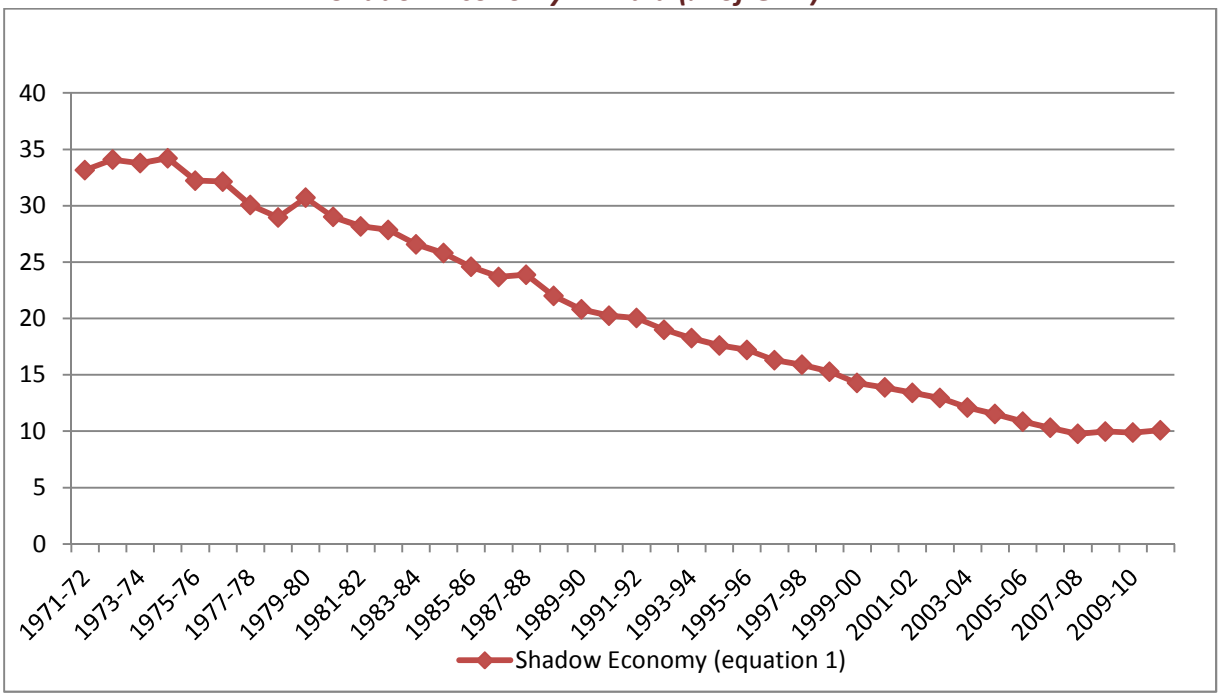
3. Likelihood ratio test baseline vs. saturated of yield similar results as of model vs. saturated (it is not reported here)
*4. ** and * denote significant at 5% and 10%, respectively. 5. Δ Denotes for first difference.*

Figure 2.9
Shadow Economy in India (at Current Price, ₹ Crore)



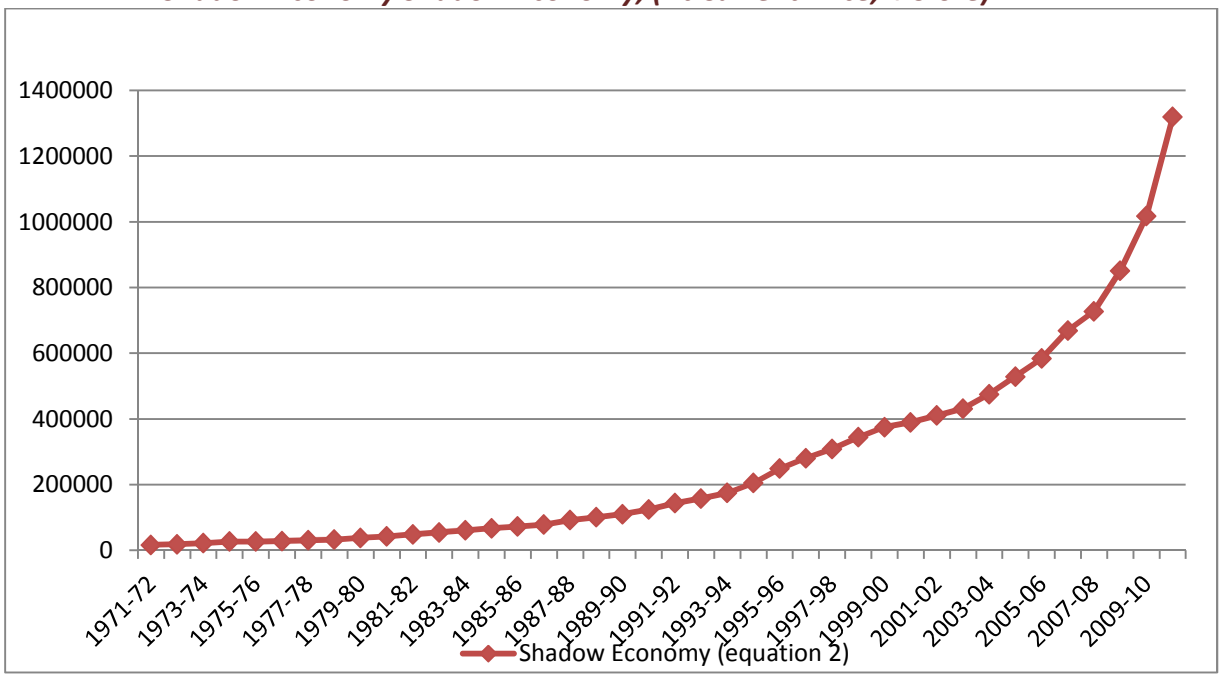
Source: *Calculation based on the results of equation 1 (Table 2.7, Column 1)*

Figure 2.10
Shadow Economy in India (% of GDP)



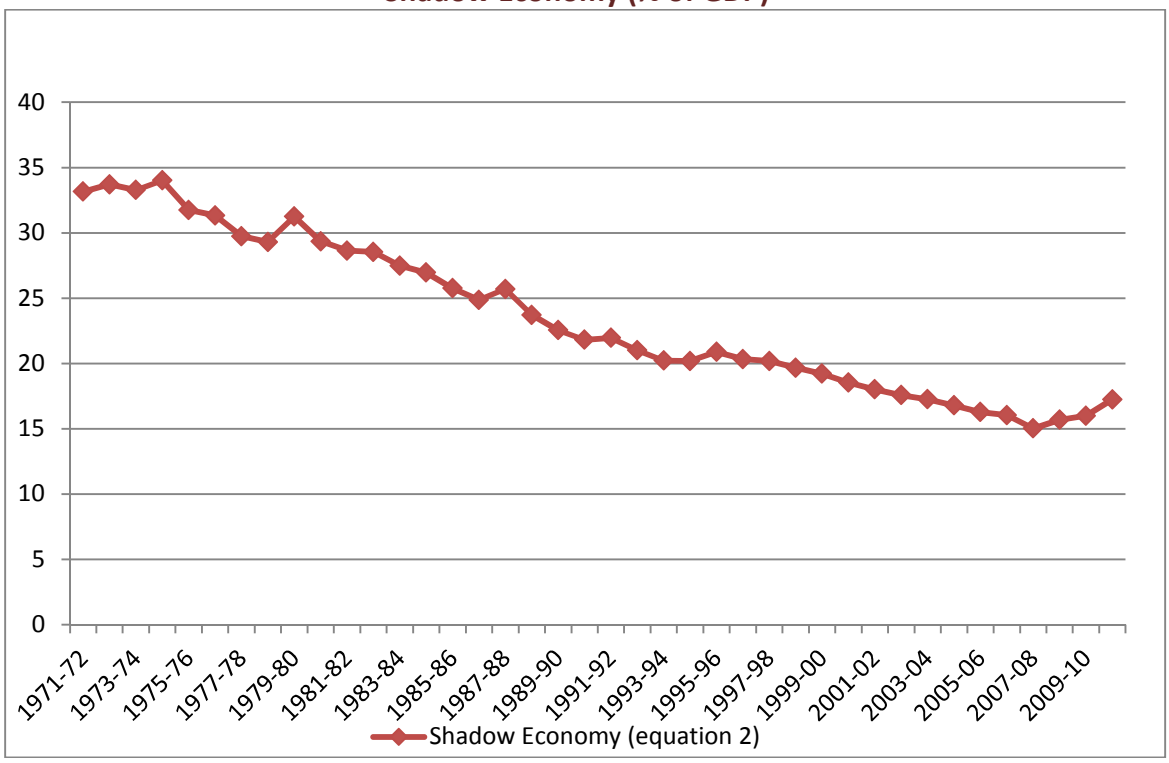
Source: *Calculation based on the results of equation 1 (Table 2.7, Column 1)*

Figure 2.11
Shadow Economy Shadow Economy, (At Current Price, ₹ Crore)



Source: *Calculation based on the results of equation 2 (Table 2.7, Column 2)*

Figure 2.12:
Shadow Economy (% of GDP)



Source: *Own Calculation based on the results of equation 2 (Table 2.7, Column 2)*

Table 2.8:
A Comparison of the Estimate of the Shadow Economy using Alternative Approach

	Canada average over				Germany average over				UK average over				USA				Italy average over			
Method	1970 - 75	1976 - 80	1981 - 85	1986 - 90	1970 - 75	1976 - 80	1981 - 85	1986 - 90	1970 - 75	1976 - 80	1981 - 85	1986 - 90	1970 - 75	1976 - 80	1981 - 85	1986 - 90	1970 - 75	1976 - 80	1981 - 85	1986 - 90
Survey of households	-	-	1.3	1.4	3.6	-	-	-	1.5	-	-	-	3.7	4.5	5.6	-	-	-	-	-
Tax auditing	-	-	2.9		-	-	-	-	-	-	-	-	4.9	6.3	8.2	10	3	3.9	-	10
Discrepancy bet. Expenditure and income	-	-	-	-	11	10.2	13.4	-	2.5	3.6	4.2	-	3.2	4.9	6.1	10.2	3.2	4.3	-	9.3
Discrepancy bet. Official and actual employment	-	-	-	-	23	38.5	34	-	-	-	-	-	-	-	-	-	-	18.4	-	-
Physical input				11.2				14.5				13.2	-	-	7.8	9.9	-	-	-	19.3
Currency demand (Tanzi	5.1	6.3	8.8	12	4.5	7.8	9.2	11.3	4.3	7.9	8.5	9.7	3.5	4.6	5.3	6.2	11.3	13.2	17.5	21.3
Cash deposit ratio (Gutmann)	13.8	15.9	11.2	18.4	-	-	-	-	14	7.2	6.2	-	8.8	11.2	14.6		23.4	27.2	29.3	-
Transactions (Feige)		26.5	15.4	21.2	17.2	22.3	29.3	31.4	17.2	12.6	15.9		17.3	24.9	21.2	19.4	19.5	26.4	34.3	-
MIMI /Model	-	8.7	-	-	5.8	6.1	8.2	-	-	8	-	-	-	8.2	-	-	-	10.5	-	-
Number of methods used	2	4	5	5	6	5	5	3	5	5	4	2	6	7	7	5	5	7	3	4

Notes:
1. Values were grouped (when possible, averaged) in the time periods in order to undertake a rough comparison.
2. Values are in percentage of GDP.
Sources:*based on Schneider and Enste, 2000 calculations.*

Conclusion

There are a range of methods employed to estimate the shadow economy in the standard literature. In Table 2.8, average findings on Canada, Germany, Great Britain, Italy and the United States are presented. The comparison of the estimates reveals that some models very often provide large estimate of the shadow economy than others. As discussed earlier, definition of the shadow economy widely varies. It is noteworthy that the definition often differs depending on the chosen method of measurement. This is mainly because different variables are used in the analysis, and definition of shadow economy depends on the selection of variables for a specific model. If one compares the three monetary approaches (currency demand, cash-deposit ratio, and transactions approach), a noticeable pattern appears. Different variants of monetary approach give

different size of the estimate. The estimates based on MIMIC model or Model approach are mostly found to be in the medium range. In general, these results demonstrate that a range of estimates of the shadow economy for a country in a given time span are achievable using different calculation methods. Hence one should be very careful while interpreting the size of the shadow economy in a country using different methods.

Our results for India are following a pattern somewhat similar to the standard trend found in literature. As the definition and measurements change according to inclusion or exclusion of variables in the models so does the estimation. In case of India, currency models focused on tax sensitive components of the economy, where currency is the prime mode of transaction. Therefore, it is likely that our currency model also captures a small part of the informal economy, which is also unaccounted in the formal income accounting. Therefore, a relatively large estimate using currency model makes sense. Our MIMIC and Dynamic MIMIC models cover relatively large areas of the economy, which include several tax components, criminal sector, political illegal funding during elections and labour market. Thus despite having a broader coverage of the economy the estimates are rather accurate and relatively lower mainly because the model does not capture parts of informal economy like our other models. Overall, our empirical results are satisfactory and indicate that the share of the unaccounted income has been decreasing in the recent years, however, absolute size is showing upward trend in the study period.

Table 2.9:
A Comparison of Estimates of Shadow Economies of India Using Different Methods

Study	Method	Period	Estimate (%of GDP)
Ghosh, et al. (1981)	National Accounts and Sectoral analysis	1950/51- 1978/79	7-9 percent
Chopra (1982)	Sectoral analysis and wage	1970/71-1976/77	5-10%
Gupta and Gupta(1982)	Currency model	1970/71-1978/79	22-48%
Gupta and Mehta (1981)	physical input approach	1964/65-1978/79	3-20%

NIPFP (1985)	Monetary and Survey approach	1975/76-1983/84	15-21%
Bhattacharyya (1999)	Currency model	1960-1992	22% (Growth Varied -14 to 380%)
Schneider et al. (2003)#	MIMIC	1989-2001	17-23%
Chaudhuri et al. (2006)	MIMIC	1974/75-1995/96	17-23% (In states 9-31%)
Schneidera, Buehnb, Montenegro (2010) #	MIMIC	1999-2007	20-23%
NIFM	Currency model (Real Currency)	1971-2009	35-47%
NIFM	Currency model (Currency/Money Supply)	1971-2009	33-43%
NIFM	MIMIC	1971-2009	7-33%
NIFM	Dynamic MIMIC	1971-2009	10-33%

2.5 Estimation of Personal Income Tax Evasion in India

Background and Introduction

In this section we make an attempt to estimate the level of personal tax evasion in India. According to our macro estimates a decreasing but still substantial large size of the Indian GDP is hidden. Our estimated figures raise concerns at a macro level, but they indicate little about the size of personal income evasion. A personal income tax evasion estimate is important and relevant as it alters the competitiveness of the market, introduces iniquities among equals and modifies the outcomes of public policies. Although measuring tax evasion is a challenging and formidable task – Schneider (2000) describes tax evasion measurement "as a scientific passion for knowing the unknown" – we believe that a better understanding of tax evasion is necessary.

This study attempts to provide an estimate of the personal income tax evasion by utilizing microeconomic data set that is representative of India's tax payer population. Such a route has already been walked by other researchers in several countries (e.g. Pissarides and Weber, 1989, Merz and Wolff, 1993, Fiorio and D'Amuri, 2005, Marino and Zizza, 2010, Hurst *et al.* 2011). Here the main assumption is that taxpayers who

decide not to comply or declare their income or hide part of their income from tax authorities might consider declaring a more correct figure to a household interviewer. Using this assumption, we estimate tax evasion in India in the post reform period by comparing income data from the Survey of workers produced by NSS. This methodology requires great care and modifications, as the dataset is not constructed for this purpose.

The working definition of unaccounted economy in this chapter is similar to that of Pissarides and Weber, 1989, and we define it as "activity that should normally be reported and taxed but actually it is not". Our approach for tax evasion is net of the amount of income which should be declared to the tax authorities and the amount actually being received. If the actual amount due to the government in the form of tax revenue was 'T' and the amount actually being collected by the government is 'C', and then the tax evasion will be 'T-C'. From the economic point of view, this can be either tax evasion or tax avoidance or both. In the apt words of former United Kingdom's Chancellor of the Exchequer, Denis Healey, "the difference between tax avoidance and tax evasion is the thickness of a prison wall. Tax avoidance is legal utilization of tax regime to one's own advantage, whereas tax evasion is illegal." But for our purpose, we have used both the terms synonymously and prime objective is to estimate the quantum of the difference. We would prefer to use the term 'tax non-compliance' to take care of both tax evasion and tax avoidance. We have also not differentiated between underreporting and non-reporting of the income to the tax authorities for income tax purpose. The estimation for the quantum of tax evasion is confined to non-corporate income tax (also called as personal income tax) only.

The underreported income and hence the lower income tax revenue can be a by-product of indirect taxation system. For example, an importing firm may over invoice the imported goods and hence report the lower profits attributable to the entrepreneur. Also, it can be due to the non-invoicing of trade of goods and services to escape the taxes. In this way, evaders help each other. Due to the higher rates and complex taxation laws, especially in the 1970's and in 1980's, it was beneficial for the

individual to claim lower income than the higher income. As in the 1980's the direct tax average share in total tax was 18.46%, which had improved in the 1990's to 25.50% and in the 2000's, the average share is 45.57%. Correspondingly, the share of personal income tax has also improved from the level of 10.95% in 1970-71 to approximately 20% in 2009-10.

In terms of comparison of taxes on income, profits and capital gains (% of total taxes) with the rest of the world for year 2009, India stands at middle in the world. Comparing with BRIC (Brazil, Russia, India and China), India performs better as it is 56.5% , while in Brazil, China and Russia it was only, 45%, 35% and 5% respectively. But compared with USA where it constitutes 92% of total tax revenue, India is far behind. The performance of personal income tax collection has been improving over the years but not corresponding to the performance of rise in personal income in the recent years. The quantum of tax evasion corresponds to loss to exchequer and *quint-essential* to estimate.

Our approach to estimate the quantity of tax evasion in the income tax has been the 'Fiscal Approach'. In this approach estimates are compared with the National Account Statistics (NAS) data to find the amount being underreported to the government. The approach has been previously applied by Kaldor (1956), Wanchoo Committee (1971), Chopra (1982), National Institute of Public Finance and Policy, NIPFP (1985).

NIPFP (1985) estimated the extent of tax evasion by using NCAER survey data and its estimate showed that during 1980-81 the personal income tax was evaded to the extent of 68% to 139%. A recent study by Bhalla (2010) attempted to analyze the issue of personal income tax compliance using summary statistics of NSS and some other database. Despite the above mentioned attempts, because of data limitations, methodically sound direct approaches like that proposed by Pissarides and Weber (1989) have never been attempted for the case of India. Their study utilize a rich data set of the British EFS (Expenditure and Food Survey) and worked with a strong

assumption that income and expenditure are reported correctly by employees whose employer filed their income report. They estimate the expenditure function for these households as the true relation between income and expenditure given a set of individual and house-hold characteristics. Assuming that expenditure is also reported correctly by other households, an estimate of their income is then estimated, and consequently their tax evasion is estimated. (See also Marino and Zizza, 2010). We have attempted to employ the similar approach for India.

Though our basic approach is similar to the earlier studies, nevertheless, our attempt here is unique in several accounts and contributes to the existing literature especially in terms of direct policy relevance.

(i) We have used National Sample Survey (NSS) data as it is extensive. It covers almost the states and Union territories at the block level. The sampling procedure is extensive and is truly representative. Furthermore, it is the only survey in India where the unit of information is at individual or workers level.

(ii) In two decades, the country has witnessed paradigm shift in the taxation policy. Considering this development, we analyze four rounds of the survey data covering almost the whole reform period.

(iii) Our analysis conducts state-wise analysis, which will be helpful for the CBDT to focus on the states where the menace of tax evasion is relatively large.

(iv) Several practical and reasonable attempts have been made to overcome to limitations of the database of the consideration for estimating the tax evasion.

Data and Its Sources

Selection of the database

For our purpose, we have two options of household survey data for utilization. First option is employment and unemployment survey. The NSSO conducts {quinquennial}

survey on employment-unemployment in the country for every five years. The survey collects data related to employment status, occupation, type of industry in which employed, number of days worked, weekly wages received, sector (rural/urban), per capital monthly expenditure and other personal information about an individual. Second option is "National Survey on Household Income and Expenditure (NCAER)" collected and provided by National Centre of Applied Economic Research. The NSS data is preferred over the NCAER data due to following reasons:

(i) The NCEAR survey does not report the individual level income information. It provides the household income information. In case of single earner family, the process of estimation is easier but in case of more than single earner family, the estimation is based upon the assumption. The tax unit in case of personal income tax is 'individual' and not the 'household'. The only survey where the unit of information is 'individual' is the NSS data.

(ii) The geographical coverage of the NSS is extensive. It covers all the states and Union territories at the block level. The sampling procedure is extensive and is truly representative. The sample size of NCAER survey is about half of the NSS.

(iii) The NCAER survey is biased towards the urban areas and this requires further adjustment in the final estimates.

(iv) Other than this, NSS data provides wide range of other information like occupation, education, number of days worked in a week, and number of months without work.

For the obvious advantage of having extensive geographical coverage, large sample size and individual as unit of information, the NSS data is preferred over the NCAER survey data.

Major *Problems and shortcomings of the NSS data*

Though the NSS data has advantages but there are certain issues/problems with the data,

(i) The NSS covers three categories of working population- the salaried/wage employees, Self-employed and the Casual workers. For the self-employed group, the wage/income information is not reported at all. For our estimation purpose, this is a very serious issue and is the limitation of the estimation procedure. But it is being observed from the analysis of the distribution of income in NCAER survey that distribution of self-employed is virtually the same as the wage and salary earners (Bhalla, 2010). So for our purpose, we have generated the wage/income for the self-employed group from the regular salaried group. For this reason, the estimates are true and more valid in aggregate than at individual level.

(ii) Another problem cited in the literature regarding NSS data is that the canvassing period is 4-5 weeks (generally a month), which is usually the period of reference and is inadequate for recording the year-round individual data (Sharma and Thavraj,1971).

This seems to be less problematic issue for our estimation purpose. Also over the years, NSS has improved its data collection methodology. It also conducts 2nd round of canvassing round the year to collect the revised estimates.

Working Assumptions

Considering the limitation of NSS data for our purpose, the estimation procedure is based on the following working assumptions:

(i) The National account statistics (NAS) provide the actual aggregate income of the country. What so ever it is evident that in the NSS data has less representation of higher and middle income group. Therefore, projection of personal income based on NSS data is substantially lower than of NAS. To overcome this problem, we compensate the difference of income in higher and middle income groups. This assumption is very important as this is based on the fact that the national

level data are being collected and the aggregates are being calculated with well-proven methodology. Over the years, proficiency has been acquired in the collection and estimation of aggregates. Also, the same data is being used at national and international level for various purposes. The country's policies are being formulated and implemented based on these aggregates only.

(ii) All the working groups report their expenditure data correctly. If there is any discrepancy or underreporting, it is in the income data.

(iii) The expenditure function in terms of state, sector, and reported income is similar for all working groups and the so can be used to generate or estimate the income of the self-employed group.

Data Extraction and Follow-Up

We have used 50th (1993-94), 55th (1999-00), 61st (2004-05), and 66th (2009-10) rounds of NSS unit level data on Employment and Unemployment to estimate unaccounted income in the country. Keeping this in our mind we have extracted data separately on Regular Salaried/Wage Employees, Casual Wage Labor and Self-Employed (including Employer). In order to fulfill the objectives of the study, we have collected the information on selected variables such as; individual earnings and working days in a typical week (so that we can calculate the daily earnings and assume the same for all working days in a year), number of months without work (with this we can generate yearly working days), monthly per capita expenditure (MPCE), sector (rural and urban), states/UTs, occupation codes, and individual weights. The collected data has been divided into states and union territories.

Regular Salaried/Wage Employees: There are some individuals whose, annual working days ('number of months without work' is not reported) data were missing. Hence, we assume that since they are regular salaried/wage employees so we considered 360 as their annual working days. However, there are also some individuals whose, weekly earnings are not reported in the survey and which we have not considered in the analysis (it is below 2 percent of total surveyed people). Further, in some cases the

current weekly status codes (i.e.NCO68/Occupation codes) are not reported and we treat them as taxable activity (it remains same for casual wage labor and self-employed classes).

Casual Wage Labor: The sample data of casual wage labor has been divided into two parts; where part one represents available data and part two implies for missing (annual income) [10]data. Both missing and available data have been classified into (based on MPCE) varying-ranges (for each State/UTs separately). The missing (annual income) data has been filled by taking the averages of annual income of available data (for respective range).

Self-Employed: The surveyed data of self-employed (including employer) clearly signifies that there is no information about income earnings. Hence, we assume that the income earnings of self-employed are as equal as regular salaried class. Therefore, we have classified both self-employed and regular salaried data into varying ranges (based on MPCE for rural and urban separately) and then the missing data (annual income) of self-employed has been filled by taking the average annual income of regular salaried class (for respective range).

Table 2.10:

Number of Persons Enumerated Per Survey in Rural and Urban Areas of All States and Union Territories

States/UTs	50th Round (1993-94)		55th Round (1999-00)		61st Round (2004-05)		66th Round (2009-10)	
	Rural	Urban	Rural	Urban	Rural	Urban	Rural	Urban
Andhra Pradesh	21420	15912	30668	22712	22591	11719	15127	11055
Assam	16706	3784	25875	4890	17182	3836	12713	3508
Bihar & Jharkhand	36575	10617	54810	15635	36045	12299	26117	10521
Delhi	244	4047	1340	6768	246	4586	251	3336
Goa	643	848	1193	1634	677	1005	738	1169
Gujarat	11849	10959	17681	17936	11552	9040	8687	7475
Haryana	6137	3124	8858	5091	9250	4934	7529	5605
Himachal Pradesh	9808	1472	10807	4703	10263	1433	7422	1380

[10] The annual income is generated by authors using the data of weekly earning and working days of individuals.

Jammu & Kashmir	4626	2553	10796	6744	10772	4284	7950	6328
Karnataka	14202	11552	19627	15232	13665	9531	9612	8062
Kerala	11856	8181	16815	12642	14319	8709	10573	7488
Maharashtra	22107	24277	28027	33233	24276	22621	18715	16760
MP & Chhattisgarh	28795	15924	39359	22425	31763	14306	21511	12686
Orissa	16653	4525	23277	6209	18755	5391	12997	4260
Punjab	11148	8779	16346	11509	13184	8805	7752	6811
Rajasthan	16846	8440	25828	13668	19887	8144	13730	7580
Tamil Nadu	16253	16405	23523	22961	16028	15487	12297	11676
UP & Uttaranchal	52149	23098	78391	34132	54664	21614	38308	19419
West Bengal	23454	13509	31813	19404	24282	12106	15038	10212
North East States	29575	14856	36963	19942	45004	18822	31418	17949
Union Territories	5305	5527	7782	11764	3620	6136	2842	5177
All States & UTs	356351	208389	509779	309234	398025	204808	281327	178457
Total Persons-Per Survey	564740		819013		602833		459784	
Where North East States are; Arunachal Pradesh, Manipur, Mizoram, Meghalaya, Nagaland, Sikkim and Tripura and Union Territories are Andaman & Nicobar, Chandigarh, D&N Haveli, Daman & Diu, Lakshadweep and Pondicherry.								

Estimation Method

The survey data provides information on various aspects of employment along with personal information at individual level. The data has been extracted for weekly wages, number of days worked in a week, number of months without work, monthly per capita consumption expenditure, sector (rural/urban), state, occupation code and weight. The principal steps in the estimation procedure are as follows: at first stage, we estimate of income for all individuals at state-level. In next stage, on the basis of prevailing effective tax rate, for each slab of income tax, we compute estimation of income tax revenue due to the government and in final stage we estimate income tax evasion by comparing computed overall tax revenue with realized tax revenue. The tax non-compliance has been estimated at state level. The state level estimates are then aggregated to estimate the national level tax non-compliance.

The detailed procedure is as follows:

Estimation of income for all individuals

First Stage: Since survey provides data on weekly wages, and for our purpose we need yearly income, the yearly income for the individual is calculated. For this first of all, the number of days, an individual has worked for the year are calculated from number of months without work subtracted from twelve and multiplied by thirty. This will give number of days worked in a year. To simplify the procedure, numbers of days in a month are taken as thirty. This will not affect the estimates as a year will be of 360 days. The yearly income is then calculated from weekly wages multiplied by number of days worked in a year and divided by number of days worked in a week.

Second Stage: The wage data for the self-employed group is not available in the database. This is estimated using our working assumptions that expenditure data provided by the individual is accurate and the expenditure function based on income is same for all occupational groups in a given quintile. Based on this, the income for self-employed group has been generated from regular salaried group based on the consumption expenditure. Since the expenditure function depends not only on income but on state/region, sector (rural/urban) and quintile, both the occupation groups have been classified on these criteria to generate the data series for self-employed group.

Third Stage: For the casual workers, the problem is of 'missing data' for the wages. Since the expenditure function of casual workers is different from other groups, the data has been generated from within the group based on the procedure explained in the previous step.

Fourth Stage: The income for all the individuals in the sample is now known. This is in turn multiplied by weight of an individual. This gives the estimation of income for whole working population in the country. The total income for all individuals is categorized in the tax slab category for that year. Since 1992, there are three income categories for the tax purpose; the income in each tax slab category is aggregated from individual income multiplied by weight.

Fifth Stage: The aggregate income estimated from NSS data is less than the NAS aggregates. This is due to the under-representation of middle and higher income groups

and over representation of lower income groups at individual level. This may happen due to habit of people to provide lesser information to NSS in fear of that the same will be further used for tax purpose. The state level estimated income is compared with personal income and the difference is allocated to that state.

This can be explained as, for example, the estimated aggregate income for a state 'X' is 'a' and according to NAS, the net SDP is 'b', so the difference of income is 'c = b-a'. In case, 'c' is negative, then underreporting is taken as zero, which is hardly a case, as in most of the states, NAS based personal income is substantially higher than the computed personal income based on the NSS data. Since for our purpose, we need the income tax revenue due to the government, and different income slabs have different effective tax rates, the problem is on what basis, this difference amount is to be allocated to the different income slabs. There is absolutely no information available regarding income distribution in NAS data. We have considered two scenarios 'Method I' and 'Method II'. In Method I, it is being assumed that underreporting is in both middle and upper income segments, so 50-50 difference aggregate income is being allocated to both the income segments, which is a highly likely case.[11] In the Method II, it is assumed that the underreporting of the income is mainly in the upper income segment group, so 100% difference income is allocated to the upper income segment. We accept that Method II is not very realistic, nevertheless it is considered in this study to estimate the upper bound of tax evasion ratio.

Estimation of Tax Liability

For our analysis, we need to estimate Tax Liability of the whole working population of the country. The procedures which are adopted for this purpose are as follows:

a) The tax liability of an individual can be estimated once we know the yearly income of an individual. Since now we know the income in each income-tax category, we can estimate the income tax due to the government. The income tax rates with income slabs are available from the union budgets. An individual has number of tax

[11] We have not compensated any difference of income in the lower income group as it is already over represented in the database. Nevertheless, their over-representation will not affect our results as this group does not fall in tax paying categories.

saving exemptions. Due to this, the effective tax, which an individual pays, is less than what is being the tax rate for that income slab.

b) Other than the exemption on savings, the Indian union income tax cannot tax agriculture income. The agriculture income tax in India is a state subject and only states are enabled to make laws to tax the agriculture income. As of now, there is no law to tax agriculture income in any of the Indian state. So, the agriculture income is treated as fully exempted. The NSS provide the occupational codes on the individual level. All the individuals, whose occupation code is agriculture, have been eliminated from the tax-revenue calculation purpose.[12]

c) The tax liability (potential income tax revenue) of an individual is calculated by applying the effective tax rate for the particular income bracket. This provides our estimates on the Income tax revenue (ITR) due to the government.[13]

Estimation of Tax Evasion/non-compliance

The Income Tax Return (ITR) calculated from the above procedure is compared with state level tax revenue collected by the CBDT. The state level CBDT personal income tax data has been collected from Revenue Receipts Audit Reports-Direct Taxes prepared by Comptroller and Auditor General (CAG). The difference of the personal income tax due (potential income tax revenue) and actually collected is the tax non-compliance.

Results of Estimation of Personal Income Tax Evasion

Projecting Personal Income Tax Collection

As discussed earlier, we have estimated the total income of working class for four rounds: 1993-94, 1999-00, 2004-05 and 2009-10. On the basis of income, we have computed taxable income for salaried and non-salaried class. Firstly this is done using Method 1, in which difference of income between NAS and NSS is compensated equally

[12] It is noteworthy that at first stage difference between total personal income between NSS (including Agricultural activities) and NAS has been calculated. We have also calculated the ratio of the income required to be compensated. In the second stage, after deducting the Agricultural activities, the same ratio of compensation has been used to compensate to underestimated income of NSS.

[13] Slab wise effective tax rates (ETR) is calculated on the basis of data taken from different sources, i.e. All India Tax Statistics (various issues) and Report of the Task Force on Direct Taxes (the Kelkar Committee report). The report provides amount collected from tax and the amount claimed through savings in an income group. For FY 2009-10, the effective tax rate has been extrapolated, as it has not been provided by the concern department.

in higher and middle slabs. Specifically, In FY 1993-94, we compensate it in slabs of 40% and 30%, while in other years of consideration, i.e. 1999-00, 2004-05 and 2009-10, we have compensated in 30% and 20% slabs. After the compensation of income, we employ effective tax rate (ETR) of each slab on the estimated aggregate income falling under each slab. This procedure will yield potential tax revenue for all three slabs for our sample years. As expected, potential tax revenue is estimated to be highest in Maharashtra among states and that is in all sample years (see, Table 2.11) distantly followed by Gujarat, New Delhi and Tamil Nadu. But the potential tax revenue that was slightly lower for Delhi in FY 1993-94 compared to Tamil Nadu has exceeded in FY 2009-10. Estimates also suggest that in 1993-94, the potential tax revenue of India was ₹ 2469 crores, which increased around fivefold to ₹ 122716 crores in 2009-10 for the salaried class. While analyzing the potential tax revenue for non-salaried class (see, Table 2.12) for our sample years we find that once again Maharashtra takes the lead, however second position is constantly held by Andhra Pradesh. Similar to the salaried class, at country level, potential tax revenue from non-salaried class increased from ₹ 12518 to ₹ 158810 crores, from 1993-94 to 2009-10 (approximately four times). Results are quite impressive as despite the substantial decrease in tax rate (also ETR); potential tax revenue has been constantly increased. This reflects the impressive growth of personal income in India in the post-reform period.

Now we analyze Method 2 of the analysis, where all underestimated income (difference between NAS and NSS) is compensated only in higher slabs. Specifically, in FY 1993-94, we compensate it in slabs of 40%, while in other years of consideration, i.e. 1999-00, 2004-05 and 2009-10, we have compensated in 30% slab. After the compensation, we employ ETR of each slab on the estimated aggregate income falling under each slab. This procedure gives us potential tax revenue under all three slabs for our sample years. While analyzing the results we find that the potential tax revenue of Maharashtra is highest in all states and all sample years (see, Table 2.13), it can be also noticed that a sharp increase (around 5 times) in the potential tax revenue of Maharashtra from 1993-94 to 2009-10 for the salaried class. Tamil Nadu, Delhi, Gujarat and Andhra Pradesh are

subsequent states to have highest tax revenue. In case of non-salaried class (see, Table 2.14) again Maharashtra has the highest tax revenue followed by Andhra Pradesh, Tamil Nadu, Gujarat, West Bengal, Karnataka and Delhi. At country level we find in the analysis that the tax revenue from salaried class and non-salaried class has increased by 5.7 and 14 times, respectively. Overall, both methods indicate that the tax revenue for non-salaried class have increased sharply with respect to salaried class over the years (1993-94 to 2009-10).

Estimating Tax Evasion

After estimating slab wise potential income tax revenue collection, we shift our attention to aggregate potential income tax revenue for each state and compare it with realized or collected tax revenue.

Focusing on Method 1, Table 2.15 reveals that major tax evading states are Gujarat, Andhra Pradesh, Tamil Nadu and Maharashtra respectively for 2009-10 in terms of revenue. But if we take the average over the years we notice that Maharashtra is the highest tax evading state followed by Andhra Pradesh, Tamil Nadu and Gujarat. It can be noticed here that three (Gujarat, Andhra Pradesh, and Tamil Nadu) fastest growing states have joined the league of top tax evading states in the economy. However, if we consider the tax evasion in terms of percentage, our results indicate that though there is an declining trend in tax evasion rate from 1993-94 to 2009-10, but still the situation is critical. North East States in aggregate have reported 90 plus percent tax evasion rate in the FY 2009-10. Results also indicate that in states like Andhra Pradesh, Haryana, Kerala, and Orissa, rate of tax evasion is alarmingly high (more than 85%) for the FY 2009-10. On the other side, lowest tax evading states were found to be Karnataka, Maharashtra and New Delhi (13.89, 18.53 and 43.74). At national level the total tax evasion which was estimated to be 75.33 percent in the FY 1993-94 has reduced to 58.90 percent in the FY 2009-10 (see, Table 2.16).

Considering the method 2, which gives us upper bound results, we find similar results here. But it can be noticed that as we have compensated the difference of NAS and NSS

estimated revenue in higher slab, Maharashtra again exceeds other states in terms of tax evasion. The probable reason could be majority of the higher income population is concentrated in Maharashtra because of it being business hub of India. Delhi which was not very much prominent to be a tax evading state in Method I, appeared to be among top five tax evading (in terms of revenue) states of the economy in Method 2. At national level though the tax evasion (absolute terms) has increased 7.7 times from 1993-94 to 2009-10. But the rate of tax evasion which was 81.85 percent in 1993-94 has declined to 73.26 percent in 2009-10 (see Table 2.17).

There has been improvement in compliance in filing returns also. The percentage of assesses evading tax has decreased over the years. The dramatic change is visible for the year 1999-00 after the first wave of personal income tax reforms based on recommendations of Chelliah Committee. Though the number of assesses had increased for the year 2004-05 but the compliance in filing return had seen slight fall which further improved in 2009-10 after the implementations of Vijay Kelkar task force recommendations. The projected number of assesses that should file income tax return to actual number of income tax return filers has improved from 33.13% in 1993-94 to 47.97% for the year 2009-10. For sake of comparison, we may compare our assesses results with that of Bhalla (2010). He has estimated the population that should pay tax from NSS database. According to him, the actual number of assesses should be 4.1crores in 1999, 6.3 crores in 2004 and 6.9 crore in 2009. Our estimates suggest that population that should pay tax is 2.3crore in 1993, 4.24 crore in 1999, 5.87crore in 2004 and 7.03crore in 2009. The overall estimates are somewhat similar except from minor differences due to estimations made by him are based on income distribution and tax schedules, where as our estimates are actual calculations based on micro-level data therefore it seems to be more accurate and reliable.

Overall we can say that though the tax evasion is increasing in the country but the rate of evasion is declining which evidently indicates that reform in tax rates and administrative is yielding a positive return.

Highlights of Key Findings

- The projected tax revenue for salaried people has increased with CAGR of 11% from 1993-94 to 2009-10. Over the years the compound annual growth rate is the highest as 19% from 1993-94 to 1999-00. The annual growth is 3.5% from 1999-00 to 2004-05 and doubled to 7.60% from 2004-05 to 2009-10.
- For non-salaried people, the projected tax revenue growth rate is impressive. The annual growth for two decades is 17% where as for the period 1993-94 to 1999-00, it has been 7% and 33% for the period 1999-00 to 2004-05.
- This shows the effect of growth of personal income during this period. The growth rate is highest in initial years due to initial effect of first generation reforms. The effect of second generation reforms is evident in doubling of annual growth rate from 2004-05 to 2009-10.
- The projected tax revenue as percentage of GDP has been almost four times the collected income tax revenue for the year 1993-94. It has been three times for the years 1999-00 and 2004-05. This is almost double for the year 2009-10. This shows there is still need to have administrative and tax reforms.
- The return compliance has also increased. In the year 1993-94, there were only one third of actual income tax file returns than the potential filers. With the tax reforms, this has been improved to half.
- The tax evasion has seen phenomenal decline in two decades of reforms. With Method-I, tax evasion was as high as 75.33% in 1993-94, which reduced to 72.58% in 1999-00 and 70.44% in 2004-05. There has been impressive decline in 2009-10 to the level of 58.90%.
- In the upper bound estimations of tax evasion also, there has been decline in the tax evasion rate. The tax evasion was highest as 81.95% in 1993-94, and declined to 78.39% and 77.99% in 1999-00 and 2004-05 respectively. It has been 73.26% in 2009-10.

- The Vijay Kelkar Committee argued that such drastic reduction of tax rates will lead to loss to exchequer. However, there have been improvement in tax compliance and assesses compliance ratio.
- In the moderate estimates with Method-I, highly tax evading states in all the rounds are Assam, Andhra Pradesh, Haryana, Kerala, Punjab, Orissa, and Jammu & Kashmir, where the tax evasion is as high as above 85-90 percent. Though growth of projected tax revenue is quite impressive in these states but the tax evasion is also very high.
- In comparison to this, the least tax evading states have been Maharashtra, Karnataka, and Delhi. The tax evasion in these states is least among all the states.

Table 2.11:

Projection of Personal Tax Income from Salaried People

Method I:Where all the under underestimated income is incorporated equally into 20 and 30 percent tax slabs*(30 and 40 per cent for50thRound)
(Without Agricultural Activities)

(Tax Revenue values are Rupees in Crores)

	50th Round (1993-94)				55th Round (1999-00)				61st Round (2004-05)				66th Round (2009-10)			
	20% tax slab	**30% tax slab**	**40% tax slab**	**Total**	**10% tax slab**	**20% tax slab**	**30% tax slab**	**Total**	**10% tax slab**	**20% tax slab**	**30% tax slab**	**Total**	**10% tax slab**	**20% tax slab**	**30% tax slab**	**Total**
State	Tax revenue ***(ETRs: 13.74%)***	Tax revenue ***(ETRs: 11.00%)***	Tax revenue ***(ETRs: 42.28%)***	Tax revenue	Tax revenue ***(ETRs: 0%)***	Tax revenue ***(ETRs: 12.77%)***	Tax revenue ***(ETRs: 25.07%)***	Tax revenue	Tax revenue ***(ETRs: 0%)***	Tax revenue ***(ETRs: 4.85%)***	Tax revenue ***(ETRs: 20.01%)***	Tax revenue	Tax revenue ***(ETRs: 0%)***	Tax revenue ***(ETRs: 4.62%)***	Tax revenue ***(ETRs: 19.06%)***	Tax revenue
Andhra Pradesh	350	356	961	1667	0	1950	2218	4168	0	1230	5301	6531	0	1952	7199	9150
Assam	130	81	168	378	0	514	655	1170	0	215	582	797	0	172	586	759
Bihar & Jharkhand	309	101	103	513	0	973	568	1542	0	393	1545	1938	0	346	1016	1362
Delhi	176	398	1114	1689	0	2387	5469	7856	0	1301	7173	8474	0	2321	8997	11318
Goa	12	33	99	144	0	156	234	390	0	150	614	764	0	250	1015	1265
Gujarat	427	397	1033	1857	0	1669	1950	3620	0	1228	4680	5908	0	2101	8111	10212
Haryana	108	154	409	672	0	894	1179	2073	0	583	3031	3614	0	1271	4568	5839
Himachal Pradesh	37	41	59	137	0	226	258	484	0	135	481	617	0	140	352	492
Jammu & Kashmir	30	57	176	263	0	292	231	523	0	175	534	709	0	123	306	429
Karnataka	294	382	1025	1701	0	1590	2017	3607	0	953	4390	5344	0	1597	5490	7087
Kerala	171	167	396	734	0	980	988	1968	0	585	2153	2738	0	876	3215	4091
Maharashtra	828	1546	4624	6998	0	5511	7384	12894	0	3399	15084	18482	0	6582	28272	34854
MP & Chhattisgarh	318	327	1099	1744	0	1377	1312	2689	0	796	2612	3409	0	912	3175	4087
Orissa	136	82	200	418	0	591	563	1153	0	367	965	1332	0	324	979	1303
Punjab	135	210	553	899	0	1086	1656	2742	0	553	2684	3237	0	1135	3770	4905
Rajasthan	243	154	218	614	0	1037	993	2030	0	563	1587	2150	0	640	1684	2324

Tamil Nadu	471	540	1314	2324	0	2371	3391	5762	0	1536	6844	8379	0	2466	8493	10959
UP & Uttaranchal	555	343	555	1453	0	1920	2076	3996	0	961	2625	3585	0	1214	3003	4217
West Bengal	479	516	1202	2198	0	4434	7049	11483	0	1070	4074	5145	0	1320	4323	5642
North East States	90	43	70	203	0	262	212	474	0	191	496	687	0	120	409	529
Union Territories	29	55	126	210	0	345	542	887	0	213	920	1132	0	400	1493	1893
All States & UTs	**5327**	**5499**	**13643**	**24469**	0	**30564**	**40945**	**71510**	0	**16597**	**68376**	**84972**	0	**26260**	**96456**	**122716**

Note:
The above Projected Tax Revenues are based on the NSSO Unit level data on Employment and Unemployment.
^The lists of North East states are; Arunachal Pradesh, Manipur, Mizoram, Meghalaya, Nagaland, Sikkim and Tripura.
**Union Territories are Andaman & Nicobar, Chandigarh, D&N Haveli, Daman & Diu, Lakshadweep and Pondicherry.*

Table 2.12:

Projection of Personal Tax Income from Non-Salaried People

Method I: Where all the under underestimated income is incorporated equally into 20 and 30 percent tax slabs*(30 and 40 per cent for50thRound)
(Without Agricultural Activities)

(Tax Revenue values are Rupees in Crores)

	50th Round (1993-94)				**55th Round (1999-00)**				**61st Round (2004-05)**				**66th Round (2009-10)**			
	20% tax slab	**30% tax slab**	**40% tax slab**	**Total**	**10% tax slab**	**20% tax slab**	**30% tax slab**	**Total**	**10% tax slab**	**20% tax slab**	**30% tax slab**	**Total**	**10% tax slab**	**20% tax slab**	**30% tax slab**	**Total**
	Tax revenue ***(ETRs: 13.74%)***	Tax revenue ***(ETRs: 11.00%)***	Tax revenue ***(ETRs: 42.28%)***	Tax revenue	Tax revenue ***(ETRs: 0%)***	Tax revenue ***(ETRs: 4.42%)***	Tax revenue ***(ETRs: 26.46%)***	Tax revenue	Tax revenue ***(ETRs: 0.70%)***	Tax revenue ***(ETRs: 6.53%)***	Tax revenue ***(ETRs: 22.83%)***	Tax revenue	Tax revenue ***(ETRs: 0.70%)***	Tax revenue ***(ETRs: 6.22%)***	Tax revenue ***(ETRs: 21.74%)***	Tax revenue
Andhra Pradesh	229	171	643	1043	0	230	609	839	28	1711	4818	6557	22	4048	14147	18218
Assam	76	17	63	155	0	84	172	256	3	506	447	956	29	250	874	1154
Bihar & Jharkhand	309	3	0	312	0	890	547	1437	16	1584	961	2561	154	673	2294	3121
Delhi	270	213	798	1280	0	2	8	10	21	931	3117	4068	116	2164	7563	9842
Goa	4	10	32	45	0	22	105	126	1	111	344	456	0	119	417	537
Gujarat	375	175	611	1162	0	342	951	1293	11	1575	4224	5811	0	3176	11101	14277
Haryana	114	84	284	482	0	274	760	1034	0	784	1574	2358	3	1348	4711	6062
Himachal Pradesh	23	6	23	52	0	31	74	105	4	161	231	396	3	99	347	449
Jammu & Kashmir	13	18	69	100	0	49	109	159	4	305	541	850	19	128	420	567
Karnataka	173	122	388	683	0	266	695	961	27	1118	3562	4707	114	2385	8336	10835
Kerala	143	87	335	565	0	176	464	639	37	1406	2852	4295	43	1622	5657	7322
Maharashtra	523	588	1821	2931	0	757	2009	2766	38	3760	10162	13960	246	5479	19145	24870
MP & Chhattisgarh	127	67	213	406	0	150	418	569	23	1066	2197	3286	16	1644	5721	7381
Orissa	34	18	52	104	0	63	180	243	7	686	1227	1920	14	681	2379	3074
Punjab	118	102	388	608	0	164	529	693	7	897	1584	2489	1	1385	4842	6229
Rajasthan	158	39	128	325	0	572	1547	2119	32	1024	1551	2607	42	911	3182	4135

Tamil Nadu	308	197	756	1262	0	359	2412	2772	24	1829	4566	6420	24	3802	13290	17116
UP & Uttaranchal	413	73	215	701	0	603	1408	2011	117	1758	2343	4218	111	1708	6018	7836
West Bengal	318	108	403	829	0	12	58	71	1	2629	4637	7267	174	3147	11001	14323
North East States	89	13	42	144	0	68	147	215	4	309	401	714	11	164	555	730
Union Territories	17	13	39	69	0	2	7	10	2	152	364	518	10	166	555	732
All States & UTs	**3831**	**1971**	**6717**	**12518**	**0**	**5116**	**13209**	**18325**	**408**	**24302**	**51702**	**76412**	**1154**	**35101**	**122555**	**158810**

Note:
The above Projected Tax Revenues are based on the NSSO Unit level data on Employment and Unemployment.
^The lists of North East states are; Arunachal Pradesh, Manipur, Mizoram, Meghalaya, Nagaland, Sikkim and Tripura.
**Union Territories are Andaman & Nicobar, Chandigarh, D&N Haveli, Daman & Diu, Lakshadweep and Pondicherry.*

Table 2.13:

Projection of Personal Tax Income From Salaried People

***(Method II:** Where all the under representation income is incorporated into 30 percent tax slab*(40% for50thRound)*

(Without Agricultural Activities)

(Tax Revenue values are Rupees in Crores)

	50th Round (1993-94)				55th Round (1999-00)				61st Round (2004-05)				66th Round (2009-10)			
	20% tax slab	**30% tax slab**	**40% tax slab**	**Total**	**10% tax slab**	**20% tax slab**	**30% tax slab**	**Total**	**10% tax slab**	**20% tax slab**	**30% tax slab**	**Total**	**10% tax slab**	**20% tax slab**	**30% tax slab**	**Total**
	Tax revenue ***(ETRs: 13.74%)***	Tax revenue ***(ETRs: 11.00%)***	Tax revenue ***(ETRs: 42.28%)***	Tax revenue	Tax revenue ***(ETRs: 0%)***	Tax revenue ***(ETRs: 12.77%)***	Tax revenue ***(ETRs: 25.07%)***	Tax revenue	Tax revenue ***(ETRs: 0%)***	Tax revenue ***(ETRs: 4.85%)***	Tax revenue ***(ETRs: 20.01%)***	Tax revenue	Tax revenue ***(ETRs: 0%)***	Tax revenue ***(ETRs: 4.62%)***	Tax revenue ***(ETRs: 19.06%)***	Tax revenue
Andhra Pradesh	350	118	1879	2346	0	1102	3883	4985	0	416	8007	8423	0	329	13891	14220
Assam	130	49	289	468	0	303	1071	1373	0	157	748	905	0	77	980	1057
Bihar & Jharkhand	309	101	103	513	0	879	753	1632	0	281	1814	2095	0	175	1721	1896
Delhi	176	135	2127	2438	0	694	8792	9486	0	277	10512	10788	0	260	17499	17760
Goa	12	8	193	214	0	54	434	488	0	27	1046	1073	0	6	2021	2027
Gujarat	427	176	1882	2485	0	922	3417	4339	0	447	7325	7772	0	229	15836	16064
Haryana	108	63	760	931	0	469	2014	2483	0	175	4337	4512	0	235	8841	9076
Himachal Pradesh	37	29	107	172	0	150	407	557	0	83	637	720	0	60	683	743
Jammu & Kashmir	30	11	352	392	0	204	403	608	0	84	845	928	0	53	592	645
Karnataka	294	163	1865	2323	0	852	3466	4318	0	384	6196	6580	0	413	10373	10787
Kerala	171	72	759	1002	0	564	1806	2369	0	270	3187	3457	0	223	5909	6132
Maharashtra	828	509	8608	9945	0	2819	12668	15487	0	1178	22383	23561	0	1175	50581	51756
MP & Chhattisgarh	318	112	1924	2354	0	848	2351	3199	0	404	3906	4311	0	246	5922	6168

Orissa	136	42	351	530	0	378	981	1358	0	215	1474	1689	0	96	1920	2016
Punjab	135	73	1081	1289	0	444	2916	3360	0	226	3703	3929	0	269	7340	7609
Rajasthan	243	105	407	754	0	682	1689	2371	0	363	2218	2581	0	289	3133	3422
Tamil Nadu	471	227	2515	3212	0	1344	5407	6751	0	535	10127	10661	0	522	16513	17034
UP & Uttaranchal	555	230	991	1776	0	1420	3056	4476	0	735	3233	3967	0	613	5481	6094
West Bengal	479	297	2044	2821	0	1212	13375	14587	0	539	5762	6301	0	430	7993	8423
North East States	90	28	130	248	0	197	338	536	0	128	694	822	0	43	728	771
Union Territories	29	24	245	298	0	115	995	1109	0	68	1404	1472	0	106	2706	2812
All States & UTs	**5327**	**2573**	**24889**	**32790**	0	**15653**	**70220**	**85873**	0	**6992**	**99557**	**106548**	0	**5849**	**180663**	**186512**

Note:

The above Projected Tax Revenues are based on the NSSO Unit level data on Employment and Unemployment.

^The lists of North East states are; Arunachal Pradesh, Manipur, Mizoram, Meghalaya, Nagaland, Sikkim and Tripura.

**Union Territories are Andaman & Nicobar, Chandigarh, D&N Haveli, Daman & Diu, Lakshadweep and Pondicherry.*

Table 2.14

Projection of Personal Tax Income from Non-Salaried People

***(Method II:** Where all the under representation income is incorporated into 30 percent tax slab*(40% for50thRound)*

(Without Agricultural Activities)

(Tax Revenue values are Rupees in Crores)

	50th Round (1993-94)				**55th Round (1999-00)**				**61st Round (2004-05)**				**66th Round (2009-10)**			
	20% tax slab	**30% tax slab**	**40% tax slab**	**Total**	**10% tax slab**	**20% tax slab**	**30% tax slab**	**Total**	**10% tax slab**	**20% tax slab**	**30% tax slab**	**Total**	**10% tax slab**	**20% tax slab**	**30% tax slab**	**Total**
	Tax revenue ***(ETRs: 13.74%)***	Tax revenue ***(ETRs: 11.00%)***	Tax revenue ***(ETRs: 42.28%)***	Tax revenue	Tax revenue ***(ETRs: 0%)***	Tax revenue ***(ETRs: 4.42%)***	Tax revenue ***(ETRs: 26.46%)***	Tax revenue	Tax revenue ***(ETRs: 0.70%)***	Tax revenue ***(ETRs: 6.53%)***	Tax revenue ***(ETRs: 22.83%)***	Tax revenue	Tax revenue ***(ETRs: 0.70%)***	Tax revenue ***(ETRs: 6.22%)***	Tax revenue ***(ETRs: 21.74%)***	Tax revenue
Andhra Pradesh	229	4	1285	1518	0	128	1217	1345	28	365	9523	9916	22	1	28294	28317
Assam	76	0	126	202	0	55	344	399	3	378	893	1275	29	0	1749	1778
Bihar & Jharkhand	309	3	0	312	0	802	1072	1874	16	1312	1914	3241	154	17	4588	4759
Delhi	270	6	1592	1868	0	1	15	15	21	231	5561	5813	116	0	15125	15241
Goa	4	1	63	68	0	6	196	202	1	12	688	702	0	0	834	834
Gujarat	375	16	1223	1614	0	183	1901	2085	11	503	7974	8488	0	0	22201	22201
Haryana	114	10	569	692	0	154	1477	1631	0	333	3149	3482	3	0	9422	9425
Himachal Pradesh	23	0	46	69	0	19	146	165	4	98	452	554	3	0	693	697
Jammu & Kashmir	13	0	138	151	0	32	215	247	4	150	1082	1236	19	8	841	867
Karnataka	173	21	775	969	0	150	1387	1537	27	308	6394	6729	114	0	16672	16786
Kerala	143	0	670	813	0	101	908	1010	37	590	5704	6331	43	3	11314	11361
Maharashtra	523	114	3642	4279	0	425	3996	4421	38	1338	18631	20007	246	2	38290	38538
MP & Chhattisgarh	127	11	425	564	0	81	837	917	23	438	4391	4852	16	8	11441	11465
Orissa	34	4	105	143	0	33	359	392	7	336	2454	2796	14	0	4758	4772
Punjab	118	1	776	895	0	76	1055	1131	7	463	3102	3572	1	0	9684	9686
Rajasthan	158	6	255	420	0	317	3071	3388	32	586	3081	3699	42	0	6365	6407

Tamil Nadu	308	1	1513	1821	0	165	3575	3740	24	582	8927	9533	24	0	26580	26604
UP & Uttaranchal	413	17	430	860	0	368	2815	3183	117	1166	4411	5694	111	0	11987	12098
West Bengal	318	5	800	1122	0	2	117	119	1	1352	9104	10456	174	0	22002	22176
North East States	89	2	85	175	0	47	270	317	4	194	802	1000	11	5	1111	1126
Union Territories	17	2	78	97	0	1	14	15	2	48	728	778	10	7	1111	1128
All States & UTs	**3831**	**226**	**13422**	**17479**	0	**3147**	**24987**	**28134**	**408**	**10784**	**98962**	**110154**	**1154**	**50**	**245063**	**246267**

Note:
The above Projected Tax Revenues are based on the NSSO Unit level data on Employment and Unemployment.
^The lists of North East states are; Arunachal Pradesh, Manipur, Mizoram, Meghalaya, Nagaland, Sikkim and Tripura.
**Union Territories are Andaman & Nicobar, Chandigarh, D&N Haveli, Daman & Diu, Lakshadweep and Pondicherry.*

Table 2.15:

Estimation of Personal Tax Evasion

(Method I: Where all the under underestimated income is incorporated equally into 20 and 30 percent tax slabs*(30 and 40 per cent for50thRound))
(Without Agricultural Activities)

(Tax Revenue values are Rupees in Crores)

	50th Round (1993-94)				55th Round (1999-00)				61st Round (2004-05)				66th Round (2009-10)			
	Projected Tax Revenue	Collected Tax Revenue	Tax Evasion	Tax Evasion (Percent)	Projected Tax Revenue	Collected Tax Revenue	Tax Evasion	Tax Evasion (Percent)	Projected Tax Revenue	Collected Tax Revenue	Tax Evasion	Tax Evasion (Percent)	Projected Tax Revenue	Collected Tax Revenue	Tax Evasion	Tax Evasion (Percent)
Andhra Pradesh	2710	389	2320	85.63	5007	1052	3955	79.00	13088	2460	10628	81.20	27368	3983	23384	85.45
Assam	533	69	464	87.05	1425	187	1239	86.92	1753	532	1220	69.62	1912	403	1509	78.91
Bihar & Jharkhand	825	157	667	80.94	2978	424	2554	85.75	4499	1146	3353	74.53	4483	1216	3267	72.89
Delhi	2969	1233	1736	58.48	7866	3329	4537	57.68	12542	6835	5707	45.50	21161	11906	9255	43.74
Goa	189	39	150	79.26	516	106	410	79.45	1220	275	945	77.47	1801	290	1512	83.93
Gujarat	3019	592	2427	80.38	4912	1599	3313	67.44	11719	2525	9194	78.46	24488	3697	20791	84.90
Haryana	1153	126	1028	89.10	3108	339	2768	89.08	5971	1061	4911	82.24	11901	1402	10499	88.22
Himachal Pradesh	189	32	157	83.00	589	87	502	85.22	1013	208	805	79.46	941	210	732	77.73
Jammu & Kashmir	363	20	342	94.41	682	55	627	91.98	1559	134	1425	91.41	996	264	732	73.47
Karnataka	2383	637	1746	73.27	4568	1720	2848	62.35	10051	4522	5529	55.01	17921	15433	2489	13.89
Kerala	1299	189	1110	85.46	2607	510	2097	80.44	7033	912	6120	87.03	11413	1334	10079	88.31
Maharashtra	9929	3165	6764	68.12	15660	8548	7112	45.42	32442	15008	17434	53.74	59725	48657	11068	18.53
MP & Chhattisgarh	2150	199	1951	90.76	3258	537	2721	83.53	6695	1217	5478	81.83	11468	1921	9548	83.25
Orissa	522	64	457	87.66	1396	174	1223	87.55	3252	394	2858	87.89	4377	755	3622	82.76
Punjab	1506	222	1284	85.25	3435	600	2835	82.53	5726	1198	4528	79.08	11134	1130	10004	89.85
Rajasthan	939	196	743	79.09	4149	531	3618	87.21	4757	890	3867	81.30	6460	1487	4973	76.98
Tamil Nadu	3586	742	2844	79.31	8534	2004	6530	76.52	14799	3561	11238	75.94	28075	6046	22029	78.47
UP & Uttaranchal	2154	436	1718	79.76	6007	1178	4829	80.39	7803	2434	5369	68.81	12053	3223	8830	73.26
West Bengal	3026	518	2508	82.89	11554	1398	10156	87.90	12412	2189	10223	82.36	19965	11797	8169	40.91

North East States	347	20	328	94.38	689	53	636	92.35	1401	NA	NA	NA	1259	49	1210	96.15
Union Territories	278	76	203	72.83	897	207	690	76.93	1651	199	1452	87.96	2625	511	2114	80.55
All States & UTs	**36987**	**9123**	**27864**	**75.33**	**89835**	**24636**	**65200**	**72.58**	**161384**	**47699**	**113685**	**70.44**	**281526**	**115712**	**165814**	**58.90**

Note:

The collected Tax Revenues were 24.67, 27.42, 29.56 and 41.10 percentages of Projected Tax Revenues of 1993-94, 1999-00, 2004-05 and 2009-10, respectively.

The above Projected Tax Revenues are based on the NSSO Unit level data on Employment and Unemployment.

^The lists of North East states are; Arunachal Pradesh, Manipur, Mizoram, Meghalaya, Nagaland, Sikkim and Tripura.

**Union Territories are Andaman & Nicobar, Chandigarh, D&N Haveli, Daman & Diu, Lakshadweep and Pondicherry.*

Table 2.16:

Personal Income Tax in India: Potential revenue and Evasion

Year	Projected Personal Income Tax (in crore) (1)	Projected Personal Income Tax revenue as % GDP (2)	Projected Personal Income Tax revenue as % Tax Revenue (3)	Collected Personal Income Tax (in crore) (4)	Collected Personal Income Tax as % of GDP (5)	Collected Personal Income Tax % of Tax Revenue (6)	Personal Income Tax Evasion (in crore) (7)	Personal Income Tax Evasion as % GDP (8)	Personal Income Tax Evasion as % Tax Revenue (9)	Projected no of Assesses (in crore) (10)	Actual no of Assesses (in crore) (11)	Compliance ratio in percentage (12)
1993-94	36987.00	4.27	69.20	9123.00	1.05	17.07	27864.00	3.22	52.13	2.333	0.774	33.17
1999-00	89835.00	4.60	70.04	24636.00	1.26	19.21	65199.00	3.34	50.83	4.249	1.957	46.05
2004-05	161384.00	5.12	71.79	47699.00	1.51	21.22	113685.00	3.61	50.57	5.873	2.680	45.63
2009-10	281526.00	4.42	61.67	115712.00	1.82	25.35	165814.00	2.61	36.32	7.028*	3.372	47.98

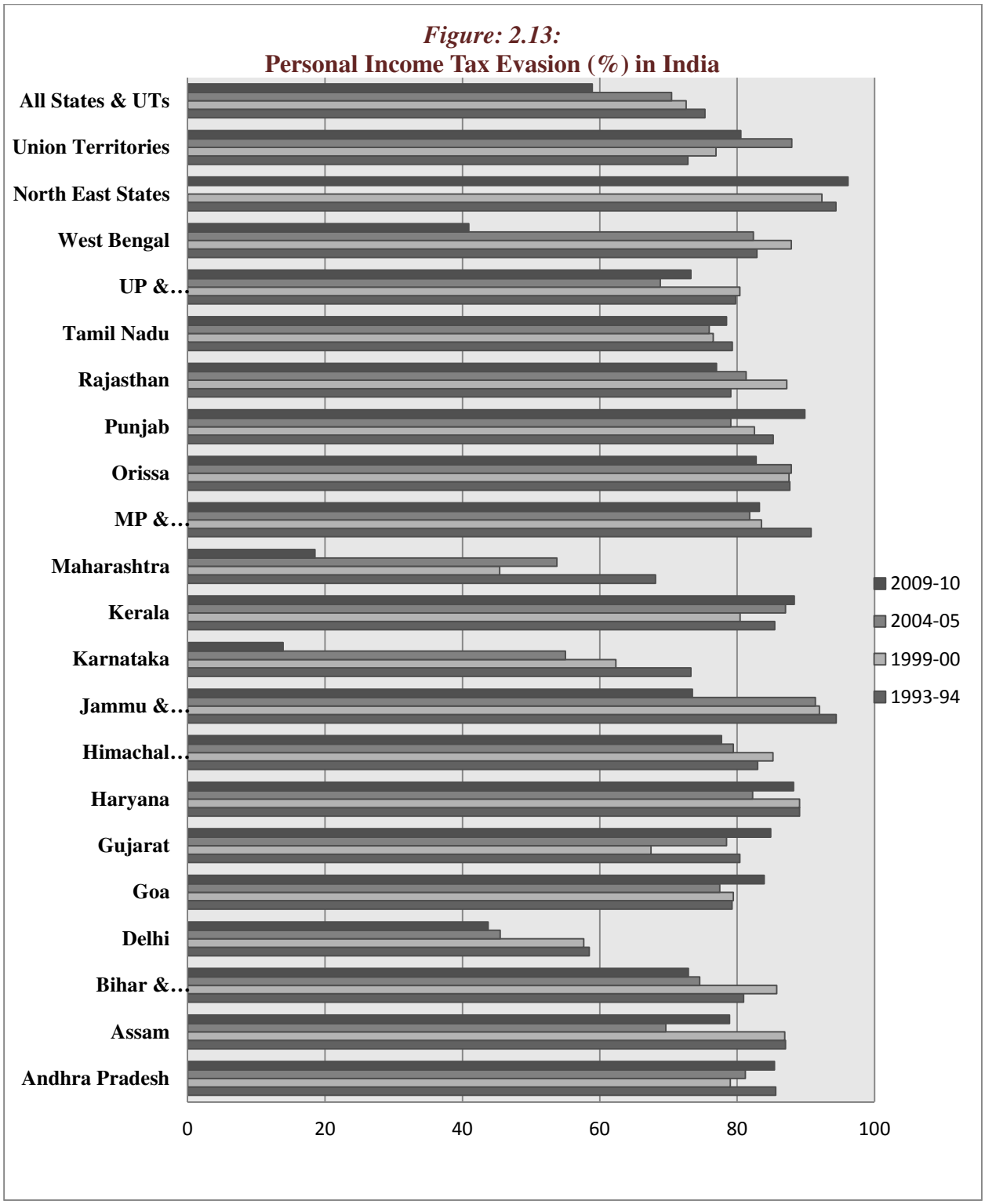
Source: *Own Calculation*

Note:

1. Estimated using Method I.

2. Income from agriculture and its allied activities were excluded while calculating tax evasion,

*3. *actual figure adjusted with trend*



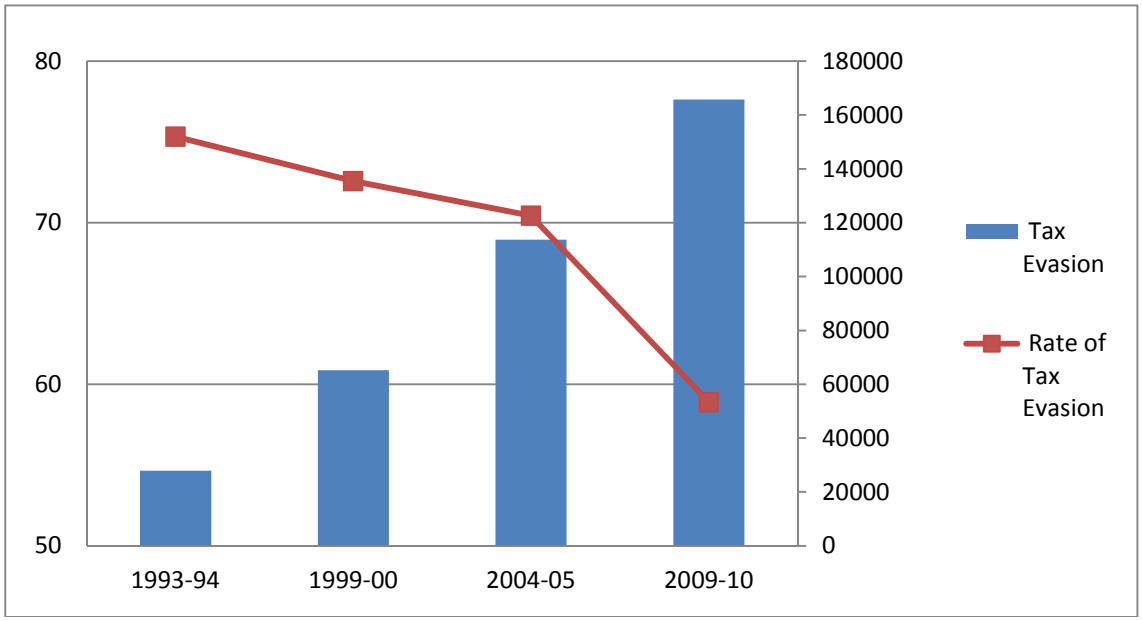
Source: *Own Calculation*

Notes:

1. Estimated using Method I (see also Table 2.15).

2. Income from agriculture and its allied activities were excluded while calculating tax evasion.

Figure: 2.14:
Personal Income Tax Evasion in India



Source:*Own Calculation*

Notes:

1. Estimated using Method I (see also Table 2.15).

2. Income from agriculture and its allied activities were excluded while calculating tax evasion.

Table 2.17:

Estimation of Personal Tax Evasion

(Method II: Where all the under representation income is incorporated into 30 percent tax slab*(40% for50thRound)

(Without Agricultural Activities)

(Tax Revenue values are Rupees in Crores)

	50th Round (1993-94)				55th Round (1999-00)				61st Round (2004-05)				66th Round (2009-10)			
	Projected Tax Revenue	Collected Tax Revenue	Tax Evasion	Tax Evasion (Percent)	Projected Tax Revenue	Collected Tax Revenue	Tax Evasion	Tax Evasion (Percent)	Projected Tax Revenue	Collected Tax Revenue	Tax Evasion	Tax Evasion (Percent)	Projected Tax Revenue	Collected Tax Revenue	Tax Evasion	Tax Evasion (Percent)
Andhra Pradesh	3864	389	3475	89.92	6330	1052	5278	83.39	18339	2460	15879	86.59	42537	3983	38554	90.64
Assam	669	69	600	89.68	1772	186	1586	89.48	2180	532	1647	75.57	2835	403	2432	85.77
Bihar & Jharkhand	825	157	667	80.94	3506	424	3081	87.89	5337	1146	4191	78.53	6655	1216	5439	81.73
Delhi	4306	1233	3073	71.37	9502	3329	6173	64.96	16602	6835	9767	58.83	33001	11906	21095	63.92
Goa	283	39	243	86.10	690	106	584	84.62	1774	275	1499	84.50	2861	290	2572	89.88
Gujarat	4100	592	3508	85.55	6424	1599	4824	75.10	16260	2525	13735	84.47	38266	3697	34568	90.34
Haryana	1623	126	1498	92.26	4114	339	3774	91.75	7994	1061	6933	86.73	18502	1402	17100	92.42
Himachal Pradesh	242	32	209	86.68	722	87	635	87.95	1274	208	1066	83.67	1439	210	1230	85.44
Jammu & Kashmir	543	20	523	96.27	855	55	800	93.60	2164	134	2030	93.81	1513	264	1249	82.53
Karnataka	3292	637	2655	80.65	5855	1720	4135	70.62	13309	4522	8787	66.03	27572	15433	12140	44.03
Kerala	1815	189	1627	89.60	3379	510	2869	84.91	9788	912	8876	90.68	17492	1334	16158	92.37
Maharashtra	14224	3165	11058	77.75	19908	8548	11360	57.06	43568	15008	28559	65.55	90294	48657	41637	46.11
MP & Chhattisgarh	2918	199	2719	93.19	4116	537	3579	86.96	9163	1217	7947	86.72	17633	1921	15713	89.11
Orissa	672	64	608	90.43	1751	174	1577	90.07	4485	394	4091	91.22	6789	755	6034	88.88

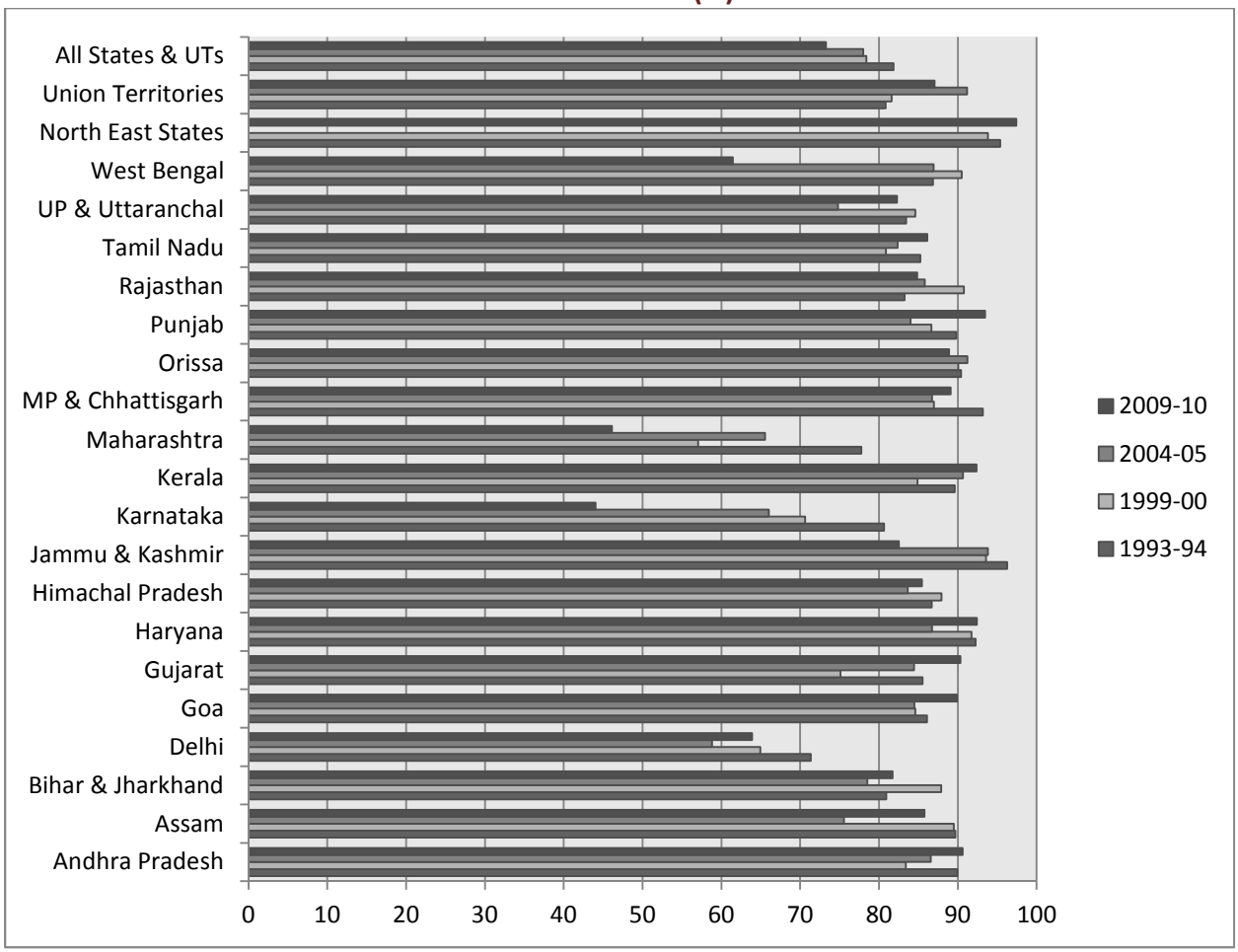
Punjab	2184	222	1962	89.82	4491	600	3891	86.64	7501	1198	6303	84.03	17295	1130	16165	93.47
Rajasthan	1174	196	977	83.26	5759	531	5229	90.79	6280	890	5391	85.83	9829	1487	8342	84.87
Tamil Nadu	5034	742	4292	85.26	10491	2004	8488	80.90	20194	3561	16633	82.37	43638	6046	37592	86.15
UP & Uttaranchal	2636	436	2199	83.45	7660	1178	6482	84.62	9662	2434	7228	74.81	18192	3223	14968	82.28
West Bengal	3943	518	3425	86.87	14706	1398	13308	90.49	16757	2189	14568	86.94	30599	11797	18802	61.45
North East States	423	20	403	95.38	853	53	800	93.82	1822	NA	NA	NA	1897	49	1849	97.44
Union Territories	395	76	319	80.86	1125	207	918	81.60	2250	199	2051	91.17	3940	511	3429	87.04
All States & UTs	**50269**	**9123**	**41146**	**81.85**	**114007**	**24636**	**89371**	**78.39**	**216702**	**47699**	**169004**	**77.99**	**432779**	**115712**	**317068**	**73.26**

Note:

The collected Tax Revenues were 18.15, 21.2, 22.01 and 26.74 percentages of Projected Tax Revenues of 1993-94, 1999-00, 2004-05 and 2009-10, respectively.
The above Projected Tax Revenues are based on the NSSO Unit level data on Employment and Unemployment.
^The lists of North East states are; Arunachal Pradesh, Manipur, Mizoram, Meghalaya, Nagaland, Sikkim and Tripura.
**Union Territories are Andaman & Nicobar, Chandigarh, D&N Haveli, Daman & Diu, Lakshadweep and Pondicherry.*

Figure: 2.15:

Personal Income Tax Evasion (%) in India



Source:*own calculation*

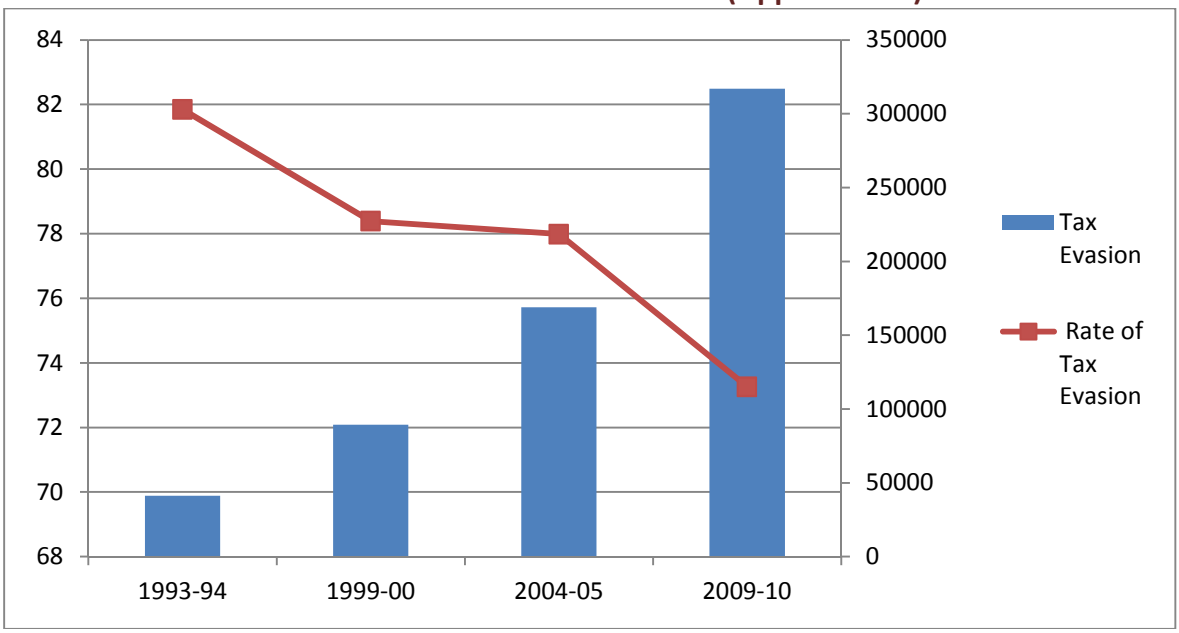
Notes:

1. Estimated using Method II (see also Table).

2. Income from agriculture and its allied activities were excluded while calculating the tax evasion.

Figure: 2.16:

Personal Income Tax Evasion in India (Upper Bound)



Source:*Own Calculation*

Notes:

1. Estimated using Method II (see also Table).
2. Income from agriculture and its allied activities were excluded while calculating the tax evasion.

Chapter - 3

SECTORS VULNERABLE TO UNACCOUNTED INCOME CAUSED AND CONDITIONS: STUDY OF SELECT SECTORS

3

SECTORS VULNERABLE TO UNACCOUNTED INCOME
CAUSES AND CONDITIONS: STUDY OF SELECT SECTORS

Background and Introduction

There are myriad of activities where tax evasion and avoidance is commonly observed worldwide. In developing countries like India the unrecorded/parallel economy constitutes a major proportion of the economic activity. The magnitude of cash transactions in this economy further escalates the problem of unaccounted income. There are some sectors in the economy that are more vulnerable to unrecorded income as a large proportion of unaccounted income[14] is generated and invested in these sectors. Some of the sectors are used to launder the unaccounted income generated elsewhere, and also to generate illicit funds within the sector itself through fraudulent activities.

Initially, in order to understand various aspects of unaccounted income or Black money and to identify (the) various sectors where the menace is more widespread, a large number of informal interviews with businessmen, tax practitioners, civil servants and other experts were pursued. This gave us some broad insights and some set of impressions were gathered. In order to justify and substantiate these impressions we decided to tap the experience and knowledge of senior revenue officials. Two sets of research instruments (for Direct and Indirect taxes) were designed. Focus group meetings with industry associations and chambers of commerce during the questionnaire design phase were undertaken. These threw up valuable qualitative

[14] The concept of unaccounted income used in the study is derived from the terminology used by the Income Tax Department. According to the Income Tax law, unaccounted amount detected in a particular year in any transaction entered into by an assessee is treated as income from unexplained/ undisclosed source for that year for the concerned assessee. Income Tax Act, 1961 envisages levy of penalty and interest on accrual of such income besides initiation of prosecution for such transaction.

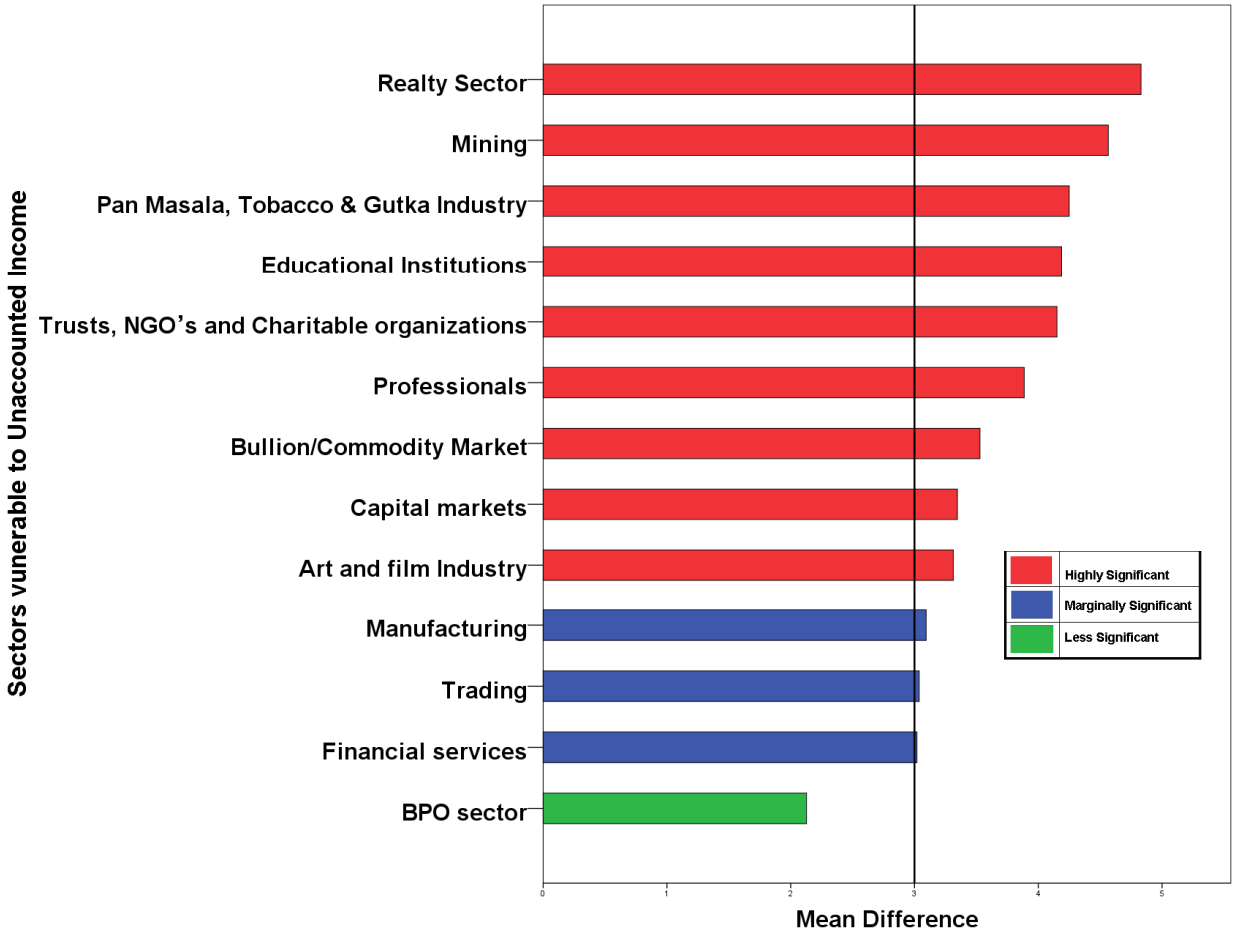
information and also several suggestions to improve the questionnaire. Half day workshops at the various commissionorates were conducted across the country (Kolkata, Delhi, Mumbai, Jaipur, Chennai, Coimbatore, Patna and Meerut) (See Annexure 3.2 and 3.3). The questionnaires were administered on senior revenue officials with at least 10 years of experience. The respondents were requested to indicate which industries, sectors and/or occupations were most likely to indulge in tax evasion and avoidance behaviours. They were also asked to indicate the most common methods of generation of unaccounted income in the vulnerable sectors and also suggest ways by which the unaccounted income is brought back into the main stream.

To this was added information gathered from unstructured interviews with experts, academicians and input from secondary data sources. Among secondary sources, information from various reports of the Comptroller and Auditor General (CAG), annual reports of Investigation Wing of Income-tax Department was also used.

The results from the field survey are presented in figure 3.1 (showing ranking of vulnerable sectors in order of gravity). During the survey, the respondents were asked to rank the sectors where the tax evasion/avoidance and generation of unaccounted income is high in order of their importance/gravity on a scale of 1-10. The survey results show that the sectors where unaccounted income is highest on a scale of 7 and above include real estate, mining, pan masala, gutkha and tobacco industry, bullion and commodity markets, film industry, educational institutes, and professionals. The other sectors, namely, securities market and manufacturing also showed high incidence of unaccounted income on a scale of 4-6. The graph depicts the sectors in order of gravity of the problem. One sample t-test has been used to test the significance of the parameters.

In addition to the survey, the Annual Reports of last five years of the Investigation Division of the Income Tax Department also studied. The most vulnerable sectors as pointed by relevant literature and annual reports included real estate, manufacturing, Diamond industry, mining, financial markets and professional sector.

Figure 3.1:
Sectors vulnerable to unaccounted income



Source: Field survey of senior revenue officials

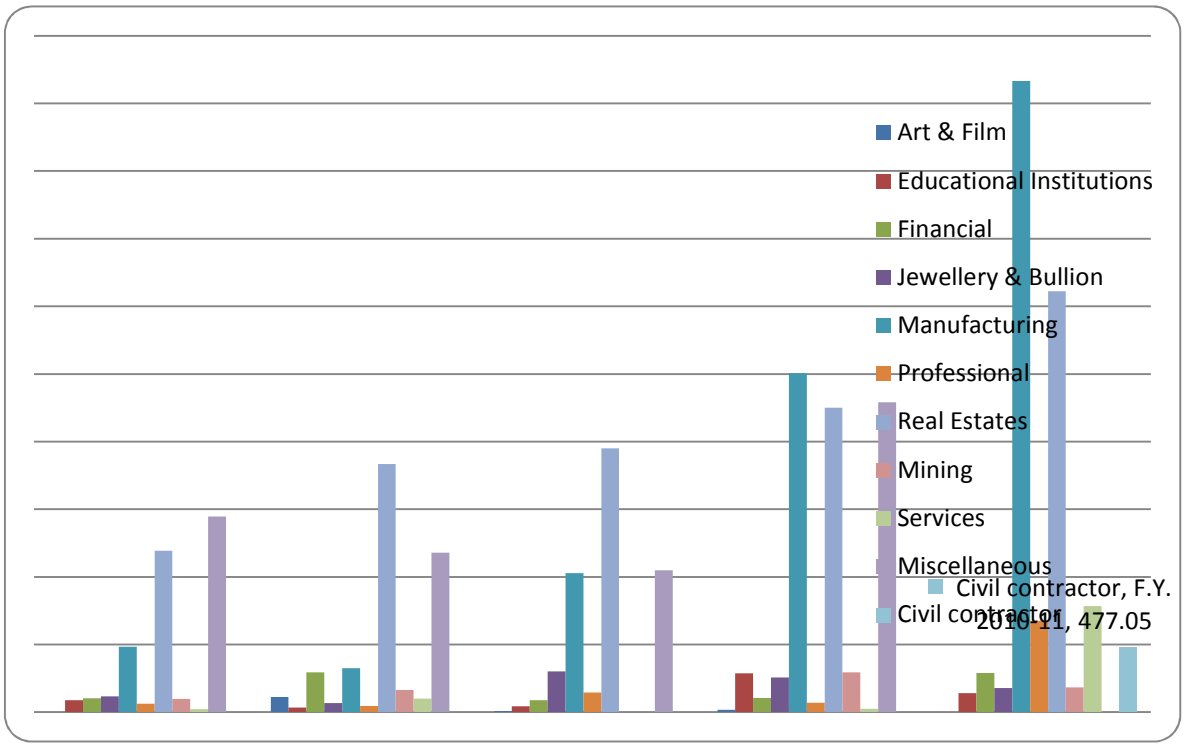
The searches conducted by the Income-Tax Department during the financial year 2009-2010 (financial year) led to an admission of undisclosed Income of ₹ 8101.35 crores in comparison to admission of ₹ 4613.06 crores during 2008-09. Thus, there is 75.62% growth in the total amount of undisclosed income admitted during searches over the year 2008-09. The admission of unreported income in 2010-2011 was ₹ 10,649 crores and this went up to ₹ 14,017 crores in 2011-12. The trend when seen in the context of number of searches conducted per year during last three years shows that there is constant growth in detection of undisclosed income which is admitted during the search

operations and the rate of growth is highest during 2011-12 as compared to last three years.

Table 3.1:	
Year-wise admission of undisclosed income	
Financial Year	**Admission of undisclosed income (in ₹ Crores)**
2006-07	3612.89
2007-08	4160.58
2008-09	4613.06
2009-10	8101.35
2010-2011	10649
2011-2012	14,017

Source: *Compilation from CBDT annual reports*

Figure 3.2:
Total admission in various sectors



Source: *Compilation from CBDT annual reports*

Sector-wise analysis of search

The Investigation Directorates during the 2009-2010 financial year conducted search operations in sectors broadly categorized as Real Estates, Manufacturing, Professional, Financial, Jewellery, Educational and Miscellaneous. The comparative chart of sector wise search operations shows that the number of searches in real estate sector is highest (80) followed by manufacturing sector (72) and jewellery sector (31) in 2008-09.

Table 3.2:					
No. of Groups Searched					
Sectors	**2006-07**	**2007-08**	**2008-09**	**2009-10**	**2010-11**
Art & Film	1	13	1	6	0
Educational Institutions	11	10	18	17	8
Financial	30	58	29	16	7
Jewellery & Bullion	31	28	33	31	21
Manufacturing	124	71	79	72	144
Professional	32	19	28	20	24
Real Estates	118	111	123	80	74
Mining	9	11	118	0	8
Services	7	18	0	0	17
Miscellaneous	156	114	0	145	0
Pan Masala / Gutkha	0	0	0	10	
Govt. Servants & Associates	0	0	0	11	
Total	529	453	429	408	303
Source: *Compilation from CBDT Annual Reports*					

Table 3.3:					
Sector wise Admission					
Sector	**2006-07**	**2007-08**	**2008-09**	**2009-10**	**2010-11**
Art & Film	0	111.66	9	17.34	0
Educational Institutions	87.61	35.16	43.6	288.22	140.1
Financial	101.7	295.24	87.8	104.25	289.71
Jewellery & Bullion	116.22	66.56	301	255.32	178.94
Manufacturing	482.66	325.75	1026.61	2507.16	4664.67
Professional	62.81	46.53	145.49	68.78	675.53
Real Estates	1192.74	1834.89	1950.86	2250.46	3112.4
Mining	98.68	164.02	0	294.29	182.85
Services	23.34	101	0	25.76	784.4
Miscellaneous	1447.13	1179.77	1048.7	2289.7	0

Civil contractor					477.05
Source: *Compilation from CBDT Annual Reports*					

The Tax department's search and seizure operations and the admission of undisclosed income sector wise indicates that real estate, manufacturing, Gems and Jewellery, mining , financial markets, informal service sector as some sectors more prone to tax evasion and playing a bigger play in the black or the cash economy.

The quantum of undisclosed income declared during searches by income tax department in the above indicated sectors is quite high and has also increased in the last few years. There was an over 200% jump in undisclosed income admitted by the manufacturing sector in 2008-09 as compared to previous year and around 100% jump in 2009-2010, though in absolute terms it still remained well behind the real estate sector. (The searches relate to evasion of direct taxes, mostly unaccounted income). Not just direct taxes, the manufacturing sector has also been on the radar for excise evasion. Excise duties, an indirect tax levied at the factory gate, have not grown at the same rate as the growth in manufacturing. Excise collections had peaked at ₹ 1.23 lakh crores in 2007-08 and are budgeted at ₹ 1.06 lakh crores in 2009-10. In contrast, manufacturing has grown at over 9% in the four years to 2007-08.[15] In 2008-09, growth had dropped to 2.8%[16]. Lot of manufacturing is in the unorganized sector, which also makes tax evasion easier and its detection difficult.

Real estate sector is always seen as a big generator of black money, as transaction values are often depressed to evade stamp duty and also absorb cash. Suppression of real value in transaction helps the buyer in ploughing back his unaccounted money into the deal and the seller in suppressing his capital gains tax liability or taxability of business income. This mutually beneficial arrangement at the expense of the exchequer generates unaccounted income easily. Stamp duty and registration expenses are levied by the state government and Income-tax is collected by Centre. In spite of the fact that

[15] DGCEI Annual report 2008-09
[16] DGCEI Annual report 2009-10

both are sufferers in terms of revenue by such undervaluation by the colluding parties, there is lack of co-ordination with the central and state governments.

Maximum number of cases picked up for search and seizure action relates to the real estate sector- 123 in 2008-09 and around 80 in 2009-2010. Sector wise details for 2011-2012 were not available. However looking at the trend, it can be said that in India real estate and manufacturing are the sectors highly vulnerable to unaccounted income.

The securities market and the diamond industry were also pointed out as the key sectors after realty sector where black money not only gets generated but also the illicit funds from elsewhere get consumed. The diamond industry attracts a fair share of unaccounted money as cash plays an important role in these transactions. It being a very high value item has got its inherent capacity of undervaluation/overvaluation. The interviews with the income tax officers also gave important insights into the methods and practices engaged and devices used in the securities market and diamond industry especially for conversion of unaccounted income to accounted income. The same were substantiated by the discussion with experts.

Given the resource and time constraint the present study has focussed more on the issues and challenges associated with unaccounted income in the real estate, manufacturing, securities sector and Diamond industry. The study team has tried to find out the major causes and conditions leading to generation of black money in these sectors. An attempt has also been made to suggest effective reforms for curbing /reducing the generation of black money.

Urban Real Estate Sector

Introduction

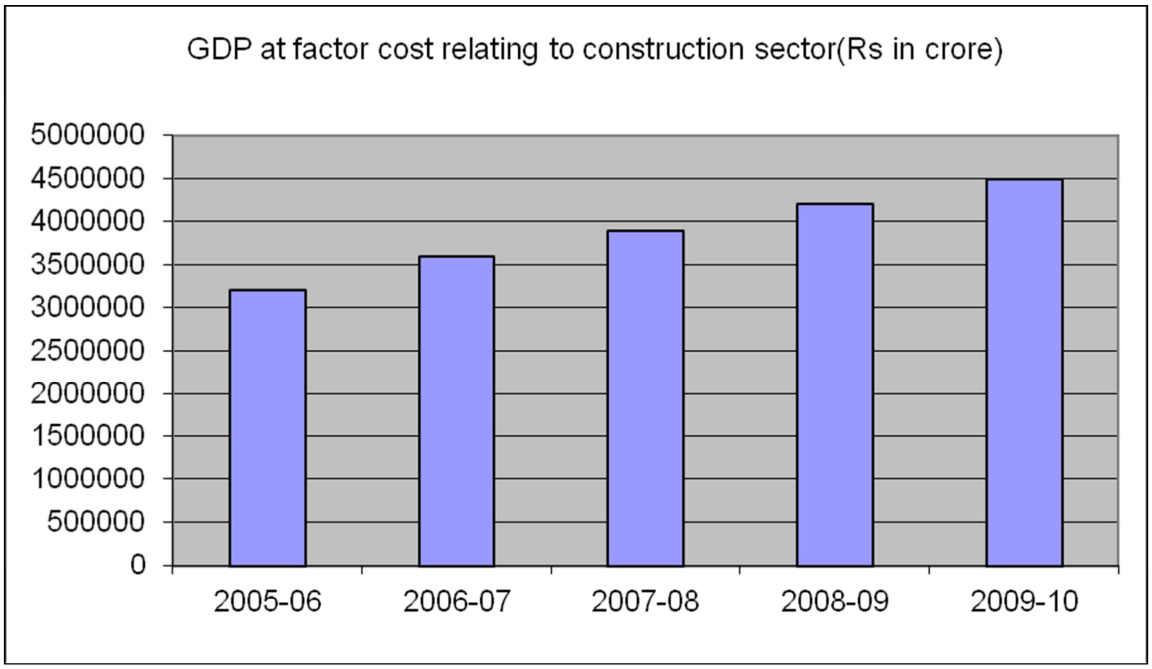
Real estate sector in India has emerged as an important driver of economic growth, both in terms of its share of GDP and its contribution towards employment generation. It is poised for growth on account of industrialization, urbanization, economic development and people's rising expectations for improved quality of living. In India, it

is observed that the contribution to GDP at factor cost (GDPFC) from real estate[17] is continuously on an increasing trend. The analysis of the CMIE data shows that contribution of the real estate sector to the annual GDP has increased from 9.55% to 10.7% in the last five years.

Table 3.4: Contribution of Real Estate, ownership of dwelling& business services to GDP			
Year	**Annual Real Estate[18] (₹ in crores)**	**Annual GDP (₹ in crores)**	**Contribution (% share of Real Estate[19] to GDP)**
Dec-05	267435.45	2799695.00	9.55
Dec-06	312903.26	3193169.21	9.80
Dec-07	367348.05	3744130.21	9.81
Dec-08	438571.56	4358677.10	10.06
Dec-09	518471.10	4981797.46	10.41
Dec-10	616833.79	5762257.43	10.70

Source: CMIE Reports

Figure 3.3:
GDP at factor cost relating to Construction Sector



Source: CAG Performance Audit Report No.12 of 2011-12

[17] CMIE data shows the data as compiled for real estate, ownership of dwelling & business services
[18] ibid
[19] ibid

In most OECD countries, it is seen that the real estate sector is a sizable sector and its activities contribute between 5 to 15 percent to the value added (and thus Gross Domestic Product). In Germany, e.g. the real estate sector amounts to 12 per cent and is the second largest industry after production, and before retail and wholesale. In Italy, it amounts to 13 percent of the GDP, in the UK to 7.5 per cent, and in Australia to 15 per cent[20].

Real estate sector in India in common parlance signifies land and buildings that may include different stages such as land development, building construction and economic exploitation of the real estate properties. Land may include undeveloped and developed land and buildings can be categorized as residential (houses and apartment buildings); and non-residential (offices, industrial buildings, commercial buildings, public buildings).

Literature Review

Literature and empirical evidence points out that the real estate sector is targeted in most economies as a means of generating unreported income and is also vulnerable to money laundering and tax fraud. The OECD surveyed 18 countries in mid- 2006 to examine the extent of illegal practices within the real estate sector[21]. The main findings confirm that this sector has been used as a conduit for fraud or illicit financial deals in most of the countries surveyed. The actual extent of the problem in these countries however remains unclear.

Financial Action Task Force (FATF)[22] and World Bank have focused on various risks that this sector contains. The OECD report[23], highlighted three common methods and

[20]Brigitte Unger and JorasFerwerda, 2011, "Money Laundering in the Real Estate Sector Suspicious Properties" pg.8

[21]OECD (2006) Report of the Centre for Tax Policy and Administration on "TaxFraud and Money Laundering Vulnerabilities involving the Real Estate Sector".

[22] The range of cases studies in the FATF typology report, "Money Laundering & Terrorist Financing through the Real Estate Sector" indicates that real estate transactions are very attractive for laundering the proceeds of a wide range of crimes.

[23] Various reports by vigilant international bodies during the last few years have mentioned that the real estate sector is considered one of the many vehicles used by criminal organizations to launder their illicitly obtained money. Several studies have been made on criminal behaviour in the real estate sector (e.g. FATF/GAFI, 2007). One of the prominent report is the OECD (2006) report of the Centre for Tax Policy and Administration on "Tax Fraud and Money Laundering Vulnerabilities involving the Real Estate Sector". The OECD surveyed 18 countries in mid-2006 to look how widespread these illegal activities are within the real estate sector and explore possible ways to combat them.

schemes for tax fraud and money laundering used in the sector namely price manipulation (escalating prices make it easier to manipulate prices of properties and transactions), undeclared income / transactions and the use of nominees and/or false identities, and corporations or trusts to hide the identity of the beneficial owners.

A survey on bribery and corruption in India by global consultancy firm KPMG has found the real estate and construction to be the second most corruption-prone area after telecom. The survey, which was based on ratings of industries by different respondents, reflected that some industries tend to have relatively higher instances of bribery and corruption than others, primarily due to the link they have with multiple parties, both in the government as well as the private realm. Almost 32 percent of the respondents surveyed regarded real estate and construction to be the most corrupt industry. In this sector, government and political intervention is considered higher. Large capital investments, multi-level approvals, complex processes and huge projects give immense opportunity for corruption and hence ground for unaccounted income[24]. The World Bank's Doing Business Report 2010[25] estimates that 60-80 percent of building projects (construction) in developing economies are undertaken without adequate permits and approvals.

The field survey and the various reports of the Investigation Directorates of CBDT[26](refer figure 3.1 and 3.2) also indicate the high vulnerability of this sector in India towards unaccounted income. According to these reports there is easy absorption and generation of black money in this sector. Discussions with experts also revealed the vulnerabilities in the Indian context, like lack of harmonized regulation and absence of a strong database making it more attractive for investment of illicit activities and criminal money. The transaction values are often suppressed to evade stamp duty and also to absorb unaccounted cash.

[24] Survey on Bribery and Corruption; Impact on Economyand Business Environment, kpmg.com/in
[25]World Bank's Doing Business Report 2010
[26] Annual reports, Investigation division CBDT Ministry of Finance Department of Revenue, GOI

The empirical analysis[27] is based on field surveys in fourteen cities including Delhi, Gurgaon, Faridabad and Jaipur in the northern region, Mumbai, Ahmedabad, Surat and Vadodara in the western region, Patna and Kolkata in the eastern region and Bangalore, Hyderabad, Coimbatore and Vijayvada in the southern region of the country. The data on total stamp duty during 2010-2011 for each of the states and the registration fees collected along with the total number of registered documents was gathered from the Inspector General Registration Office of the states. The data in some states was not available for the entire year and in some data for 2009-2010 and 2010-2011 was also received. In order to understand various aspects of unaccounted income or black money informal interviews with brokers, builders and the customers were pursued. The annual reports and search and seizure data of CBDT was studied and impressions from the officers of various state registration department were also gathered. The interactions gave some idea about some of the causes and conditions which are contributing to generation of unaccounted money in this sector and also some rough estimates of the amount of unaccounted income in circulation in the year in that city. The informal interviews with the brokers and builders in these cities gave an idea about the market price of the property. Although circle rates or the official property prices vary even within the city and area wise also there are large disparities and variations in rates some impressions were generated. Broker information indicates a high percentage of black payments; however one thing was apparent that there was little hope of achieving definitive quantitative estimates. Size of the sample of information from this source was not big enough to warrant full confidence. Yet looking and analysing the urban real estate sector data one can definitely recognize the fact that the principal form of black money is undeclared capital gains, defined as the non-cheque portion of the proceeds of sale of a property. The results from the survey are discussed later in the chapter.

Reasons for vulnerability of real estate sector to unaccounted income

[27] Initially, it was intended to carry out the study for this sector for all the states in India. However, because of limitations in getting data from the official sources has limited our scope for the study.

- Real estate properties are high value and high-yield investments and its correct value can be easily under/over declared.
- The real estate market lacks the transparency and homogeneity of most financial markets, and so fraudulent transactions may be more difficult to identify. As each property has unique features, the market is heterogeneous. (For example, on a survey of Delhi market, it was found that no authentic information was available on number of dwelling units in unauthorized colonies and transfer of properties in resettlement colonies and their modification into larger units.)
- High real estate turnover and use of large amounts of cash coupled with corruption and possibility of complex layering of transactions help and assist in laundering illegal proceeds and tax abuse.
- The possibility to conceal ownership increases the vulnerability in the sector. It has been observed that ownership can be concealed by a) use of nominees/ benami transactions; b) unreported acquisition of properties overseas; c) on shore acquisitions through offshore companies and/or through a complex structure of ownership; and d) property flipping.[28]
- Rapidly escalating prices of residential and business properties due to population pressures make it an attractive destination for investment.
- Real estate agents and other intermediaries in this sector act as key facilitators of money laundering and tax fraud by assisting in concealing ownership and accessing fraudulent loans through false applications.

Causes and Conditions for Generating Unaccounted Income

[28] Chain of buying and selling where the value of real estate increases in a short period of time and where the identity of the real contracting parties is unclear

The real estate sector involves a wide range of activities with different characteristics. The causes and conditions leading to generation of unaccounted income have been studied by classifying these activities[29] in the stages of:

a) land acquisition;

b) building and construction process; and

c) in the resale market;

Land Acquisition

Land acquisition is the first phase of real estate development. Political patronage and payment of large amounts of cash are observed as primary considerations for allotment/ purchase of land in auction from the government. As per CAG report (Revenue Receipts) for the year ended 31st March, 2011, hill station type areas in Pune district were identified without any expert study or survey and Lavasa Corporation Limited (LCL), the developer was selected without any transparency. The project was driven by private interests rather than public interest. The Maharashtra state government's policy decision in November 1996 to develop townships in hill station type areas with participation of private sector, was implemented without wide publicity/ inviting Expression of Interest, resulting in only one project namely the Lavasa, being sanction in June 2001, in Pune district.

Conversion of land use is another area where discretion is could be exercised according to bribes paid. Conversion of agriculture land to urban use can escalate its price many fold as commercial potential of land can then be exploited. Unauthorised occupation of land is often regularized through payment of bribes (observation during field interactions).

State regulations dealing with land are interpreted in different ways by different authorities giving rise to confusion and corruption. Sometimes, inside information prompts abnormal bids for lands where restrictive or no construction is permissible.

[29] Commercial real estate is also an important activity. However, because of paucity of time and constraint, it has not been included in the present study.

However, later the authorities permit more construction benefiting the bidders. Many a times, builders or investors being privy to inside information on critical infrastructure projects buy huge parcels of land from farmers before it is earmarked as a site for the project and later sell it at a multiple amount.

Greater Noida Indusl.Devt. Auth.Vs.Devendra Kumar and OINR MANU/SC/0806/2011

Proceedings of acquisition of land of Village Shahberi located in District Gautam Budh Nagar, Uttar Pradesh were carried out in the name of planned industrial development. The Supreme Court examined whether colourable exercise of power vested in the State Government under the Land Acquisition Act, 1894 read with the Uttar Pradesh Industrial Area Development Act, 1976 and the New Okhla Industrial Development Area (Preparation and Finalisation of Plan) Regulations, 1991 and held that the whole exercise of acquisition was designed to serve the interest of the builders and the veil of public purpose was used to mislead the people in believing that the land was being acquired for a public purpose. It was found by the Court to be nothing but a designed attempt by the functionaries and officers of the State Government and the Authority in connivance with the builders to frustrate the right of the tenure holding Lack of bona fides on the part of the State Government and the Authority further also clearly evincible from facts and circumstances of the matter and conduct of proceedings. Greater Noida Authority was directed by Court to pay cost for undertaking an exercise of allotment of land to the builders in complete violation of the purpose for which the land was sought to be acquired and even before approval by the State Government for the change of land use. The Court directed that those who have paid money to the builders for booking flats etc., to get back the amount along with interest at an appropriate rate.

A Delhi based group which is engaged in the business of land trading and construction was searched and incriminating documents were seized showing suppression of profits on the business transactions made by the group. Evidence was also found regarding cash payments by the group for purchase of land. On the basis of the above, the key person of the said group made a disclosure of unaccounted income of ₹ 52 Cr.

Source; CBDT Annual Report, 2009

The Land Acquisition, Rehabilitation and Resettlement Bill, 2011 was introduced in Parliament in September 2011 and was referred to a Parliamentary Standing Committee which submitted its recommendations in May, 2012. It is expected that the Bill after its

enactment will bring systemic improvements and increase the transparency in area of land allotment in the country.

Building and Construction Process

With acquisition of land, the builder has to decide the nature of construction and also seek various permissions and licenses by paying off official in government agencies for entitlements, such as, approval for drawings electricity/water connection, completion certificate, municipal and fire clearance, etc.

How much area can be constructed depends on the FSI[30] available on the land. Interpretation of FSI is flexible as it varies from area to area, and even case to case. Opaque mechanism of awarding FSI to different parts of the same city, give birth to corruption and in turn, black money.

Over and above FSI, the builder can obtain TDR (Transfer of development rights)[31]. Likewise, a person whose land is acquired for public cause, say for a Bus depot, may be paid off in terms of TDR rather than money. This is a marketable right which gives a right to the purchaser for further construction, over and above the construction available as per FSI. Valuation of TDR is again a thorny issue. Like that of land, its purchase consideration is almost always underreported.

A group of Pune engaged in business of executing civil contracts was searched by I.T. Authorities. During the search operation it was found that the group was inflating expenses under the head Site Expenses by preparing non genuine cash vouchers. It was also found that the group was investing the unaccounted income generated through this modus operandi in purchasing assets such as land, TDR etc. The undisclosed additional income of ₹ 2 crores were admitted during search for the FY 2006-07, 2007-08.

[30](FSI of 1.33 means that the Builder can construct, say, on a piece of land admeasuring 1000 sq yd, 1333 sq. yd. As per BMC rules, areas included in staircase, balcony, basement etc are not counted in FSI, Staircase, balcony, etc has to be constructed over and above the FSI available to him. Additional FSI is available to Institutions, Hospitals, Govt... Buildings, for slum Development, or on handing over of land for public Purposes etc.)

[31]TDR is a marketable right obtained by a person who helps in construction for a public cause. Builders, who construct low cost housing for government (the housing of poor people), may get TDR from the government in accordance with the policy framed for this purpose as government is generally not in a position to give monetary compensation.

This cycle of cash payments in land acquisition and seeking multiple approvals by builders distorts revenue recognition, land valuation, supplier's payments, and utilization of loans and so on. Builders suppress the sale price and consequent incidence of tax by accepting cash from customers. They charge for amenities they are not supposed to and so insist on cash payments. The Bombay HC disallowed the sale of common areas but still builders charge for parking slots or by built up area instead of carpet area.

Builders violate loan terms by exploiting bank finance. They buy land, advertise a scheme and collect 20% of the booking amount from the buyers. But instead of beginning construction, they use the loan to buy another plot for a new project in-spite of the fact that banks are not allowed to fund land acquisition and NHB guidelines also require them to produce certificate of end use in case of funding for land acquisition by NBFCs. Debt structured as equity with foreign developer and underreporting debt by creating SPV are also the methods used for getting bank financing.

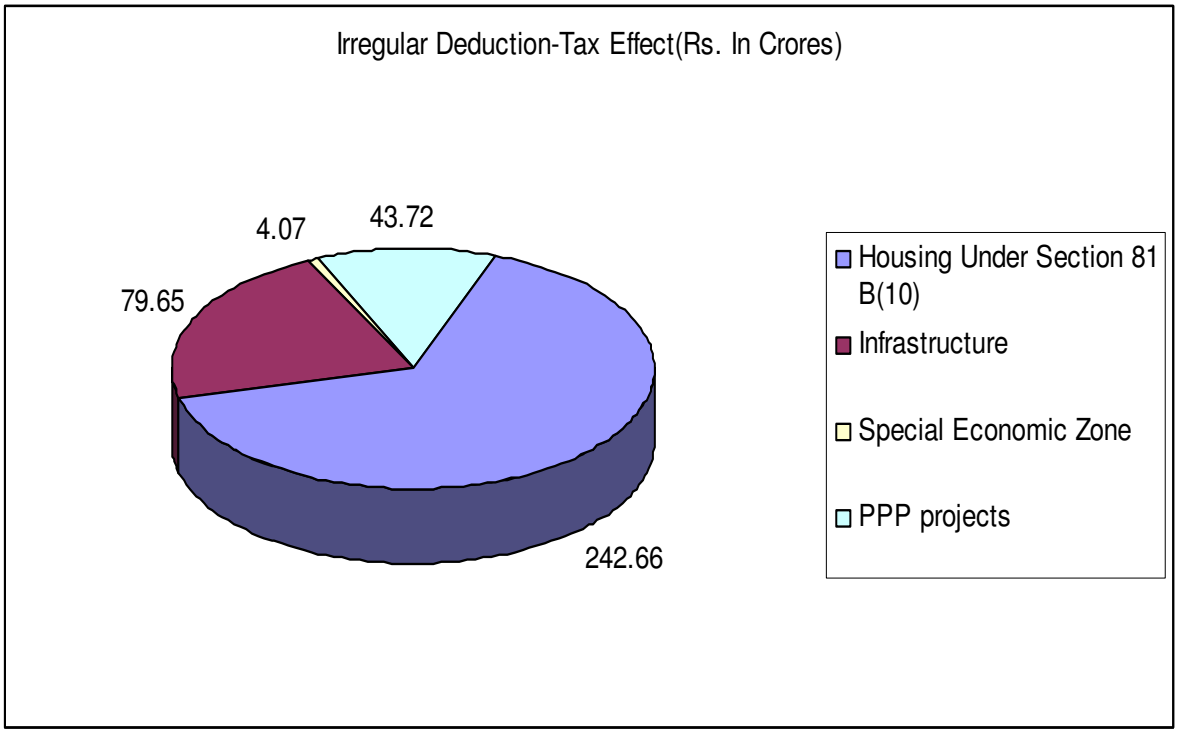
These distortions in the realty/construction sector have a ripple effect in the other sectors which are connected to it. Thus, the involvement of developers such as Unitech and DB realty had repercussion spilling over the 2G sector resulting into in 2G scam, Money matters, a loan broking company of one Shri. Rajesh Sharma arranged loans to builders by bribing banks and financial institutions, unleashing corruption in banking and financial sector.

The builders and developers often indulge in sharp accountancy practices and do not report the actual percentage of completion of the project. In developed markets, the revenue recognition standard in case of construction projects requires the revenue to be recognized only on delivery. However, in India the builder lobby has prevailed to let percentage completion method [32]of revenue recognition continue which (i) does not differentiate between finished products and stock-in-trade and (ii) does not provide incentive to builders to commit period of delivery. The builder decides what the work-in-progress is during the year and the progressive WIP up to the year and when to declare completion of the project leaving a scope for manipulation and window dressing in accounting. Further, there is a tendency on the part of builders and developers to inflate the expenses yet to be incurred for completion of project so as to reduce the overall profit from the project. Some of the ways of inflating expenses are, booking indirect expenses to the project cost; booking expenses of engaging shadow workers etc.

Besides such relaxed accounting practices, the real estate lobby is adept in extracting tax concessions from the government. Thus deductions from income under sections 80 IA/80 IB of Income Tax Act, 1961 in the name of development of infrastructure are more often than not wrongly claimed to suppress taxable income and generate black money by circumventing the law.

[32]For estimating income on the basis of percentage of completion method, first of all total revenue and total expenses of the project are estimated to estimate the overall profit from the project. Generally, the actual cost incurred on the project is divided by the total project cost to compute percentage completion of the project unless some other method is justified.

Figure 3.4:
Irregular Deductions- Tax effect (₹ in Crores)



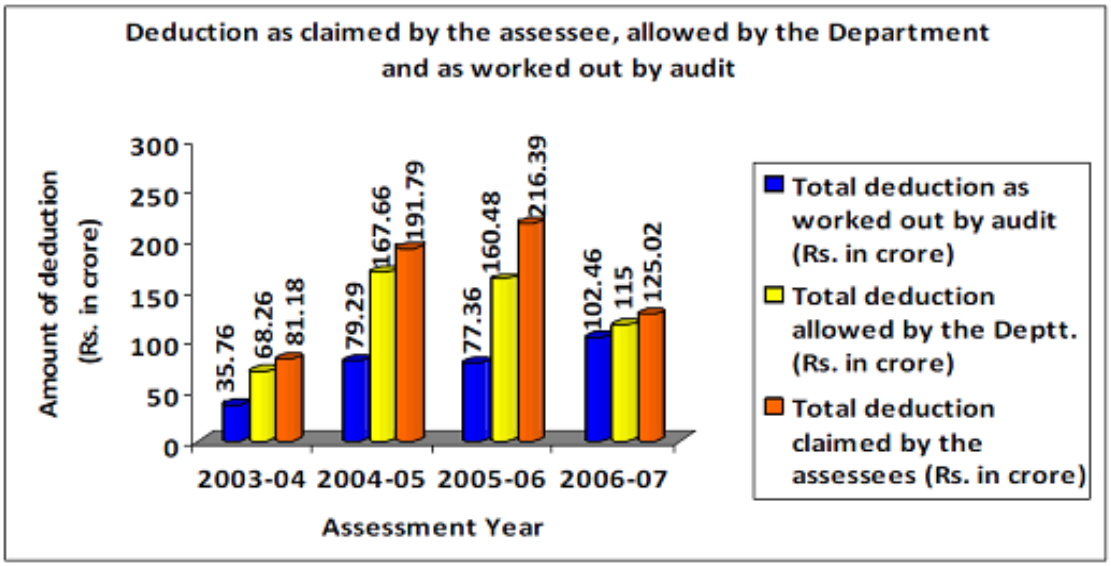
Source: *CAG Performance Audit Report, 2011-12.*

Thus, 92 cases involving effect of ₹ 242.66 crore where deductions were allowed even though the builder did not fulfill either of the conditions specified in the Income Tax Act, 1961 have been reported by CGA Performance Audit Report, 2011-12.CGAAuditstudyfor2009alsorevealed that the number of irregularities in Housing sect or (section 80IB [10])is morethanothersectorsundersection80IB.Itcan be observed from the status ofdeductions shown in the chart, that there is potential for further realisation of revenue to the extent of over-claimed deductions.

M/s Akruti Nirman case for assessment Years 2001-02 to 2007-08 were completed under section 143(3) /153A and 143(3) of the Income Tax Act. During the course of the search assessment, various enquiries /investigations were made with respect to the projects undertaken by the assesse and accordingly the assessment was finalized on 30/12/2008. Total additions made in assessments exceed ₹ 120 crores and the total demand raised are₹ 44 crores. The claim of deduction under section 801B amounting to ₹ 70 crores was denied to the assesse. Apart from these disallowances u/s 801A(4), additions on account of deemed dividend u/s 2(22)(e), disallowances u/s 14A and additions on account of undisclosed

sales and unexplained expenses were also made on the basis of loose papers found and seized at the assesse' s office.
Source:*Annual Report 2008-09, Investigation Division, Central Board of Direct Taxes, Ministry of Revenue*

Figure 3.5:
Status of Deduction in Housing Sector



Source: *CAG Performance Audit Report, 2008-09.*

MM Buildcon Pvt. Ltd., Shivgori Builders Pvt.Ltd. Witness Builders Pvt. Ltd and Believe Developers and Promoters Pvt. Ltd.
Total addition of ₹ 106 Cr. was made in the hands of these four companies on account of sale of land to Ansal Group of companies. The main issue involved was of benami payments to various MDLR Group entities and signing of sham agreements to sell to disguise the amount of payments and nature of transactions. Additions were also made in these four cases on account of disallowance of bogus losses claimed by them on account of forfeiture of advance money. The additions were made on the basis of third party inquiries and seized documents.
Unity Group of Cases
In the course of the assessment proceedings it was observed that the assesse group has claimed deduction under Sections 80IA & 80IB of the I.T. Act, 1961 amounting to ₹ 37.37 Cr. and ₹ 13.94 Cr. respectively. A detailed analysis and investigation were carried out from the contract agreements executed by the assesse, and it was observed that the assesse was a contractor in executing the infrastructural projects. The detailed analysis of the statutory provisions was done and the recent judgment of the special Bench of the Mumbai ITAT in the case of M/s. B.T. Patil & Sons Constructions was also perused. Analysis of the facts and circumstances

of the case, coupled with the application of the legal pronouncement has resulted in raising demand of ₹ 68.02 Cr. on account of disallowances of deductions claimed under Section 80IA & 80IB of the I.T. Act, 1961.
Source:*Annual Report 2009-10, Investigation Division, Central Board of Direct Taxes, Ministry of Revenue, GOI*

The builder retains some residuary rights in the project even after the project is completed and fully sold out. Such rights include, right of maintaining of flats/houses and collecting the charge for the same till a society is formed; sale of parking lots; unexploited FSI; terrace rights including the right to put up hoardings; right to use unoccupied land which can be leased out of commercial purposes; and rent from Community Hall when it is leased for purposes like marriages, etc. The value of these rights and income they generate is generally not disclosed in the books of accounts and in the return of income.

The Resale Market

The widest form of generation and investment of unaccounted money is found in the resale market. Under declaration of property values in transactions leading to generation of huge amount of black money in the system and transfer of property in the name of benami[33] lead the menace in this market. The *Benami Transactions (Prohibition) Act,* 1988 sought to prohibit such transactions (essentially by removing the ability of both parties to claim title to the asset. However, it has not been effectively implemented as has been admitted by the Government itself. The amendment has further diluted its provisions by excluding spouse from definition of benami owner. The High rates of taxes-stamp duty, varying from 5-14% and long-term capital gains of 20% encourage both buyer and seller to under report the value of transaction and transact the differential in cash.

A buyer of property pays two taxes which are levied by state governments: stamp duty and registration. Stamp duties are typically a one-time charge on the transfer of

[33] Benami transactions are transactions conducted in the name of a person who does not pay any consideration for the underlying asset, but merely lends his name while the real title remains vested in the true owner.

immovable property; tax base of which is the value of the transaction. The state governments have laid down the circle rate which is the basis on which the Stamp Duty is calculated. The sale-purchase of a property and stamp duty also attracts provisions of Income Tax Act, 1961. As per Section 50C of the Income-tax Act, 1961, while computing the capital gains of a person on selling immovable property, the sale consideration as declared by the tax payer (in Sale Deed etc.) will be replaced by the "circle rate" of the property and accordingly, the capital gains would be computed.

In contrast, a "registration fee" is a payment made for a specific service provided by government in recording contracts and deeds, which is also a requirement of law on transfer of property and so is more closely related to a user charge. The government maintains a registry of deeds in return for a fee. However, the payment of the registration fee does not entitle the payee to a guaranteed legal title. For the most part, government agents (called "sub-registrars") are not concerned with the legal validity of the document but only with the correct payment of the fee.

As the stamp duty on property is usually paid by the buyer, he tries to coax the seller to agree to undervalue the property on paper and accept the rest in black money. On the other hand, sellers have an incentive in accepting black money from the buyer in order to evade the taxation of capital gains. Parties involved in the transfer of property transaction are required to pay a part of the consideration in "black money" as the value of the property is declared at a lower price on the sale deed than the one at which the transaction actually occurs, that is, they must pay the difference in cash. In this way, the cash consideration paid is not recorded as part of the transaction, be it for the buyer or for the seller. The seller is in possession of black money that is unlikely to be whitened as long as continued operations in the black economy are possible and desirable. Given the high levels of stamp duty rates, many immovable property sales transactions are deferred and many are not even recorded.

If the seller is a builder, he benefits by having to explain source of lesser amount of investment and book construction expenses on material and services in cash (thus evading sales and excise taxes) besides making on money payments in bribes for getting

approvals. In this way the black money continues to circulate in the black economy. The issue has also been highlighted by the World Bank Policy Research Working Paper titled, "Stamp Duties in Indian States- A Case for Reform".

During the search on a Mumbai based group engaged in the business of real estate development, it was found that the assesse was maintaining its financial accounts in two accounting softwares, namely ERP (SAP) and 'TALLY". The ERP software contained the genuine purchases of materials made by the assesse company. The 'TALLY' software contained the combined records of genuine purchases as well as the bogus purchases. It was found that the assesse had debited non-genuine purchases of ₹ 361 Cr. in its books. Further evidences showing unaccounted cash receipts from the sale of flats amounting to ₹ 39.62 Cr. and undisclosed sale of scrap materials of ₹ 7.69 Cr. were found and seized. The company declared an undisclosed income of ₹ 350 Cr. and paid tax of ₹ 40 Cr. so far on the undisclosed income admitted.
Source: ***Annual Report 2009-10, Investigation Division, Central Board of Direct Taxes, Ministry of Revenue, GOI***

Suraj Lamp and Industries Pvt. Ltd.Vs. State of Haryana and Anr.
Special Leave Petition (C) No. 13917 of 2009 MANU/SC/0806/2011
Four states confirmed Sale Agreement (SA)/General Power of Attorney (GPA) /Will transactions required to be discouraged as they lead to loss of revenue (stamp duty) and increase in litigations due to defective title. While deciding on whether, SA/GPA/Will transactions are valid, the Supreme Court held, immovable property could be legally and lawfully transferred/conveyed only by registered deed of conveyance. Transactions of nature of GPA sales or SA/GPA/WILL transfers did not convey title and did not amount to transfer, nor could they be recognized or valid mode of transfer of immoveable property. They could be continued to be treated as existing agreement of sale. However, nothing prevented affected parties from getting registered Deeds of Conveyance to complete their title. SA/GPA/WILL transactions could also be used to obtain specific performance or to defend possession under Section 53A of Act.

Field Analysis

The empirical analysis on the real estate sector was carried out [34] based on field surveys in fourteen cities spread out in the country including Delhi, Gurgaon, and Jaipur were selected in the northern region, Mumbai, Ahmedabad, Surat and Vadodara in the western region, Patna and Kolkata in the eastern region and Bangalore, Hyderabad, Coimbatore and Vijayvada in the southern region of the country. The state-wise data on total stamp duty and registration charges collected during 2010-2011 along with the total number of transfers of properties registered documents was gathered from the office of the Inspector General (Registration) Office of the states. The data in some states was not available for the entire year and in some data for 2009-2010 was also received. In order to understand various aspects of unaccounted income involved in the realty sector, interviews of brokers, builders and the customers were carried out. Impressions from the officers of various state registration departments were also gathered. These interviews formally through questionnaires and informally by personally interacting with the concerned respondents provided invaluable insights into the issues relating to unaccounted money and its role in the real estate sector. The informal interviews with the brokers and builders in these cities gave an idea about the market price of the property. It was observed in many cases that the value adopted by the stamp valuation authority in form of circle rates is much lesser than the fair market value of the properties on the date of transfer. Large disparities and variations have been noted in the different parts of the country. Broker information indicated a high percentage of black payments; however one thing was apparent that there was little hope of achieving definitive quantitative estimates of unaccounted money involved in these transactions. Size of the sample of information from this source was not big enough to warrant full confidence. Yet looking and analysing the urban real estate sector data one can definitely recognize the fact that the principal form of black money is undeclared capital gains, defined as the non-cheque portion of the proceeds of sale of a property.

[34] Initially, it was intended to carry out the study for this sector for all the states in India. However, because of limitations in getting data from the official sources has limited our scope for the study.

Data on total stamp duty collected during one financial year 2010-11 was taken for the sample of cities surveyed. The rate of stamp duty prevalent in these states was also gathered. With the help of the data collected, an attempt has been to estimate the value of transactions as per government rates and compare it with the value of transactions as per market rates. The market price was based on the sample collected from the brokers. The value as per government rates only gives a broad estimate since individual properties may have been registered at a price less or more than circle rates. Individual property transactions data is very cumbersome and compiled data was also not available in any of the states. Given the limitation, the government values or values as per circle rates were estimated for an aggregate based on the value of total stamp duty collected during the period. There would definitely be some bias but the estimate would serve as a close approximation of the government value.

We do understand that the size of the sample of information gathered from brokers was too small and also there were disparities. However, the information does give a general indication of the market value of the property being transacted and the government value of the same. The estimates based on market price have been kept at a conservative level (example, if brokers mentioned 50-60% as the non cheque portion, we have taken as 55%). The reason for taking a downward bias is because the sample is too small to warrant full confidence.

When we look at the data of various cities in different states gathered during the survey, what clearly emerges is a huge disparity between market value of property transaction and the government value that is a large proportion of undisclosed being invested and recycled in the process. Intrastate and interstate disparities were also observed. The range of black money varying between 40% to 70% in some cities.

The field study has also pointed that some states like, Gujarat, Maharashtra, Bihar and Karnataka have taken steps in implementing the reforms in stamp duty. The reforms have resulted in developing a healthy real estate market in these states and also have reduced the gap between the market rates and circle rates.

Table 3.5:									
Field results from different states (Values in ₹ Crores)									
State-Karnataka									
CITY – Bangalore							**CITY - Bangalore**		
SEGMENT - Gandhi Nagar			Remarks				(Urban)		Remarks
Year	2009-2010	2010-2011	Area	Market Rate	Cash Component	Cheque Component	Year	2010-2011	As reported by the Govt. officials Cash Component is 10% to 15% and as per market survey it is 25% to 30% and at times as high as 40%.
Total no. of Documents Registered	2829	3121	Mahadev Pura	2000-2500	25%	75%	Total no. of Documents Registered	236716	
Rate of Stamp Duty	6.72%	6.72%	Vertu	2000-2500	25%	75%	Rate of Stamp Duty including Registration	7.72	
Total Stamp Duty collected	41.17	31.95	Jala	2000-2500	25%	75%	Total Stamp Duty collected	2583.8	
Value of Transaction as per Govt. rates	612.64	475.44	Yalanky	2000-2500	25%	75%	Value of Transaction as per Govt. rates	33468.9	
Value of Transaction as per Market rates	816.85*	633.92*	J.P. Nagar	2000-2500	25%	75%	Value of Transaction as per Market rates	41836.14*	
Unaccounted money in one year	204.21	158.48	Airport Road	4000	40%	60%	Unaccounted money in one year	8367.23	
Sub Registrar Mr. J. Prakash		** Calculation based upon 25% cash component*					** Calculation based upon 20% cash component*		

State- Andhra Pradesh					
	City Vijaywada (Urban)	**City Vijaywada (Rural)**	**City HYDERABAD (NORTH)**		
Year	2010-2011	2010-2011	April, 2009 to March 2010	April, 2010 to March,2011#	Remarks
Total no. of Documents	18595	42843	NA	NA	As reported by the Govt. officials Cash

Registered					Component is 35% to 40% and as per market survey it is 50% to 60%.
Rate of Stamp Duty	5%	5%	5.0%	5.0%	
Total Stamp Duty collected	169.32	75.99	87.9	86.31	
Value of Transaction as per Govt. rates	3386.40	1519.80	1758.00	1726.20	
Value of Transaction as per Market rates	6772.8*	3039.6*	3516*	3452.4*	
Unaccounted money in one year	3386.40	1519.80	NA	NA	
** Calculation based upon 50% cash component*					

	City Ahmedabad (Memnagar)	City Ahmedabad (Rural + Urban)	City Vadodara		City Surat
Year	May to Oct.2011	2010-2011	2010-2011	Remarks	Apr. to Oct.2011 (7 months)
Total no. of Documents Registered	6927	---	71056	As per market survey 60% cheque & 40% cash	66042
Rate of Stamp Duty	4.9%	4.9%	4.9%		4.9%
Total Stamp Duty collected	80.35	1162.74	283.52		377.2
Value of Transaction as per Govt. rates	1639.80	23729.39	5786.12		7697.96
Value of Transaction as per Market rates (*)	2602.85	37665.70	9643.54		17696.46
Unaccounted money in one year	963.05	13936.31	3857.41		9998.50
** Calculation based upon 37% cash component*					

State- Gujarat
Special notes

City - Ahmedabad (Rural + Urban)			
Area	**High Value**	**Middle Value**	**Low Value**
Govt. Rates	INR1900/-	INR1300/-	INR929/-
Market Rates	INR4500-5000/-	INR2250-2850/-	INR1700-2000/-
Cash Component	58%	37%	45.35%
Cheque Component	42%	63%	54.65%
City – Vadodara			
Area	High Value	Medium Value	
Govt. Rates	1800/-	*1260/-*	
Market Rates	3000/-	*2100/-*	
Cash Component	40%	*40%*	
Cheque Component	60%	*60%*	
City – Surat			
Area	M/s Shri Kuberji Corridor (Commercial)	M/s Krish Enclave	Average
Market Value	13500/- sq. ft.	5000/- sq. ft.	
Govt. value	-------	1350/- sq.ft.	
Cash Component	40%	73%	56.50%
Cheque component	60%	27%	43.50%

	State - TAMIL NADU	State - BIHAR	State - RAJASTHAN		State- - MAHARASHTRA	State - WEST BENGAL		
	City - CHENNAI	**City - PATNA**	**City - JAIPUR**		**City – MUMBAI**	**Kolkata**	**N-24-P**	**S-24-P**
Year	**2010-2011**	**2010 to 2011**	**2010-2011 April -**	**2011 April-September**	**2010-2011**	**2010-2011**		

			March					
Total no. of Documents Registered		81602	61330	32363	35574	34810	137210	158209
Rate of Stamp Duty	8.0%	6.5%	6.5%		5.0%		7+1.1=8.1	
Total Stamp Duty collected	1784.96	233.56	131.64	81.65	1.05	423.02	271.37	534.1
Value of Transaction as per Govt. rates	22312.00	3117.08	1755.20	1088.67	21.04			
Value of Transaction as per Market rates	37186.67	5667.42*	3900.44*	2419.26*	24.75*			
Unaccounted money in one year	14874.67	2550.34	2145.24	1330.59	3.71			
Total Stamp Duty collected (considering 1% Registration fee)		202.42						
Total Stamp Duty@			114.09	70.76				

Special notes	
Chennai	As per market survey rates vary between 60% in high concentration area and 10-20% in low concentration areas. Accordingly talking into consideration the lower value properties are sold more frequently. Taking into consideration all these we take an average of 40%
Patna	As per the statement by the Govt. officials Cash Component is 20% to 25% and as per market survey it is 40% to 50%. * Calculation based upon 45% cash component.
Jaipur	As per the market survey Cash Component is 50% to 60%. * Calculation based upon 45% cash component.
Mumbai	As per the statement by the Govt. officials, there are no sale/purchase of property in Mumbai fort properties are transacted/rented out on lease and licenses basis, Cash Component is 15-20%. * Calculation based upon 15% cash component.
Kolkata	As per the statement by the Govt. officials Cash Component is 5-7% and as per

	market survey it is as high as 50% in New Kolkata.

State Delhi City Delhi (fig in ₹ crores)				
Year	**2009-2010**	**2010-2011**	**Cash Component**	
Total no. of Documents Registered	151303	143393	65%	Value as per cash component @65% As per the market survey cash component is 60% to 70%
Rate of Stamp Duty	8%	8%	65%	
Total Stamp Duty collected	414.67	534.59	65%	
Value of Transaction as per Govt. rates	5183.38	6682.38	65%	
Value of Transaction as per Market rates	14809.64	19092.50	65%	
Unaccounted money in one year	9626.27	12410.13		

State Haryana City Gurgaon (fig in ₹ crores)				
Year	**2009-2010**	**2010-2011**	**Cash Component**	
Total no. of Documents Registered	45221	51738	50%	Value as per cash component @50% As per the market survey cash component is 40% to 60%
Rate of Stamp Duty	4%-8%	4%-8%	50%	
Total Stamp Duty collected	673.89	1221.23	50%	

Value of Transaction as per Govt. rates	11231.50	20353.83	50%	
Value of Transaction as per Market rates	22463.00	40707.67	50%	
Unaccounted money in one year	11231.50	20353.83		

Suggestions based on observations

The real estate market in India, at present is widely known and acknowledged as extremely inefficient and opaque. An efficient real estate market where transactions, i.e., sale and purchase of properties, can take place smoothly, without any barriers, and in a transparent manner is considered to be one of the key drivers of growth especially for a developing economy like India. The suggested reforms in the real estate sector can be classified into two major heads, first reforms to bring transparency to check tax evasion, underreporting of transactions and to ensure better compliance; secondly to suggest measures to combat money laundering in the sector.

Suggested reforms to bring transparency through law

(i) Constitution of a Regulatory Authority: Real estate has so far been governed by a patchwork of regulations that promote arbitrariness in doing business and leaves plenty of room for underhand dealings. The field observations and interactions with experts have pointed out that the absence a regulator is the one of the prime causes of malpractices and corruption in the sector. The Real Estate (Regulation & Development) Bill, 2011 has already proposed establishment of the Real Estate Regulatory Authority for regulation and aims at planned development of the real estate sector and by ensuring sale of immovable properties in an efficient and transparent manner. It also seeks to protect the interest of consumers in the real estate sector and establish an

Appellate Tribunal to adjudicate disputes and hear appeals from the decisions or orders of the Authority and for matters connected therewith or incidental thereto.

The appointment of a regulator will ensure that the builders follow rules, deliver quality and can be penalised if they fail to deliver. However, taxes on land and building ((List II, Entry 49) is a state subject in India and in the proposed real estate law the Centre will be the regulator to the sector. This would leave many grey areas as the power of regulator over state bodies or municipalities will be limited.

(ii) Rationalising circle rates with market rates:

With increase in population and its living standards and resultant increase in real estate demand, the gap between the circle rates and the market price widens. The drastic increase in the cost of input materials, high rate of home loans and high inflation have also been major factors in taking the prices of real estate up and the government should take measures to rein in these factors. Since there is no mechanism to monitor on a continuous basis, the market price of properties of different kinds spread out in different areas, circle rates are prescribed by the state governments more or less like a thumb rule. Thus the categories of land into the urban or the rural or areas or localities is done in a subjective manner which are far from day to day reality and do not take into account all features of property involved in a transaction. A balance, therefore, will have to struck between higher or lower circle and mechanism will have to be evolved by the state governments so that the prescribed rates for registering a transaction relating to property takes into account realistic market rates as prevailing in the area and the characteristics such as location, state of development etc. One way of establishing parity with prevailing market rates could be putting all property deals on internet so that there is a transparency in such deals and comparative evaluation is possible.

For a genuine buyer, an increase in circle rates to some extent could be regarded as a favourable move as he would be able to avail higher loans from banks and financial institutions considering home loans are usually 80-85 percent of the purchase price or market value of the property, for which circle rates are an indicator. However, very high

increase in rates may act as a deterrent and adversely affect buyer sentiment as property registrations would become costlier.

(iii) Rationalization of stamp duty: One of the impediments to the efficient functioning of the real estate market has been, and continues to be, the prevalence of high rates of stamp duty on the conveyance transactions relating to property. Under declaration of value of property values for evading stamp duty adversely affects other taxes too, like property tax and capital gains tax and has a cascading effect on generation and circulation of unaccounted income and wealth. Lowering the rates may bring in better compliance regime and consequently efficient economic environment.

A comparative study shows that the stamp duties and taxes on real estate transactions in India are quite high in comparison with those prevailing in other countries (Table 3.6).Few countries impose stamp duties exceeding 5 percent of valuation of property, and even in those cases, the higher rates are reserved for exceptional cases such as very high-value personal property. Lower stamp duty rates are not limited to industrial countries alone; countries such as Vietnam and the Philippines have stamp duty rates in the range of 1 to 2 percent. The high rates of stamp duty prescribed by various states in India have been counterproductive in as much as that they have not brought expected revenues and at the same time provided powerful incentives for corruption and fraud in the administration of such duty.

High rates of stamp duty and their adverse effects on the economy, and consequently the need to reduce them have been underlined by various committees and experts. The need to rationalise Stamp Duty has also been proposed by the state reforms under JNNURUM. Recognizing the adverse effects of high stamp duty rates, JNNURM requires the states to reduce the rates to 5 percent or less (including the surcharge that ULBs levy in several states).

Table 3.6

Stamp Taxes on immoveable Property: International Comparisons

Country	**Tax(present of value of transaction or market**	**Exemptions (US$)**	**Lower Boundary of Highest Rate**	Exchange Rate (US$/LOC as of

	price)		(US$)	1/7/04)
Australia (New South Wales)	1 to 5.5 sliding		$385,000	0.77
The Bahamas	2 to 10 sliding	First time home buyers with value up to $2.50,000	$250,.000	1
China	0.05	Property donated to the government, or social housing for widowed, aged, injured, or schools		
Hong Kong*	3.75			
Indonesia	5	Amount of exemption is local government decision		
Ireland (commercial)	1 to 9 sliding	Properties less than $12,700	$190,500	1.27
Ireland(residential)	0 to 9 sliding	Houses less than $161,000	$806,451	1.27
Japan	No specified amount			
Malaysia	1 to 4 sliding		$390,000	0.26
Mexico	2 to 3			
New Zealand	Abolished in 1999			
Pakistan (Punjab)	6			
Pakistan (Sindh)	3 to 6			
Pakistan (Islamabad)	6			
Philippines	1 to 15		$18	0.018
Singapore	1 to 3 sliding		$313,200	0.58
South Korea**	0.15 to .2		$80,000	0.0008
Taiwan (Taipei)	0.1			
Thailand	No specified amount			
US (Florida)	0.7			
Vietnam	2			
*Tax rate is only for Real Estate Investment & Trusts ** The sliding rate scale largely decline with value whereas for all other sliding scales above the rates increase with value				
Source: *Tax Notes International, various issues*				

The field discussions and interactions with the various stakeholders across states under the study have specifically pointed out that:

- high rates of stamp duty lead to undervaluation of properties, resulting in substantial loss of revenue to the states and the ULBs.

- existence of high duty rates in some states and low or moderate duty rates in others lead to diversion of economic activity, which is often unhealthy and economically inefficient.

In the present status, we find that while the stamp duty has become the third-largest revenue source for many Indian states. The total revenues from stamp duties (and registration as per revised estimates) were of the order of ₹ 39,230[35] crore (2009-10). In states such as Bihar, Gujarat, Kerala, Punjab and West Bengal, stamp duties are the second most important source of revenue, next to VAT/sales tax, and in others, the third most important revenue source.

It should be noted that stamp duties are commonly levied throughout the world. However, the level of these taxes is in most instances much lower than those prevalent in India. Typically, transfer tax rates are around 1 percent of the value of the transaction. Further, the broad trend in this respect is more or less uniform in most of the countries. Even countries having diverse characteristics such as the United Kingdom, Australia, New South Wales, Mauritius, Switzerland, Germany, China, Singapore, Malaysia, and Colombia, have low registration charges as a common denominator. Basic reforms in many countries have focused on:

- Exempting taxes on financial transactions;
- Reducing, and sometimes eliminating, the tax rate;
- Utilizing modern technology in the payment and collection of taxes; and
- Linking the payment of taxes to specific sectorial expenditures.

It follows that any reduction in stamp duty rates that is undertaken as a part of the JNNURM should not result in revenue loss to the states or the ULBs. It is, therefore, important that reduction in stamp duty rates is carried out with adequate preparation and in a systematic manner.

Although a few states have taken steps to bring down the stamp duty rates, in several states, the rates are in excess of 10 percent, deterring individuals, businesses and

[35] Budget DocumentState Government

industry from registering properties at actual, or market values. Of the 29 states, 15 have reduced the stamp duty to below 5 percent of the property. In several others, it remains above 10 percent. Studies have shown that every reduction in stamp duty has led to greater compliance. Simulations[36] indicate that revenues lost due to a lowering of stamp duty rates closer to international levels are quite likely to be recovered in higher collections of other taxes. However, these taxes would at least in part be collected by other levels of government. Thus, reform could be made a more viable option through appropriately designed intergovernmental transfers.

(iv) Automated clearance: In several countries, in Singapore, for instance builders submit proposals for building-plan approvals through the Internet. Every detail like land size, built-up area, height of building, amenities and so on is filed online. The software used by the town planning authority approves or rejects an application within a week, citing reasons. Such a system could also be adapted for India and this would not only lead to speedy clearances but also less of human interaction and consequently lesser room for bribery and corruption. However, for a country as diverse as India where some specific requirements may be there on a case-to-case basis complete doing away with human interaction may not be feasible.

(v) Single-window clearance: Interviews with builders revealed that they are required to take multiple approvals from various authorities. At times, these approvals are just procedural and unnecessary. The facility of single-window clearance for all licenses/ clearances would definitely reduce corruption and increase efficiency and transparency in the sector. Instead of having a multitude of agencies dealing with different aspects of a building, it is proposed to have a single authority or a single state clearance system within stipulated time frame. This authority will process for all proposals, if necessary, after coordination with the municipal corporation, Power Company or the fire department.

[36]**James Alm, Patricia Annez, and Arbind Modi, Stamp Duties in Indian States- A case for Reform,2004**

(vi) Include Real Estate in Goods and Service tax: According to an estimate by builders, about one-fourth of construction costs go to the government in the form of various taxes, including tax on material, service tax and value-added tax. The builders have often lamented that they cannot set off one tax against other taxes, leading to a multiplicity of tax regimes.

A task force on the goods and service tax (GST), appointed by the thirteenth Finance Commission, and had proposed including real estate (land and construction) sectors under the proposed GST. Their recommendation was to replace stamp duty and registration fee with GST, and allow for input tax credit. Uniform stamp duty for property transactions across states will check under declaration and curb black money generation. The sector will then be freed from multiple taxes at the central and state levels. GST will also ensure an audit trail for all property transactions. However, in spite of the support of Chairman of the Finance Commission, this proposal was excluded from the final report.

(vii) Eliminate 'percentage of completion' method: The existing accounting method of recognising revenues is the 'percentage of completion' method. In this, a builder recognises revenues equivalent to the percentage of project completed. This, however, does not push builders to prioritize completion of projects. Linking revenue recognition to total completion, the 'completed projects' method, which is the norm in developed markets, will enforce that discipline and good practice. CGA Performance Audit Report 2010-11 contains a recommendation to ensure that accounting treatment for ongoing construction projects commenced after April 2003 to conform to Accounting Standard 7 as revised[37].

(viii) Post records online: At present, land records are not properly maintained. The government receives a lot of data, but it's not in the public domain. If data, such as sale deeds, list of building plans approved and registration data are made public, transparency would increase and people will have an estimate of supply.

[37] Report No. 12 of 2011-12(Performance Audit), CBDT, Ministry of Finance, Department of Revenue, pg 32

It is suggested that a master plan for surplus land available for development be prepared and put online. It will result in increased transparency and would lay down a roadmap of how much land is available for private development, enabling the builders to buy accordingly. The move may also usher in a healthy competition and realistic price of property available in the market.

(ix) Use of advanced tools like data mining: The absence of a strong database on the real estate sector is well recognised and considered critical in the context of on-going reforms in India. Information systems and data need to be strengthened to enable usage of data mining techniques. This will improve the understanding and management of financial flows to enhance the sector's contribution to GDP and the revenue base of governments.

(x) Generation of Suspicious Activity Reports to spot tax fraud and money laundering: Red flag indicators like discrepancy between apparent and reported or recorded data, movement of large amounts of money and distorted behavior can be used to spot tax fraud and money laundering. The properties can be classified into three categories- highly suspicious, suspicious and normal to increase the security of ownership and help in preventing fraud attempts.

It is a new but highly important and growing method used in investigating cases related to money laundering and tax fraud by many OECD countries. This will also require cooperation across multiple national agencies: automatic exchange of information and data between national tax authorities on real property transactions.

(xi) Capacity Building: There is a need for deeper integration, strengthening of financial regulatory framework and signaling system in the real estate sector. Better tax compliance can also be achieved through forums for compliance staff, other education campaigns, making new information sources available including databases of real estate transactions, setting up of specialized tax teams and other organizational changes and taking up an inventory of properties.

Manufacturing Sector

The manufacturing sector in India, at present, is estimated to be around US$ 250 billion industry with CAGR of 7-8 per cent (since 2004) and employs manpower to the level of 120 million[38]. It is the only sector of the economy which gets flows of different kinds (materials, information, cash, skills etc.) to and from all other sectors of the economy. Though the sector is considered very vital for the growth of the country, it has contributed only about 16% to the GDP compared to services more than 60%. The increasing gap in both, the sectoral share of the manufacturing and the productivity of the manufacturing sector in India, compared with the manufacturing sectors of other countries particularly, China, indicates that the country has not been able to fully leverage the opportunities provided by the dynamics of globalization in this sector. Given the easy availability of most raw materials and the relatively inexpensive workforce, the manufacturing sector in India should have performed much above the benchmark. The share of Indian manufacturing in the world Manufacturing Value Added is miniscule at around 1.36 percent. There is vast scope to increase India's share through appropriate actions for improving the price competitiveness as well as quality improvement of the manufacturing products.

A study done in the year 2002 comparing the prices of a range of manufactured products in India and China found that the prices of Indian products were higher, on average, between 28 to 33 percent, half of which is attributed to the difference in indirect tax levels. Currently the combined tax levels in India are between 28 to 35 percent as against a combined VAT rate of 17 percent in China and of similar levels in other competing countries.

Besides the cascading impact of taxes, the growth of Indian manufacturing industry has been hampered by multiplicity of inspections, delayed clearances and approvals, difficult land acquisition, stringent exit mechanisms, rigid labour laws, lack of skilled human resource and inadequate infrastructure. Much research on the role of taxpayer morale in public finance suggests that compliance with tax regulation rests on a belief in the legitimacy of the tax process and trust in government. Research has shown that if

[38]The New National Manufacturing Policy,2011

the implicit contract between the government and the taxpayer is broken, the firm is likely to evade taxes.[39]

Moreover a lot of manufacturing is in the unorganised sector. Manufacturing sector in India like most of the developing countries has a large low productivity informal sector along a relatively small high productivity formal sector. It would not be incorrect to say that businesses shaken down by various bottlenecks respond by greater underreporting of income to the tax authorities. Income Tax Department's search and seizure operations of last 5 years have revealed manufacturing sector to be a big tax evader, just behind real estate, indicating that the sector may have acquired a bigger role in undisclosed income or the cash economy. There was an over 200% jump in undisclosed income admitted to by the manufacturing sector in 2008-09; though in absolute terms it is still well behind the real estate sector. The searches related to evasion of direct taxes and admission of unaccounted income.

In order to understand the various aspects of black money and the modus operandi of the generation of the unaccounted income in the manufacturing sector we pursued a large number of informal interviews with various stakeholders including businessmen , chartered accountants , civil servants and other professionals. It was difficult to achieve definitive answers to many of our questions through any rigorous quantitative procedures. However we could gather some impressions. One fact was emerging from the informal discussions that not just for direct taxes evasion, the manufacturing sector has also been on the radar for excise evasion also. Various Modus Operandi are adopted by manufacturers to evade central excise duty. In order to improve upon these impressions we decided to tap on the wealth of Senior Revenue Officials from the Indirect Tax Department. Accordingly a questionnaire was designed in consultation with the senior revenue officials. The questionnaire, which is reproduced as an annex, outined some alternatives to the questions and asked the respondents to rank these on

[39] Taxpayers are more likely to refrain from cheating if they trust the government (Scholz and Lubell, 1998; Scholz and Pinney, 1995; Torgler, 2007) and are satisfied with government performance (Spicer and Lundstedt (1976), Smith (1992), Alm, Jackson and McKee (1992), Pommerehne, Hart, and Frey (1994)). Therefore, if, as suggested by the trust literature, bribes demanded by public officials are a signal to the firm that the government is dishonest, it leads to loss of trust in the government and thus to tax evasion.

a scale of 1-10 in order of importance of gravity of the issue. One day workshops were conducted in CBEC Commissionorates offices in 5 cities namely Mumbai, Delhi, Meerut, Chennai and Coimbotore and the questionnaires were circulated to more than 80 senior revenue officials. It is important to mention that the respondents were restricted to senior officials since they were expected to be experienced with diversified knowledge.

Of course since a small homogenous clientale was only being approached it has its own limitations. One another obvious limitation was that of nature of the questionnaire if the alternatives were excluding some important possibilities then the responses were likely to be defective. However , the responses were very informative and were quite consistent with the informal interviews.

The Indian Manufacturing industry is **broadly divided into**: Capital Goods & Engineering, Chemicals, Petroleum, Chemicals & Fertilizers, Packaging, Consumer non-Durables, Electronics , IT Hardware & peripherals, Leather & Leather Products, Steel & non-Ferrous Metals, Textiles & Apparels and Tobacco.

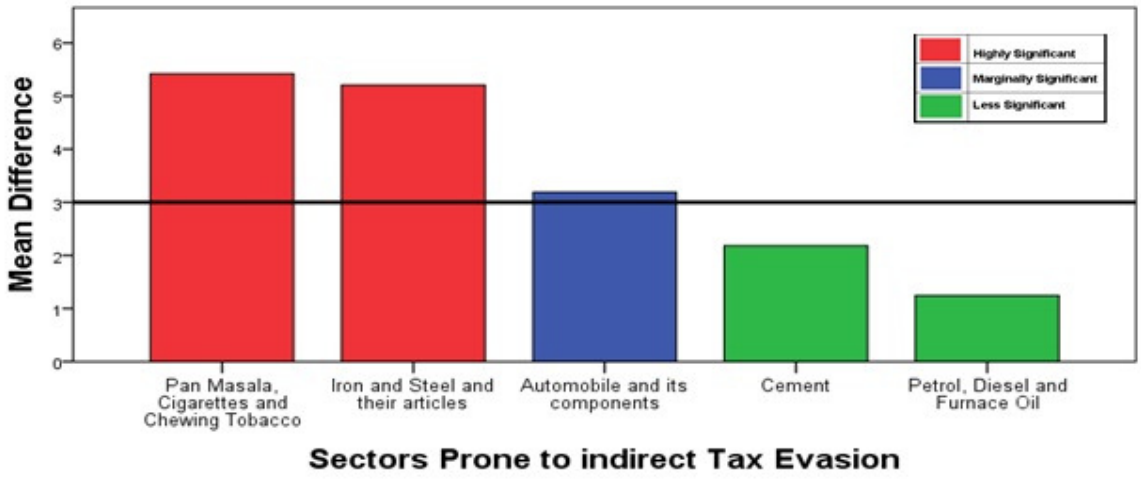
Analysis of intelligence and performance reports received by the DGCEI[40] for the last five years , indicate that the major evasion prone industries are Iron & Steel, Gutkha / Pan Masala, Khaini, Copper and articles thereof , Cement and pharmaceuticals. The global commodity prices of Iron & Steel & non-ferrous metals have gone up in the recent past. The heavy demand from infrastructure has led to a further increase in demand in the consumption of these products. The increase in price has also lead to increased evasion in the unorganized sector in the recent past. The industry has come out to be the most evasion prone which can be seen in the number of cases and amount of duty evaded by the Iron & Steel companies. During the last three financial years the number of cases booked against Iron & Steel companies increased from 278 in 2008-09 to 303 in 2009-10 and 423 in 2010-2011 involving evasion of ₹ 701.87 crore, ₹ 445.31 crores and ₹ 646.27 crore respectively. Further, the manufacturing units availing area based exemption Notifications were also found to be prone to evasion. DGCEI and Commissionerates put

[40] Annual reports of DGCEI, 2007-8,2008-09,2009-10,2010-2011

together, detected Central Excise duty evasion of ₹ 5326.99 crore in 2978 cases during 2010-2011.

Figure 3.6 below gives the result of the survey of the senior officials. The result of the survey reiterates the findings from the DGCEI reports of the last 5 years. The industries most prone to excise evasion as indicated in the analysis are Iron & Steel, Gutkha / Pan Masala, Khaini, automobiles followed by Cement and petrol and diesel.

Figure 3.6:
Sectors Prone to Indirect Tax Evasion

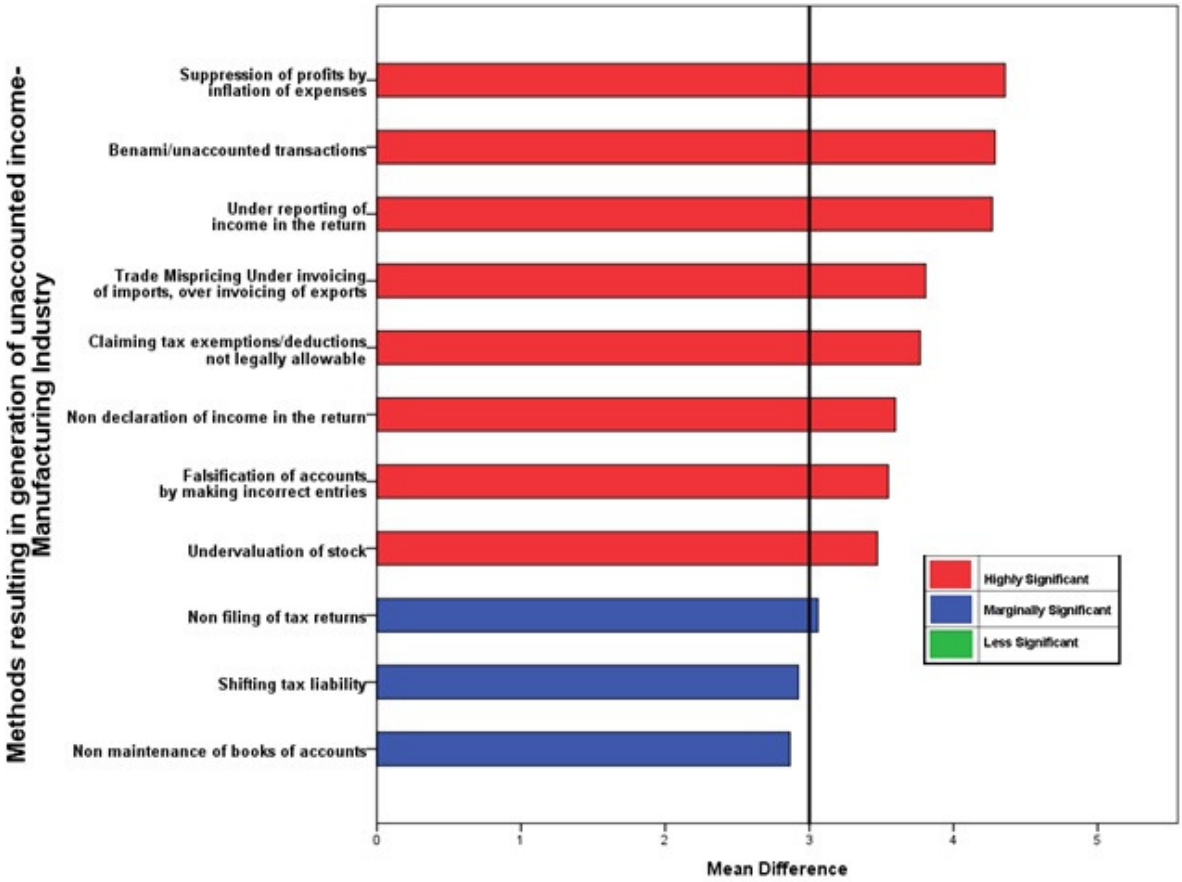


Source:*Field survey of senior revenue officials*

The indirect tax structure has seen a large number of changes over the past years including rationalization of tariffs and easing of procedures. However evasion of central excise duties is still prevalent despite reduction in duties over the last decade. The manufacturers adopt various methods to evade central excise duty. The discussions and interaction with the experts, senior officers from revenue department pointed instances where even the reputed manufacturers indulge in under valuation, particularly in case of consumer products or goods meant for mass consumption. Non-filing of tax returns; not declaring income/underreporting income; and the over-claiming of expenses by businesses and corporations, trade mispricing false claiming of tax exemptions and

deductions were rated high on the gravity scale by the respondents. Some of the other methods of tax evasion as pointed by the respondents and also as disclosed in the various reports of the revenue department included: non maintenance of books of accounts, undervaluation of stocks, non-payment of advance tax and non-filing of return of income, Personal drawing from the company which attracts provisions of deemed dividend u/s *f* (22) (e) of Income tax Act; 1961 ,Group Companies utilizing their accumulated profit for benefit of the individuals and other companies/ concerns of the group incomplete books of accounts and wrong claim-of exemption u/s 10A of the Income Tax Act, 1961.

Figure 3.7: Methods resulting in generation of unaccounted income- Manufacturing Industry



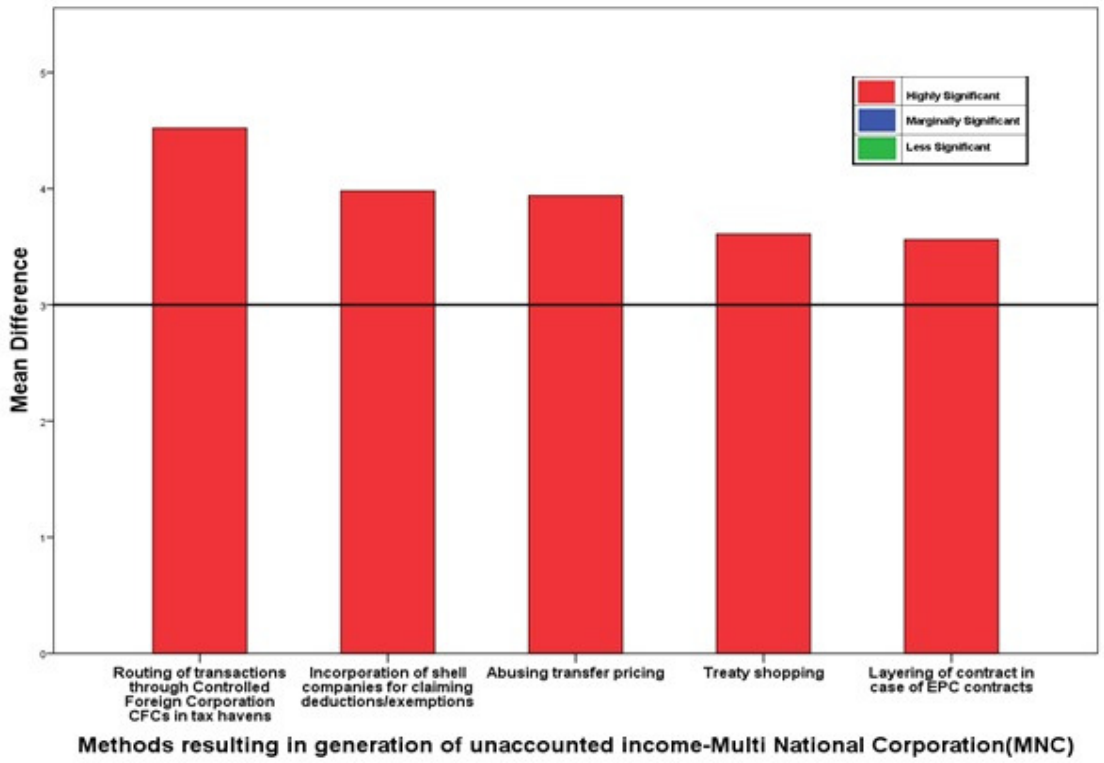
Source: Field survey of senior revenue officials

The common methods of tax evasion commonly adopted by the manufacturing units are as given on the y axis of the Fig 3.7 above. The red bars indicate that the responses have been ranked high on the gravity scale of 1-10(score more than 6). Suppression of profits, bogus transactions, underreporting of income and trade mispricing are the methods most widely adopted to evade taxes. The DGCEI has found many cases in which these practices are rampantly followed.

> *"Over claiming business expenses (failure to report accurately) may be the non-compliant behaviour that is observed and that needs to be addressed. However, the driver of the behaviour may be the taxpayer's need to increase cash flow in an attempt to remain competitive in a business environment where competitors routinely under report their income or deal in cash. Alternatively, the driver may be the taxpayer perception that the tax rates are too high and the desire to recoup some money as compensation. In a situation such as this, treating the behaviour (the symptom) will only have an impact on the affected taxpayer and even then only for a limited period of time. Moreover, the taxpayer concerned may actually feel hard done by to have been singled out for attention when those around him/her get away the same behaviour. This may be in turn simply serve to fuel feelings of resentment to the taxation system and provoke further acts of non-compliance. Thus, looking for the underlying cause of the behaviour and selecting the appropriate strategy to address it could account for a difference in outcomes between short-term, isolated compliance (or even aggravated non-compliance) and long term sustainable compliance[41]".*

[41] The OECD Compliance risk Management Guidance Note

Figure 3.8:
Methods resulting in generation of unaccounted income: Multinational Corporation



Source: Field survey of senior revenue officials

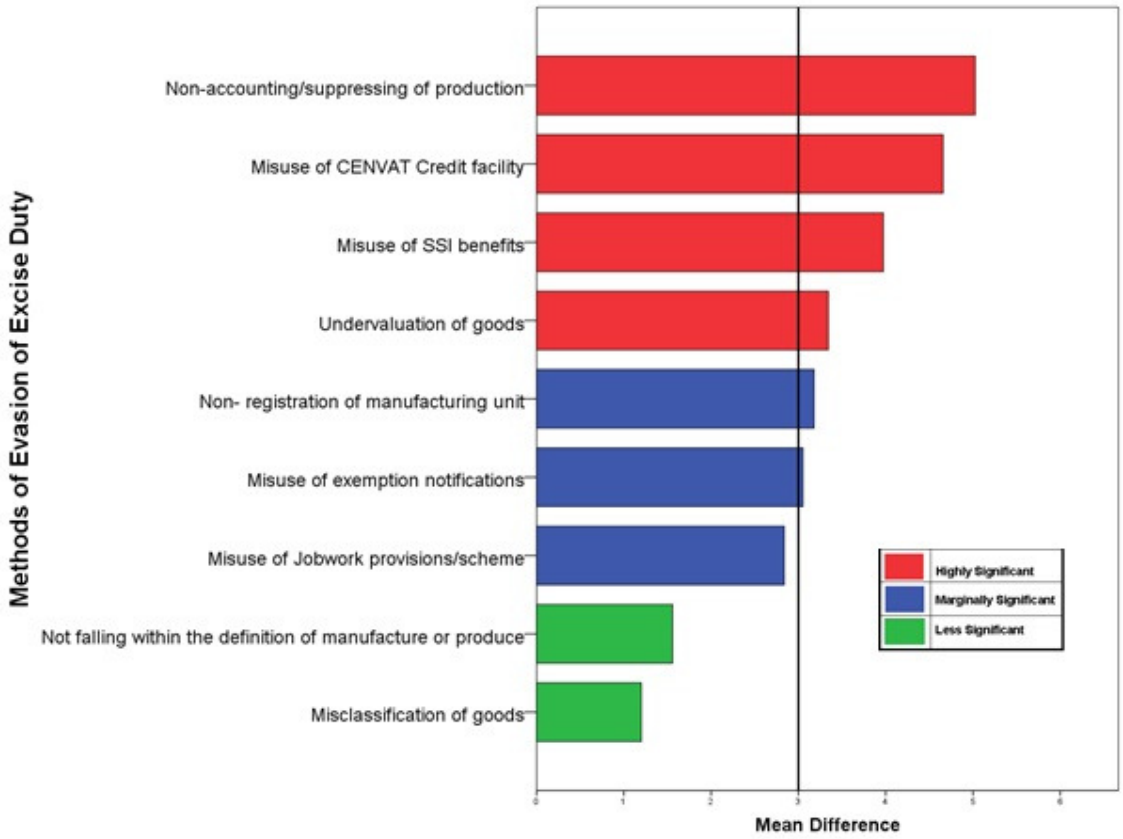
The various multi- national companies operating in India were also found to be indulging in tax evasion and avoidance behaviours. All the respondents ranked high the methods related to the abuse of transfer pricing, treaty shopping, shell companies to claim deductions and exemptions and routing transactions through CFC's in tax havens (Fig 3.8).

Excise duty evasion continues to be yet other favored mode of generation of unaccounted money. Based on an analysis of the major cases (cases involving duty of INR10 lakh and above) from the DGECI reports it is observed that the CENVAT credit related frauds, wherein only duty paying documents changed hands between the parties for availing irregular and undue CENVAT credit without any movement of goods are major category of duty evasion. In cases where CENVAT is not available to end user, clandestine clearance without payment of duty is the preferred mode of evasion. The

use of sophisticated tools and techniques by tax evaders has made the task of detection of evasion even more complicated and challenging. The modus operandi analysis of last five years for cases of evasion of duty involving duty of ₹ 10 lakhs and above as indicated in the DGCEI reports are as given below in the table 3.7.

Table 3.7:												
Modus operandi of last five years for cases of evasion of duty involving duty of ₹ 10 lakhs and above												
	2005-2006		**2006-2007**		**2007-2008**		**2008-2009**		**2009-2010**			2010-2011
Modus Operandi	**Cases**	**Duties (in₹. Crores)**	**Cases**	**Duties (in₹. Crores)**	**Cases**	**Duties (in ₹ Crores)**	**Case**	**Duties (in ₹ Crores)**	**Case**	**Duties (in ₹ Crores)**	**Case**	Duties (in ₹ Crores)
Misuse of Cenvat Credit	206	303.19	436	727.66	485	550.59	530	672.24	543	832.78	1043	1733.15
Clandestine removal	336	414.37	495	601.81	648	1019.6	778	1772.52	843	1431.9 1	523	981.97
Misuse of duty Exemption Notification	111	269.51	245	669.99	285	711.2	203	441.12	196	484.65	280	857.78
Misclassificati on	14	217.08	56	354.21	60	313.13	36	131.81	62	446.35	64	468.62
Undervaluati on	62	83.12	173	309.94	143	195.67	315	437.69	137	367.32	120	379.56
Others	93	82.04	305	248.39	297	405.35	369	390.04	454	1788.1 2	440	400.18
Total	**822**	**1369.31**	**1710**	**2912**	**1918**	**3195.54**	**2231**	**3845.42**	**2235**	**5351.1 3**	**2470**	4821.26
Source: *DGCEI Annual Reports*												

Figure 3.9:
Methods of Evasion of Excise Duty



Source: Field survey of senior revenue officials

Analysis of intelligence inputs collected by the Directorate General and the interaction with the Officials during the workshop relating to evasion of central excise duty indicates that clandestine removal, misuse of duty exemption notification, misclassification and undervaluation, misuse continues to be among the most favoured modus operandi for excise duty evasion (Fig3.9).

Relaxations in controls and procedures and the facility of monthly payment of duty has prompted the evaders to resort to clandestine removal which has been reported in all sectors, though the method and sophistication for indulging in evasion varies from sector to sector(as pointed in Annual reports of DGCEI). Some very common ways to cover up clandestine removal by tax evaders is by resorting to various techniques like parallel invoicing, wrong description on the invoices, recovery of sales proceeds under

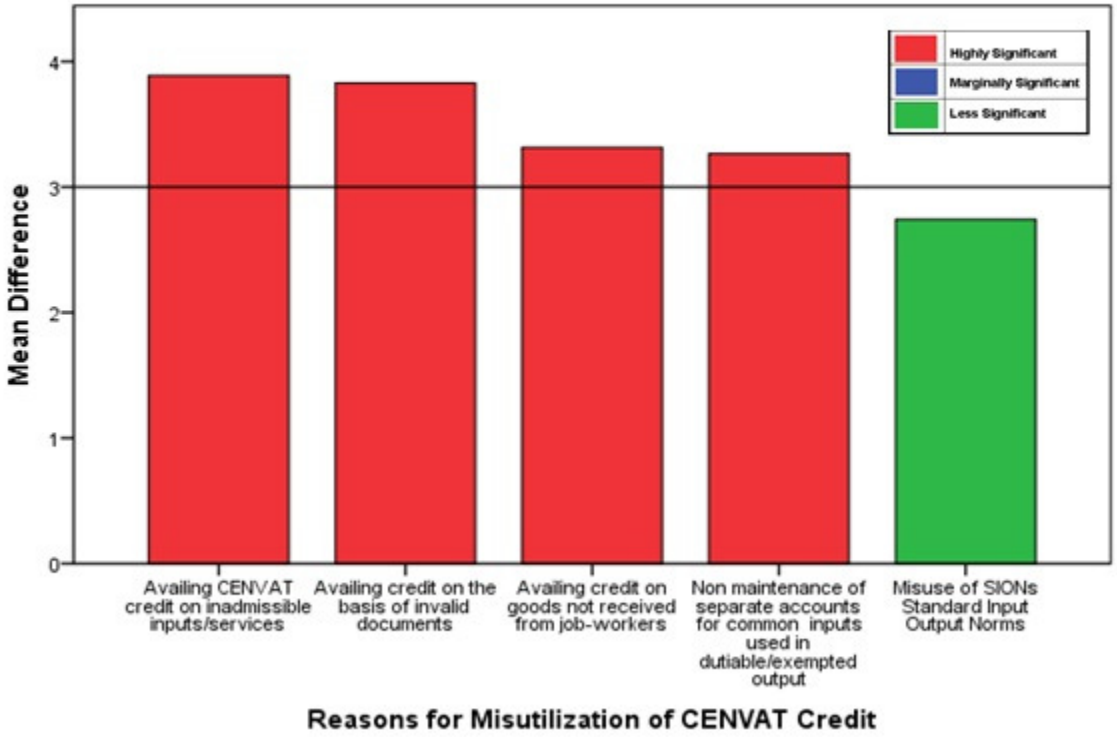
the garb of other charges / commission, creation of dummy/ fictitious sellers/ buyers, use of trading bills for sale etc. Evaders are also increasingly making use of electronic devices like pen drives to compile and store data of unaccounted purchase of raw materials, finished products and sale proceeds accrued on account of clandestinely cleared goods. The department has detected clandestine removal mainly in commodities like iron & steel, gutkha, Chewing Tobacco, Ceramic Frit, machinery and machinery parts and cement.

Various modus of misuse which have surfaced during the investigations done by the excise department include availment of CENVAT without receipt of goods by purchasing Cenvat-able excise documents on payment of marginal premium. In order to make the transactions look genuine, the manufacturer availing Cenvat credit arranges for payment of invoice amount by cheques. These cheques are encashed through benami accounts and the amount involved is remitted back to the manufacturer in cash after withdrawal of the same from the benami bank account. Major commodities in which such cases were detected include iron and steel, capital goods and non-ferrous metals. Utilizing of Cenvat credit on common inputs for manufacture of dutiable as well as exempted final products, wrong availment of Cenvat credit on inputs service attributable to trading activities and availment of Cenvat credit wrongly on inputs not used in or in relation to manufacture of final products has been used as a modus operandi towards evasion of duty[42].

The responses from the field survey (Fig 3.10) indicated availing credit on inadmissible inputs/services, availing credit on the basis on invalid documents and on goods not received from job workers as rating high on the scale as ways of misutilization of CENVAT credit.

[42] From survey

Figure 3.10:
Methods for misutilizing CENVAT Credit



Source: Field survey of senior revenue officials

The impressions gathered during the interaction with the various field officers of the department and the available literature and cases pointed that there is widespread misuse of exemption notifications by certain sectors like export oriented units and units availing benefits under area-based exemption notifications. In one case M/s Perfect Technologies & Peninsula Technologies, Sikkim manufacturers of Automation Gateway System has misused Notification No. 71/03 dated 09.09.2003 and wrongly availed rebate under Rule 18 of Central Excise Rules, 2002. Cases of fraudulent refund claims by importers of timber logs were also detected during the year 2010-11. It was revealed that several importers of timber Logs, who cleared the consignments from Kandla and Mundra Ports are fraudulently claiming refund of 4% SAD paid at the time of importation vide Notification no. 102/2007-CUS. The said notification provides the refund of SAD only in case where imported goods are sold on payment of VAT, without

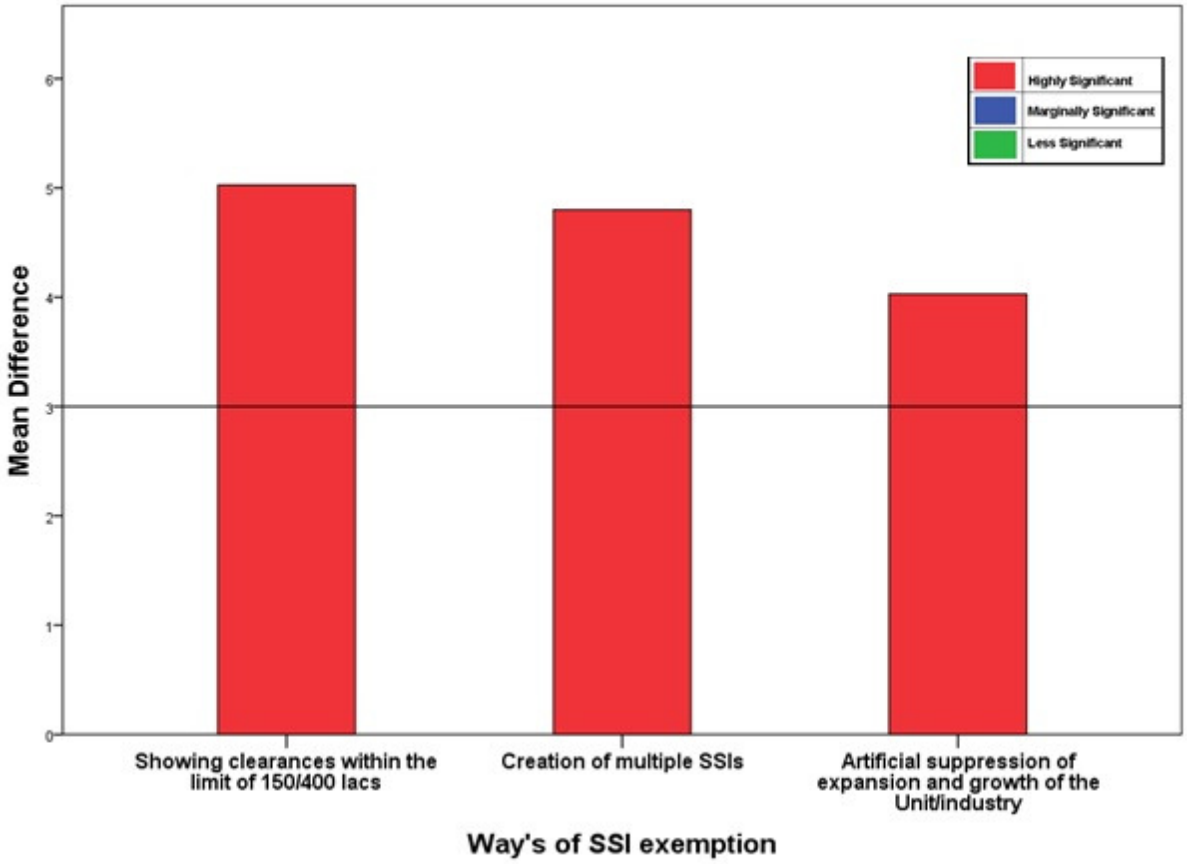
carrying out any process. The department investigation revealed that importer of timber log have cut and sawed the logs and subsequently sold the same as sawn timber. The sales invoices were forged by these importers to show as if the goods were sold without sawing or cutting activities.

Misuse of SSI Exemption has also been highlighted in the survey. According to the scheme, a unit qualifies for an SSI tag if its annual turnover is below ₹ 4 crore. Government gives benefit to small manufacturers in terms of exemption of duty on value of ₹ 1.5 crore goods sold if the total value of its clearance remains below ₹ 4 crore in that particular financial year. The CBEC survey and discussions with officers from DGCEI pointed to many cases where small manufacturers are keeping their value of clearances below ₹ 4 crore to avail this benefit. It said the remaining goods, which are in the range of 8-10 times of the declared value, are being diverted without duty payment and are sold in the black market.

All the SSI exemption notifications have innumerable controversies about the scope and application of these exemptions because what is given as an incentive is misused as a tool of tax planning such that those SSI who are not eligible for concession also avail the same by resorting to creation of front or dummy Units, which, by themselves, have no proprietary interest in production and sale of excisable commodities. In certain exceptional cases the legal personality of a company was misused for tax evasion or for circumventing tax obligation. In such cases the Supreme Court held that tax authorities and courts were entitled to pierce or lift the corporate veil to find out the economic realities behind the legal façade.

In order to bar such unfair practices provisions have been made for **clubbingof turnover** in cases where the turnover appears to have been fragmented or distributed in order to avail the benefit of SSI exemption. Some of the common ways to misuse SSI exemption noted during the survey are as shown in Fig.3.11 given below. The red bars indicate that the responses were with a rank showing high gravity.

Figure 3.11:
Methods of Misutilizing SSI Exemption

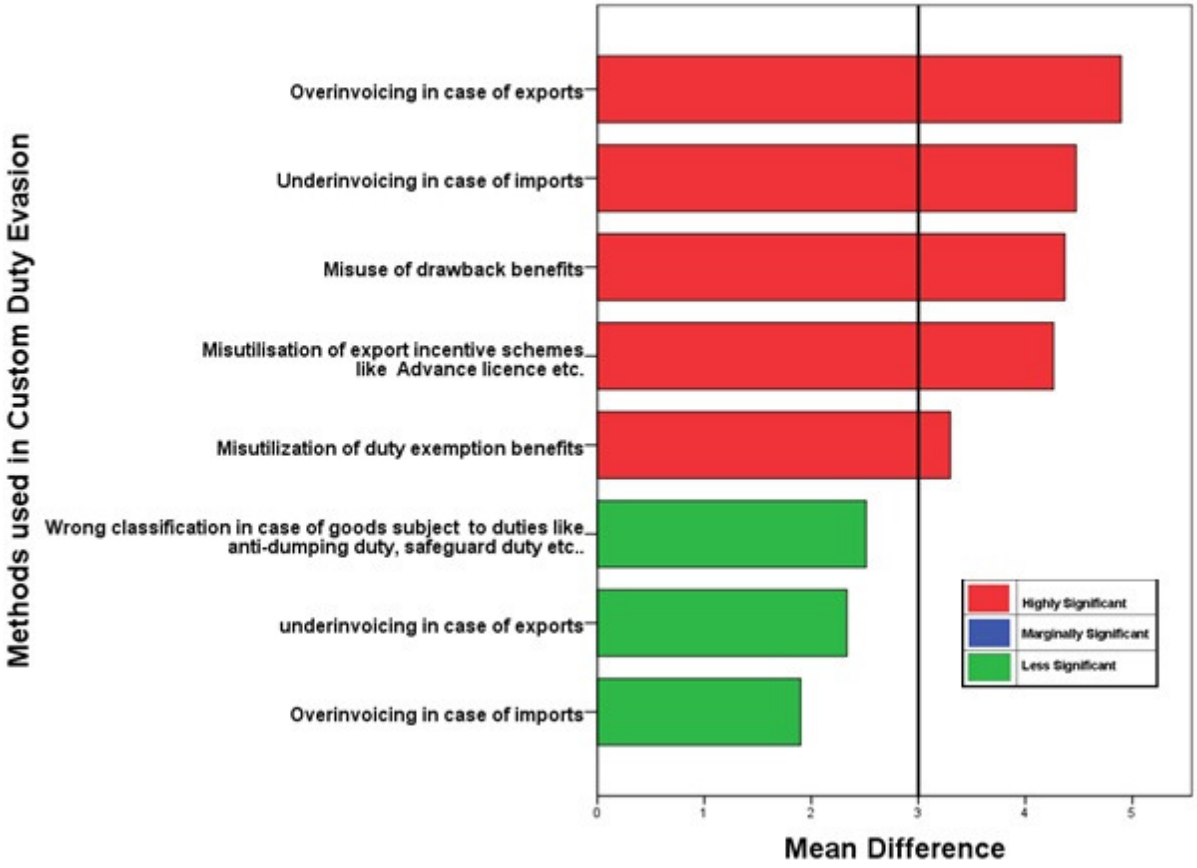


Source: Field survey of senior revenue officials

Large scale manipulations in prices in order to evade the customs duties, was also observed as a method for generation of unaccounted money. The most common method adopted by various companies in case of imports from their foreign principals or associated companies is to declare higher value for goods exempted from duty or entitled to lower rate and to declare lower value for the goods having higher rate of duty. Over invoicing of exports under export promotion schemes to claim higher Drawback, DEPB, DFRC, Advance Licenses etc. was also noted as a common modus operandi. In case of goods procured by the foreign principals and supplied to their Indian counterparts, the country of origin is sometimes mis-declared to claim exemption from customs duty applicable under a trade agreement or to declare lower values

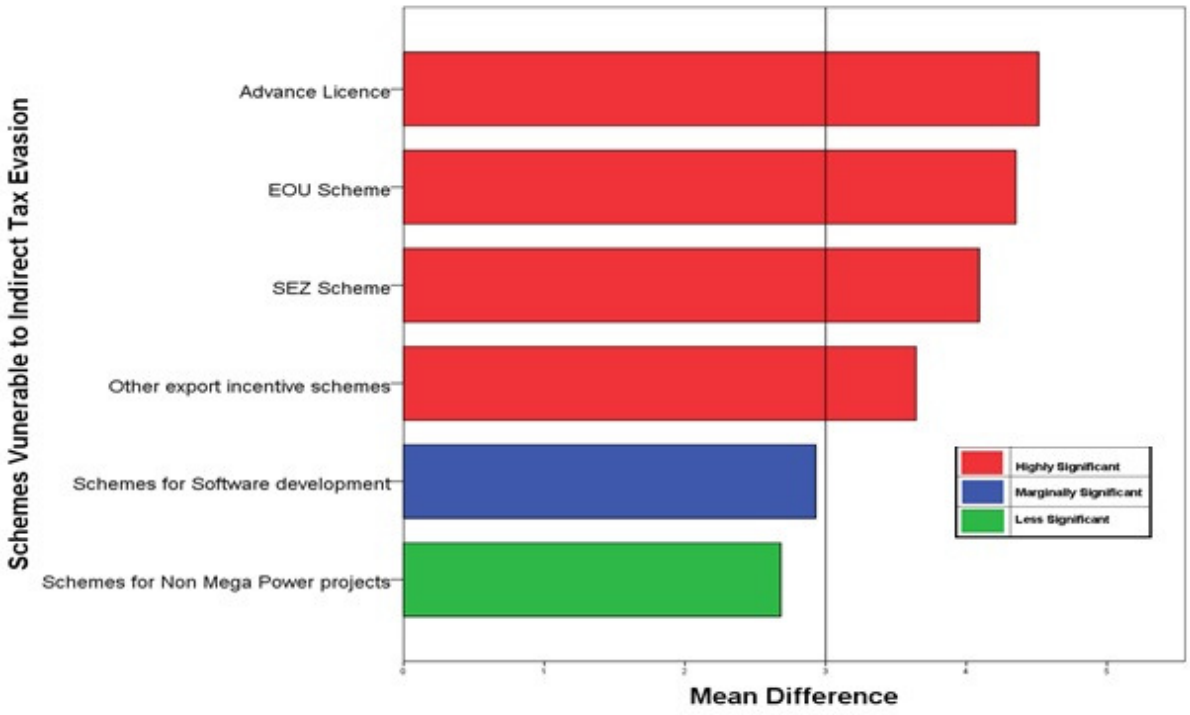
applicable for the goods of origin of that country; e.g. goods of Japan or Korean origin are declared as goods of Chinese origin and lower values applicable for Chinese goods are declared. Misuse of various incentives and exemption schemes is also evident from the data given below:

Figure 3.12:
Methods of customs duty evasion



Source: Field survey of senior revenue officials

Figure 3.13:
Schemes Vulnerable to Indirect Tax Evasion



Source: Field survey of senior revenue officials

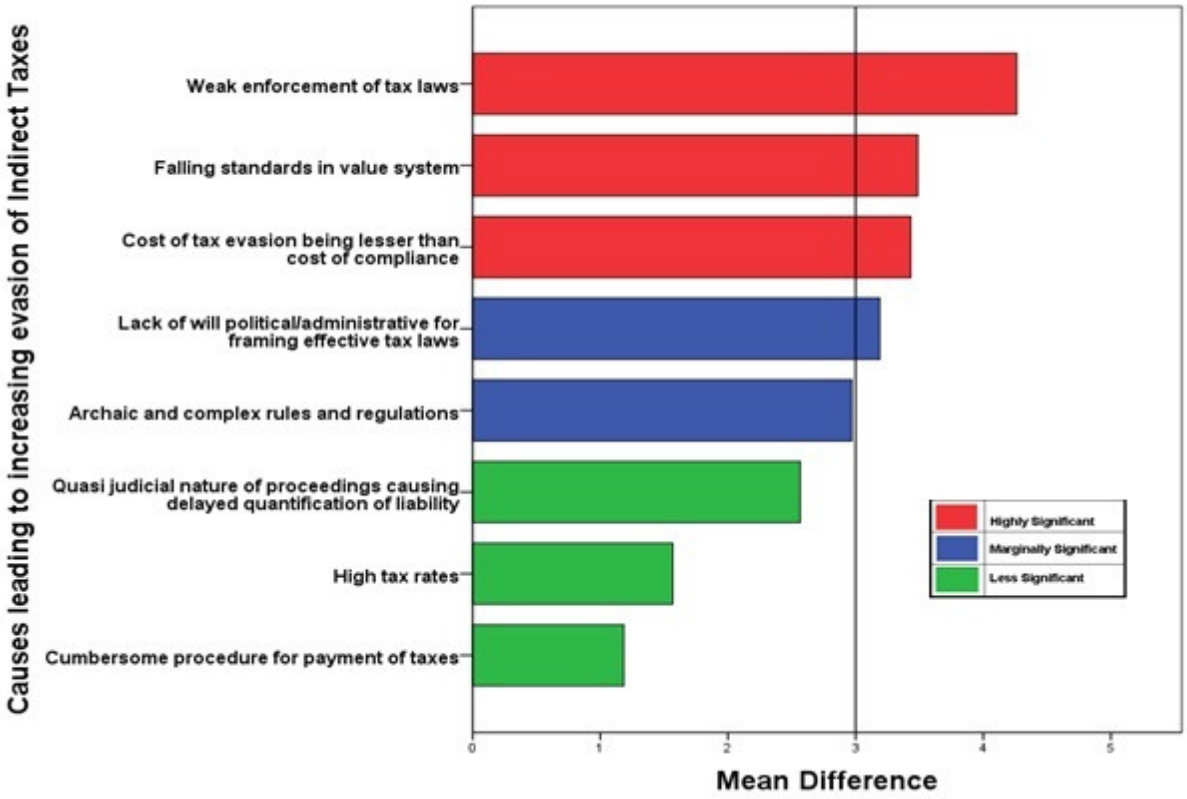
Table 3.8:						
Commercial Fraud Cases (by Typology) Detected by DRIduring Financial Year 2011-2012						
(Figures ₹ in crores)						
	2010-11			**2011-12**		
	No. of Cases	**Duty or Export Benefit Involved (₹. crore)**	**Share of Duty/ Export Benefit**	**No. of Cases**	**Duty or Export Benefit Involved (₹. crore)**	**Share of Duty/ Export Benefit**
Under Valuation	197	132.12	15.99%	186	496.24	26.95%
Mis-declaration	91	110.19	13.33%	129	861.93	46.80%
Misuse of DEEC/Advance License Scheme	18	264.62	32.02%	1	0.10	0.01%
Misuse of DEPB Scheme	34	3.8	0.46%	26	23.93	1.30%
Misuse of EPCG Scheme	10	3.33	0.40%	6	25.72	1.40%
Misuse of EOU/EPZ/SEZ Scheme	4	0.04	0.00%	6	9.66	0.52%
Misuse of end-use & other notifications	26	100.55	12.17%	56	309.24	16.79%
Misuse of Drawback Scheme	102	81.42	9.85%	13	25.93	1.41%
Others	99	130.4	15.78%	104	88.85	4.82%
TOTAL	**581**	**826.47**	**100.00%**	**527**	**1841.60**	**10.00%**

Table 3.9:											
DUTY-EVASION CASES DETECTED BY DRI (SCHEME WISE)											
S.No.	**SCHEME**	**2007-08**		**2008-09**		**2009-10**		**2010-11**		**2011-12**	
		No. of Cases	Duty	No. of Cases	Duty	No. of Cases	Duty	No. of Cases	Duty	No. of Cases	Duty
1.	Under Valuation	207	192.58	144	509.33	105	166.18	197	132.12	186	496.24
2.	Mis-declaration	63	31.26	66	100.76	100	215.24	91	110.19	129	61.93
3.	Mis-use of DEEC/Advance License	10	93.14	5	22.71	10	5.66	18	264.62	1	0.10
4.	Mis-use of DEPB	9	16.20	12	7.60	21	7.40	34	3.80	26	23.93
5.	Mis-use of EPCG	1	3.65	23	67.20	3	0.90	10	3.33	6	25.72
6.	Mis-use of EOU/EPZ/SEZ	6	83.35	7	34.75	9	3.28	4	0.04	6	9.66

7.	MIS-USE OF END-USE & OTHER NOTFN.	29	84.44	17	145.16	15	24.60	26	100.55	56	309.24
8.	DRAWBACK	37	12.82	7	21.80	38	91.76	102	81.42	13	25.93
9.	OTHERS	72	209.02	59	619.28	90	100.21	99	130.40	104	88.85
	TOTAL	**434**	**726.46**	**340**	**1528.59**	**391**	**615.23**	**581**	**826.47**	**527**	**1841.60**
Source: DRI Annual report											

During the survey it was also intended to seek the opinion of the experts on the ways to check the unaccounted income in areas of indirect taxes. Most of the respondents considered weak enforcement of tax laws, failing standards and value system and cost of tax evasion being lesser than cost of compliance being the primary reasons for evasion of taxes.(see figure 3.14)

Figure 3.14:
Causes leading to increasing evasion of indirect taxes



Source: Field survey of senior revenue officials

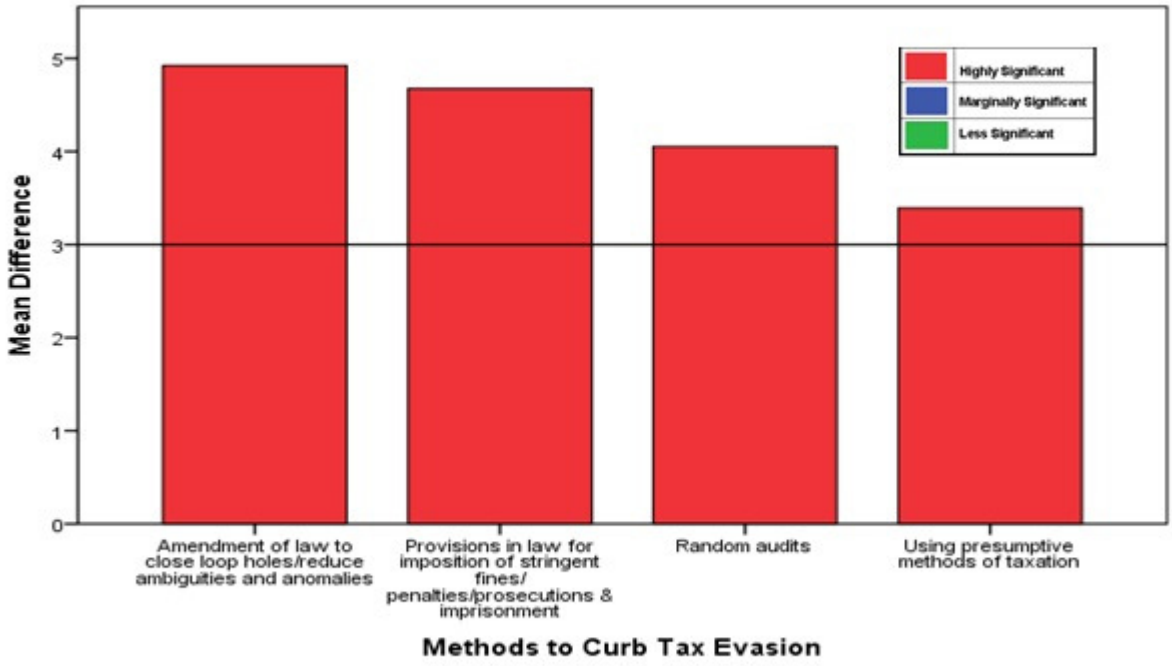
Suggestions based on observations

The most difficult challenge before the policy makers in India is of combating unaccounted money and money laundering in the manufacturing sector without impeding growth and innovation. Over the last two decades, India's tax administration has undergone extensive and much-needed modification and modernization. This has fostered a less intrusive tax system and encouraged voluntary compliance, such that effective tax rates have gone up in a dramatic manner. Unfortunately, true and effective attempts at simplification are often taken over by the piecemeal amendment of the tax laws to close loopholes that taxpayers have taken advantage of to avoid tax. This has actually led to increased complexity rather than simplification and in some cases further increases the opportunities for tax avoidance. Tax administration and governance issues relating to voluntary compliance, integrity and ethics and promoting trust in tax administration still remain a challenge before Indian tax administrators.

The poor state of tax administration has also been considered a major reason for low levels of compliance and high compliance cost. A major aspect of this is the virtual absence of data on both direct and indirect taxes even at the central level. There is an immediate requirement for networking of the information from various sources. Systems have to be evolved to put together information received from various sources. There must be meaningful exchange of information between the direct and indirect tax administrations and it is necessary to exchange information between central and state taxes. Most of the respondents agreed that building computerized information system will help to improve enforcement of taxes.

The tax reform in 2009/2010 includes a policy initiative for introducing a new package of presumptive taxation to encourage voluntary compliance by small businesses is welcome step in the area of simplifying tax administration and increasing compliance. Similarly, the introduction of production based levy for pan masala and guthka, by the Central Board of Excise and Customs in India in 2009 was a huge success.

Figure 3.15:
Methods to Curb Tax Evasion



Source: Field survey of senior revenue officials

Whereas such reforms have resulted in the simplification of many aspects of the fiscal legislation, there still remain several areas where further attention is needed. One such area is implementation of Goods and Services Tax (GST). GST would facilitate greater vertical equity in fiscal federalism, reduce cascading nature of commodity taxes and through shift to value addition as the basis for assessment unify the market for goods and services.

With regard to tax policy, changes can be expected in terms of legislation as well as administrative reforms to improve efficiency. The main legislative proposals are the DTC and the GST both of which are in various stages of legislative consultation. The DTC seeks to simplify the tax code, revamp the system of tax deductions and remove ambiguities of law. The GST aims at bringing a fairly unified system of input tax credits across the value chain and at an interstate level. Currently the central excise and service taxes have limited credit facilities up to the manufacturing stage. The state VAT is not geared to provide interstate input tax credits. It is proposed to institute a dual GST structure with separate central and state GSTs. This would require a constitutional amendment to allow

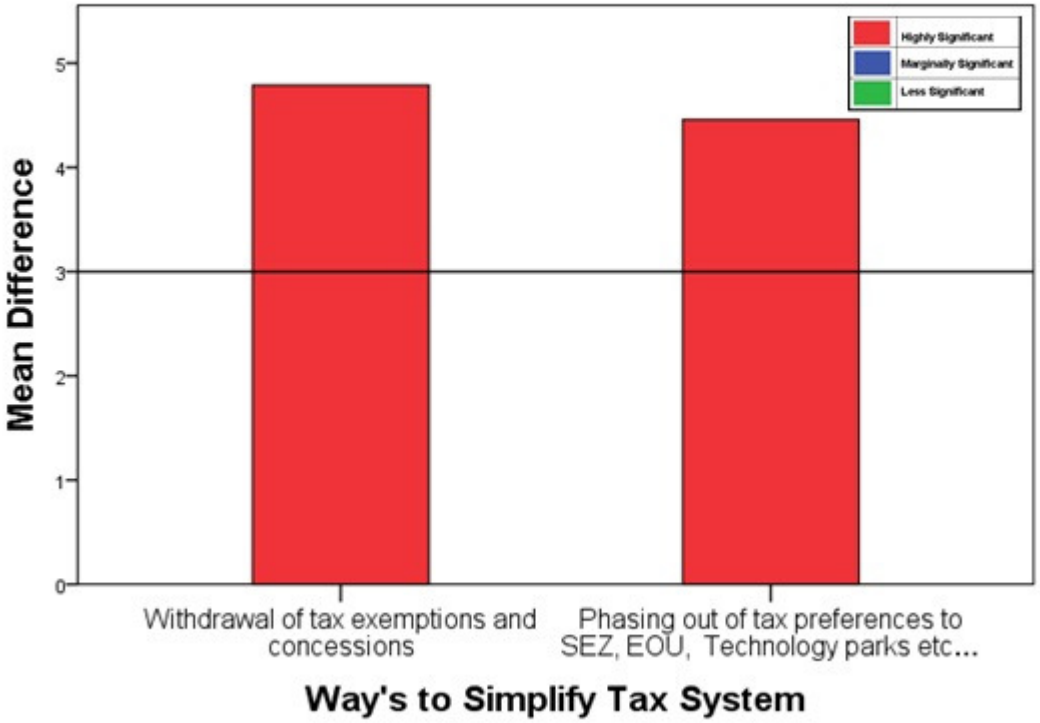
both the central and state governments to have concurrent jurisdiction over the entire value chain. Interstate GST credit and full credit for the central GST is envisaged. This would also require an advanced information technology (IT) infrastructure (Empowered Committee, 2009). IT is also likely to be further leveraged for improving the direct tax administration. Moves in this direction include increasing the number of Centralised Processing Centres (CPCs) that carry out bulk processing functions from one to four the number of taxpayer help centres and web-based taxpayer interface facilities are also to be increased substantially.
Ministry of Finance. 2011[43].

In defining options for further reform, the starting point is the basic structure of the tax. The corporate tax regime in India has a higher base rate, set off with sector specific tax incentives (exemptions/deductions). This complicated the effective tax computation as also resulted in protracted litigation. On the corporation tax, base broadening involves getting rid of the tax preferences. In particular, the exemption for profits from exports, free trade zones, technology parks, area-based exemptions for backward area development, for infrastructure should be phased out.

With regard to import duties, the reform will have to move in the direction of further reduction and unification of the rates. Equally important is the need to get rid of plethora of exemptions and concessional treatment to various categories including project imports. Wide ranging exemption is a problem also with excise duties. Therefore, one of the most important base-broadening measures should be to reduce the exemptions. In particular, the exemptions given to small-scale industry has not only eroded the tax base but has inhibited the growth of firms into an economic scale.

[43]**"Fiscal Policy Strategy Statement (Budget 2011-12)."**

Figure 3.16:
Ways to simplify tax system



Source: Field survey of senior revenue officials

Most of the respondents pointed towards the need for the policies avoiding negative protection. Protected markets make enterprises soft and encourage obsolete technologies. The World Bank has advocated this policy for India as working a level playing field (World Bank, 2008). This is a complex area in taxation practice and yet is very important. Regarding indirect taxes over the past several years, significant progress has been made to improve the tax structure, broaden the base and rationalize the rates. The indirect tax structure should be stimulus friendly and lead both to a wider tax net and a payer friendly system. In a nutshell, it can be recommended that the following steps will aid in the better tax compliance and growth of the manufacturing sector in India:

- the total tax levels should be brought down to levels obtaining in competing countries;
- early introduction of combined Goods and Services Tax (GST);
- rationalization of other taxes and duties, particularly at the state level;

- domestic value addition should be the core principle guiding tax structure;
- necessary studies in this regard for framing policies and guidelines should be initiated and corrections to be made in inverted duty structures where ever prevalent.

Securities Market

Securities markets provide effective intermediation of savings, allocation of investment, price discovery and hedging of risk. Participants in this market range from multinational financial conglomerates that employ tens of thousands of people to single-person offices offering stock brokerage or financial advisory services. New products and services are developed constantly in this market, in reaction to investor demand, market conditions, and advances in technology. The market has a high level of sophistication as the products are complex like derivatives and other structured products and the transactions are effected electronically and across international borders.

The securities market however, is subject to information imperfections, excess volatility, and market manipulation. This along with the sheer volume of transactions in many markets and jurisdictions make it potentially vulnerable to tax abuse and money laundering. The uniqueness of securities markets is that it can be used both to launder illicit funds obtained elsewhere, and to generate illicit funds within the industry itself through fraudulent activities.

The FATF report 2009[44] points out that in most of the countries, this sector, along with banking and insurance, is one of the core industries through which persons and entities can access the financial system. This easy access makes the sector vulnerable for parking ill-gotten unaccounted income.

Reasons for vulnerability of securities market

Some of the vulnerabilities peculiar to securities market are as under:

- The securities market because of being global in nature provides opportunities to carry out transactions across borders with a relative degree of anonymity;

[44] FATF Report October 2009,on Money Laundering and Terrorist Financing in the securities Sector, page 6;

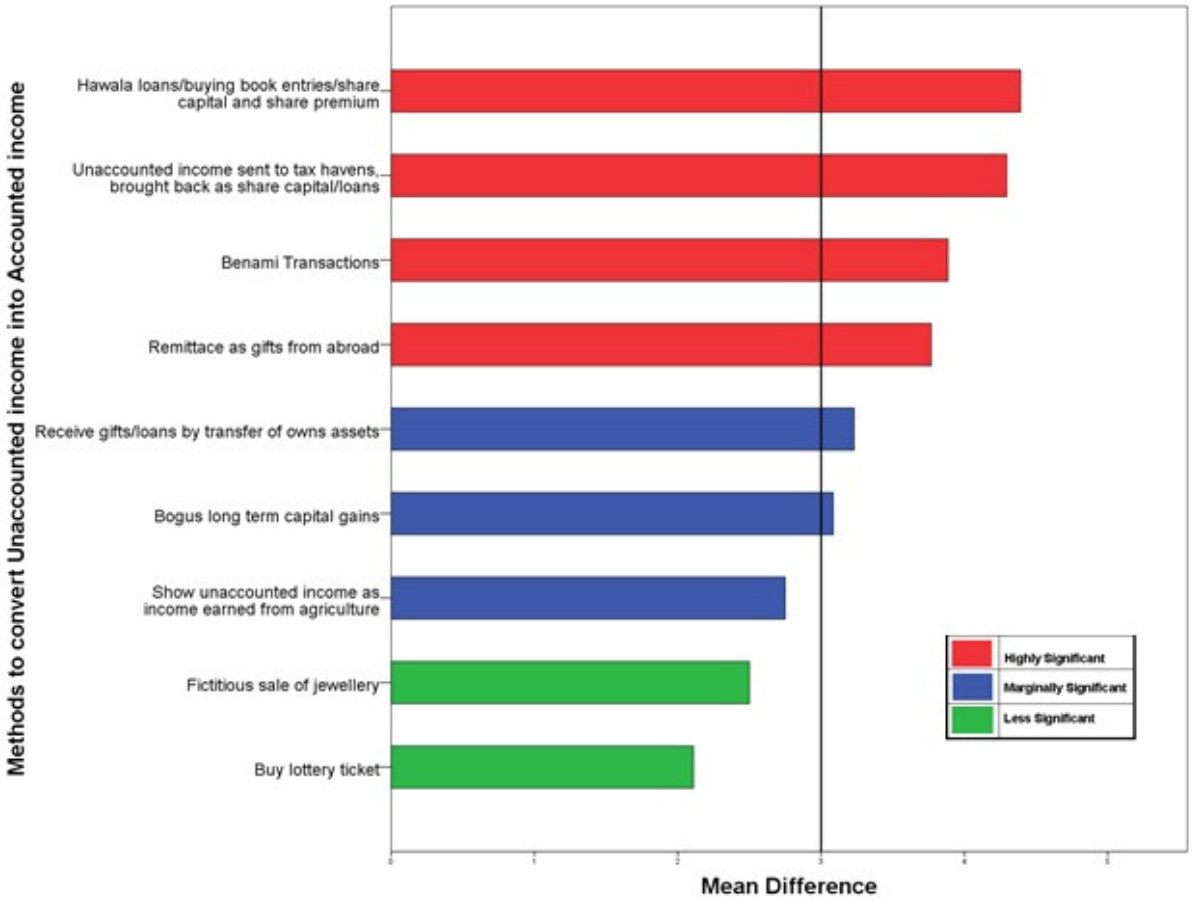
- The complexity of the products and the diversity of the players is one of the reasons for its attractiveness to unaccounted income;
- Accounts of the clients are introduced from one intermediary to another without adequate know your customer (KYC) investigations. This further complicates the structure and with multiple jurisdictions it often may erroneously be assumed that adequate due diligence procedures on a particular customer have already taken place in another jurisdiction.
- Establishing complex corporate structures and misusing corporate veil or intermediary companies;
- Transactions with customers or financial institutions operating in tax havens; and
- Usage of unregistered or unregulated modern investment vehicles like Participatory notes.

Methodology

The findings and observations on the securities market during the study are based on numerous unstructured interviews and focus group discussions with the various stakeholders like brokers, dealers, representatives from SEBI and RBI and on the basis of study material provided by CBDT (annual reports, seizure and search cases;),OECD and other literature. A questionnaire was developed to get insights into various aspects of securities market which are related to black money in the country. Workshops as mentioned in the section on sectoral analysis were carried out in various centers. The respondents included primarily senior revenue officials. The impressions gathered during the survey pointed apparently to an array of methods for converting unaccounted income into accounted income in the securities market with the different techniques customized to varied situations and needs of the individual/corporates/ firm etc. Amongst the various ways frequently adopted, the most widespread techniques which ranked higher on the gravity scale by more than 70% of the respondents are shown in the figure below. However, it is emphasized that these results are no more than a summary of the qualitative impressions of a certain groups of people. The value lies in the accumulated

knowledge and experience of people who are professionally concerned with black income and tax evasion.

Fig. 3.17:
Methods to convert unaccounted income into accounted income



Source: Field Survey of Senior Revenue Officials

The graph depicts the variables in order of importance. Any variable above the central line represents a statistically significant parameter considered to be most important. One sample t-test has been used to test the significance. The red bars depict those variables which are highly significant and the gravity of the parameter is more than 6 on the scale of 1-10. Blue bar depict moderate importance with gravity on a scale of 4-6 and green are less significant parameters with gravity less than 4.

The highest number of respondents considers that arranging for hawala loans, buying book entries and admission of share premium is the most common method utilized for conversion of black money into white money. It is followed by the method of using tax havens and bringing back the unaccounted money as share capital or loans. As per the respondents Benami transactions, getting gifts from abroad and bogus long term capital gains are also utilized invariably for conversion of unaccounted income.

Some brief description of the modus operandi in the various methods is as under:

Arranging of Hawala Loans: Hawala is a method used to round trip the unaccounted money to India. The money transferred outside may come back to India through various methods such as investments in Indian stock markets through participatory notes, raising of capital through foreign direct investment (FDI) especially from beneficial tax jurisdictions and by Indian companies raising capital through Global Depository Receipts (GDRs).

Participatory Note[45]*(*P-notes) Investment in the Indian Stock Market through PNs is another way in which the black money generated by Indians is re-invested in India. These instruments are traded overseas outside the direct purview of SEBI surveillance thereby raising many apprehensions about the beneficial ownership and the nature of funds invested in these instruments. Participatory Notes also aid in reducing the tax liability of the FIIs. The FII is subject to capital gains tax in India if he sells the shares and makes a profit from the sale of such shares. However, when the FII issues a PN to a hedge fund or other institutional buyers, the P-Note holder is not subject to Indian tax because the citus (issuance) of the P-Note is not in India.

The White Paper on Black Money[46] issued by CBDT, Department of Revenue, Ministry of Finance, GOI, highlighted the widespread use of participatory notes in the securities market in order to transfer illicit funds and convert them into white money. The White Paper is silent on quantum of monies round-tripped into India using the P Notes.

[45] Participatory Note is a derivative instrument issued in foreign jurisdictions, by a Foreign Institutional Investor (FII) or its sub-accounts against underlying Indian securities. PNs are popular among foreign investors since they allow these investors to earn returns on investment in the Indian market without undergoing the significant cost and time implications of directly investing in India.

[46] White Paper on Black Money, Ministry of Finance, Department of Revenue, Central Board of Direct Taxes, May, 2012

As response to the White Paper, the Securities and Exchange Board of India (Sebi), tightened the rules governing participatory notes by cutting the time lag in reporting these transactions[47]. It is also to be noted that though the dangers of crime money entering through P Notes is very well known, no attempt has been made so far to recount the recommendations of Tarapore Committee of Reserve Bank of India which recommended a ban on P Notes.

Admission of share application, share capital and share premium: This practice is very commonly employed in case of unquoted shares to convert black money into white money. The private limited companies either issue shares at a very high premium or book share application money. The idle share application or share premium money is just like an unsecured loan but without interest.

> ***Investigation case***
> ***On the basis of information received from FIU, search was conducted by the Mumbai directorate in four related cases. After discreet enquiries large networking of entry providers was unearthed. It was found that persons of one group were running more than 36 companies which were being used for providing bogus entries relating to share capital, Long Term capital gain, Short Term capital gain, gifts, sale and purchase bills etc. The transaction appeared to be genuinely conducted on stock exchanges. However, during enquiries it was accepted by the persons involved that none of the transactions had taken place on Stock Exchange. More than 24 agents all over India were using more than 300 bank accounts for the purpose. The estimated concealment of income on account of these transactions was likely to be around ₹ 1000 crores.***
> **Source: Annual Report 2009-10, Investigation Division, Central Board of Direct Taxes, Ministry of Revenue, GOI, pg 60**

One major amendment in Budget 2012 is under Section 56(2) of the Income tax Act whereby the share premium in excess of fair market value shall be treated as income. A new clause (viia) has been inserted in the Section 56(2) which reads as follows:

> *Section 56(2)(viia), "where a firm or a company not being a company in which the public are substantially interested, receives, in any previous year, from any person or persons, on or after the 1st day of June, 2010, any property, being shares of a company not being a company, in which the public are substantially interested,—*

[47]According to circular no. CIR/IMD/FIIC/14/2012 dated June 8, 2012 issued on June 8, 2012 by Sebi, foreign institutional investors will have to report monthly details of transactions done through P-notes within 10 days. Earlier, FIIs had a window of six months to report these transactions. The first such report will be for the month of October 2012, by November 10, 2012.

(i) without consideration, the aggregate fair market value of which exceeds fifty thousand rupees, the whole of the aggregate fair market value of such property;
(ii) for a consideration which is less than the aggregate fair market value of the property by an amount exceeding fifty thousand rupees, the aggregate fair market value of such property as exceeds such consideration :
Provided that this clause shall not apply to any such property received by way of a transaction not regarded as transfer under clause (via) or clause (vic) or clause (vicb) or clause (vid) or clause (vii) of section 47.
Explanation.—For the purposes of this clause, "fair market value" of a property, being shares of a company not being a company in which the public are substantially interested, shall have the meaning assigned to it in the Explanation to clause (vii);]
The insertion will become applicable w.e.f. 1-4-2013.

Now, the most important issue is... what is this fair market value of the unlisted share? No rules have been prescribed till now, to deal with this. How can fair market values be worked out for software and technology companies? Most acquisitions of private companies happen on the basis of mutual discussions between the acquirer and the current shareholder.

Benami transactions

Benami transaction is one where an asset is transferred or purchased in the name of one person but another person has paid consideration of transfer. Such transactions help to a large extent safe investment of black money. The existing legislation the Benami Transactions (Prohibition) Act, 1988 was proving highly ineffective to check the benami transactions. The Benami Transactions Prohibition Bill, 2011 will replace The Benami Transactions (Prohibition) Act, 1988. Various offences have been added in Parts A and B of the Schedule to the Bill, including those pertaining to insider trading and market manipulation which will aid in preventing money laundering by these activities.

Bogus long term capital gains

As long term capital gains of shares sold through recognized S.E on payment of Securities Transaction Tax (STT) are not subjected to tax, many a times business income is disguised as capital gains to take advantage of the wide gap in tax rate between the long term capital gains and business profit.

Investigation of claims of capital gains on shares resulted in conclusively establishing a large scale network of sham transactions of more than thousand five hundred crores. The investigation also exposed areas of systemic failures on the part of various regulatory agencies.

The Mumbai investigation unit conducted searches and surveys of share market hawala operators who were involved in arranging official LTCG. It was found that some of the beneficiaries were from Bangalore. Consequent to the information received, Bangalore Investigation Directorate conducted searches in respect of the beneficiaries on 20.4.2006. In response to the notices the assesse had filed return disclosing LTCG on sale of shares... It was found that the assesse had purchased physical shares of M/S Fast track entertainment Pvt. Ltd for ₹ 1 during April/May 2004 and sold the shares electronically through Bombay Stock Exchange for ₹ 55/ to INR90/ in May /June 2005. And LTCG was disclosed in the return for AY. 2005-06. Investigation into the buyers of the shares at high prices showed that they were none other than the promoters and directors of the company. The bank account related to these transactions showed credits in cash on proximate dates for the purpose of each purchase. This indicated that the whole transaction was only stage managed. Investigation with respect to flow of money from the assessee's account, his share broker, BSE, purchaser's share broker to purchaser's account revealed that huge sum of money in cash was deposited in ABN AMRO Bank or Standard Charted Bank and the same money was given back to the assesse after routing it back through various bank accounts of the Hawala Operation This investigation has not only exposed the bogus claim of Capital Gain but also indicated areas of systemic failures on the part of regulatory agencies like SEBI, Registrar of Companies, Company Law Board, etc. It was established that a sum of ₹ 400 Crores was laundered in the name of just one company whose capital base is ₹ 7 Crores with net profit of ₹ 1.25 Lakhs out of the turnover of INR3 Lakhs. There are 25 such companies in whose name thousands of crores of Black Money has been laundered and given the color of share transactions. It is estimated on a conservative basis, that about ₹. 2,500 Crores of black money has been converted through this modus-operandi.

Source: Bogus Long Term Gains in Share Transactions, Let Us Share, Vol II 2009, CBDT page 81

As per the experience of the tax experts the rate for giving bogus LTCG in the grey market is approximately 5%. It is suggested that if a nominal tax of say 10% on LTCG in case of all taxpayers is levied, it will make bogus LTCG costly and thereby act as a deterrent or reduce the incentive to for LTCG route to convert black money.

Treaty with Mauritius

Foreign portfolio investors and other categories of investors have to pay a short-term capital gains tax of 10% in India if they sell shares within a year of purchase. They are, however, exempt from paying long term capital gains tax as local investors if they sell the shares after one year of purchase. But by routing their investments from Mauritius, foreign portfolio investors do not have to pay even the short-term capital gains tax by virtue of Indo-Mauritius tax treaty. The Income tax department cannot deny the treaty tax benefits as the Supreme Court observed in *Vodafone International Holding BV v. UOI and Another[2012] 107 CLA 63 (SC)*, that certainty and stability form the basic foundation of any fiscal system.

Vodafone International Holdings BV v. Union of India and another [2012] 107 CLA 63 (SC)
The supreme court has held that applying the 'look at test' in order to ascertain the true nature and character of the transaction, the offshore transaction between two non-resident companies is nothing but a bonafide structural foreign direct investment into India which falls outside territorial jurisdiction of India and is hence not taxable. Thus, where the offshore transaction evidences participating investment and not a sham or tax avoidant pre-ordained transaction and the offshore transaction is between two non-resident companies and the subject-matter of the transaction is the transfer of the shares in a foreign company, the Indian tax authority has no territorial tax jurisdiction to tax the offshore transaction.

The apex court also mentioned that the Direct Tax Code ('DTC') Bill, 2010 proposes to tax income from transfer of shares of a foreign company by a non-resident, where at any time during 12 months preceding the transfer, the fair market value of the assets in India, owned directly or indirectly, by the company, represents at least 50 per cent of the fair market value of all assets owned by the company. Thus, the DTC Bill, 2010 proposes taxation of offshore share transactions. This proposal indicates in a way that indirect transfers are not covered by the existing section 9(1) (*i*) of the Income Tax Act. In fact, the DTC Bill, 2009 expressly stated that income accruing even from indirect transfer of a capital asset situate in India would be deemed to accrue in India. These proposals, therefore, show that in the existing section 9(1) (*i*) the word indirect cannot be read on the basis of purposive construction. The question of providing 'look through' in the statute or in the treaty is a matter of policy. It is to be expressly provided for in

the statute or in the treaty. Similarly, limitation of benefits has to be expressly provided for in the treaty. Such clauses cannot be read into the section by interpretation.

Another active method of tax avoidance through Mauritius is share buyback, which the Indian subsidiaries of multinational companies such as, Accenture and Capgemini have used in recent year. For example, Accenture holds nearly 100% in Accenture India through a Mauritius-registered entity, Beaumont Development Centre Holdings. In the last five years, Accenture India has twice bought back shares, paying ₹ 474 crore to Beaumont. Long-term capital gains tax (holding period of above one year) in India is zero. And since India has a double taxation avoidance agreement with Mauritius, the company does not have to pay capital gains tax in the island nation too. Had Accenture routed the profits as dividend, it would have had to pay dividend distribution tax of 16.9% (16.2225% now) or ₹ 80 crore. Even Capgemini India had a share buyback scheme in March 2011, where it extinguished 7% of its capital for ₹ 366 crore; interestingly only one shareholder, Kanbay Asia (Mauritius), participated. In this way, multinationals and FII are making use of the loopholes available in tax laws and tax treaties to avoid tax liability**.**

Engaging in Market Manipulation

Market manipulation generally refers to a conduct that is intended to deceive investors by controlling or artificially affecting the market for a given security. The main purpose behind it is to drive the price of scrip up or down in order to profit from the price differentials. There are number of methods which manipulators use to achieve these results. The most pervasive method is the *"pump and dump schemes"***.** This involves market manipulation by artificial inflation of stock prices on misleading information. The modus operandi is simple. Individuals obtain large blocks of stock in a company before it is traded publically. The stocks may be purchased using black money. The shares are usually purchased at very low prices. Then the perpetrators get in touch with brokers to promote these shares to their clients. Misleading information is circulated in order to create artificial demand by the perpetrators through multiple jurisdictions. When shares reach a peak price the perpetrators of this fraud sell the shares and obtain profits from the artificial inflation of the prices. Eventually the company is allowed to fail and the shares to become worthless.

Setting up a company as a front for money laundering

During discussion with brokers, officials from SEBI and with other financial experts many instances involving setting up of companies as a front for money laundering were brought out. Cases are there in which public traded companies are established in order to serve as front for a money laundering operation and also to sell its shares to unwitting investors. A company is created for a legitimate commercial activity and then illegal funds are introduced using various fraudulent accounting practices. Establishing various offshore entities through which funds may be channelled is one favourite such method.

Trading in Derivatives

Derivatives[48] are primarily risk management tools. More accurately, they are volatility management tools. Trading in derivatives has now become an integral part of the global financial market. The past three decades have seen a singular rise in the development and growth of derivatives markets the world over. Trading in futures and options has seen a big rise and time and again, new products have been introduced which are related to this concept. Taxation of derivatives is perhaps as complex an exercise as the transaction itself. Several questions arise about characterization of income, point of taxability, treatment of the derivative and the underlying transaction etc. The most common issue that arises in taxation of derivatives transaction is that of whether derivatives transactions are always to be regarded as business transactions. The Finance Act, 2005 amended the proviso to section 43(5) w. e. f assessment year 2006-07 to provide that derivative trading transactions were not be regarded as speculative transactions, subject to fulfilment of certain conditions. However, the issue of whether an activity amounts to a business or not depends upon various factors, and is not decided just because of the existence or absence of any one circumstance. There can be situations where derivatives transactions may not amount to a business. In general, if a

[48]The term derivative is defined u/s.45V of the Reserve Bank of India Act, 1949 as meaning "an instrument, to be settled at a future date, whose value is derived from change in interest rate, foreign exchange rate, credit rating or credit index, price of securities (also called 'underlying'), or a combination of more than one of them and includes interest rate swaps, forward rate agreements, foreign currency swaps, foreign currency-rupee swaps, foreign currency options, foreign currency-rupee options or such other instruments as may be specified by the Bank from time to time".

derivative transaction is entered into in the ordinary course of business, it should be considered as 'business income' otherwise, it should be characterized as 'other income'.

On the other hand, a derivative, being a security and a right under a contract, is certainly a valuable right, which is capable of being assigned. The right under the derivatives contract can therefore certainly be regarded as property, and therefore as a capital asset. A view is therefore possible that on expiry of the derivatives, there is a transfer of the capital asset. The gains or losses arising from such derivatives would accordingly be taxable under the head "Capital Gains".

Foreign Exchange derivative transactions[49] have also been introduced now. The corporate sector in India has entered into a number of foreign exchange derivative transactions in recent year This combined with extreme volatility in the foreign exchange market in the last financial year is reported to have resulted in substantial losses to these companies on account of trading in forex derivatives. A large number of companies are reporting such losses on 'Marked to Market[50]' basis either *suo motu* or in compliance of the Accounting Standard or advisory circular issued by the Institute of Chartered Accountants. The issue whether such losses on account of forex derivatives can be allowed against the taxable income was considered by the

[49]The following issues arise in connection with the allowability of forex derivative losses :

(a) Whether losses on account of forex derivatives are to be considered in the threshold itself u/s.28 as a business loss or they are in the nature of business expenditure subject to the restrictions u/s.29-44?

(b) Whether the MTM loss provided for in the books of an entity pursuant to AS-30 is allowable under the Income-tax Act?

(c) Whether crystallised losses on account of forex derivatives including exotic option contracts settled otherwise than by delivery of foreign currency are speculative in nature and liable to be dealt with separately as per S. 43(5) of the Income-tax Act ?

(d) In cases where few assessees have challenged the validity of these contracts on the ground that they are wager in nature and void u/s.30 of the Contract Act, whether the said loss may be termed as speculative u/s.43(5) of the Income-tax Act ?

In cases where the exporters have gone to the Courts challenging the validity of the contracts under the Contract Act on the ground that they are illegal contracts, whether disallowance could be made under explanation to S. 37(1).

[50] Marked to Market" is in substance a methodology of assigning value to a position held in a financial instrument based on its market price on the closing day of the accounting or reporting record. Essentially, 'Marked to Market' is a concept under which financial instruments are valued at market rate so as to report their actual value on the reporting date. This is required from the point of view of transparent accounting practices for the benefit of the shareholders of the company and its other stakeholdeINR Where companies make such an adjustment through their Trading or Profit/Loss Account, they book a corresponding loss (*i.e.,* the difference between the purchase price and the value as on the valuation date) in their accounts. This loss is a notional loss as no sale/conclusion/settlement of contract has taken place and the asset continues to be owned by the company.

Board. The CBDT issued Instruction No. 03/2010[51] to assessing officers regarding the loss on account of currency derivatives.

The entire concept of taxation of derivatives is at crossroads. As the market for derivatives is large and fast growing, a clarification on the taxation aspects of these transactions is of paramount importance.

With respect to technology, automation, disclosure, risk containment and reduction in transaction costs Indian capital market has outperformed those in developed countries. More participation and depth of instruments is still required. The improved monitoring systems will reduce the chances of market manipulation by injecting unaccounted money in the system and help in evolving a transparent, principle based capital market in India.

Diamond Industry

The two major segments of the gems and jewellery business in India are jewellery fabrication and diamond processing in form of cut and polished diamonds (CPDs). A predominant portion of rough, uncut diamonds processed in India are exported either in the form of polished diamonds or in the form of finished diamond jewellery. Gold jewellery fabrication comprises 29.86% of the total gem and jewellery export basket while Cut & Polished Diamonds (CPDs) have a bigger share of around 65.49%.[52]

The diamond industry has registered a remarkable growth over the last four decades. India has the distinction of being one of the first countries to introduce diamonds to the world and also one of the first countries to mine, cut & polish, and trade in diamonds. India is the leading diamond cutting nation in the world.

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[51] As the revenue implications of such transaction are large, the Assessing Officers need to examine the statements of accounts and the notes to accounts with a view to find out any reference to any loss on account of forex-derivatives. In some cases, these losses may be camouflaged under the 'financial charges', 'foreign exchange loss' or some similar head which may make it difficult to detect them. In such cases, the Assessing Officers should make a specific query asking the assessee to give a break up of any 'Marked to Market' loss on a forex-derivatives included in the Profit and Loss Account and examine whether such transactions are 'eligible transaction' in terms of section 43(*5*)(*d*). An adjustment to the taxable income may therefore be made, if necessary, keeping in view the provisions of law referred to above.

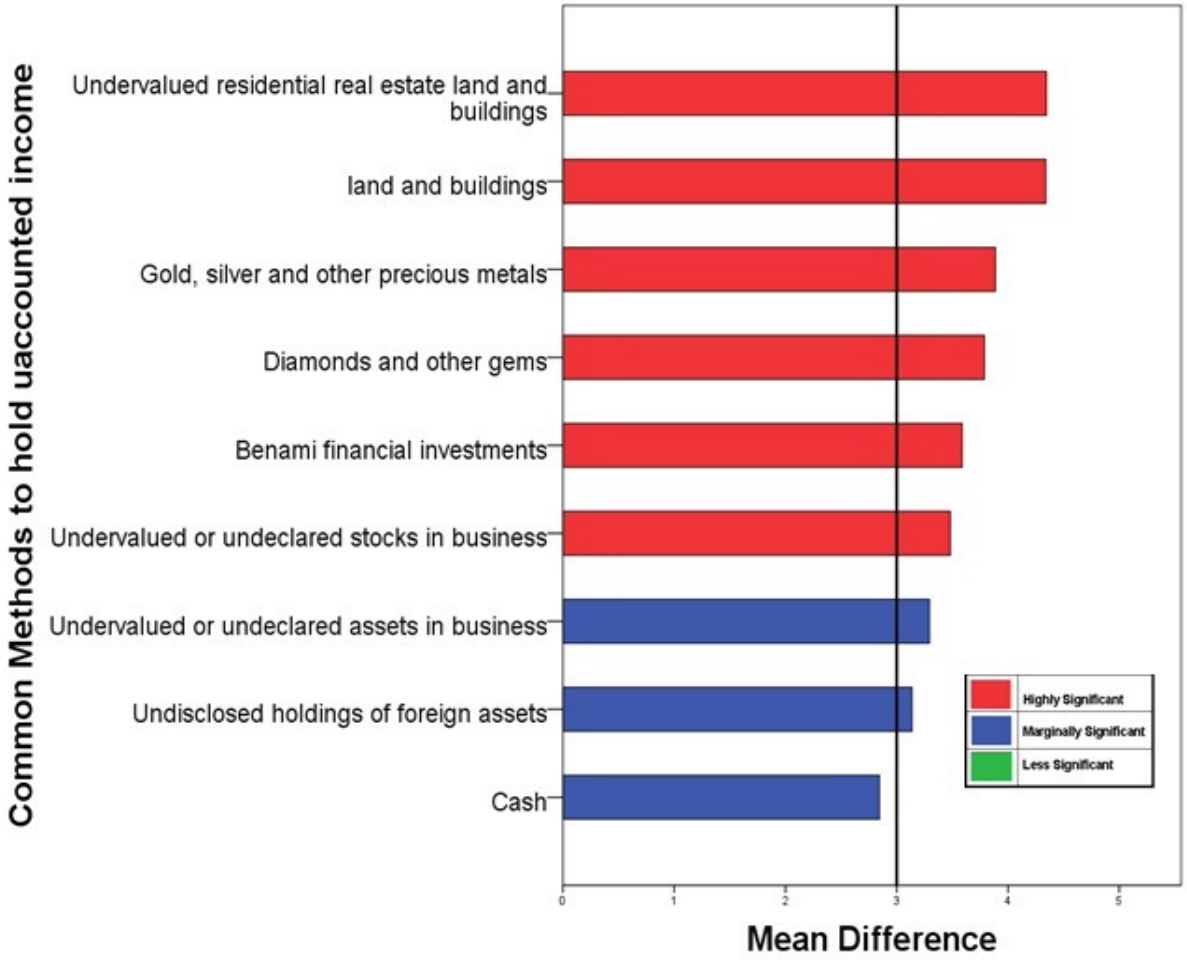
[52] Gems and Jewellery Export Promotion Council Annual Performance Report, 2010-11.

The performance of the gem and jewellery industry is critical as it contributes around 14% to India's total merchandise exports.[53]. The industry has also witnessed a considerable growth in the volume of exports from export figures of US$ 29358.49 million in the FY 2009-2010, to US$ 43139.24 million in FY2010-2011, thus indicating a net increase of 46.89% in the total Gem & Jewellery export sector. The growth in the sector was primarily driven by Cut & Polished Diamonds which registered an increase of 54.91% in FY '11. The exports of CPDs grew from US$18243.92 million in 2009-10 to US$ 28251.92 million in 2010-2011.

This industry has a highly unorganised trade, has labour intensive operations and is subject to price volatility. There are very peculiar features in diamond trading which make it vulnerable to tax evasion and money laundering. A number of interviews were conducted during the course of the present study to identify the reasons for high vulnerability of this sector to unaccounted money.

[53] Ibid.

Fig: 3.18:
Common methods to hold unaccounted income



Source: Field survey of senior revenue officials

Vulnerabilities of Diamond Industry

Discussions and interactions with Officials from CBDT and CBEC and representatives from Gems and Jewellery Export Promotion Council supported by literature review revealed that admission of unaccounted income in the gems and jewellery sector, especially, in the diamond industry is very high. In fact in the case of the diamond trading real transactions never tally with what is recorded in the books of accounts presented before the tax authorities. The results of the field interactions also pointed that the most preferred form of holding black money after real estate was in the form of diamond, gold and other gems (see figure 3.20).

Based on the survey results, it was considered important to understand the vulnerabilities in the diamond industry in details. The decision to delve further was supported by the fact that figures of export of diamond and gold jewellery generally, defy the trends on market consumption abroad and particularly the economic condition prevailing in the West and other countries. Thus, there was a strong suspicion on just re-routing of these items. It was noted that several cases of this kind have been booked by enforcement agencies like DRI and Preventive Wing of Customs over the years.

On a detailed discussion with experts, some of the major vulnerabilities of diamond industry noticed are as under:

- Valuation of a diamond is an art and not a science. It cannot be valued based on average or weighted average of past purchases since qualities of all purchases are different unlike other metal or commodity where particular type of quality is only manufactured or dealt in. Typically value of any particular diamond is based on the following 4Cs (Caratage, Colour, Clarity and Cut), by changing any of the characteristics, value is affected disproportionately, other factors being equal.
- Maintenance of stock details/ register of diamonds based on quality or number of pieces is impracticable since there are large variations in quality. The practice in the industry has been to maintain stock on caratage basis. This leads to lot of subjectivity in stock valuation and there is a scope for huge manipulation.
- Diamonds have a high intrinsic value and have a compact size. This makes it as an attractive vehicle for money laundering world- wide. The ease with which the diamonds can be hidden and transported and its high value make it further vulnerable for money laundering.

Common methods of generation of unaccounted income

Experience of tax officials as found through survey reveals that the most common methods of suppression of profits and generation of unaccounted income in this trade include

- suppression of the value of closing stock and stock manipulation;
- understatement of yield;

- inflation of labour expenses;
- overstatement of rejection;
- bogus purchases through accommodation bills;
- unaccounted trading;
- family controlled; and
- dabba system

Detailed methodology in this regard has been explained by tax authorities as under:

Suppression of the value of stock and stock manipulation: Rough diamonds of lower quality are purchased in the local market abroad and imported into India. When these diamonds reach India, these are shown to be against the invoices from the Diamond Trading Company (DTC), but actual stock may not be of the quality shown in these invoices. Sometimes actual exporters also manipulate the valuation of stock of diamonds by taking bills from bill providers in view of the fact that stock of diamonds cannot be maintained quality-wise.

In the case of Dr. Subhashchandra & Co. vs. ACIT, [2010] 123 ITD 635 (AHD), the Hon'ble ITAT Ahmedabad Bench, has held that assessee's method of valuation of closing stock of polished diamonds on the basis of net realizable value is not correct. Assessing Officer took a view that valuation so made was without any basis and, thus, rejected assessee's books of account and thereafter, Assessing Officer valued closing stock at average cost and made certain addition to assessee's income. Hon'ble ITAT while confirming the addition made by the AO held that even though net realizable value method is duly recognized by AS-2, yet onus shown by him is correct value and is less than cost.

Understatement of yield: This is another common method of suppression of production. Yield depends upon the quality and size of the rough diamonds. The average yield generally ranges between 25 to 40%. An understatement of yield by even 2 to 3% can make a big difference in suppression of income.

Inflation of labour expenses: The manufacturing of the diamond is done at the factory site and the labourers are generally paid in cash. Such payments in cash to labourers or job work contractors are sometimes not shown in the regular books of accounts and are shown only when payments are received through banking channels which have to be recorded in books of

accounts. The head office sends bank drafts. The bank drafts are deposited in the bank account, and simultaneously cheques are prepared in the names of job work contractors which are deposited in the bank account of the job contractors and cash is withdrawn from their bank account. Cash so withdrawn, is again sent to the head office, through the 'angadias' or otherwise.

*In the case of **DCIT vs. Samir Diamonds Export, [1999] 71 ITD 75 (Mum)**, the ITAT Mumbai Bench upheld the order of AO in estimating the profits of the assesse. A diamond exporter, who imported rough diamonds and after cutting, polishing, etc., exported the final product. Assesse admitted before the Assessing Officer that it did not maintain details of polished diamonds on the basis of weight, cut, clarity, shape and number of pieces. Assesse also did not furnish details regarding issuing of lots of rough diamond to labour parties for cutting, polishing, etc., and actual yield therefrom as they were said to have been destroyed after goods were received back. Assessing Officer further found that assesse had shown a uniform yield between 25 per cent to 26 per cent of polished diamonds from all sorts of rough diamonds, good or bad;, while number of yield varied from 4 pieces to 200 pieces per carat. He also found that labour charges were also shown to have been paid at uniform rate irrespective of quality of diamond which was inconceivable. He, therefore, concluded that in absence of vital details and in view of incompleteness of books of account, book results could not be accepted and on the basis of assessee's own record and results disclosed by sister concerns, made flat addition at 5 per cent of disclosed sales. The ITAT held that assesse cannot claim that since his books of account were found to be correct and complete in preceding years, it is a conclusive proof of fact that they are correct and complete for subsequent year also. Further the ITAT rejected the contention of the assesse that it was its prerogative to maintain books of account in a manner that it liked and that Assessing Officer could not reject them because they had been accepted in past. The Hon'ble ITAT held that in instant case, Assessing Officer was correct in coming to conclusion that accounts were not correct and complete because corroborative and contemporaneous evidence had been admittedly destroyed and was, therefore, justified in invoking provisions of section 145(2). Further, since assesse did not furnish any explanation for a sharp decline in gross profit rate from 11.7 per cent in immediately preceding year to only 5.99 per cent in assessment year under consideration, Assessing Officer was justified in making flat addition at 5 per cent of disclosed sales.*

Overstatement of rejection or wastage: Only the trader has the knowledge of wastage in polishing and so he decides how much rejection is to be shown in the regular books of accounts. The tax authorities do not have any basis to determine or estimate it. It can range from 2-3% to 50% of the total rough diamonds imported. The so-called rejection is sold in the

local market at higher rate in view of the fact that these are not rejection but actual rough diamonds. In these transactions, the entire sale consideration is trader's profit earned outside the books of accounts, as he has already debited purchase value of such stock. Rejection is claimed to be of no commercial use or value, it is shown as re-export, and the documents relating to re-export are obtained in support of the claim.

Bogus purchases through accommodation bills: The Indian sight holders procure rough diamonds from their companies sometimes based in Belgium. These sight holders sometimes sell in local market either in Belgium or in India and get premium on rough diamond. These are then exported to India via the hawala route through bill providers. The bill providers mainly operating from Kolkata comply with all the formalities i.e. RBI and claim that they are genuine importers. The person who takes the goods from bill providers sells it in local market unofficially and settlement of payment takes place through Angadia (parallel banking system). Rough diamonds circulating in the market get converted into polished diamonds and on conversion are again sold in local market unofficially and thus result in generation of unaccounted income and wealth. Actual exporters also buys polished diamonds from such people unofficially however bills for such purchases are taken from bill providers who has imported the rough diamonds at first instance. The bill providers, converts rough diamonds imported in books as polished diamonds through dubious means by fudging their accounts. The bill providers charge commission (around 0.10 to 0.20 % of turnover) for facilitating such transaction for diamond exporters/ importers.

Unaccounted Trading: The diamonds sold by the DTC through sight system are of better quality and there is always a huge demand in the open market for such diamonds. The sight holder sells entire or part of the diamonds purchased from sight in the open market, and earns profit on such transactions which are not recorded in regular books of accounts. Such profit is brought to India with the help of sister concerns having offices outside India. Therefore, the transactions of a diamond merchant with his sister concerns require deep scrutiny.

1. On the basis of information received, two passengers carrying jewellery worth ₹ 1.27 Cr. from Ahmedabad to Mumbai were intercepted by the AIU, Mumbai on 10.10.2009. In their statements, they could not offer any satisfactory

explanation regarding source of the said jewellery. Accordingly, a survey was conducted on the business premises of the Jewellery Company which led to detection of certain incriminating documents in the form of Jangads for unaccounted diamonds worth ₹ 8.81 Cr. The jewellery was also not recorded in the books of the Jewellers and it had claimed to have purchased the said jewellery from a jeweller in Bhavnagar. Accordingly, the AIU, Ahmedabad was requested to verify the facts. The Bhavnagar jeweller however denied the delivery of such jewellery. When this fact was confronted to the Director of the jewellery company, he could not offer any satisfactory explanation and admitted undisclosed income of ₹ 10.08 Cr for F.Y.2009-10.

2. AIU, Mumbai intercepted a passenger who was carrying Diamond Jewellery worth INR85 lac. When questioned, he could not produce the transfer vouchers and also failed to explain satisfactorily the source of the same. Accordingly, a survey action was carried out on the business premises of the company engaged in the business of manufacturing and sales of diamond studded gold jewellery which led to detection of unaccounted stock of ₹ 8.56 Cr.

Source: Annual Report 2009-10, Investigation Division, Central Board of Direct Taxes, Ministry of Revenue, GOI, pg 77

Family Controlled: The diamond trading business is generally controlled by a very close group of blood relations. Almost 90% trade is in the hands of a group of businessmen reportedly from Palitana and the balance 10% is in the hands of Kathiawadis and some other trading. This facilitates close group operations and transaction in the manner the trader's desire. Money is retained in India or abroad at their sweet will, by way of under or over-invoicing of imports and exports which is managed through imports of rough diamonds or export of finished diamonds.

In the case of CIT v. Shatrunjay Diamonds [2003] 128 Taxman 759(Bom.) the assesse had imported diamonds from a sister concern in New York and on comparison of prices of diamonds imported, the AO found that the diamonds are excessively priced, the AO made disallowances u/s 40A(2)(b) of the Act. On appeal, in view of the entities not being at arm's length, the High upheld the order of the AO.

Dabba system: Another practice adopted by some of the diamond merchants is called 'dabba system'. In this, the exported polished diamonds are brought back to India through persons who are engaged in making accommodating entries and bills showing the transactions as imports in their books of accounts and show sale of imported diamonds to the exporting The purpose behind such practice is to inflate export turnover to get "export house" status, to get more credit facilities from the banks both in India and abroad etc., and to claim higher

deduction under several provisions of the Act. Further these people obtain double finance from institution in India as well as abroad. When the rough diamonds are received at the head office, it is generally shown that these diamonds have been got converted into polished diamonds and then exported.

Alternatively sometime the entire stock of rough diamonds as such is sold in the local market and profits not disclosed in regular books of accounts. In order to obtain bank finance at cheaper rate, the trader may purchase polished diamonds from local market and export the same for and on behalf of other exporting This system is known as buying exports for utilizing the bank facilities because theses exporters have got the export credit facility at cheaper rate and they divert the funds in stock market / realty market. It is called round-tripping of diamonds- a process in which a series of exports and imports of the same goods for the purpose of receiving greater bank financing. This was very prevalent till an import duty of 2% was recently levied. This taxation of diamond imports has to some extent put a check on the round-tripping of diamonds.

Suggestions

This sector is an important sector from the point of view of both generation and investment of unaccounted income. It has been observed that most of the transactions in this sector go unreported which make the sector all the more vulnerable.

- More law enforcement measures are required to be devoted to curb abuses in the diamond trade. Income tax Act making it mandatory to obtain PAN or Form 60/61 for purchase of bullion above 5 lakhs is a step in the direction to reduce unreported income generation and use.
- Coordination between Income Tax and the Customs department may also facilitate better monitoring of in case of evasion by unaccounted trading and accommodation bills.
- As suggested in the white paper if any unexplained bullion is found during course of search , mandatory penalty @300%u/s 271 (1)c should be imposed.

- Where high value rough diamonds are purchased and still a higher rejection is being claimed, verification of physical stock of rejection with reference to what is shown in books is suggested.

Chapter - 4

MONEY LAUNDERING: NATURE OF ACTIVITIES AND RAMIFICATIONS TO NATIONAL SECURITY

4

MONEY LAUNDERING: NATURE OF ACTIVITIES AND RAMIFICATIONS TO NATIONAL SECURITY

Background and Introduction

The terms of reference of the study relating to *profiling the nature of activities engendering money laundering both inside and outside the country with its ramifications on national security* are discussed in this section of the report. As a preliminary initiative the meaning of the term money laundering has been conceptualised and later an attempt is made to understand the various *modi operandi*.

The term 'Money Laundering[54]' (ML, *in the sequel*) is the process by which economic offenders disguise the unlawful origin of a sum of money. In this sense ML is a by-product of illegal economy and illegal money thus generated floats in the financial system, both domestically and overseas.

The increasing integration of the world's financial system and with improvement in technology has facilitated free movement of capital across borders and within borders, helping money launderers to make use of the system to hide their ill-gotten gains. This has serious social consequences. It impacts not only the economic system of the country, ratherit is a threat to national security because it provides the fuel for, terrorists, arms dealers, and other criminals to operate and expand their criminal enterprises.

The Directorate of Enforcement (*henceforth*, ED) is the authorized agency of the Government of India to investigate all ML related issues within the purview of Prevention of Money

[54] According to PMLA, 2002, the goal of a large number of criminal activities is to generate profit for the individual or group that carries out the acts. The term 'money laundering' is the processing of following criminal proceeds to disguise their illegal origin. Illegal arms sales, smuggling, and other organized crime, including drug trafficking and prostitution rings, can generate huge amounts of money. Embezzlement, insider trading, bribery and computer fraud schemes can also produce large profits and create the incentive to 'legitimise' the ill-gotten gains through money laundering. The money so generated is tainted and is in the nature of 'dirty money'. It is process of conversion of such proceeds of crime, the 'dirty money', to make it appear legitimate money.

Laundering Act (*henceforth*, PMLA). The available statistics highlight the scope of money laundering offence in India and gives an account of searches / confiscation of currency during 1990 to 2010 under FERA and FEMA (see Annexure 4.I).

Money Laundering: Genesis, Issues, and Challenges

The review of related literature[55] on money laundering revealed that tax evasion and slush funds are the strong bases for the process of money laundering. Availability of easy unaccounted money in any part of the world fuels activities of terrorists, drug dealers, illegal arms dealers and other criminals to operate and expand their criminal enterprises.

Certain locations[56], more prone to ML activities were identified for gathering primary information. During the course of discussions with experts, senior officials of revenue and enforcement agencies and steering committee members it was indicated that the following are the prominent activities at International Bordering States of India that involve in activities engendering ML: *drug trafficking; smuggling of Gold / Electronic goods; false declaration of goods under export/import as part of organised crime to obtain illegally certain benefits given by the government to promote business; human trafficking; cyber fraud; identity theft and illegal control of bank accounts; counterfeiting of Indian currency (FICN) and related smuggling; counterfeited credit/value cards; trafficking in wild life products; theft of objects having cultural significance and smuggling of such products to foreign countries; arms and ammunition; white*

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[55]*Financial Action Task Force (FATF); Asian Development Bank (ADB); Organisation for Economic Co-operation and Development (OECD); Asia Pacific Group on Money Laundering (APG); International Money Laundering Information Networks (IMoLIN-Austria); United Nations Office on Drugs and Crime (UNODC); Eurasian Group on Combating Money Laundering and Financing of Terrorism (EAG); Eastern and South African Anti-Money Laundering Group (ESAAMLG); Inter-Governmental Group of Action Against Money Laundering in West Africa (GIABA); Financial Intelligence Unit – India (FIU-IND); National Crime Records Bureau – India (NCRB-IND); Narcotics Control Bureau – India (NCB-IND); Directorate of Revenue Intelligence – India (DRI-IND); Central Board of Excise and Customs – India (CBEC-IND); Central Economic Intelligence Bureau – India (CEIB-IND);* and *Other research papers published in periodicals.*

[56]Suggestions sought from North East (NE) and Jammu and Kashmir (J&K) Divisions at Ministry of Home Affairs (MHA), Government of India besides basing on reviewed literature:

(i) *Dimapur (Nagaland), Imphal (Manipur), Aizwal (Mizoram), Agartala (Tripura), Namsa (Nagaland), Sunauli/Bhairawa (Near Gorakhpur, Uttar Pradesh), Gate No. 2 at Moreh (Manipur), and Nonwah (Nagaland) from North Eastern States.*

(ii) *Sopore, Rajouri, Kupwara, Baramula, and Poonch from Jammu and Kashmir.*

(iii) Certain international airports were identified as the main landing points of fake Indian currencies routed from United Arab of Emirates, Nepal and Bangladesh: *Bangalore, Chennai, Calicut, Cochin, Hyderabad, Mangalore, Mumbai, New Delhi, and Kolkata.*

(iv) The Anti-trafficking Nodal Cell, MHA and Narcotics Control Bureau (NCB) and Central Bureau of Narcotics (CBN) reports suggests that followings places are the hub for human trafficking, drug trafficking, and fake currencies: *Surat (Gujarat), Malabar Hills (Kerala), Chennai (Tamil Nadu), Hyderabad (Andhra Pradesh), Malda (West Bengal), Kishenganj (Bihar), Purulia (Bihar), Goa, and Etah (Uttar Pradesh).*

collar crime; corruption and bribery; illegal liquor / alcohol trading; Hawala; extortions; and cattle smuggling. Such activities engender ML with its ramification to national security through following sectors: *Trading; Gems & Jewellery; Entertainment Industry; Electoral Financing; Terrorism Financing; Sports; and Non-Profit Organisation (NPO) / Non-Government Organisations (NGO) / Foundation / Trusts / Charitable Organisations.*

Activities which give rise to slush funds and consequently money laundering are more prominent in sectors like: arms, oil, public works, wholesale trading of certain item[57], mining[58], civil aviation[59], road, rail and sea transport[60], telecommunications[61], banking and insurance[62], education[63], chemicals and food[64], hotels[65], cable service[66],wholesale trading of vegetables and fruits[67].

The above activities may generally result in massive misappropriation of funds, which disappear from bona-fide accounts and resurface in some tax-heavens.

Economic crimes involving criminal conspiracy; cheating; criminal breach of trust; forgery of valuable security and other crimes of forgery are manifestations of frauds. These criminal activities are amongst the major sources of ML, as identified by the law enforcement agencies in India.

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[57]like Auto parts, Electrical goods, Electronic goods, hardware, utensils etc.

[58]One case of rampant illegal mining in Karnataka resorted to with a nexus between businessman, politicos and bureaucrats resulted into seizure of ₹ 10.2 crores and detection of unaccounted income of ₹ 1605 crores (Let Us Share-CBDT-Vol.5). In another case against three Bellary based groups engaged in Mining and export of iron ore etc.there was admission of undisclosed income of ₹ 110.06 crores. (Annual Report – CBDT-2007-08).

[59](domestic/international touring: Substantial unaccounted money is used in such tours. There should be mandatory provision of PAN No. and report to IT deptt.

[60](Road transport is an unorganised sector which is used by industries, coal mining, ore mining etc. sectors which are tax- evasion prone sectors. The trucks carry goods without proper documents. Even if the goods transported are covered with some documents, still in large number of cases actual quantity transported is more than the recorded one.

[61] The 2G Scam.

[62]One BakulMashruwala, Ahmedabad purchased Single Life Insurance Policies for which payments were made through multiple DDs of less than ₹ 50,000/-. His returns showed nominal income. Investigations revealed that he had invested ₹ 6,30crores in insurance policies out of his unaccounted income. (LET US SHARE Vol.1—IT Dept.).

[63]Receipt of unaccounted cash towards capitation fee—In one case of M/s SubhartiKrishan Kumar Bhatnagar Charitable Trust running a University, a Medical college, a Dental college and also a hospital resulted into detection of undisclosed income of ₹ 211. 6 crores (appx.) Three benami Kolkata based companies hid the undisclosed referred income and rerouted it by pledging their fixed deposits as third party guarantee for high value loans to the trust. The interest cost on the loans was offset by the interest earned on the fixed deposits of these benami parties. (Let Us Share-Vol.5-CBDT.

[64] Fertilizers---23% subsidy. Import reported to be 11 times than required. (Chemicals and Fertilizers Deptt..

[65]For all luxury hotels PAN should be must.

[66] It is very big source of generation of unaccounted income. All payments are collected in cash and service provider is given in cash and actual number of service users is shown too less.

[67]All over India is mainly carried out in cash. The middleman corners more profits mostly without accounting the same.

India's anti-money laundering regime is centered on the Prevention of Money Laundering Act, 2002 (PMLA). The PMLA has been further amended by the Prevention of Money Laundering Amendment Act, 2005 and the Prevention of Money Laundering Amendment Act, 2009. The formal objective of the PMLA is to prevent money laundering and to provide for confiscation of property derived from or involved in money laundering. The Unlawful Activities (Prevention) Act, 1967 (UAPA) tackles the matters' relating to terrorism and it's financing. The UAPA was amended in 2004 to criminalise, inter alia, terrorist financing. The UAPA has been further amended by the Unlawful Activities (Prevention) Amendment Act, 2008 to strengthen the fight against terrorism and terrorist financing.

The Vienna and Palermo Conventions require countries to establish a criminal offence for the following knowing/intentional acts: conversion or transfer of proceeds for specific purposes; concealment or disguise of the true nature, source, location, disposition, movement or ownership of or rights with respect to proceeds; and — subject to the fundamental/constitutional principles or basic concepts of the country's legal system — the sole acquisition, possession or use of proceeds (Art. 3(1)(b)&(c) of the Vienna Convention; and Art. 6(1) of the Palermo Convention against Transnational Organised Crime — the TOC Convention).

The ML offence in the PMLA extends to any property derived or obtained, directly or indirectly, by any person as a result of criminal activity relating to a scheduled offence (see infra under the heading predicate offences) or the value of any such property (PMLA s.2(1)(u) - definition of proceeds of crime). Property is defined as any property or assets of every description, whether corporeal or incorporeal, moveable or immoveable, tangible or intangible and includes deeds and instruments evidencing title to, or interest in, such property or assets, wherever located (PMLA s.2(1)(v)).

As said, the PMLA (s.3) provides that money laundering is committed where someone "directly or indirectly attempts to indulge, knowingly assists or knowingly is a party or is actually involved in any process or activity connected with the proceeds of crime and projecting it as untainted

property". The section 3 *mensrea* threshold is lower than the Art. 6.1(a) of the TOC Convention in that no specific purpose or intention is required. The substantive element of "projecting it as untainted property" carries the notion of knowing disguise, as required by the Conventions, but does not appear to cover all concealment activity, such as the physical hiding of the assets.

Section 8A of the NDPS Act offence is an almost faithful transposition of the Vienna Convention ML provisions. The PMLA takes a different approach by using a terminology that by its broad wording is intended to generally correspond with the criminal activity targeted by both the Vienna and Palermo Conventions.

Since the NDPS Act does not contain any general definition of property or proceeds of crime, the relevant definitions in the Code of Criminal Procedure (CrPC) apply. Similarly to the PMLA definitions, the term proceeds of crime means any property derived or obtained, directly or indirectly, by any person as a result of criminal activity (including crime involving currency transfers) or the value of any such property (CrPC s.105A(c)); while the term property means property and assets of every description whether corporeal or incorporeal, moveable or immoveable, tangible or intangible and deeds and instruments evidencing title to, or interest in, such property or assets derived or used in the commission of an offence and includes property obtained through proceeds of crime (CrPC s.105A(d)).

It is no formal and express legal condition that a conviction for the predicate offence is required as a precondition to prosecute money laundering, although some practitioners whom the assessment team met, felt that only a conviction would satisfactorily meet the evidentiary requirements. The definition of property in the PMLA however requires property to be "related to a scheduled offence". Consequently, the section 3 ML offence not being an "all crimes" offence, in the absence of case law, it is generally interpreted as requiring at the very minimum positive proof of the specific predicate offence before a conviction for money laundering can be obtained, be it for third party or self-laundering.

Similarly, under section 8A of the NDPS Act, although it is debatable that the person charged with money laundering needs to have been convicted of a predicate offence, the positive and formal proof of a nexus with a drug-related predicate offence is essential.

As far as the PMLA is concerned, India follows the list approach for predicate offences, according to the Schedule to the PMLA, as amended by the Prevention of Money Laundering (Amendment) Act since 1 June 2009. The Schedule comprises three Parts:

- Part A covering 33 offences without threshold value;
- Part B covering 46 offences with a threshold value of ₹ 3 million ("30 lakh rupees") or USD 60 000;
- Part C including all offences listed in Part A and Part B (without monetary threshold), supplemented by all offences covered by Chapter XVII of the Indian Penal Code, 1860 (IPC - offences against property), when these offences have cross-border implications.

All in all, the list of predicate offences includes 156 offences under 28 different statutes (see Appendix 4.1). Although, the scheduled offences now include a range of offences in each of the designated categories of offences, all offences under Schedule B only count as a predicate to money laundering where the value involved is ₹3 million/USD 60 000 or more.

According to section 2(v)(ra) of the Prevention of Money Laundering (Amendment) Act, 2009 an offence with cross border implications that is included in Part C of the Schedule means:

- any conduct by a person at a place outside India which constitutes an offence at that place and which would have constituted an offence specified in Part A, Part B or Part C of the Schedule, had it been committed in India and if such person remits the proceeds of such conduct or part thereof to India; or
- any offence specified in Part A, Part B or Part C of the Schedule which has been committed in India and the proceeds of crime, or part thereof have been transferred to a place outside India or any attempt has been made to transfer the proceeds of crime, or part thereof from India to a place outside India.

Since the 2009 Amendment, predicate offences for money laundering also extend to conduct that occurred in another country which constitutes an offence in that country and which would have constituted a predicate offence had it occurred domestically.

Criminologists have been at the forefront of analysing what works to prevent crime. Prestigious commissions and research bodies have analysed their and others' research on what lowers rates of crime. They agree that governments must go beyond law enforcement and criminal justice to tackle the risk factors that cause crime because it is more cost effective and leads to greater social benefits than the standard ways of responding to crime. Interestingly, multiple opinion polls also confirm public support for investment in prevention.

Review of Literature and Reports

Estimates on Money Laundering

The White Paper[68]mentions that the money stashed in Swiss bank (at Switzerland branch only) by Indians has reduced from₹23,373 crores in the year 2006 to ₹9,295 crores in the year 2010. However, the paper doesn't mention as to what happened to the balance amount of ₹23,373 – ₹9,295 = ₹14,078 crores. There have been large number of scams[69]and a simple guesswork about total slush funds being generated in India coming to light may be just tip of the iceberg.

Theparallel domestic economy levers the outflow of illicit funds. According to theDevKar's report[70], the average, annual, normalized estimate of illicit fund flows out of developing countries is US$ 612 billion per year during the period 2002-06. The same estimate on the non-normalised basis is US$ 716 billion. As such, the irreducible estimate of illicit fund flows out of developing countries could be of the order of US$ 612 billion. The study indicates that the

[68]White Paper on Black Money published by Ministry of Finance, Government of India, May 2012.

[69]Tendu Leaf, Bofors, Urea Scam, and Securities Scam (₹1,500 crores), Fake Stamp paper Scam (Initial report – ₹30,000 crores, RBI report – ₹200 crores, Securities Scam – Harshad Mehta, C. R. Bhansali Scam, UTI Scam, Home Trade (₹300 crores), Securities Scam – Ketan Parekh – ₹1,500 crores, Hasan Ali Khan Scam (Worth 8-9 billion dollars and tax-defaulter of arrears more than – ₹50,000 crores – Minister of State for Finance dated 04.08.2009), DSQ Software – ₹600 crores, Satyam Fraud – ₹12,000 crores, 2G Scam – ₹1,76,000 crores, Commonwealth Games Fraud and Allocation of Coal Blocks – ₹6,31,000 crores (PSEs – ₹3,37,000 crores, private parties – ₹2,94,000 crores — CAG initial draft report). For details See Appendix – II.

[70]Report released in December, 2008 by Global Financial Integrity, titled: 'Illicit Financial Flows from Developing Countries: 2002-2006, authored by DevKar and Devon Cartwright Smith.

volume of illicit flow of funds has grown at 18.2% over the study period 2002-06. The estimate of the flow of illicit funds from developing countries in the last year of the study – year 2006 - was US$859 billion on the normalized basis and US$ 1060 billion on the non-normalised basis. Other studies have estimated that about half the illicit financial flows from developing countries originate in Asia. The broad source of these illicit money flows are as under: (i) bribery and misappropriation by government officials – 3%; (ii) criminal funds – 30-35%; and (iii) tax-evaded funds – 60-65%.

At the disaggregated level for India, the estimate of average annual illicit outflow of funds in the period 2002-06 was US$ 22.7-27.3 billion; the estimate for the final year of the study – year 2006 - was US$ 44.6 billion. India ranks fifth amongst the countries in Asia for outflow of illicit funds. The region is led by China, and followed by Saudi Arabia, Mexico and Russia, in that order. In Indian currency, at the lower end of the estimate the average, annual illicit out flow of funds from the country in the period 2002-06, was of the order of ₹1,10,000 crores, which is 2.3 % of the country's GDP, or 15% of the annual central budget. The extant direct tax concessions for export earnings in the IT sector could be driving outflows of illicit funds from the accumulated black money.

GFI's estimate of outflow of illicit funds is not exaggerated. A very common way of acquiring illicit foreign exchange is through Hawalatransactions (See Fig. … Chapter 3)for converting domestic black money into illicit foreign assets. These transactions can never be captured by GFIs study because Hawala transactions are not recorded anywhere in the government system.

The statutory backing available under the Prevention of Money Laundering Act does not seem to be adequate to meet the threats of the parallel economy. First and foremost, the quantum of money laundering linked to the statutes[71] listed in the Prevention of Money Laundering Act is insignificant compared to the volume of the parallel economy. The social damage through these scheduled crimes[72] is enormous, but they might involve relatively paltry amounts of illicit funds.

[71]PMLA, 2009.
[72]Indian Penal Code (waging war against the country, counterfeiting of currency notes); Wild Life (Protection) Act; Immoral Traffic (Prevention) Act.

Well-informed estimates of the funds from the parallel economy used in the 1993 Bombay blasts would not put the figure at more than ten lakh rupees; estimates of the fund requirements for the terrorist attacks in Delhi, Jaipur, Hyderabad, Malegaon and Varanasi suggest small fund requirements. Majority of the volume of the parallel economy is through tax-evaded funds, which have the fungibility to effortlessly turn into resources for several economic offences / other crimes

The nineties saw a spectacular increase in export remittances, and a consequential dramatic improvement in the balance of payments. However, a significant part of the increase in export earnings was the result of the 'round-tripping', and the resultant laundering of illicit domestic funds. *It supposedly known to the Enforcement Directorate, the foreign exchange regulations division, that* there were ample evidence to indicate the wide-spread prevalence of such transactions. During that period, the Directorate had estimated, on a set of very conservative assumptions, and using back-of the envelope calculations, that the inflated export earnings, facilitated by hawala-routed foreign funds, could not be less than US$ 1 billion[73]. This mode of money laundering continues even today on account of the continuing tax exemption granted to export earnings of the IT and gem and jewellery sectors and from SEZs/EPZs/FTXs/EOUs/STPIs.

The bed-rock of the current neoliberal economic policy is the principle that no special concessions/relaxations should be given to any particular area or sector of activity. Consistent with that, all concessions and tax exemptions need to be withdrawn, so that all investment decisions are taken on the basis of unhampered market forces. Based on this dictum, subsidies in various sectors benefitting individuals – petroleum products, food grains through the public distribution system, higher professional education, agriculture power tariff, fertilizer price, etc. – have been removed, or reduced, over the last decade and a half. Yet, ironically, almost over the entire period of economic reforms, corporate tax exemption has been extended to export earnings of IT sector. Very recently this concession as extended up to FY 2010-11 Conceptually, no other exemption/subsidy provision causes as much harm to the enforcement of fiscal laws, as the tax exemption available to export earnings in the IT and gems and jewellery sector.

[73] An amount that was not small by the standards of the export trade of those days.

Money-laundering and corruptions seem to be inter-related. Corruption itself generates unaccounted money/wealth and further it often facilitates laundering illicit proceeds of others also[74].

Most common money laundering techniques utilise the following: currency exchange house, stock brokerage house, fraudulent exports/imports[75], gold dealers[76], casinos[77], automobile dealerships, insurance companies[78], NBFCs[79], trading companies, floating a large number of fictitious firms[80], two brothers[81], private banking facilities, mutual Funds[82], samitis[83], illicit proceeds of corruption and ML through companies[84], free trade zones, wire systems, and trade financing. All have the ability to mask illegal activities. This, being a specialised job, services of bankers, lawyers and accountants etc. are hired.

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[74]OECD Annual Report: Feb. 1998—Corruption remains the chief impediment to Maxico's anti-laundering efforts.

[75] In one such case one exporter produced records of exports of goods of value more than ₹ 20 crores to Russia. On verification it was found that the goods never reached Russia and the exports proceeds came from some other country. Obviously, the said sale proceeds received were the exporter's own unaccounted funds sent out via hawala route.

[76]cheques are given in lieu of unaccounted cash on consideration while showing purchase of old and used jewellery by the jeweller.

[77] There are few in Goa only.

[78]One BakulMashruwala, Ahmedabad purchased Single Life Insurance Policies for which payments were made through multiple DDs of less than ₹50,000/-. His returns showed nominal income. Investigations revealed that he had invested ₹6,30crores in insurance policies out of his unaccounted income. (LET US SHARE Vol.1—IT Dept.).

[79]There were12,630 NBFCs registered with the RBI as at end-June 2010, with a total assets of ₹109,324 crores and net owned funds of ₹16,178 crores (INSIGHTS Contemporary issues in direct issues Vol.1 (IT dept, Mumbai).

[80]Deposit of cash of ₹10 Crore in one bank account was found. Related investigationled to the unearthing of more than 36 companies which were being used for providing bogus entries relating to share capital, Long Term Capital Gain, Short Term Capital Gain, gifts, sale and purchase bills, etc. The persons concerned were issuing bills of sale/purchase of shares which appeared to be genuine and the transactions appeared to have taken place on Stock Exchanges. However, none of these transactions had taken place through Stock Exchanges and the transactions reflected in the bills were not genuine. Similarly, these persons were accepting cash from different parties and routing it through 2-3 accounts. They were using this amount for providing share capital entries to private limited companies. The estimated concealment of income on account of these transactions is likely to be around ₹1,000 Cr. (CBDT Annual report-2009-10).

[81]Sh. Surender Kumar Jain and Sh. Virender Kumar Kumar Jain received cash from beneficiaries, through intermediaries. The cash was introduced in the banking channel through dummy concerns run by the two bothers or by outsourcing to various parties working on their behalf. Cheques/RTGS were issued to the beneficiaries through intermediaries for a commission. The case revealed "entry business' of ₹3,800 crores (Let Us Share-Vol. 5(CBDT).

[82]One Kolkata based person made investment to the tune of ₹29 lakh in Mutual Funds through multiple transactions without quoting PAN. The reason for not having PAN was shown as not assessed to tax. Investigations revealed that the person was regularly assessed to tax and was maintaining seven bank accounts along with large number of fixed deposits. The total deposits in the accounts were found at ₹3,93crores. (Annual Report-2007-08).

[83] A Bhopal based group were Samitis which were involved in providing facilities to traders for depositing huge sums, in cash, and issuing cheques, at par, and drafts to facilitate payments to various parties for their unaccounted purchases. Samiti also allows withdrawal of cash against drafts and cheques. There was evidence of the parallel banking facilities, of the samiti members/local traders through bank accounts. Total amount of turnover, routed through the bank accounts of these societies, was over ₹2500 crore, large part of it was unaccounted. Search action in these cases led to revelation of huge unaccounted transactions. In the name of a trusted person of the group, the society and their promoters, have transacted credits of more than ₹76 crore during FY 2005-06 and 2007-08. (CBDT Annual Report-2008-09).

[84]Observations of High Court of Andhra Pradesh in Writ petition Nos.25844, 25845 and 25846 of 2009. (The accused- controller of M/s. Jagathi Publications) floated number of companies wherein *Quid Pro Quo* investments have been made out of the benefits received by the investors / beneficiaries from the decisions of the State Government in various forms like SEZs, irrigation contracts, relaxation/permission for real estate ventures off shore banking shell corporations.

Commercial frauds[85] typically involve under and overvaluation which have become the dominant mode of trade based money laundering and are a growing concern for the global economy with their possible links with drug trafficking, terror financing etc. The duty involved in such cases booked by field formations and DRI during the year 2011 was ₹3279 crores. In the discussion with various officials having background of such preventive work, on the condition of anonymity, it was conveyed that value of such seizures normally does not exceed 5-10% of total evasion being carried out in a period. Taking the maximum value i.e., 10%, total evasion during the year works out to be appx. ₹33,000 crores. It is DRI's observation that the incidence of commercial fraud has not shown decline even though the taxation structure has been simplified and the tariff rates have been significantly reduced. (DRI Annual report-2011: P/27). Also, total value of physical exports from SEZs in the years 2007-8, 2008-9 and 2009-10 was Appx. ₹3,87,038 crores out of which Appx. ₹2,30,824 cores (Appx.60%) was on account of (i) Computer/electronic software, (ii) Gems and Jewellery and (iii) Trading and services (Normal checks of quantity/quality/value etc. of goods by any agency are not allowed in SEZs—Investigations conducted by D.G.C.E.I. Ahmedabad in the year 2007-08 revealed that one unit located in SEZ was clearing Hot Briquetted Iron directly to their sister units located in DTA without payment of appropriate duties of customs. The total duty involved was ₹261.39 crores. The party deposited ₹180.72 crores voluntarily). Obviously, objective of liberalisation and globalisation of trade has been misused and exploited by excessive greed of the law breakers.

The Director of Enforcement (ED) maintains statistics on ML investigations, prosecutions and convictions under the PMLA. The statistics in Appendix 4.2relate to the number of investigations and prosecutions for the ML offence between 2006 and 2009. The important increase in the number of investigations in 2009 was explained as an effect of the 2009 amendment of the PMLA widening the scope of the scheduled predicate offences, particularly in respect of drug offences, and of the possibility for the ED to intervene at an earlier stage of the investigation process.

[85] Def.

The Ministry of Home Affairs (MHA) administers the UAPA and maintains the statistics on FT offences in consultation with the law enforcement agencies (LEAs) and State Governments. Since the financial year 2006-2007, 105 cases of FT have been registered involving 231 suspects. 29 trials are pending starting from 2006, and one conviction was obtained in 2009. Assets with a value of ₹ 47,009,800 (approximately USD 850,000) have been seized/attached, with ₹ 411,000 (around USD 108,000) forfeited (see Appendix – 4.3.)

The FIU-IND maintains statistics on the receipt, analysis and dissemination of STRs along with breakdowns of the type of financial institution submitting the report and the agencies to which information is disseminated. The total numbers of STRs disseminated in the table of Appendix – 4.4differentiate from the numbers included in the table of Appendix -4.3 for the following reason: STRs processed but not disseminated in a previous year may be disseminated in one of the following years based on a request from domestic law enforcement and intelligence agencies, foreign FIUs or other information or new intelligence received that justifies the dissemination.

The total number of Currency Declaration Forms (CDFs) collected at international airports in India for cross border currency transportation is set out in the table at Appendix – 4.5. The Indian authorities are not in a position to provide details regarding the number of CDFs collected at Land Customs Stations.

Section 6 of the FEMA empowers the RBI to prohibit, restrict, or regulate, inter alia, the export, import, or holding of currency or currency notes. Further, the Government has empowered, by application of the Regulations, customs officers to exercise the powers and discharge the duties of the Director of Enforcement in so far as they relate to restrictions/prohibitions imposed by the RBI on the import and export of currency. Therefore, violations of the FEMA in this regard are adjudicated by the customs authorities, and the fines imposed for non-declaration or misdeclaration of currency are imposed by the customs authorities in respect of violation of both the FEMA and the Customs Act, which prohibits the import or export of goods in violation of any prohibition placed by any other law in force. The statistics in this regard are presented at

Appendix – 4.6.These cases relate to smuggling of currency have not been identified any direct linkages to FT.

Most financial transactions that would potentially generate STRs are small, reducing the ML (but not TF) risk: domestic money orders average approximately ₹895 (USD 18); NEFT remittances average of approximately ₹53000 (USD 1060); the average balance in post office savings accounts is approximately ₹3000 (USD 60); the average balance in post office recurring deposit accounts is approximately ₹9000 (USD 180); the average deposit/bank account is approximately ₹56000 (USD 1120). Similarly, Indian authorities point out that while there are 82000 commercial bank branches in the country, 63% of them are in rural/semi-urban areas with low/value customers/transactions that involve relatively few suspicious transactions.

Indian authorities estimate that expenditures for terrorism directed against India total approximately USD 30-40 million per year, but that about 70% of these funds go to infrastructure for terrorism outside India, including infrastructure for terrorist organisations' headquarters; field infrastructures, supply lines, training camps, communication centres, weapons, explosives and other procurements and also towards salaries/subsistence to the terrorists and their families. The 30% of terrorist financing estimated to occur within India itself relates primarily to funds for special operations and subsistence maintenance of terrorists and their families.

India's STR reporting format does not contain a separate text box for capturing information on whether the report is explicitly terrorism-related, and most reporting entities do not clearly classify the STR as FT related by explicitly mentioning 'terrorist financing' as the grounds of suspicion, even when the STR has been generated because it involves a typical FT scenario. However, some STRs are subsequently identified as terrorism related by the FIU review of the fact pattern discussed in the grounds of suspicion.

Methodology

Organization of the Study

NIFM shared the following concerns with the experts / officials in various agencies / departments / ministries / organisations / stakeholders with a view to explore insights on the specific Terms of ReferenceToR(b):

- comprehend the activities while identifying activities involving ML in India;
- assess the incidence / Impact of ML in North-Eastern States and select special category states in India; and
- identify the role of reporting and non-reporting institutions contributing threat to national security and / or promoting money laundering.

The methods and techniques employed to consolidate on the above concerns included the following were as: Observations and Interactive Discussions; Interviewing the linknets; Focus Group Discussions (FGD); Back-up/Back-end Questionnaire; Qualitative Data Analysis Techniques; and Content Analysis.

Target Group

The survey was conducted using unstructured questionnaire comprising of three types of target groups, *namely*, Reporting Institutions[86] (RIs), Non-Reporting Institutions[87] (NRIs) and the Public[88]. There were questions of common interest to the three groups and also some specific questions.

The survey excluded members of the legislative assembly and others known to be politically active. It also excludes people from law enforcement, supervisory bodies, journalists, trade

[86]Reporting Institutions means institutions that have got an obligation under the Financial Intelligence and Anti-money Laundering Act to report suspicious transactions to the FIU. It includes *Banks, Money Changers, Management Cos, NBFIs, Insurance Cos, Insurance Agents, Stockbrokers, Traders, Accountants / Auditors, Advocates / Bar Councils, Judges, Notaries, Excise and Customs, Narcotics Officials, Police, and IB*.

[87] T*he* ***Non-Reporting Institutions means*** *institutions where the risk of money laundering and the financing of activities with its ramification to national security are present but have no obligation to report suspicious transactions to the FIU. It* includes *New Car Dealers, Imported Second-hand Dealers, Car Rental, Spare Parts, Charitable institutions, Real Estate Agents, Chartered Surveyors, Contractors, Architects, Interior Designers, and Gem Dealers.*

[88]The General Public is divided into two sub-groups; namely a specific group of interest for profession, occupation and sectors not captured in the Non-Reporting Institutions and a sub-group for members of the General public by geographic location and strategic points. The Special Categories includes NGOs, Trade Unions, Labour Unions, Hotels, Restaurants, Electronic Shops, Doctors, Discotheque/Clubs/Bars, Gems and Jewellery Shops, Liquor Traders, Journalists, and Educational Institutions

unionists, representatives of politically sensitive non-governmental organisations and educational institutions.

A survey of the reporting institutions was designed to capture information about the control system in place and its efficiency, risk assessment programme, reporting of STRs, training and the general perception about the AML/CFT legislations and institutions set up to detect, prevent, prosecute and disrupt money laundering and the financing of terrorism and insurgent activities.

A survey for non-reporting Institutions was designed to establish the usage of cash in some sectors and to capture more or less the same information as the reporting institutions.

The responses were collected through self-administered questionnaire through face to face interviews/discussions.

Survey of a small sample of the general public was carried to gather information on their awareness and perception about the risks of money laundering. Their views on the AML/CFT legislations and institutions put in place to fight money laundering and terrorist financing were also being captured.

Limitations of Discussion

Discussions carried out with the representatives from various enforcement agencies and also with the other stakeholders were very informal. Since the nature of the activities involving money laundering have national security concerns, only part of the impressions gathered during the survey have been reproduced.

Another limitation of the study was that not much information could be gathered from the Enforcement Directorate, the authorized agency of GOI dealing with money laundering offences. The response conveyed by ED when members of the team interacted with the Officials for relevant data and information that, the ED is exempt from disclosing any information by virtue of Section 24 of the Right to Information Act, 2005 read with the second

schedule thereof[89]. In the absence of any data and cases only broad impressions could be gathered.

In addition to the above, the usual limitations of qualitative data survey also apply to the findings of the study.

Findings

While India has initiated a large number of ML investigations (798 at 31 December 2009), only six prosecutions are underway and there are no convictions so far. India has yet to achieve convictions and additional prosecutions that demonstrate the effectiveness of its inter-agency coordination and co-operation. In consonance with the activities or offenses associated with the economic crimes which engender money laundering with its ramifications on the national security, followings are the observations recorded on review of literatures and discussions thereof on the realms of money laundering activities.

Methods and Trends of Money Laundering

The actual process through which the illicit funds are transferred abroad and further laundered are diverse and based on the innovative design of economic crime offenders. In the last decade-and-a-half both direct and indirect tax rates have come down considerably and are comparable with many developed countries[90]. There appears to be reduced propensity to under-invoice imports in order to reduce the burden of customs duty. However, during the very same period there is a marked increase in propensity to over-invoice the exports. This is because, for some time now, profits earned by hundred percent export-oriented units in SEZs / EPZs / EOUs / FTZ / STPIs have been fully deductible under Sec. 10A and 10B of the Income Tax Act from corporate tax for ten years after commissioning. The deduction is applicable to manufactured products as well as software IT products and services – the deduction has been available for manufactured

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[89]The ED had put up a condition to NIFM that information sought, if provided, relating to PMLA cases of the Directorate would not be made part of the report and that the same would not be put in public domain in any other manner.

[90]Australia, United Kingdom, and others.

products from 1981 and for software products from 1994. This concession has last been extended up to FY 2010-11.

The provision from income deduction has become a major escape route for black money. To maximize gains from this opportunity, corporate entities convert domestic black money through the *Hawala* route, into illicit funds abroad. Such illicit foreign funds are then used to make good the difference between the over-invoiced price and the real market price of the exported product. It needs to be pointed out that such a malpractice is particularly risk-free for software and gems & jewellery exports – most IT products are custom-made for a particular user taking into account the specific organizational circumstances and the objectives to be achieved; and, gems and jewellery are also difficult to value as much depends on intangibles and the aesthetic sensibility of the purchaser. There may not be a free and competitive market where the price of such products could be determined through competition between different purchasers; the price is fixed through a two-party negotiation, depending on what the purchaser is willing to pay for the perceived gains from the product. In such situations, it is near impossible for any enforcement authority to establish that an exported IT product is over-invoiced. The product can be exported with impunity at an outrageous documented price and the enhanced export earnings can enter the accounts of the exporting entity as tax-free, lawful earnings. Thus, over-invoicing of tax-exempt export earnings, with the support of *Hawala* transactions, provides a risk-free route for laundering domestic black money. It is because of these circumstances that, despite low levels of direct and indirect taxes, even today, the *Hawala* market is thriving, and the premium on *Hawala* foreign exchange continues to rule high at about 8-10%.

Over-invoicing of imports is the *modus-operandi* used to siphon-off money from the company and transferring in another individual/company and stashing the same abroad. This money is then brought back camouflaging as FDI after making necessary adjustments. Two such cases of imports of plant and machinery and software pertaining to well-known industrialists were noticed. FDI which is normally permitted with a cap of 49% may contain anywhere upto 30% such siphoned off money.

Based on the typological survey reports of FATF, followings are the profile of nature of activities engendering money laundering:

Money Laundering Methods & Typologies		
Sl. No.	**Trends of Money Laundering**	**Typologies**
1	Large-Scale Transnational Frauds	I, O, R, F
2	Corruption and Bribes	O, D
3	Human Trafficking/People Smuggling	I, R
4	Remittances	I
5	Drug trafficking	D, O, F
6	Smuggling of Gold / Electronic goods	I, O, F
7	False declaration of goods under export/import as part of organised crime to obtain illegally certain benefits given by the government to promote business	I, O, F
8	Human Organ trafficking	D, I
9	Cyber fraud	R, O, F
10	Identity theft and illegal control of bank accounts	O, F
11	Counterfeiting of Indian currency and related smuggling	O, F, R
12	Counterfeited credit/value cards	I, D
13	Trafficking in wild life products	I, O, F
14	Theft of objects having cultural significance and smuggling of such products to foreign countries	I, O, F, D
15	Arms and ammunition	O, F, D
16	White collar crime	O, F
17	Illegal liquor / alcohol trading	D, O
18	Hawala	O, F, I
19	Cattle smuggling & FICN	O, F, R
20	Extortions/ Kidnapping for ransom	O, R, F, D
21	Maritime Piracy	I, O, R
22	Commercial Websites, Mobile Payment System and Internet Payment Systems / New Payment System	D, R, I, O, F
23	Free Trade Zones / Special Economic Zones	D, O
24	Real estate agents	D, O
25	Non-Profit Organisation (NPO)/ Non-Government Organisations (NGO)/ Foundation	I, F, D
26	Naxal/Extremist/Terrorist Financing	D, R, I, O, F
27	Entertainment Industry	D, I
28	Sports (IPL Cricket)	O, R, F
Note:	**D: Domestic; R: Returning; I: Inbound; O: Outbound; F: Flow Through**	

Conditions which facilitate Money-laundering: (i) failure to criminalize money laundering from all serious crimes or limiting the offence to narrow predicates, such as conviction of a drug trafficking offence (ii) Extensive foreign banking operations, wire transfers or multiple branches of the foreign banks (iii) Countries with free trade zones where there is little government presence.

After scrutinising records/reports etc. of many departments/offices etc. and having discussions with a large no. of officers(serving as well as retired)/ lawyers, jewellers, traders etc. it is felt that much is still required to be achieved through PMLA. Number and value of the properties attached/forfeited so far is felt not to be in tune with the volume of ML in the country. In legal circles it is felt that no. of prosecutions and convictions in the courts are too low so far. This requires many steps to be taken on the part of the govt.

Drug Trafficking

India, a drug-transit country, having strategic location between the countries of the Golden Triangle and the Golden Crescent is the world's largest producer of licit opium gum for the pharmaceutical preparations. It is estimated that between 20 to 30%[91] of the opium crop is diverted. The illicit cultivation is mainly located in the areas of Arunachal Pradesh and Himachal Pradesh in the North of India.

The trafficking patterns appear to be changing. Historically, India has been an important transit area for Southwest Asian heroin from Afghanistan and Pakistan and, to a lesser degree, from Southeast Asia–Burma, Thailand, and Laos. India's heroin seizures from these two regions continue to provide evidence of India's trans-shipment role. Most heroins transiting India appeared bound for Europe. Seizures of Southwest Asian heroin made in New Delhi and Mumbai tend to reinforce this assessment. However, the bulk of heroin seized in the past two years has been of domestic origin, was seized in South India, and was apparently destined for Sri Lanka. Trafficking groups operating in India fall into *four* categories. Most seizures in Mumbai and New Delhi involve West African traffickers. Traffickers who maintain familial and/or tribal ties to Pakistan and Afghanistan are responsible for most of the smuggling of Pakistani or Afghan heroin into India. Ethnic Tamil traffickers, centered primarily in Southern

[91]International Narcotics Control Strategy Report of 2011 Southwest Asia - Section India - Volume I.

India, are alleged to be involved in trafficking between India and Sri Lanka. Indigenous tribal groups in the northeastern states adjacent to Burma maintain ties to Burmese trafficking organizations and facilitate the entry into Burma of precursor chemicals and into India of refined "white sugar" heroin through the porous Indo-Burmese border. In addition, insurgent groups in these states have utilized drug trafficking as a means to finance their operations against the Indian Government.

The Indian-produced methaqualone (Mandrax) trafficking to Southern and Eastern Africa continues[92]. Although South Africa has increased methaqualone production, India is still believed to be among the world's largest known clandestine methaqualone producers. Seizures of methaqualone, which is trafficked in both pill and bulk forms, have varied widely, from 472 kilograms in 2005 and 4,521 kilograms in 2006, one kilogram in 2007 and 2,361 kilograms in 2008 has been seized. Cannabis smuggled from Nepal is mainly consumed within India, but some makes its way to Western destinations. India is also increasingly emerging as a manufacturer and supplier of licit opiate/psychotropic pharmaceuticals (LOPPS, hereinafter), both organic and synthetic, to the Middle East, Pakistan, Bangladesh and Afghanistan. Some of the LOPPS are licitly manufactured and then diverted, often in bulk. Some of the LOPPS are illicitly manufactured as well.

Indian-origin LOPPS and other controlled pharmaceutical substances are increasingly being shipped to the U.S. The DHS Customs and Border Protection intercept thousands of illegal "personal use" shipments in the mail system in the United States each year. These "personal use" quantity shipments are usually too small to garner much interest by themselves, and most appear to be the result of illegal internet sales. However, as a whole, these small shipments are indicative of a negative trend which signifies that India is increasingly becoming a source country for illicit pharmaceuticals.

The drug situation in India is a complex combination of many factors as summarised below:

- diversion of opium from licit cultivation and indigenous production of low quality heroin;
- trafficking of heroin from South West and South East Asia to India and again to Sri Lanka, Maldives and Western countries;

[92]pp. 18, *op.cit.*

- trafficking in hashish from Nepal and further to Europe (hash-tourism);
- illicit cultivation of cannabis and opium;
- clandestine manufacture of methaqualone and trafficking to South Africa;
- diversion of precursor chemicals and other controlled substances;
- attempts to establish methamphetamine laboratories in active collaboration with drug operatives based in China; Hong Kong (China); and Canada;
- diversion of pharmaceutical preparations and prescription drugs containing psychotropic substances and trafficking to neighbouring countries;
- internet pharmacies and misuse of courier services;
- involvement of foreign nationals in trafficking and distribution networks, such as Nigerian nationals in case of heroin and Israeli nationals in case of hashish.

An area of recent concern has been the diversion of Ketamine (and anaesthetic) from India for abusive purposes. Although there have been no reports of its abuse in India, attempts were made to smuggle Ketamine to certain destinations in South East Asia.

Counterfeiting of Money

The counterfeiting of money is well developed in India. The FATF report that high quality counterfeit Indian currency notes are being printed in Pakistan and are smuggled through transit nodes in third countries. The Indian Government is very much concerned about the threat it represents for the Indian economy. In a press release issued on 2009, 2011 and 2012, the Reserve Bank of India (RBI, henceforth) recognised a sharp increase in the number of fake bank notes detected.

According to the Indian law enforcement agencies, fake notes thus principally originate from Pakistan, but are smuggled through various routes. The most popular among them are via the United Arab Emirates, Nepal and Bangladesh. Fake notes from Dubai are transported by air with the help of *bona fide* passengers or couriers. Thailand, Malaysia, Myanmar and Sri Lanka are also used as transit points. International airports in Bangalore, Chennai, Calicut, Cochin, Hyderabad, Mangalore, Mumbai and New Delhi are identified as the main landing points. Open land borders with Nepal and porous land borders with Bangladesh are utilised by organised

criminal gangs to smuggle counterfeit notes into India. Once smuggled, the fake money is exchanged for original notes on a roughly 2:1 ratio[93].

Human Trafficking

In South Asia, human trafficking is often referred to as one of the fastest growing transnational organised crimes. Countries in South Asia, including India, serve as origin, transit and destination countries for women, children and men being trafficked. India's trafficking patterns indicate that 90% of THB is domestic (i.e. intrastate and interstate trafficking), with only 10% taking place across international borders. In addition to being a source for trafficking, India is also a destination and transit country.

Based on case studies and NGO interviews, the diversity of India's states and territories leads THB to differ greatly based on the characteristics of a given region. NGOs indicated that trafficking was prevalent in destination states because of high inflows of migrants, high demand for sex workers, generic gender/caste issues, a lack of community responsibility for social security and welfare, and the absence of a strong legal framework. For transit areas, the main reasons cited were infrastructure and, naturally, location between source and destination states. Notably, poverty was not mentioned as a primary trafficking influence in destination or transit regions.

The field surveys pointed that the most prevalent sectors employing trafficked people in India are the following: commercial sex work; bonded labor in different industrial and agricultural sectors; domestic work; entertainment sector (circuses, camel jockeying); and begging & other cartel-like exploitative activities.

There are both supply-side and demand-side factors that are root causes of THB. Supply-side factors leading to trafficking include: poverty; social and cultural practices such as gender discrimination; impacts of globalization on livelihoods through the removal of traditional agricultural jobs; caste/tribe marginalization; the availability of vulnerable street children; vulnerability of women and children to trafficking due to conflicts/disasters; and governance issues that make it easy for traffickers to get away with the crime. Demand-side factors include increased sex tourism in India's major tourist destinations and economic booms that have led

[93] B Srinivasulu, SP, Intelligence, Hyderabad:*Pak ISI Sponsored Counterfeit Currency Circulation.* Website UNODC - South Asia: Human trafficking.

to increased demand for cheap labor (e.g. child labor and bonded labor) and, subsequently, increased levels of migrant workers who, far from home and mostly male, have a demand for sex workers.

Corruption and Bribes

India has been ranked one the five highest bribe payers among 22 countries[94]. India ranks 95 among 180 countries in the Corruption Perceptions Index in 2011 with a mean score of 3.4.

The cases from 1948 to 2012 reveal that, similar to other sophisticated criminals, corrupt PEPs use a broad array of methods to hide their proceeds. Corrupt PEPs disguise their ownership through corporate vehicles and trust companies and use gatekeepers and nominees to launder proceeds through the domestic and foreign financial institutions. They have used their power to acquire state assets, control law enforcement, and capture banks. Finally, past cases demonstrate that PMLA standards are not always being implemented by financial institutions; nor are PMLA and regulations being enforced by regulatory authorities or supervisors. Case after case shows how financial institutions have failed to follow PMLA procedures - even where those procedures called for only an ordinary risk-based approach - and have thus given corrupt PEPs continued and unabated access to the global financial system.

The most prominent economic effect of corruption seems to be diversion of money from the government budget to expenses with lower multiplier effects. If money that is meant as an investment in economic development or poverty relief is diverted as result of embezzlement or other forms of public corruption towards private spending - it will in most cases incur a transfer towards expenditures with a lower multiplier effect, such as imported "Hummers" instead of medicines in the hospitals, or foreign fittings in newly built middle-class city mansions instead of school materials.

Laundering of corruption proceeds can take a variety of forms, depending on the nature of the corrupt act. In the grand corruption context, the most prevalent forms of proceeds are those arising from 1) bribe-taking or kickbacks; 2) extortion; 3) self-dealing and conflict of interest; and 4) embezzlement from the country's treasury by a variety of fraudulent means.

[94]Transparency International's Bribe Payers Index, 2011.

Understanding the typical methods by which PEPs unlawfully obtain proceeds assists in understanding how those funds could be laundered.

Terrorist Financing

India continues to be a significant target for terrorist groups and has been the focus of numerous attacks. The bulk of terrorist activities have been orchestrated by groups and entities linked to the global Jihad with the support of external organisations including State and non-State actors. In addition, several domestic groups involved in separatism and terrorism are also active. There are no published figures of terrorist cells operating in the country.

Domestic terrorist organisations: The Indian authorities report that the principal terrorist threat emanates from the activities of groups espousing the Maoist ideology, such as Communist Party of India (Maoist) and separatist groups in some of the North Eastern States. Special structures and mechanisms (including for conflict resolution) have been established by the Government to combat these activities with considerable success.

Externally based terrorist organisations: On the other hand, external terrorist organisations operate from bases in neighbouring countries beyond the jurisdiction of the Indian legal apparatus. These include Pakistan based terrorist outfits, such as the Lashkar-e-Tayyeba, Jaish-e-Mohammed, Harkat-ulAnsar/Harkat-ul-Jihad-e-Islami. Other groups, such as the HizbulMujahideen, etc. are essentially Kashmir centric though their leadership is based in neighbouring countries. The Indian authorities also report that the influence and spread of the activities of the latter groups have declined substantially over the past few years.

In its attempt to counter terrorist financing and ML, the Government is particularly concerned about the 4,100 km porous India-Bangladesh border. Out of the sanctioned length of 3,436 km, 2,709 km has been fenced. India's inability to protect its porous maritime borders came to light since the perpetrators of the 26 November 2008 Mumbai attacks arrived by sea from Pakistan, with the backing of state and non-state actors of Pakistan. According to the Government of India has taken a number of measures to strengthen its Coastal/Maritime security.

Correspondingly, the pattern of terrorist financing in India covers a wide spectrum. The highest threat emanates from FT issues relating to the external terrorist groups affiliated with the global Jihad. The threat is particularly high since the groups are based outside the country and

operate through multiple nodes across the world. The Indian authorities report that issues relating to domestic terrorist groups are fully monitored and the level of threat is considerably lower.

A threat assessment regarding terrorism and its financing is undertaken by the MHA on a regular basis with other relevant agencies. India itself has identified the following threats as the major sources for terrorist financing:

- funds/resources from organisations outside India including foreign NPOs;
- counterfeiting of currency;
- criminal activities including drug trafficking and extortion;
- use of formal channels and new payment methods.

Based on the results of the threat assessment, it can be stated that while the threat is high from the criminal activities listed under (a) and (b), which according to the Indian authorities relate essentially to external terrorist organisations; the threat emanating from (c) and (d) is perceived by the Indian authorities to be low.

The Unlawful Activities (Prevention) Amendment Act, 2008 and the establishment of the National Investigation Agency (*henceforth*, NIA) have, among other actions, further strengthened the fight against terrorism and its financing.

Non-Profit Organisation (NPO)/ Non-Government Organisations (NGO)/ Foundation

According to the FATF, "The misuse of non-profit organisations for the financing of terrorism is coming to be recognised as a crucial weak point in the global struggle to stop such funding at its source."[95] Numerous cases from around the world have demonstrated how terrorists have successfully abused this weak point to finance or support their operations. Well-known cases include the International Islamic Relief Organization (IIRO) Philippine Branch, as well as the Holy Land Foundation for Relief and Development (HLF) in the United States.

Although various studies specifically refer to the threat of "terrorism financing," it is important to emphasize that terrorist abuse of NPOs extends beyond the diversion of monetary funds.

[95]Financial Action Task Force on Money Laundering (FATF). "Combating the Abuse of Nonprofit Organisations: International Best Practices," October 11, 2002, http://www.fatf- gafi.org/dataoecd/53/53/34260889.pdf(accessed February 2, 2011).

Several known cases demonstrate that terrorists have abused NPOs in a variety of ways, such as,

- diverting finances;
- diverting materials (such as gifts-in-kind);
- using them as an intermediary to local partners that divert financing/materials;
- using them to facilitate travel and/or board travellers;
- using them as a front or cover for illicit activities, such as the transfer of arms;
- openly using them to provide social services as a means to solicit public support;
- using them as a platform to distribute messaging as a means to gain political/ideological support;
- using them to radicalize and/or enlist individuals;
- taxing them for access to certain impoverished areas;
- kidnapping and ransoming employees;
- impersonating employees to obtain access to particular areas/people; and/or
- using an NPO's name to raise funds, without the NPO's knowledge.

These examples illustrate that many other facets of NPOs can be abused for terrorist purposes and that finances are not the only vulnerability. As such, the term "terrorist resourcing" provides a far more accurate picture of the abuse than the term "terrorist financing." Terrorist resourcing encompasses the use of funds, materials, personnel and other associated individuals, beneficiaries, as well as property to further a terrorist cause.

Real estate agents

The real estate sector merits closer consideration given the large scope of monetary transactions, its significant social impact, and because of the number of cases in which money laundering, and in limited circumstances terrorist financing and tax fraud schemes, have been detected.[96] Abuse in this sector also has the undesirable effect of political, institutional and

[96]It is important to note as is mention by the OECD (Sub-group on Tax Crimes and Money Laundering) in its real estate report that in many countries, their tax authorities investigate these cases in partnership with other law enforcement agencies. In some instances, parallel investigations for tax fraud and money laundering may be pursued. The OECD examined tax fraud and money laundering involving the real estate sector, along with identity theft and identity fraud. It also developed a training manual to assist tax auditors in detecting and reporting cases of suspected money laundering and/or terrorist financing. The confidential report contains: the scope and nature of the issue, how cases are successfully detected and investigated, a list of red flag indicators (catalogue), the benefits of multi-agency co-operation (including effective exchange of information), compliance results and risk prevention strategies and an inventory of relevant case studies.

economic destabilisation. Moreover, due to the international nature of the real-estate market, it is often extremely difficult to identify real estate transactions associated with money laundering or terrorist financing.

Given that the purchase or sale of a property is one of the largest financial transactions a family or individual may undertake, changes in property prices have a substantial impact on the considerations taken into account by potential buyers and sellers of properties. Fluctuations in property prices have an impact on decisions about where to live and work in addition to affecting an owner's networth. Moreover, to the extent that property values influence rents, the effect is manifested in the distribution of wealth between landlords and tenants. Finally, property prices significantly influence the building industry. Taken together, these factors all suggest that fluctuations in property prices may influence economic activity and price stability by affecting aggregate supply and demand, the distribution of income, and the debt decisions undertaken by households.[97]

Nevertheless, it is difficult to monitor and explain variations in property prices due to a lack of reliable and uniform information. Property markets are geographically segmented and numerous factors shape the local price of real-estate. Understanding the factors that underlie pricing in the property market is therefore essential.

Investment in the real-estate sector offers advantages both for law-abiding citizens and for those who would misuse the sector for criminal purposes. Real property has historically appreciated in value, and many countries offer incentives to buyers, including government subsidies and tax reduction. Most importantly for misuse by criminals, however, is the facility the sector may provide for obscuring the true source of the funds and the identity of the (ultimate) beneficial owner of the real asset, which are two key elements of the money laundering process.

The real-estate sector is therefore of extraordinary importance to the economy in general and the financial system in particular. The widespread use of mechanisms allowing households to access the property market, the elimination of personal limitations on property ownership, the economic development and growth of tourism in many regions have all led to exponential

[97] European Central Bank (2006).

growth in the number of financial transactions linked to real-estate. The extraordinary range of possibilities for misusing these processes also allows suspected criminals to integrate and enjoy illegally obtained funds.

Through the implementation of international standards in recent years, countries have put various measures into place within their formal financial sector — which includes, among others, banks and credit unions — in order to prevent money laundering and terrorist financing. Because of the tendency for illegal activity to move to other financial / economic areas that may have less formal oversight or where there is relatively less potential for detection, countries must consider extending AML/CFT measures to other parts of their economies, if they want to respond successfully to this threat. For the real-estate sector, this would necessarily include such key players as real-estate agents, legal advisors and notaries.

In order to misuse the real-estate sector, a number of methods, techniques, mechanisms, and instruments are available. Many of these methods are in and of themselves illegal acts; however, certain of them might be considered perfectly legal if they were not associated with a money laundering or terrorist financing scheme (or if this association could not be detected.

Casinos

Casinos generate enormous revenue streams for providers and forgovernment through taxation and licensing fees. The size of the global casino business was estimated at over USD 70 billion in revenue in 2006, although a figure for overall turnover of funds was not available. Casinos in North America (US and Canada) account for almost half of that figure. Macao China is the fastest growing casino jurisdiction, and recorded more than USD 10 billion in gaming revenue in 2007. In addition there is a proliferation of Internet gambling sites, with global revenues estimated around USD 15 billion,[98] plus a significant amount of illegal gambling occurring around the world, which is largely unmeasured.

There is very wide range of legal gaming / gambling across the globe. This includes various games of chance and gambling forms ranging from casino and card room gaming, lotteries, online gaming, race and sports wagering and charitable gaming, such as raffles, bingo and other low technology games. Legalised gambling has become more prevalent over the last 25 years as

[98] "eGaming Data Report: Global Internet Gambling Revenue Estimates and Projections", *Christensen Capital Advisors 2005,*http://www.cca-i.com.

more jurisdictions take advantage of the revenue sources from the taxation and regulated gambling industries. Over this time many governments have allowed for the expansion of legal gambling, including casinos, or introduced regulatory regimes over existing gambling.

Casinos are not legal in India except in the State of Goa where the Goa Public Gambling Act, 1976 has been amended to permit the operation, in a restricted manner, of land-based and offshore casinos.

The Home Department of the Government of Goa issues licences to casinos and, at the time of the on-site visit, it had issued licences for 14 land-based casinos (located in five-star hotels) and 6 offshore (ship-based) casinos, although only eleven onshore and three offshore operators had started business. Offshore casinos must also be licensed by the Director General of Shipping at the Ministry of Surface Transport, and must also possess a certificate of non-objection from the Captain of Ports. Onshore casinos are prohibited from providing live tables, and are restricted to offering slot machines and electronic games. Offshore casinos are able to provide live tables, but the gambling activities are primarily incidental to the dining and entertainment facilities on the ships. The casinos were brought within the PMLA framework via the amendments to the PMLA, which came into force on 1 June 2009.

Free Trade Zones / Special Economic Zones

Free Trade Zones (FTZs) have proliferated in recent years, such that today there are approximately 3,000 FTZs[99] in 135 countries around the world with a total turnover in the billions of U.S. dollars.[100] FTZs are designated areas within jurisdictions in which incentives are offered to support the development of exports, foreign direct investment (FDI), and local employment. These incentives include exemptions from duty and taxes, simplified administrative procedures, and the duty free importation of raw materials, machinery, parts and equipment. In addition to boosting economic opportunity, these incentives can result in a reduction in finance and trade controls and enforcement, creating opportunities for money

[99] The geographic area in which special regulatory and tax treatment is applied to certain trade-related products and services, which in this paper is referred to as a free trade zone, is also known by various other names throughout the world, including: free zones, freeport zones, port free trade zones, foreign trade zones, e-zones, duty free trade zones, commercial free trade zones, export processing zones, logistic zones, trade development zones, industrial zones/parks/areas, hi-tech industry parks, hi-tech and neo-tech industrial development zones, investment zones, bonded zones, special economic zones, economic development zones, economic and technological development zones, resource economic development zones and border economic cooperation zones.

[100] Akinci, G. and Crittle, J. (2008).

laundering and the financing of terrorism. Because the same characteristics that make FTZs attractive to legitimate business also attract abuse by illicit actors.

SEZs present a unique money laundering and terrorist financing threat because of their special status within jurisdictions as areas where certain administrative and oversight procedures are reduced or eliminated in order to boost economic growth through trade. The special tax and administrative arrangements available to exporters and export service providers in SEZs, although intended to boost legitimate trade, can create money laundering and terrorist financing vulnerabilities.

A number of jurisdictions do not apply the same PMLA regulations in the zone as in the rest of the country. In particular the regulations that relate to preventatives measures such as reporting large-value currency transactions and, in some cases, Suspicious Transaction Reports (STRs) as they relate to financial institutions and businesses operating in the zones.

As mentioned above, the use of cash in SEZs continues to be important because it is easy to use in trade transactions. Cash does not require financial institutions and presents particular ML risks because of its portability, anonymity and lack of an audit trail. Moreover, even if banks outside of the SEZs are involved in the trade transactions, they are less able to manage ML risks because of the others vulnerabilities of the zones (opaqueness and relaxed oversight).

Commercial Websites, Mobile Payment System and Internet Payment Systems / New Payment System

Some commercial websites and Internet payment service providers apply a risk-based approach when identifying customers. If the risk profile of the customer and transaction are high, additional verification methods are applied (simplified Customer Due Diligence (CDD) vs. enhanced Customer Due Diligence (CDD). The mechanisms of verification can be adapted to the country of registration and changed as necessary to adapt to criminal techniques to bypass identification and verification processes. The private sector representatives who participated in the study indicated that criminals do attempt to circumvent these processes and although none of the methods had a zero-failure rate, they were effective on a risk-weighted basis. In certain countries, online customer identification mechanisms using an electronic identity card are used and reduce the risk of identity theft.

Internet payment systems: Before a user of an Internet payment system can effect a transfer of funds through the system he generally must first fund the transfer. Funding a transfer through an Internet payment system may involve funding an "account" from which funds will be drawn for subsequent transactions or transfers, or providing the Internet payment system with the equivalent amount of funds the user wishes to transfer. Depending upon the operations of a given Internet payment system, the user may have several options for funding a transaction, and may not be limited to the use of the user's credit card or personal bank account. To avoid fraud or any form of criminal misuse, the Internet payment service provider may attempt to verify that the customer has control over and is authorised to use certain funding methods, such as a credit card or bank account. Once the user has successfully been verified, the user is free to conduct transactions through the Internet payment system.

Payment in cash can be made directly between buyer and seller, but this mechanism is not believed to be regularly used. With Internet payment systems, the transaction takes place electronically very rapidly. For global stakeholders (commercial websites and Internet payment systems available in different countries), the policies, practices, facilities (commercial and payments) made available to customers, may be different depending on the location of the parent company, local branch, or local website.

Commercial websites and Internet payment systems can be used by criminals to commit fraud. One of the mechanisms used is the sale of fictitious items which the seller will not deliver to the buyer after receiving the payment. If commercial websites are used to attract buyers (in this case the victims of the fraud), Internet payment systems are not necessarily used to collect the funds (the proceeds of these activities). Criminals frequently use bank accounts in traditional financial institutions or money transfers and postal orders to be paid for the goods they do not deliver. The same channels are thereafter used to launder the proceeds of these illegal activities by making the funds disappear.

Maritime Piracy

Piracy, kidnapping, illegal restraint, and hostage-taking fall under the Financial Action Task Force's (FATF's) categories of designated serious offences for money laundering. The

international community has responded by deploying flotillas of warships in oceans and seas where the problem is most serious, especially off the coast of Somalia, including the Gulf of Aden, the Indian Ocean, and, most recently, the Arabian Sea. With ransom demands and payments for the release of vessels and hostages escalating, there appears to be a definite link to money flows related to both those who are financing piracy and the proceeds of this criminal activity. Despite this, international maritime operations involving warships from dozens of countries remains the primary response against such.

Piracy encompasses both physical capture of cargo from a vessel, as well as obtaining a ransom in exchange for the vessel, crew and cargo. While the majority of this paper is deals with PFR, both forms of piracy have a financial component.

Likewise, although most of the current attention is focused on the Gulf of Aden and Somalia, which is reflected in this project report, it also takes place elsewhere in the world and is proliferating.

There has been considerable discussion regarding possible linkages between Somali pirates, the al-Qaida-affiliated al-Shabaab terrorist organisation and other terrorist groups operating in the Horn of Africa. While no clearly evident link has been established, and, in fact, piracy has been considered to be *haram* (forbidden) under Islam, anecdotes of Somali pirates paying "docking fees" and "taxes" to al-Shabaab and possibly to other terrorist groups were recurrent themes in information collected for this report.

Piracy has now become a financially lucrative criminal activity. In five years the average amount demanded for each captured vessel has increased from USD 150 000 (2005) to USD 5.2 million (2010)[101]. All indications suggest ransom payments will continue to rise.

A common ratio that academic experts use in theorizing about the amount of maritime piracy-related monies remaining in Somalia versus the amount leaving there is 60:40. However, even if indeed "only" 40% of ransom proceeds leave Somalia, the actual and potential exploitation of the financial sector by those who commit and support maritime piracy globally still represents a money laundering and terrorist financing threat.

Extortions/ Kidnapping for ransom

[101]The Economist *op cit*

Kidnapping for ransom (KFR) as a means of financing terrorism has been identified by law enforcement agencies worldwide as a significant source of revenue for terrorist groups often operating in politically unstable countries where central authority is often weak, public and private corruption is endemic, and the social fabric of those nations has unraveled to a considerable degree.

The two primary motives for terrorists to resort to such ransom are financial and political. Ransoms resulting from such ransom enables terrorist groups to recruit and indoctrinate new members, acquire sophisticated weapons and communications gear such as satellite phones, establish training camps and support units, including "safe houses" and transportation operations, as well as provide financial resources which can be used to bribe government officials, law enforcement personnel and others who can be of use to a terrorist organisation in conducting its nefarious activities.

The financial dimensions of KFR cannot be trivialized. For example, al Qa'ida in the land of the Islamic Maghreb (AQIM) is estimated to have collected at least USD 65 million in ransom payments since 2005[102]. It has been reported that the average ransom payment for the release of a hostage taken by AQIM between 2008 and 2009 was USD 6.5 million[103]. This fact alone should raise serious concerns about terrorist financing and the potential vulnerabilities which may arise for the international financial system.

A kidnapping can occur in one jurisdiction but the ransom may be paid in another. A further complicating factor is the multitude and variety of actors that can be involved in ransom payments. Based on research and case studies, these can include family members, non-governmental organisations (NGOs), multi-national businesses, insurance companies, government entities and third party intermediaries.

In many cases, individuals, families and private businesses may choose to deal directly with the kidnappers out of fear that harm may come to the hostage(s) if the authorities are notified. In such cases, ransom payments are deposited in bank accounts designated by the kidnappers or the money flows through alternative remittance systems such as*hawalas.* Third party intermediaries are often employed as negotiators/couriers. Depending on the circumstances,

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[102] EU/US Consultations on Terrorist Financing, December, 2011

[103] EU/US, *Op Cit*

competent authorities may be completely unaware of the involvement of third party intermediaries in negotiations of such ransom case and the activities of the third party in facilitating a ransom payment. Without the involvement of law enforcement or specialised hostage intervention units in the kidnapping, terrorists involved in KFR become emboldened because of the absence of dissuasive measures and/or post incident investigations. This type of situation minimises the cost/risks to terrorist groups and serves as an incentive to expand such ransom operations. It should be emphasised that if a terrorist group knows an individual, business, or other entity is willing to pay ransoms, the greater the likelihood that those who pay will be targeted again.

Large Scale Transactional Frauds

In recent years large-scale transnational fraud has transformed from a localised crime problem into a global crime threat, the true scale of which is difficult to ascertain with any degree of certainty. However, it is widely accepted that losses run into tens of billions rupees annually. While these billions of rupees are laundered using a variety of vehicles it is also widely accepted that at some stage in the laundering cycle, the majority of these funds pass through the banking system.

The money laundering feature associated with large-scale fraud is that of the difficulty in differentiating money laundering from the predicate offence; unlike money laundering related to drug trafficking, for example, the money laundering in large-scale fraud commences simultaneously with the commission of the predicate offence; they work hand in hand.

APG mutual evaluations, APG typologies collections and typologies workshops continue to highlight threats from money laundering associated with large-scale transnational frauds, in particular telemarketing/boiler room/lottery frauds. Jurisdictions that have conducted investigations of these frauds and associated money laundering highlight the involvement of transnational organised crime groups and highly profitable criminal activity.

Telemarketing and related frauds present a good example of how transnational organised crime activity has adapted and grown with globalisation. Telemarketing frauds and associated ML have proliferated, utilising an increasingly wide spectrum of modus operandi to present a fraudulent solicitation to a prospective victim. Global in nature, the perpetrators, victims, and

the bank accounts used to launder the proceeds of such fraud, are normally located in different jurisdictions.

Money Laundering through the IPL Cricket

With the growing economic importance of Cricket during the last two decades, including the increasing profits that can be made out of Cricket, money gradually started to exert a strong influence on the world of cricket. The influx of big money into Cricket has positive effects, but there are negative consequences. There is a higher risk of fraud and corruption given the amount of money at stake. Sport also can be used as a channel to launder dirty money.

As the biggest, truly global, high value sport, IPL Cricket seems to be confronted with various forms of crime and corruption - including money laundering. Cricket has undergone an accentuated growth and commercialisation since the early 1990's. The influx of big money, in combination with some specific factors has made Cricket one of the many sectors that can be attractive for criminals to launder proceeds of crime.

A variety of money flows involving various financial transactions increase the risk of money laundering through Cricket. These are related to the ownership of Cricket clubs or players, the transfer market and betting activities. Other cases show that the Cricket sector is used as a vehicle for perpetrating criminal activities, and thus creating dirty money. Those criminal activities mainly refer to illicit trafficking in human beings, corruption, drug trafficking (doping) and tax crime.

It appears that betting in sport has reached new levels of sophistication with various operators involved across several countries and continents and new offshore betting companies being established. The use of the Internet and mobile phone services for online betting further also increases the risk of money laundering.

Money Laundering through Legal Professionals

The general observations about legal professionals should also be given attention to the particular activities performed by legal professionals on a national, provincial, or local basis. Because legal professionals typically refer to those benefiting from their services as "clients" rather than "customers", that term is thus generally used throughout.The legal professionals include both lawyers and notaries. Lawyers are members of a regulated profession and are

bound by their specific professional rules and regulations. Their work is fundamental to promoting adherence to the rule of law in the countries in which they practice. The financial transactions between legal professionals and clients are usually done in cash, thus vulnerable to ML risks.

This refers to sole legal practitioners and partners or employed legal professionals within professional firms. It is not meant to refer to "internal" (i.e. in-house) professionals that are employees of other types of businesses, nor to legal professionals working for government agencies, who may already be subject to separate measures that would combat money laundering and terrorist financing.

The PMLA does not cover those common law notaries who perform merely administrative acts such as witnessing or authenticating documents, as these acts are not specified activities.

Money Laundering through Accountants

Accountants in practice may provide a very wide range of services, to a very diverse range of clients. They are the first professional consulted by many small businesses and individuals when seeking general business advice and a wide range of regulatory and compliance advice. Where services are not within their competence, accountants advise on an appropriate source of further assistance.

Some of the functions performed by accountants that are the most useful to the potential launderer include:

- Financial and tax advice - Criminals with a large amount of money to invest may pose as individuals hoping to minimise their tax liabilities or desiring to place assets out of reach in order to avoid future liabilities.
- Creation of corporate vehicles or other complex legal arrangements (trusts, for example) - such structures may serve to confuse or disguise the links between the proceeds of a crime and the perpetrator.
- Buying or selling of property - Property transfers serve as either the cover for transfers of illegal funds (layering stage) or else they represent the final investment of these proceeds after their having passed through the laundering process (integration stage).

- Performing financial transactions - Sometimes accountants may carry out various financial operations on behalf of the client (for example, cash deposits or withdrawals on accounts, retail foreign exchange operations, issuing and cashing cheques, purchase and sale of stock, sending and receiving international funds transfers, etc.).
- Gaining introductions to financial institutions.

Having regard to the size of accounting firm, the framework of internal controls should:

- Provide increased focus on accountants' operations (products, services, clients and geographic locations) that are more vulnerable to abuse by money launderers and other criminals.
- Provide for regular review of the risk assessment and management processes, taking into account the environment within which the accountant and the accounting firm operates and the activity in its market place.
- Designate an individual or individuals at management level responsible for managing PMLA compliance.
- Provide for PMLA compliance function and review programme.
- Ensure that adequate controls are in place before new products are offered.
- Inform senior management of compliance initiatives, and identify compliance deficiencies, corrective action taken, and suspicious activity reports filed.
- Provide for programme continuity despite changes in management or employee composition or structure.
- Focus on meeting all regulatory record keeping and reporting requirements, recommendations for PMLA compliance and provide for timely updates in response to changes in regulations.
- Implement appropriate risk-based policies, procedures and processes.
- Provide for adequate controls for higher risk customers, transactions and products, as necessary, such as transaction limits or management approvals.
- Enable the timely identification of reportable transactions and ensure accurate filing of required reports.

- Provide for adequate supervision of employees that handle currency transactions, complete reports, grant exemptions, monitor for suspicious activity, or engage in any other activity that forms part of the firm's PMLA programme.
- Incorporate PMLA compliance into job descriptions and performance evaluations of appropriate personnel.
- Provide for appropriate training to be given to all relevant staff.
- For groups, to the extent possible, there should be a common control framework.

Money Laundering through Life Insurance Sector

Money launderers and terrorist organisations have considerable knowledge of life insurance companies and intermediaries and take extreme measures to hide their financial activities and make them indistinguishable from legitimate transactions. A risk-based approach is designed to make it more difficult for these criminal elements to make use of life insurance companies and intermediaries due to the increased focus on the identified higher risk activities that are being undertaken by these criminal elements. In addition, a risk-based approach allows life insurance companies and intermediaries to more efficiently and effectively adjust and adapt as new MLmethods are identified.

Funds that are used to finance terrorist activities may be derived either from criminal activity or may be from legal sources, and the nature of the funding sources may vary according to the type of terrorist organisation. Where funds are derived from criminal activity, then traditional monitoring mechanisms that are used to identify money laundering may also be appropriate for terrorist financing, though the activity, which may be indicative of suspicion, may not be identified as or connected to terrorist financing. It should be noted that transactions associated with the financing of terrorists may be conducted in very small amounts, which in applying a risk-based approach could be the very transactions that are frequently considered to be of minimal risk with regard to money laundering. Where funds are from legal sources then it is even more difficult to determine that they could be used for terrorist purposes. In addition, the actions of terrorists may be overt and outwardly innocent in appearance, such as the purchase of materials and services (i.e. commonly held chemicals, a motor vehicle, etc.) to further their goals, with the only covert fact being the intended use of such materials and services

purchased. Therefore, both for terrorist funds derived from criminal activity and for legitimately sourced funds, transactions related to terrorist financing may not exhibit the same traits as conventional money laundering. However in all cases, it is not the responsibility of the insurance company or intermediary to determine the type of underlying criminal activity, or intended terrorist purpose, rather the company's role is to report the suspicious activity. The FIU and law enforcement authorities will then examine the matter further and determine if there is a link to terrorist financing.

Therefore, the ability of life insurance companies and intermediaries to detect and identify potential TF transactions without guidance on TF typologies or without acting on specific intelligence provided by the authorities is significantly more challenging than is the case for potential ML and other suspicious activity. Detection efforts, absent specific national guidance and typologies, are likely to be based around monitoring that focuses on transactions with countries or geographic areas where terrorists are known to operate or on the other limited typologies available (many of which are indicative of the same techniques as are used for ML).

A "free look" provision is a contractual provision, often mandatory under local law, which allows a policy owner or annuitant of a life insurance or annuity contract to examine a contract for a certain number of days and return it for a full refund.

Life insurance companies and intermediaries should therefore work with regulators and law enforcement to take adequate measures to mitigate and manage potential risks.

Recommendations

SUGGESTIONS AND RECOMMENDATIONS

Followings are the suggestions may be executed for an effective PMLA in India:

PMLA & its Legal Gaps

i. The monetary threshold limitation of ₹ 3 million for the Schedule Part B predicate offences may be abolished.

ii. The present strict and formalistic interpretation of the evidentiary requirements in respect of the proof of the predicate offence may be put to the test of the courts to develop case law and receive direction on this fundamental legal issue.

iii. The level of the maximum fine imposable on legal persons may be raised or left at the discretion of the court to ensure a more dissuasive effect.

iv. The practice of making a conviction of legal persons contingent on the concurrent prosecution/conviction of a (responsible) natural person may be abandoned.

v. Legal measures are taken to allow for confiscation of the money laundered as subject of the ML offence and which is not contingent on a conviction for the predicate offence (stand-alone ML offence).

vi. The confiscation regime may also include clear provisions and procedures on how to deal with the assets in case the criminal proceedings come to a halt because of the death of the defendant.

vii. Govt. may provide guidance on how to interpret the definition of beneficial ownership and on the procedures required to identify the ultimate natural person who owns or controls the customer (all regulators);

ML & Financing Terrorism

i. The Indian authorities ensure that the definition of proceeds of terrorism is wide enough to allow for confiscation of instrumentalities and funds used to finance an individual terrorist.

ii. The terrorist acts under section 15 of the UAPA may also target international organisations.

iii. The section 16A UAPA offence of making demands for nuclear material, etc. may be included in the section 15 list of terrorist acts.

iv. The attempt to commit the section 17 and section 40 UAPA offences may be fully covered.

v. The sole willful financing of terrorist individuals and terrorist organisations may be criminalized.

vi. The UAPA and the NDPS Act may explicitly provide for full equivalent value confiscation.

vii. Govt. may amend the PML Rules to: require renewal of CDD when there are suspicions of money laundering or terrorist financing, or where there are doubts about the adequacy or veracity of previously obtained customer identification data; and require

institutions proactively to determine whether a customer is acting on behalf of another person.

viii. Govt. may incorporate specific provisions for time barred ML investigations.

ix. Govt. may organise periodic training of law enforcement, judicial and financial sector personnel and appropriate manpower of the officers and staff in the three organs for registering cases pertaining to narcotic substances.

x. FICN case(s) may have a reasonable value of the seizure.

FIU-IND & its functions

i. FIU-IND may enhance its capability in relation to intelligence and information dissemination to all competent authorities, including the State Police.

ii. FIU-IND may enhance its dissemination of public information regarding trends and typologies, which could include strategic reporting.

iii. Govt. may widen the sharing of intelligence with other related wings e.g., wider coordination in REIC meets.

iv. Govt. may set provision of a nodal agency for exclusive export data for tracing the details of transactions and digitalisation of the records.

v. Govt. may set rules/laws for having a single bank account system with the facility of Bank Account Portability options; transaction not without the use of PAN.

vi. Govt. may harmonize predicate offenses under anti-money laundering laws across all Financial Action Task Force cooperating countries.

Customs

i. Govt. may undertake an in-depth analysis and envisage taking the necessary actions based on the deficiencies identified in relation to the arrival card for passengers used at international airports, including the absence of the necessary guidance, and the use of Customs Declaration Forms at land borders.

ii. Govt. may introduce targeted actions for the detection of smuggling of currency and BNI via the mail and containerized cargo.

IRDA

i. Govt. may introduce measures to prevent the opening of client accounts unless the professional intermediary is willing and able to provide information on the beneficial owners (RBI);

ii. Govt. may introduce requirement to understand the ownership and control structure of legal persons (IRDA);

iii. Govt. may introduce a requirement that an institution may consider filing an STR when an institution can no longer be satisfied that it knows the true identity of a customer (RBI and IRDA); and

iv. Govt. may remove the exemption for term life policies from the AML obligations at the time that the policy is first written (IRDA);

v. Govt. may introduce consistent requirements within all three sets of circulars to ensure that all institutions may have appropriate ongoing risk management procedures for identifying (and applying enhanced CDD to) PEPs, customers who are close relatives of PEPs, and accounts of which a PEP is the ultimate beneficial owner.

vi. Govt. may review the procedures under which the insurers are entirely reliant on the basic identification procedures carried out by their agents (IRDA).

Casinos

i. It is essential that the Home Department of the Government of Goa may undertake a thorough study and determine what additional instruction needs to be applied to the casinos in order to address the perceived risks and to comply with the standards. In this respect, it will clearly be helpful to review the circulars issued by the financial sector regulators and draw from their experience.

ii. The authorities in Goa may review the need to issue further enforceable guidance to the casino sector, especially in relation to the implementation of appropriate internal systems and controls. This is especially important in the context of the offshore casinos, which pose the greater (albeit still quite low) risk.

Legal Professionals

i. Govt. may ensure that information on beneficial ownership of legal persons is collected by either the corporate registry, within corporate records held by legal persons, or by

company secretaries. Govt. may also prohibit nominee directors and nominee shareholders, or (alternatively) establish measures to mitigate the risk of ML associated with those kinds of directors and shareholders.

ii. There may be measures in place to ensure that beneficial ownership information relating to Hindu Undivided Family (HUF) businesses is available through a requirement for HUFs to register with a central registry and maintain beneficial ownership information or through other measures such as a requirement for all HUFs to obtain PANs and to maintain information on all beneficial ownership information available to law enforcement or other authorities on request.

iii. Govt. may take measures to ensure that competent authorities have access to accurate and current information on the ultimate beneficial owners and controllers of all legal persons on a timely basis. The current powers of the competent authorities are hampered to the extent that the repositories of information from which the authorities could obtain information do not maintain sufficient beneficial ownership information.

NPOs/NGOs

- Govt. may undertake a comprehensive NPO sector review capturing all relevant data necessary, including the adequacy of domestic laws in the NPO sector.
- Govt. may undertake comprehensive outreach to the NPO sector with a view to protecting the sector from abuse for terrorist financing as well as wider outreach in relation to good governance and accountability.
- Govt. may ensure that NPOs maintain information on the identity of the persons who own, control or direct their activities, including senior officers, board members and trustees.
- Govt. may demonstrate that appropriate measures are in place to sanction violations of oversight measures or rules by NPOs or persons acting on behalf of NPOs, other than those registered under the Income Tax Act and the FCRA.
- Govt. may implement measures to ensure that all NPOs are licensed and/or registered as such and make this new information available to the competent authorities.

Traders (Gems and Jewellery/Commodity market)

i. The activities of the commodity market may be contained / discouraged to check unaccounted cash transactions which ultimately might get laundered.

ii. Revisiting the regulating provisions of processing / manufacturing pertaining to the select external sector transaction w.r.t. gems /jewellery, and gold.

iii. Govt. may legislate provisions to curtail trade mispricing by sharing the details of imports/exports amongst trading countries / partners.

iv. Govt. may legislate provision of a specialized agency to prepare the data of purchases and imports of a specified volume and interact with the jurisdiction of supply to ascertain whether the transaction has a bribery angle on lines of Foreign Corruption Practices legislation prevalent in some countries.

FTZs/SEZs

i. Govt. may legislate stringent measures against units flouting regulations of SEZs; and stringent measures against the offenders of rules / regulation for imported/exported goods from the ports /airports etc.

ii. Govt. may consider withdrawal of declared special status of goods, especially high priced articles like gems/jewellery, moving through SEZs etc.

iii. RBI may discourage third party remittance – export incentives for earning foreign exchange by units to strictly base on receipt of remittances and that condonation by RBI be given very selectively.

Chapter - 5

ESTIMATION OF THE QUANTUM OF NON-PAYMENT OF TAX DIE TO EVASION BY REGISTERED CORPORATE BODIES

5 ESTIMATION OF THE QUANTUM OF NON-PAYMENT OF TAX DUE TO EVASION BY REGISTERED CORPORATE BODIES

Background

Corporates are the major source of income generation in India and are expected to pay corporate tax on their income. However, there is a gap between the corporate tax that government expects from these corporate bodies and the tax actually paid by them, which is known as the Tax Gap. The official data of the tax department indicate that revenue foregone[104] in 2010-11 is ₹72,881 crore (Annual budget documents, MoF). The data also indicates that a large number of firm do not even file the tax return. The conclusion that one can possibly draw is that for the corporate sector, which has been growing at higher pace than the rest of the economy, a large size of tax evasion is taking place apart from tax avoidance.

Tax avoidance seeks to minimise a tax bill without deliberate deception (which would be tax evasion) but contrary to the spirit of the law. It, therefore, involves the exploitation of loopholes and gaps in tax system and other legislations in ways not anticipated by the law. These loopholes may not be in the domestic tax law alone, but they may also exist between domestic tax law and company law or between domestic tax law and accounting regulations. The process also seeks to exploit gaps that exist between domestic tax law and the law of the other countries when undertaking international transactions.

These losses are different from tax evasion, which is the illegal non-payment or under-payment of taxes. It usually results from filing false return of income or by filing no return of income in respect of taxes due to the relevant tax authorities, resulting in legal penalties (which may be civil or criminal) if the perpetrator of tax evasion is caught.

[104] This revenue foregone is because of several tax rebates, thus this is an issue of tax avoidance.

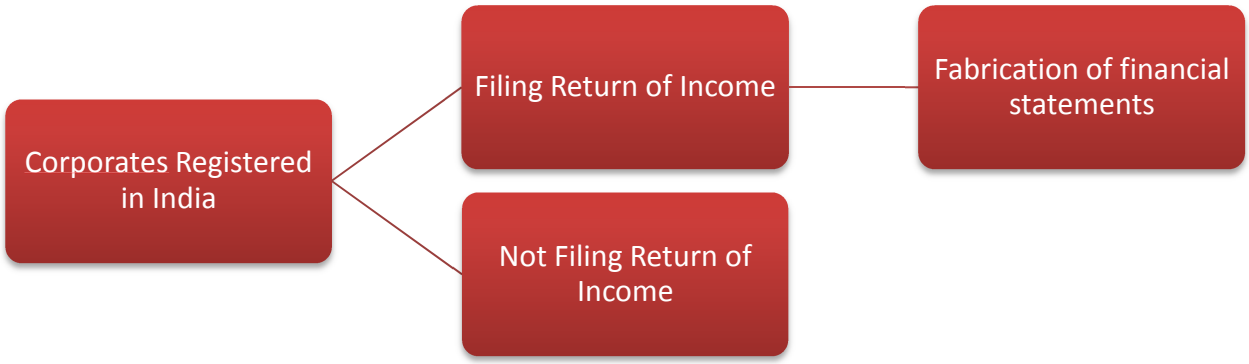
An accurate estimation of the corporate tax gap will have to cover both losses due to tax avoidance as well as loss due to tax evasion.

In this chapter of the report, we focus on tax evasion in the corporate sector. The section is broadly divided in two parts; first part mainly focuses on the stylized facts of the corporate tax, while the second section estimates the size of the corporate tax evasion using the MIMIC model.

Possible Reasons for the Tax Gap

Tax evasion may arise either due to a corporate not filing a return of income or suppressing its profits by fabricating its financial statements. If a corporate files a return of income, the only way it can reduce its tax pay-out and thereby increase the tax gap is by fabricating its financial statements. Diagrammatically this can be represented in the following manner:

Figure 5.1:
Process of Fabrication



Hence, in those cases where the return of income has been filed, the main tax gap arises because of fabrication of the financial statement prepared by the corporate. This fact has been acknowledged in the White Paper on Black Money issued in May, 2012 by the Ministry of Finance, Government of India. On page 4 of the said White Paper, the following diagram has been used to depict the various modes by which suppression of income takes place and thus results in the suppression of taxes. All kinds of manipulations listed below (with the exception of manipulation of capital) have an impact on the Profit & Loss Account of a corporate. Hence the study of the financial statements assumes added significance. The said diagram is being reproduced below as figure 5.2 :

Figure 5.2:
Understanding Genesis of Black Money: Financial System Approach

There are various reasons for tax evasion and tax avoidance. In order to develop methods and instruments for combating tax evasion and avoidance, it is important to establish a broad understanding of the different reasons underlying these problems. These reasons can be grouped in two categories. The first category comprises of factors that negatively affect taxpayers' compliance with tax legislation. These factors can be assumed either contributing to a low willingness to pay taxes (low tax morale) or to high costs to comply with tax laws. The second category contains reasons for the low ability of tax administration and fiscal courts to enforce tax liabilities. These factors can result from insufficiencies in the administration and collection of taxes as well as weak capacity towards auditing and monitoring tax payments which limit the possibility to detect and prosecute violators. Some of the possible reasons of evading tax are as follows:

Low quality of the service in return for taxes

In general, corporates expect some kind of service or benefit in return for the taxes paid. If the government fails to provide basic public goods and services or provides them insufficiently, corporates may not be willing to pay taxes and tax evasion and avoidance will be the consequences (Pashev, 2005; Everest Phillips, 2008; Lieberman, 2002; Brautigam et al., 2008). Furthermore, companies which are facing severe infrastructure problems, i.e., electricity problems, connectivity problems, and spending their own resources to correct the problems, may have higher tendency to evade taxes.

Tax system and perception of fairness

Some studies suggest that high tax rates foster evasion. The intuition is that high tax rates increase the tax burden and, hence, lower the disposable income of the taxpayers (Alligham and Sandmo, 1972; Chipeta, 2002). However, the level of the tax rate may not be the only factor influencing people's decision about paying taxes. In fact, the structure of the overall tax system has an impact as well. If, for example, the tax rate on personal income of individuals is relatively low, but companies are facing a high tax rate on their profit, they may perceive their tax burden as unfair and choose to declare only a part of their income. Similarly, large

companies can more easily take advantage of tax loopholes, thereby contributing to the perceived unfairness in the system. Tax rates and the overall structure of the tax system, therefore, have a significant effect on the disposition to evade and avoid taxes.

High level of corruption

Bribe payment often works as an extra tax. If after high levels of corruption, companies cannot be certain whether their paid taxes are used to finance public goods and services their willingness to pay suffers and it becomes more likely that they evade their tax liabilities. A taxpayer might consider evading taxes if the cost of bribing a tax auditor is lower than the potential benefit from tax evasion.

Lack of rule of law and weak fiscal jurisdiction

Strong fiscal courts are essential to protect taxpayer's rights and safeguard them from arbitrariness. If the legal system does not operate in accordance with the rule of law, companies have to fear arbitrariness, discrimination, unequal attendance in the Court, etc. The lack of rule of law reduces transparency of public action and fosters distrust among citizens. As a result, companies may not be willing to finance the state through taxes, and may decide to evade these liabilities.

High compliance costs

High compliance costs, i.e. the costs the taxpayer has to bear to gather necessary information, fill out tax forms etc., can be additional reasons for tax evasion and avoidance. Small and medium sized enterprises (SME) particularly suffer from high compliance costs. A survey among Indian firms[105] on the regulatory costs of doing business revealed that taxes are perceived as the problematic set of regulations.

Weak capacity in detecting and prosecuting inappropriate tax practices

A well-functioning body of tax investigation is essential for the detection and prosecution of cases of tax fraud. The lack of sufficient capacities in tax administrations reduce the probability

[105] World Bank enterprise survey,

of detection that again influences the decision of a taxpayer as to whether to evade or not ? Additionally, the legal framework is an important prerequisite for any enforcement activity. For example, the size and nature of penalties that are incurred after evasion has been detected are directly connected to the level of tax compliance (Fishlow and Friedman, 1994).

Corporate Tax Collections in India – Historical Perspectives

As corporate activity increases, the natural conclusion would be an increase in the corporate tax collections as well. Corporate tax and income tax are the two main components of direct tax revenues collected by the Central Government. The amount of Gross Tax Revenue, Direct Tax, Corporate tax and Personal Income Tax collected by the Central Government from 1990 to 2010 are enumerated in Table 5.1 below.

Table 5.1:

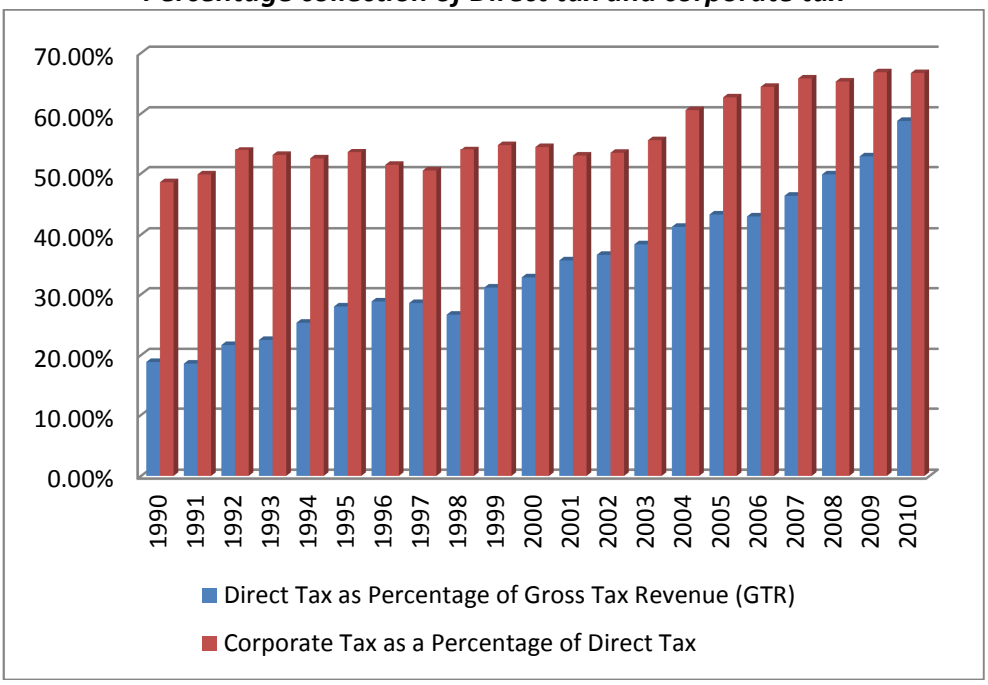
Tax Collection by the Central Government

Figures in Crores

Year	Gross Tax Revenue	Personal Income Tax	Corporate Income Tax	Total Direct Tax	Direct Tax as Percentage of Gross Tax Revenue (GTR)	Corporate Tax as a Percentage of Direct Tax
1	**2**	**3**	**4**	**5 (3+4)**	**6 (5/2 %)**	**7 (4/5 %)**
1990	51636	5010	4729	9739	18.86%	48.56%
1991	57576	5371	5335	10706	18.59%	49.83%
1992	67361	6731	7853	14584	21.65%	53.85%
1993	74637	7888	8899	16787	22.49%	53.01%
1994	75743	9123	10060	19183	25.33%	52.44%
1995	92294	12025	13822	25847	28.01%	53.48%
1996	111224	15592	16487	32079	28.84%	51.39%
1997	128762	18231	18567	36798	28.58%	50.46%
1998	139221	17097	20016	37113	26.66%	53.93%
1999	143797	20240	24529	44769	31.13%	54.79%
2000	171752	25654	30692	56346	32.81%	54.47%
2001	188603	31764	35696	67460	35.77%	52.91%
2002	187060	32004	36609	68613	36.68%	53.36%
2003	216266	36866	46172	83038	38.40%	55.60%
2004	254348	41387	63562	104949	41.26%	60.56%

2005	304958	49268	82680	131948	43.27%	62.66%
2006	366151	55985	101277	157262	42.95%	64.40%
2007	473512	75093	144318	219411	46.34%	65.78%
2008	593147	102644	192911	295555	49.83%	65.27%
2009	605298	106046	213395	319441	52.77%	66.80%
2010	624528	122370	244725	367095	58.78%	66.67%
Source: *Annual reports of the Ministry of Finance, GOI*						

Figure 5.3:
Percentage collection of Direct tax and corporate tax



From an analysis of the data presented in the table above the following conclusions can be drawn:

- Over a period of time the importance of direct tax as a constituent of the overall tax kitty of the government has been increasing.
- Direct tax constituted only 18.86% of the total tax collected in 1990 by the government and this increased to 58.78% in 2010, clearly indicating the growing importance of direct tax collections.

- Within Direct Tax, the share of corporate tax has increased from 48.56% to 66.67% over the same period, indicating that corporate tax is an important constituent of the total direct tax collected.

Figure 5.4:
Direct Tax (DT) as % of Gross Total Revenue (GTR)

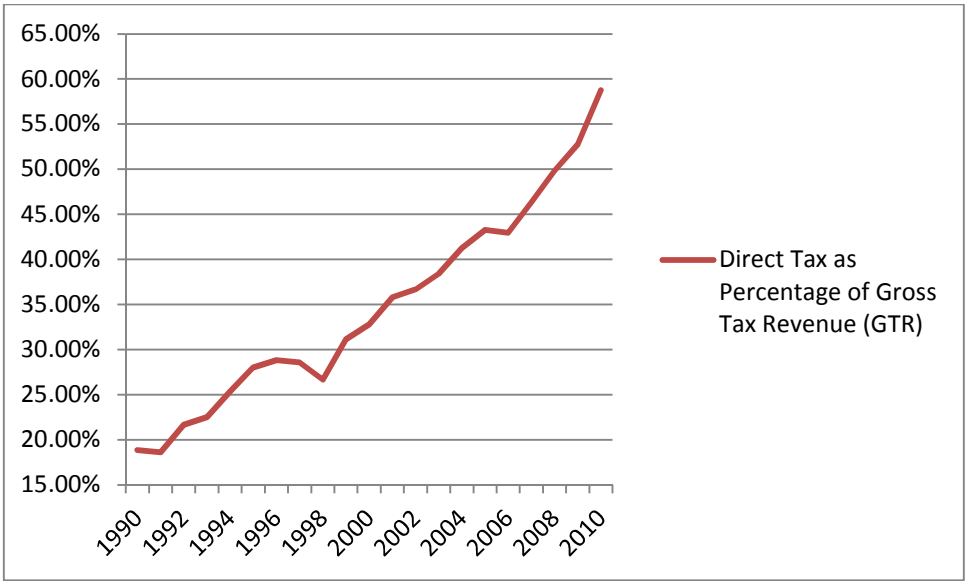
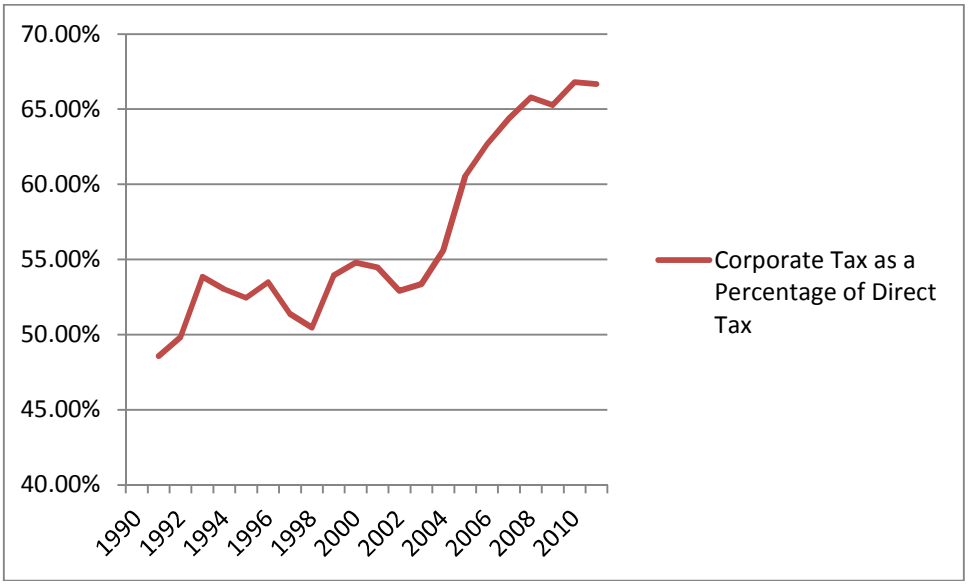


Figure 5.5:
Corporate Tax (CT) as % of Gross Total Revenue (GTR)



Having established the importance of Corporate Tax as a source of revenue for the country, we now analyse the relationship between corporate tax and GDP. For this purpose the measure of corporate tax buoyancy is used. Corporate Tax buoyancy is defined as a change in the amount of corporate tax collected in relation to changes in the GDP over a time series. For the purposes of this analysis the time period of 1991 to 2010 has been considered. The relevant data over this period is enumerated in the table below (Table 5.2):

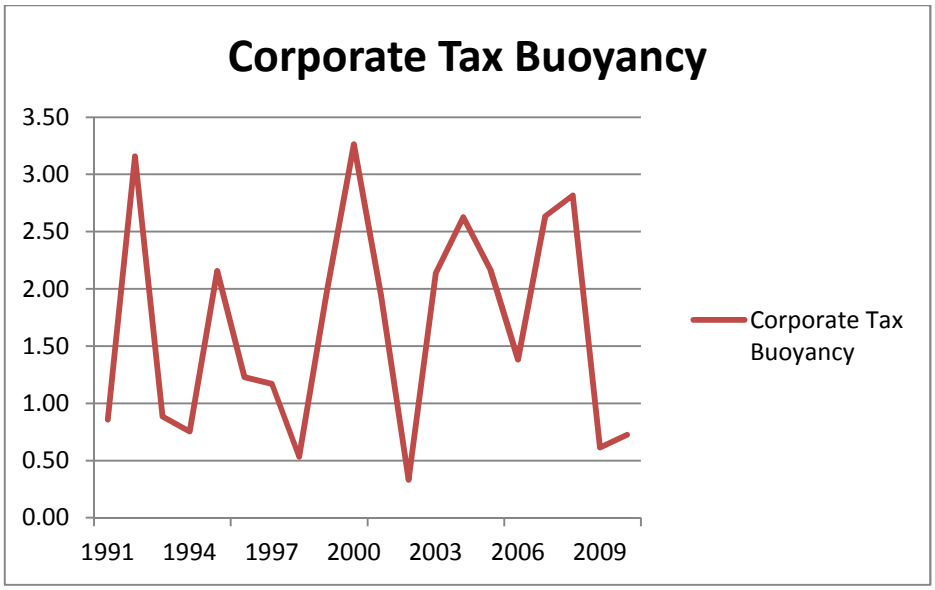
Table 5.2:

Corporate Tax Buoyancy

Figures in crores

Year	GDP at Market Price	Percentage Increase	Corporate Tax Revenue	Percentage Increase	Corporate Tax Buoyancy
1	**2**	**3**	**4**	**5**	**6 (5/3)**
1990	569624		4729		
1991	654729	14.94%	5335	12.81%	0.86
1992	752591	14.95%	7853	47.20%	3.16
1993	865805	15.04%	8899	13.32%	0.89
1994	1015764	17.32%	10060	13.05%	0.75
1995	1191813	17.33%	13822	37.40%	2.16
1996	1378617	15.67%	16487	19.28%	1.23
1997	1527158	10.77%	18567	12.62%	1.17
1998	1751199	14.67%	20016	7.80%	0.53
1999	1952036	11.47%	24529	22.55%	1.97
2000	2102314	7.70%	30692	25.13%	3.26
2001	2278952	8.40%	35696	16.30%	1.94
2002	2454561	7.71%	36609	2.56%	0.33
2003	2754620	12.22%	46172	26.12%	2.14
2004	3149407	14.33%	63562	37.66%	2.63
2005	3586795	13.89%	82680	30.08%	2.17
2006	4170774	16.28%	101277	22.49%	1.38
2007	4843699	16.13%	144318	42.50%	2.63
2008	5422831	11.96%	192911	33.67%	2.82
2009	6362782	17.33%	213395	10.62%	0.61
2010	7650202	20.23%	244725	14.68%	0.73

Figure 5.6: **Corporate Tax Buoyancy**



Data given in the table above and the pattern of the chart shows that corporate tax buoyancy is a phenomenon which does not follow any specific path. This conclusion is more apparent from the chart given above where severe and regular oscillations are observed in the trend line.

Revenue Foregone

The main reason for the ETR being lower than the headline tax rate is because of the various incentives and deductions which are available to a corporate while computing the taxable income. These deductions and incentives result in the taxable income being lower than the income shown in the books of account and consequently, in a lower ETR.

The amount of revenue foregone on account of various deductions and incentives claimed by the corporate are captured by the Ministry of Finance, Government of India and from the year 2005-06 onwards is published as Annexure 12 to the Budget Documents. The cumulative amount of revenue foregone for the years 2005-06 to 2009-10 is tabulated below and is also expressed as a percentage of the total corporate tax collected during that period.

Table 5.3:					
Amount of revenue forgone					
					figures in crores
	2005-06	2006-07 *	2007-08	2008-09	2009-10
Revenue Foregone	34,618.00	50,075.00	62,199.00	66,901.00	72,881.00

% Increase		44.65%	24.21%	7.56%	8.94%
Revenue foregone as %of Corporate tax	34.18%	34.70%	32.24%	31.35%	29.78%
in the absence of actual figures, projected figures have been taken as given in the Annexure 12 of the annual budget documents					

Figure 5.7:
Amount of Revenue Foregone

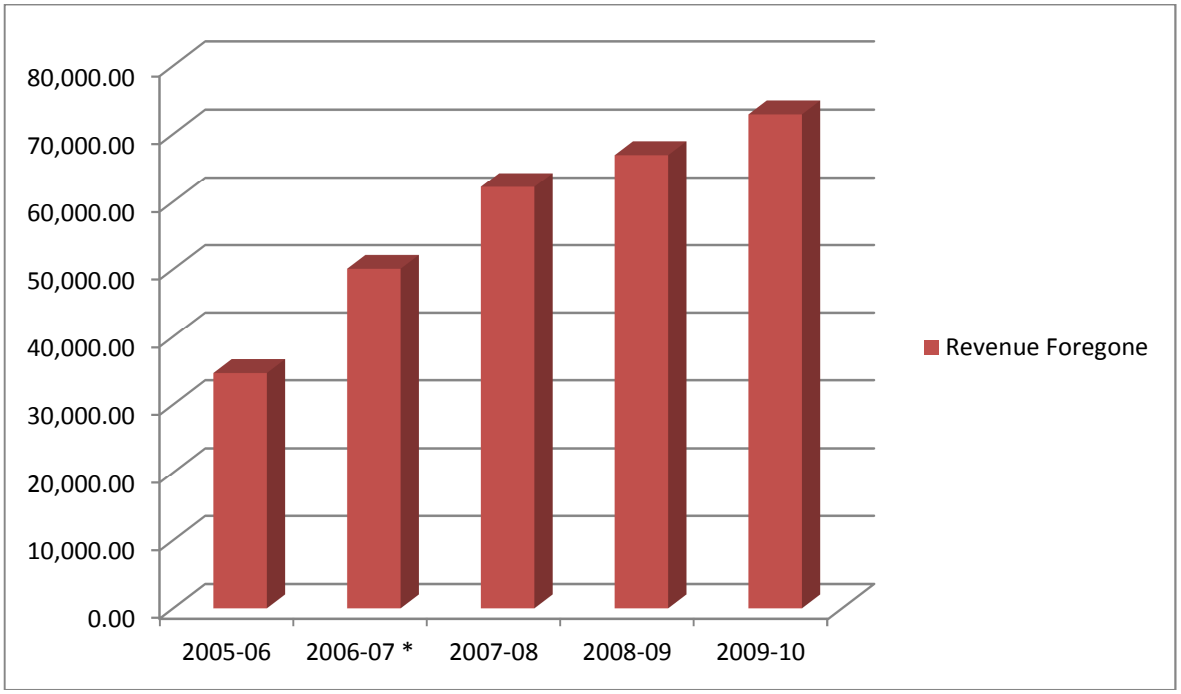
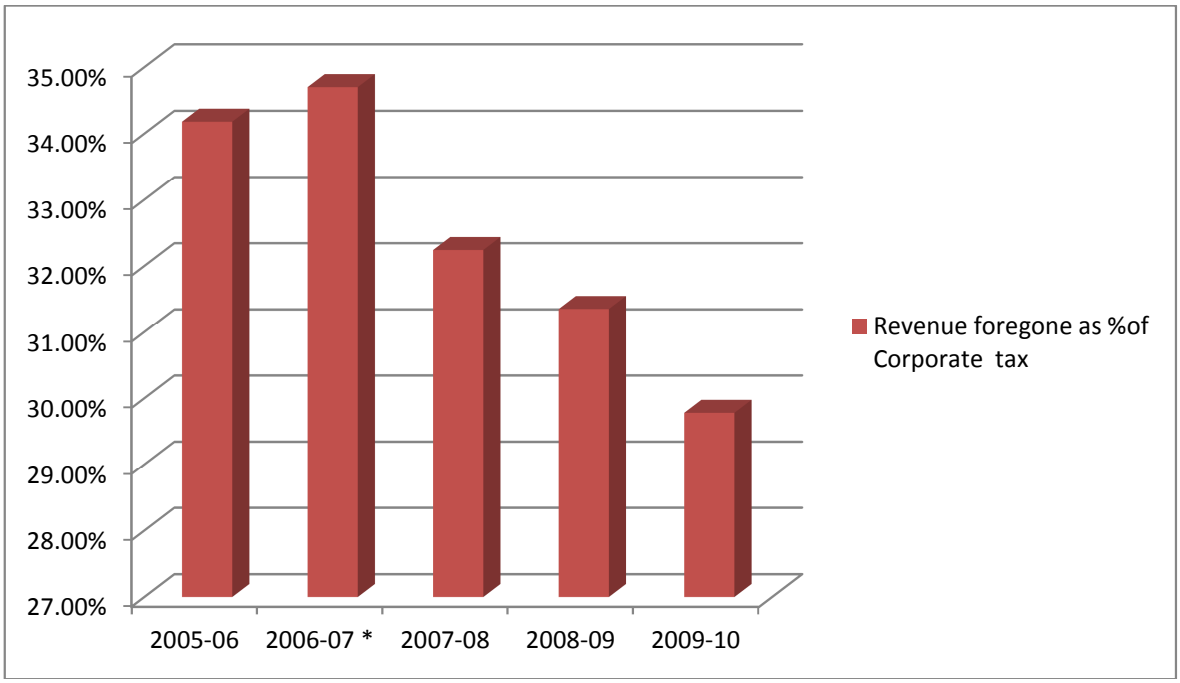


Figure 5.8:
Revenue Foregone as a percentage of Corporate Tax



From the above table the following conclusions can be drawn:

- The amount of revenue foregone has been increasing at a lower rate as compared to the increase in the amount of Corporate Tax collected;
- The total amount of revenue foregone expressed as a percentage of the corporate tax collected has fallen from 34% to 29% over the period.
- However, the sharp reduction in the revenue foregone as a % of corporate tax collected is not accompanied by a similar sharp increase in the ETR during the same period. This clearly indicates that despite the reduction in the amount of revenue foregone, companies have found some other avenues to keep their ETR low.

While computing the ETR for the corporates, the Ministry of Finance, GoI mentions the sector wise Book Profit and tax paid. This statement provides us with the Book Profit of all the corporates who file a return of income with the income tax department. A simple method of computing the correctness of the revenue foregone would be to adjust the book profit of all the corporate for deductions and for the array of tax incentives that are legally applicable, as well

as for special conditions for small and medium industry, and then compared with declared taxable income from the return filed with the Income Tax Department.

Table 5.4					
Shortfall in tax collection					
					Figures in Crores
Particulars	2005-06	2007-08	2008-09	2009-10	2010-11
Total PBT	4,08,444.00	7,11,206.00	6,68,373.00	8,21,943.00	9,46,576.00
Less: Adjustment of a/c of Accelerated deduction					
Depreciation	1,885.85	38,087.67	62,297.73	86,225.36	1,00,076.77
Weighted deduction a/c Scientific Research	8,352.46	5,884.08	7,431.60	7,107.97	14,104.01
Expenditure on a/c of eligible projects	-	91.20	229.48	305.97	310.08
Adjusted PBT	3,98,205.69	6,67,143.04	5,98,414.19	7,28,303.69	8,32,085.14
Less: Profits claimed as exempt under various Heads	91,609.30	1,38,929.10	126866.7255	1,20,779.64	1,36,364.87
Taxable Profits	3,06,596.40	5,28,213.94	4,71,547.46	6,07,524.05	6,95,720.28
Tax on above	1,04,212.12	1,79,539.92	1,60,278.98	2,06,497.43	2,31,100.88
Actual Tax Collected	78,669.00	1,58,149.00	1,52,215.00	1,93,808.00	2,28,061.00
Shortfall In tax Collection	**25,543.12**	**21,390.92**	**8,063.98**	**12,689.43**	**3,039.88**
Figures for 2006-07 are not available ***Source:*** **Ministry of Finance, GoI**					

The above table shows a cumulative tax gap of ₹ 70,727.33 crores over a five year period. This tax gap indicates that various assesses have claimed excess deductions / incentives and the same needs to be thoroughly scrutinised. The fact that excess deductions / exemptions have been claimed is also corroborated by the findings of the CAG in the Performance Audit Reports of the Income Tax Department for the respective years. Further, due to data limitations, this analysis cannot be done for the earlier years.

Summary of the stylized facts

Based on the analysis in the paragraphs above, the following conclusions can be drawn:

- National Income statistics may be a reliable measure to estimate the indirect tax gaps but surely not the direct tax gap, which is essentially based on the profits earned by the corporates and also depends upon the various incentives and deductions which are made available to the corporates;

- A large number of corporates though registered with the MCA, yet are not filing their ROI with the Income Tax Department. There is also a strong possibility that some of the corporate may have already wound up .The real reason for the same needs to be found out. Our limitation in the study has been that in spite of repeated requests for data from Ministry of Corporate affairs the same was not provided to the NIFM. Without data it would be erroneous to assume that such corporates do not earn any income.
- If the amount of tax gap is computed by grossing up the revenue foregone figures as contained in the budget documents the figure comes to ₹ 70,727.33 crores over a five year period. This tax gap indicates that various assesses have claimed excess deductions / incentives and the same needs to be thoroughly scrutinised.

Estimating corporate tax evasion using MIMIC Model

Corporate tax evasion has attracted much attention in policy debates. The empirical literature is rather limited. In this section we shall provide an empirical contribution to the literature by applying a structural equation model (SEM) to estimate an index of corporate tax evasion in India during the last decade. Estimates of the extent of corporate tax evasion in an economy or cross-country comparison often rely on narrow proxies or anecdotal evidences.

Considering the very nature of the issue, reported data is not very reliable. However, most of the previous studies on this issue relied heavily on reported data. Some studies have alternatively used survey method to determine size of corporate tax evasion. However, this method is found not very effective for measuring corporate tax evasion unlike in the case of personal tax evasion. Therefore, we shall attempt an alternative for the economic analysis of corporate tax evasion in India. To the best of our knowledge this is the first attempt to estimate the size of corporate tax evasion using the MIMIC model.

The MIMIC approach is considered for the analysis of the Indian economy because of the following reasons:

- Lack of availability of data to conduct tax auditing, labour force discrepancies and other similar survey-based methods in the Indian case.

- Other approaches of the corporate tax evasion have some serious limitations and weaknesses.
- The standard literature has shown that MIMIC approach yields very reliable estimate of the Shadow Economy (see Schneider, 2005). For example, the technique has been employed mainly for Vuletin (2008) in 32 Latin American and Caribbean countries in the early 2000s, Dell'Anno, et.al., (2007) in three Mediterranean countries, namely, France, Spain and Greece, Pickhard and Pons (2006) for Germany, Mexico, Schneider et al.,(2008).

In doing so, we would be contributing to the empirical literature on corporate tax evasion in the following ways:

First, using a specific form of a SEM with one latent variable, that is a Multiple Indicators Multiple Causes (MIMIC) model, we can capture the unobservable nature of corporate tax and account for the manifold potential causal and indicator variables of evasion.

Second, we use the MIMIC estimation results to rank the corporate tax evasion in the economy and compute an index.

Third, we also utilize information from World Bank's Enterprise Surveys data for India, to know the base year's magnitude of the corporate tax evasion.

Finally, we utilize a range of variables in the MIMIC model estimation, which can significantly cause corporate tax evasion in India.

Estimation method: Structure Equation Model (The MIMIC Model)

SEMs have statistical relationships among latent (unobserved) and manifest (observed) variables. They imply a structure of the empirical or database covariance matrix which, once the parameters have been estimated, can be compared to the resulting model-implied covariance matrix. If the two matrices are consistent with one another, then the structural equation model can be considered as a likely explanation for the relations among the examined variables.

Data and Empirical hypotheses

To estimate the corporate tax evasion using the MIMIC model, we need to quantify causes and indicators of tax evasion in the corporate sector.

Probable Causes

Presence of Public sector units

There are hardly incentives for the public sector units (PSUs) to evade taxes. Nevertheless, in the reform period role and presence of PSUs have decreased significantly. This changing dynamics may have positive effects on the extent of tax evasion in India. Considering this viewpoint, we included a ratio of public to private sector number of firms in the analysis. We expect positive effects of this variable on shadow income of the corporate sector.

Tax burden

Taxation is a major cause of the existence of the shadow economy. The expected impact of the variable is, therefore, positive on the shadow income of the corporates. Theoretically, the greater the tax burden, the greater will be the incentives for corporates to under-report revenue. Alternatively, the tax burden has been taken into account not only as the relationship between taxes paid and gross domestic product, (GDP), but also as it is perceived by taxpayers, measured as the increase in the tax burden indicator. In the standard literature, this variable shows a positive sign and is always significantly different from zero. In this study, we have included effective corporate tax rate in the model.

The tax administration

The efficiency and activeness of corporates are important factor in underreporting of sales. If the tax authority and officials are motivated and active, not only the cost of underreporting is higher but also it leads to legal, administrative and regulatory problems. To capture this aspect in the model, amount of seizure data (from corporate entities by tax department) can be utilized as a proxy of the tax administration nevertheless this data may also works as an indicators of size of shadow economy generation in the corporate sector. It is expected that size of seizure and activism of tax officials would have negative effects on the unaccounted income in our empirical model.

Regulation

Adhering to the tax system and laws by corporates units could be negatively affect the size of under-reporting in the sector. However, finding an appropriate proxy which can measure this tendency among firms seems to be difficult. Percentage of firms not filling ROI provided by the tax department could be a considerable indicator. The decreasing ratio will lead to lower shadow economy or tax evasion and vice versa in the sector.

Other variables

To capture the size and capital, we have included paid up capital and revenue variables. Furthermore, considering the interest rate sensitivity of some of the sectors, we have also included interest rate. These variables are used as control variables in the model.

Table 5.5:

Data Description

Variable	Definition	Data Source
Public- Private	Ratio of Number of Public- Private Companies	CBDT (Internal)
Filing ROI	Percentage of firms not filling ROI	CBDT (Internal)
Seizure	Total amount of seizure	CBDT (Internal)
Paid up capital	Total paid up capital	CBDT (Internal)
FDI	FDI inflows	RBI
ETR	Effective tax rate	Calculation based on CBDT and Prowess Data
Interest rate	Deposit rate	RBI
Corporation-Tax	Collection of Corporation-Tax	Report on Public Finance, 2011-12, (Ministry of Finance, India)
Revenue	Revenue of Corporation	CBDT (Internal)

Estimation Results

Table 5.6 shows the results of the mimic model. As expected Public-Private variable has positive effects on the shadow economy in the corporate sector. Filling ROI is considered as proxy of adhering to the regulation, thus, not filling ROI is expected to have negative impact on the shadow economy. Surprisingly, it is found to be positive in the model. Both of these variables are statistically significant. Seizure variable indicates the effectiveness and alertness of tax administration and it should have positive effects. Our results of the estimation confirm it. We also found the negative coefficient of ETR, which may indicate that tax rate is not a major issue

for the corporates in the reform period. Results of other control variables have turned out to be on the expected lines.

Computation of Projected Taxable income and Projected Tax from Corporate Bodies

Based on the results of Table 5.6 we compute the index of Shadow Income in the corporate sector. In the first stage, based on the results we compute an index of the shadow economy in the corporate sector in India (see Figure 5.9). The computed index clearly reveals that the shadow economy has increased sharply and steadily in the study period. Since we do not have any information regarding base year's shadow income, we have utilized the World Bank's Enterprises survey data on India (2004-05) (see, http://www.enterprisesurveys.org/). On the basis of results of the survey we first estimate total projected income, which includes shadow income generated by the corporations in India. Figure 5.10 represents the reported and projected incomes of the corporates in India. It suggests that after the financial year 2007-08, the intensity of under-reporting of income has increased sharply. The estimated gap between estimated and reported income was below 20%, but it crosses even 30% in the recent years. Subsequently, using ETR data, we have also estimated the total projected corporation tax collection. The result of the computation is presented in Figure 5.11, which again indicates similar results as of the income. Estimated results reveal that in 2004-05, around ₹ 15000 crore was evaded, which has surged to ₹ 95000 crore. It seems that the economic turbulence and uncertainty have encouraged or forced corporations to evade more taxes.

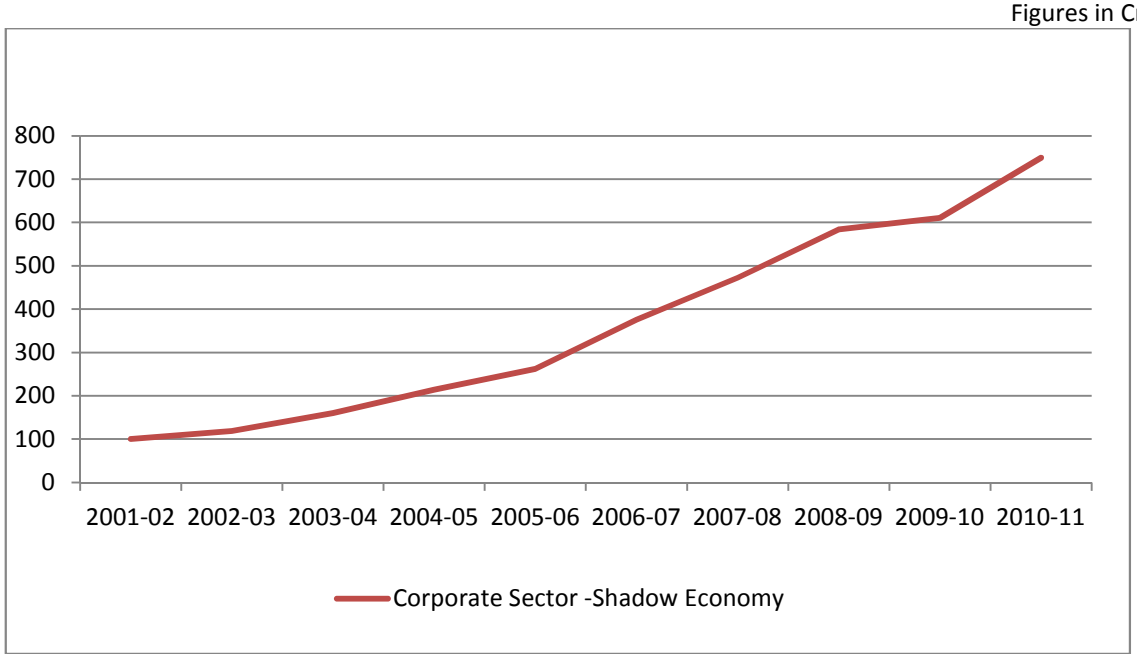
Table 5.6		
MIMIC Model Results		
	Coefficient	Standard Error
Cause Variables		
Public- Private	0.553154	0.1466494
Filing ROI	-2.205687	0.3149861
Seizure	-0.0084187	0.1347141
Paid up capital	0.1309786	0.0898327
FDI	0.055951	0.0202
ETR	-0.7619575	0.0665176
Interest rate	-0.0868521	0.1775338
Indicator		
Corporation-Tax	1	

Revenue	0.6560036	0.012401
LR test (χ^2)	292.80	
RMSEA	0.00	

Note:
1. SE is in parentheses,
2. LR test is Likelihood ratio test of model vs. saturated,
3. Likelihood ratio test baseline vs. saturated of yield similar results as of model vs. saturated (it is not reported here)
*4. ** and * denote significant at 5% and 10%, respectively. 5. ΔDenotes first difference.*

Figure 5.9:
Corporate sector – Shadow Economy (Index)

Figures in Crores



Source: Author's calculation based on results of the MIMIC Model

Figure 5.10:
Projection of Total Corporation Income

Figures in Crores

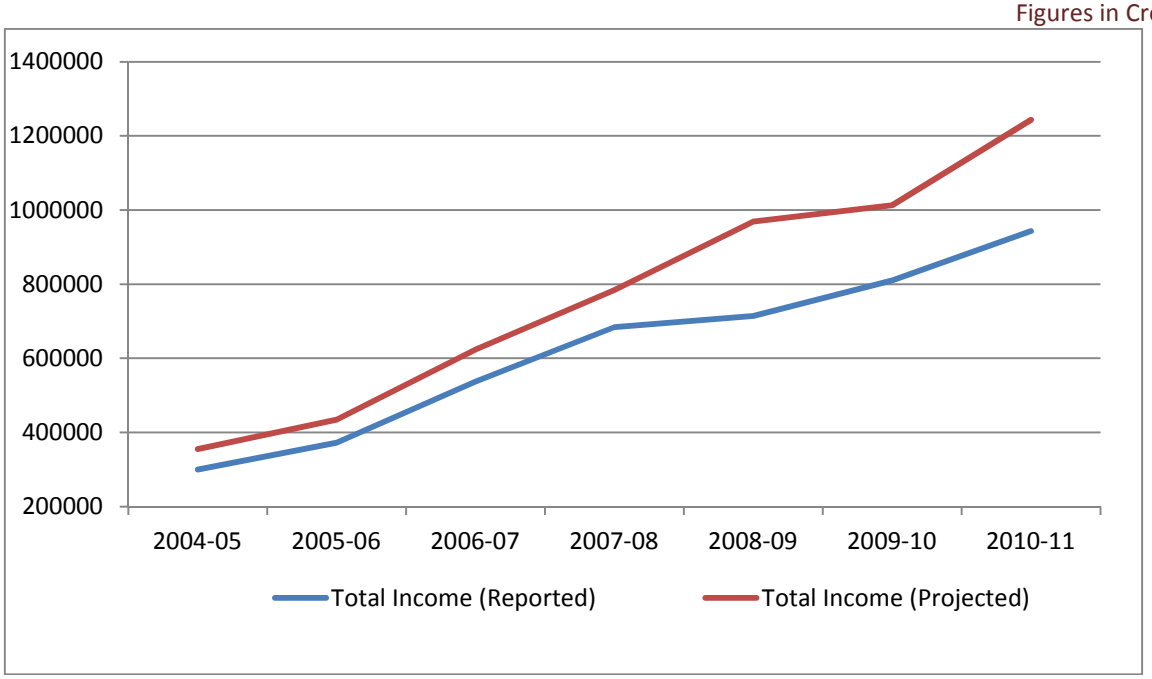
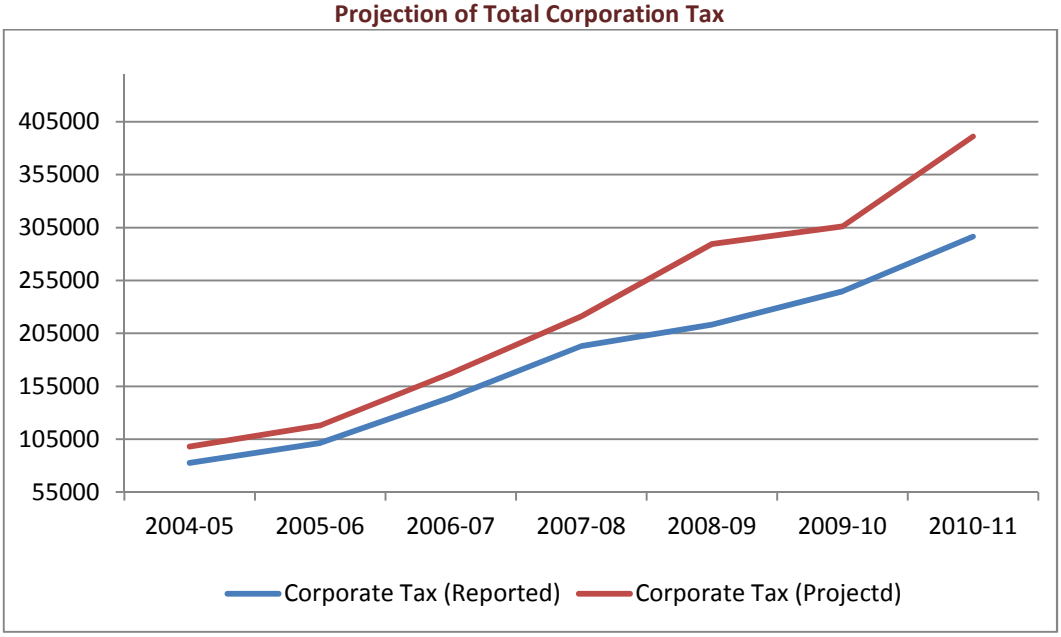


Figure 5.11:
Projection of Total Corporation Tax



Conclusion:

Our analysis in this section has shown that on the one hand corporate tax revenue has been increasing at a high rate; on the other hand the corporate tax buoyancy has been relatively low. It is also quantified that a large number of corporates though registered with the MCA, are not yet filing their ROI with the Income Tax Department, which seems to be a serious concern for the tax authority. The issue of revenue forgone seems to be also high and growing. Using the structural equation modelling we also estimate the tax evasion, which is indicated to be quite sizable corporate tax evasion in the country. It has increased from 18.5% of corporate tax revenue in 2004-05 to 32% in 2010-11. Therefore, it seems that perhaps the current corporate tax revue can be increasing substantially, if the appropriate policy action is taken on the issues which are recognized by our study.

Chapter - 6

METHODS TO BE EMPLOYED FOR BRINGING TO TAX UNACCOUNTED MONEY KEPT OUTSIDE INDIA

6 METHODS TO BE EMPLOYED FOR BRINGING TO TAX UNACCOUNTED MONEY KEPTOUTSIDE INDIA

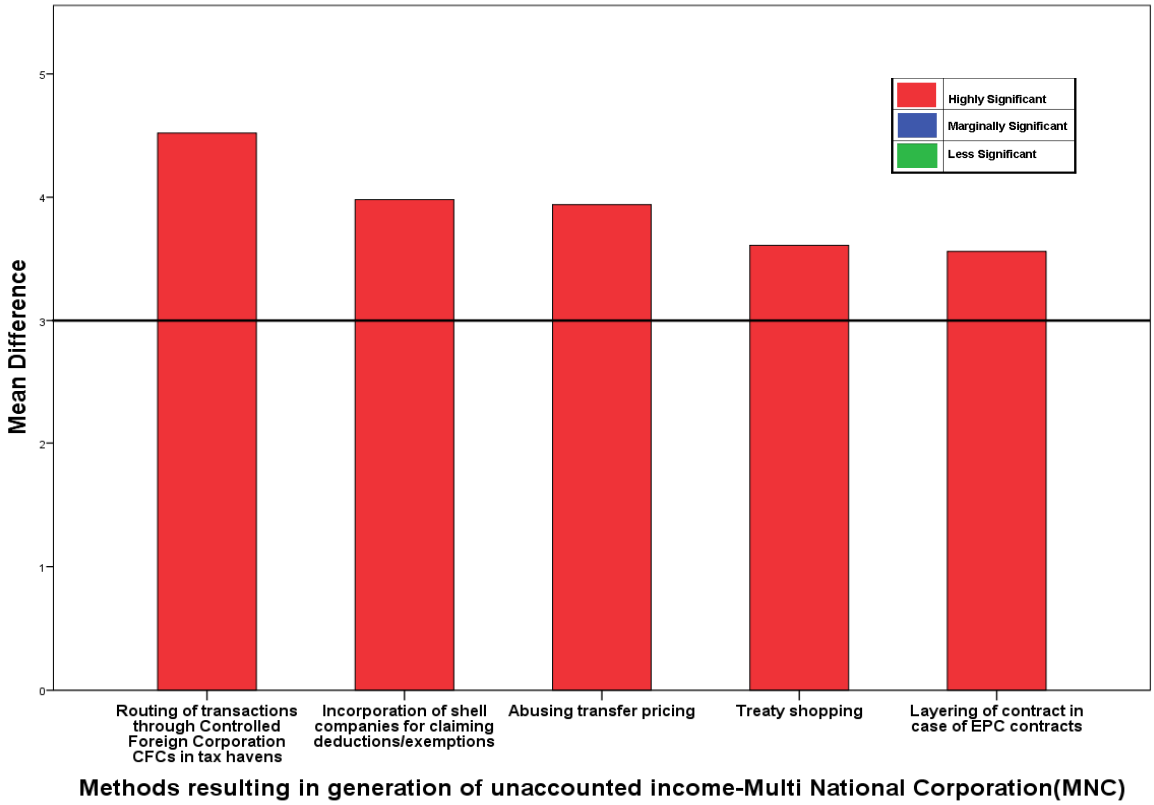
Introduction

Generation of black money and its stashing abroad is a serious concern with many countries. In India, the Parliament and also the Supreme Court of India have expressed their concerns in this context on many occasions. This phenomenon not only presents a challenge to the efficiency and effectiveness of tax administration, it also results in scarce national resources flowing outside the country, that too illegally. The issue at present is not only to stop this capital flight outside the country but also to find ways and means to bring back money to tax which is stashed abroad.

This chapter suggests a few methods for bringing tax money stashed outside the country. In order to understand the ways which would bring the stached money abroad into the country; and to understand the modus operandi of how the capital flight takes place, we conducted informal interviews with various stakeholders that included businessmen, chartered accountants, senior international tax officials, consultants and other professionals.

Based on our interviews with senior revenue officials, we attempted to rank the prevalent or frequently used ways by which money is sent abroad, especially by the MNC's in the order of gravity on a scale of 1-10. These methods include (figure 6.1) treaty shopping, abuse of transfer pricing, incorporation of shell companies, sending money to tax havens etc. The responses were informative and consistent with the informal interviews.

Figure 6.1:
Methods resulting in generation of unaccounted income: Multinational Corporation



Source: Field survey

Our study reveals that various multi-national companies operating in India indulge in tax evasion and avoidance. All the respondents ranked high the methods related to the abuse of transfer pricing, treaty shopping, shell companies to claim deductions and exemptions and routing transactions through CFC's in tax havens.

In the present era of globalisation and liberalisation, the world has become an economic village. A number of MNCs are establishing their businesses in various countries. The entities are entering into the global markets to fulfil their capital needs. This leads to search for highly desirable locations for multinational entities wishing to reduce their global tax liabilities. These multi-national entities, consisting of a network of several corporate and non-corporate bodies set-up shell companies in tax havens and artificially transfer their incomes to such shell companies. Tax havens are usually low tax jurisdictions specializing in providing corporate and

commercial services to Non Resident Offshore Companies for investment of offshore funds on a scale which is incommensurate with the size of its own economy. They usually offer strong confidentiality or secrecy regarding wealth and accounts, making them very attractive locations for safe keeping of unaccounted wealth. They also offer a liberal regulatory environment and allow opaque existence, where an entity can easily be set-up without indulging in any meaningful commercial activity and yet claim to be a genuine business unit, merely by getting itself incorporated or registered in that jurisdiction. The role of tax havens and their facilitation contains abusive and undesirable arrangements which result in significant fiscal challenges to other countries.

Methods to Bring Unaccounted Tax Money Kept Outside India

It is observed that taxpayers in many countries reduce their taxes or avoid paying taxes in their home country by stashing the money abroad. The significance and importance of an effective tax system is, therefore, to reduce the flight of capital both to and from the country of origin. Governments across countries in recent years have been making concerted efforts to bring back unaccounted money stashed abroad. A review of related literature and government reports besides interactions with various stakeholders rendered insights into possible ways by which money stashed abroad can be brought to tax. Diverse experience of some of the countries and various methods adopted by them for this purpose are briefly discussed in Annexure 6.1. These activities can be divided into two broad categories – one time measures and regular measures;

1. One Time Measures
    a. Amnesty Scheme
2. Regular Measures
    a. Whistle Blower Reward Scheme
    b. Anonymous Tax
    c. Sharing of Information (through efficient network of DTAAs and TIEAs)
    d. Assessments based on information (through enabling powers under Income tax Act)
    e. Assistance in collections of taxes (through efficient network of DTAAs)

f. On-going Amnesty Scheme

g. Legislative Changes

h. Social Measures

Offshore Voluntary Disclosure Scheme

Bringing unaccounted money to the mainstream of the economy along with revenue generation are the main objectives of the offshore voluntary disclosure scheme. Amnesty Scheme, when effective, will result in multiple disclosures and collection of taxes in an easy and simple manner. It is otherwise a difficult task for taxing authorities to individually collect information, enquire into, prove and ultimately tax the same undisclosed income.

Offshore Voluntary Disclosure Scheme is recommended for bringing to tax unaccounted money kept outside India.Tax amnesties have been used in many countries, both in the developed and the developing world, for bringing money back to the country. Within the OECD countries, they have been employed in Austria, Australia, Belgium, Finland, France, Greece, Ireland, Italy, Portugal, and Switzerland, besides more than half the States in the United States. Developing countries, where they have been employed, often repeatedly, include Argentina, Bolivia, Chile, Colombia, Ecuador, India, Pakistan, Panama, Peru, Mexico and Philippines.

In today's scenario with talks going on about unearthing black money, evaders are aware of consequences and engage in counter-action at their end in case an Amnesty Scheme is brought about. The decision of the evaders either to disclose or not to disclose depends on their perception of the possibility of being spotted and punished by the taxing authorities. Most evaders disclose their unaccounted income only when they realize that there is no other option but to disclose. This realization dawns on them upon their conviction that the tax authorities know the whereabouts of black money and that they are in a position to file appropriate cases against them.

The effectiveness of the existing framework of tax legislation and tax rules together with their extensive enforcement serves as a potential deterrent towards tax evasion. It may, therefore, be appropriate and in the fitness of the existing scenario that laws to be enacted and the rules

to be promulgated are effectively enforceable. This deterrent effect of law needs to be widely publicised. The fact of generation of huge amount of black money and its overseas transfer is an evidence to the fact that a lot of work needs to be done in this regard.

The Amnesty measures adopted by USA and UK in bringing to tax the unaccounted income stashed abroad have been highlighted in Annexure 6.1. The Government of India has, in the past, come up with such schemes more than once in order to curb this menace. An amnesty scheme has positive as well as negative aspects. The positive aspects would be generation of revenue for the government by way of collection of taxes and bringing black money into the mainstream economy. When unaccounted money gets disclosed and comes into the system, it will have positive effect on the economy. The quantum of disclosure will be inversely proportional to the decrease in the ills of black money in the parallel economy. Amnesty Scheme will help those assesses who want to disclose their unaccounted income to the government without having to undergo penal consequences. Fear of punishment would in the normal course prevent such conversion of money. Thus, it acts as an incentive for those who disclose their unaccounted income.

However, such a scheme may get challenged in different jurisdictional courts on various grounds. One among them could be constitutional validity of the scheme. The Government has to prepare itself on this front to aptly tackle and defend the scheme.

The 1997 Amnesty Scheme and its after effects should be a lesson to minimize and reduce ambiguity caused and irregularity committed in its implementation and also to improve it.

Lessons from 1997 VDIS Scheme

At the time of the launch of the VDIS 1997 Scheme the Government of India had made the following submissions before the Honourable Supreme Court of India regarding the policy of the Government post the VDIS-1997.

After December 31, 1997, the Income-tax Department will considerably step up survey operations under section 133A of the Income-tax Act 1961, and search operations under section 132 of the Income-tax Act, 1961.

1. *According to Chapter XIV-B of the Income-tax Act as amended with effect from January 1, 1997, if in the course of a search, undisclosed income is detected then the assessee is liable to the following;*

   (i) Tax at the rate of 60 per cent ;

   (ii) Penalty which can be up to 300 per cent. on the tax evaded ;

   (iii) Interest under section 158BFA.

2. *In addition, the Finance Minister announced that in every case of detection of undisclosed income, prosecution would be launched. The relevant provisions are in Chapter XXII of the Income-tax Act.*

3. *Besides tightening up of legal provisions, the following steps have also been taken;*

   (i) Acceleration of the process of issuing Permanent Account Number (PAN) ;

   (ii) Acceleration of the computerisation of the Income-tax Department ;

   (iii) Installation of software to detect assesses who satisfy the criteria laid down under the proviso to section 139(1) of the Income-tax Act.

It seems that not all the above contentions made by the Government were actually followed leading to a weakening of the sanctity of such statements and also sending a wrong signal to tax evaders about the seriousness of the government to bring all tax evaders in the tax net through the proposed harsh measures against the tax evaders. An effective Amnesty scheme has many advantages and as such it may be desirable to examine the feasibility of launching another such scheme to offer a one-time carrot approach in respect of foreign incomes and assets. The following points may be useful in devising a scheme, which would be effective in its contents and would also be easy in implementation.

- clarity of the language / statements in the scheme
- confidentiality clause in the scheme may operate only if complete disclosure is made;
- once the disclosure is made, complete tax must be recovered from the evaders;
- delays in paying tax after disclosure may be charged with interest at an economically reasonable rate;

- gold and other assets to be valued at market price prevailing on the date of disclosure;
- prompt collection of wealth tax;
- in case of part disclosure, procedure for compliance may be clearly spelled out;
- disclosure followed by non-payment of tax to be tackled very effectively..
- new assesses may remain in the tax net in subsequent years after the disclosure;
- certificates may not be issued to assesses without paying complete tax along with interest, if any and incidences of issuing certificates to ineligible persons to be avoided;
- incidences of multiple disclosures may need to be curbed;

Whistleblower Reward Scheme

The Public Interest Disclosure and Protection to Persons Making the Disclosure Bill 2010, (commonly known as the Whistleblowers' Bill) has been passed by the Lok Sabha and is under consideration of the Rajya Sabha. The bill seeks to provide adequate protection to persons reporting corruption or wilful misuse of discretion which causes demonstrable loss to the government, or commission of a criminal offence by a public servant. While the measure sets out the procedure to inquire into disclosures and provides adequate safeguards against victimisation of the whistleblower, it also seeks to provide punishment for false or frivolous complaints. The purpose of this Bill is to establish a mechanism to receive complaints relating to disclosure on any allegation of corruption or wilful misuse of power or wilful misuse of discretion against any public servant and to inquire into or cause an inquiry into such disclosure and to provide adequate safeguards against victimization of the person making such complaint and for matters connected therewith and incidental thereto. Similar type of provisions can also be used under the Income-tax Act also. Though, the Income tax Department rewards the informants, but the procedure is not transparent and consistent.

In USA, the Internal Revenue Service (IRS) Whistleblower Officer rewards[106] the person who blows the whistle on those persons who fail to pay the tax that they owe. If the IRS uses information provided by the whistleblower, it can award the whistleblower up to 30 per cent of

[106]http://www.irs.gov/uac/Whistleblower---Informant-Award

the additional tax, penalty and other amounts it collects. The law provides for two types of awards. If the taxes, penalties, interest and other amounts in dispute exceed $2 million, and a few other qualifications are met, the IRS will pay 15 per cent to 30 per cent of the amount collected. If the case deals with an individual, his or her annual gross income must be more than $200,000. If the whistleblower disagrees with the outcome of the claim, he or she can appeal to the Tax Court. These rules are found in Internal Revenue Code IRC Section 7623(b) - Whistleblower Rules.

The IRS also has an award program for other whistleblowers - generally those who do not meet the dollar thresholds of $2 million in dispute or cases involving individual taxpayers with gross income of less than $200,000. The awards through this program are less, with a maximum award of 15 per cent up to $10 million. In addition, the awards are discretionary and the informant cannot dispute the outcome of the claim in the Tax Court. The rules for these cases are found in Internal Revenue Code IRC Section 7623(a) - Informant Claims Program, and some of the rules are different from those that apply to cases involving more than $2 million.

Recently, the IRS has awarded former UBS banker, Bradley Birkenfeld[107], a whistleblower reward of $104 million for his contributions in providing the U.S. Government with insider information on UBS illegal offshore banking scheme. This is believed to be the largest reward ever given to an individual whistleblower in the United States and the first major reward issued under the IRS tax whistleblower law.

Anonymous Withholding Tax

An "Anonymous Tax", the tax imposed on an institution which holds undisclosed funds on which taxes may have been evaded in the home country, emphasises taxation of incomes rather than taxation of entities earning those incomes. Thus, a country may impose tax on a financial institution which holds accounts of residents of that country without identifying such individuals. Collection of such anonymous taxes have found place in Germany, United Kingdom and Austria, which executed agreements with the Swiss banks to make them pay taxes at the

[107] http://www.nydailynews.com/news/crime/swiss-banker-bradley-birkenfeld-a-104-million-reward-irs-blowing-whistle-thousands-tax-dodgers-article-1.1156736

tax rates prevalent in the home country on funds held in Swiss bank accounts of the residents of those country. The details of such schemes are given in Annexure 6.2.

The Anonymous Tax has an advantage for the home country as it leads to instant realisation of taxes but fails to identify the persons who have earned incomes on which such taxes are paid . This may lead to non-identification of the sources of such incomes. There is always a possibility of the funds moving out of the financial institution, which makes that agreement and pays taxes on behalf of its depositors. Once the funds move out of the said institution there will be no further payment of taxes.

Implementing a scheme like the Anonymous Tax requires a curb on the tendency to identify the particular tax evaders – by the Government, by the media and by the public as well. As it is, it may not work very effectively in India given the fact that the authorities / people are also concerned with identifying the tax evaders who might be public servants or those in charge of the governance. However, introducing a scheme like Anonymous Tax may be welcomed by those in the government or in public service who would like to stash their illicit wealth in institutions which pay Anonymous Tax and get away without explaining the bona fides of their wealth to the people who put their trust in them and placed them in the positions of power.

Sharing of Information under DTAAs and TIEAs

India has so far negotiated 22 new Tax Information Exchange Agreements with several countries generally perceived as tax havens. Nine of these agreements have been approved by the Government. Further, India has also initiated process of negotiations with 75 countries to broaden the scope of Article concerning exchange of Information to specifically allow exchange of banking information. . As on date, it has completed negotiations with 18 existing Double Tax Avoidance Agreement (DTAA) countries. 22 new DTAAs have also been finalized where the exchange of information article is in line with the international standards. Thus negotiations/re-negotiations of the DTAAs with 40 countries has been completed. DTAAs with Switzerland (amendment), Norway (revised), Mozambique (new), Colombia (new), Ethiopia (new), Georgia (new), Taipei (new), Lithuania (new) and Tanzania (revised) have been signed.

The protocol amending India's tax treaty with Switzerland was signed on 30th August, 2010 and has been approved by the Swiss Parliament (on 17th June, 2011). After following the mandatory constitutional process, the DTAA will become operational. It will enter into force when Switzerland completes its internal process. Upon entry into force, it will allow India to obtain banking information (as well as information without domestic interest) from Switzerland in specific cases from 1st April, 2011.

The TIEAs provide for exchange of requested information even in the cases in which the conduct of the taxpayer does not constitute crime in the jurisdiction of the requested country (tax haven). The country is also required to provide requested information which is not in its possession by gathering it. Most importantly, the TIEAs provide for obtaining information from the banks and the financial institutions regarding ownership of companies, partnerships, trusts including ownership information of the persons in the ownership chain and also information on the settlers, trustees, and beneficiaries. This is one of the most important provisions of the agreement, which makes it possible, at least theoretically, to unravel ultimate beneficiaries of the tax haven bank accounts. It is well known fact that beneficiaries of the tax haven bank accounts are often shielded by a deliberately created complex ownership structure consisting of a maze of entities. It is also important to note that the TIEA does not place any restrictions on information exchange caused by bank secrecy or domestic tax interest requirements. Despite having the well-designed provisions in the TIEAs, many believe that the TIEAs may still not work for various reasons. *Firstly*, there is a conflict of interests among tax haven and non-tax haven countries. Secrecy jurisdictions are hardly interested in sharing information about their customers. In many jurisdictions, ownership and beneficial ownership information are protected by domestic laws. From the OECD's Progress Report on Tax Transparency (2011), it becomes clear that making legal and structural changes in secrecy jurisdictions are going to be a time consuming affair. So far, out of total 81 peer reviews launched, Global Forum has adopted 59 reports. Out of the 59 reviews completed, 42 are phase 1 reviews and 17 are combined reviews (reviews of both the phases conducted simultaneously). Nine Jurisdictions will move to phase 2 after they fix the deficiencies pointed out in the peer reviews. Thus, jurisdictions have to do considerable work to enable them to exchange tax information effectively. Moreover, one

of the conclusions of the report is that the information exchange is too slow. *Secondly*, there is no automatic exchange of information. The TIEA requires that for getting information on a taxpayer, the applicant country has to provide specific information of the taxpayer such as (a) the identity of the taxpayer under examination or investigation; (b) the period for which information is requested; (c) the nature of the information requested and the tax purpose for which the information is sought; (d) grounds for believing that the requested information is present in the requested country or is in the possession of a person within the jurisdiction of the requested country; (e) to the extent known, the name and address of any person believed to be in possession of the requested information; (f) a statement that the request is in conformity with the law and administrative practices of the applicant country, that if the requested information was within the jurisdiction of the applicant country, then the applicant country would be able to obtain the information under the laws of the applicant country or in the normal course of administrative practice and that it is in conformity with this agreement; (g) a statement that the applicant-country has pursued all means available in its own territory to obtain the information, except which would give rise to disproportionate difficulties. Thus, very high amount of information is required to be furnished for making a request, meaning that the tax administration should already have substantial evidence against the taxpayer rather than gathering evidence against a taxpayer to make a case of tax evasion. Very often, furnishing such information before the completion of investigation is like putting a cart before the horse. *Thirdly*, a taxpayer can move his deposits from the bank account of one tax haven to another before developing of an enquiry making tax administration's efforts futile. *Lastly*, experiences of some of the countries indicate little usefulness of the TIEAs, as they have sparingly used them for the information exchange.

It may not be out of place to mention here that the information on the basis of which the Income-Tax Department has recently initiated action against those persons holding bank accounts with LGT Bank Lichtenstein was not received under the TIEA. The information on Indian account holders in LGT Bank Lichtenstein was provided by Germany, which, in turn, had bought it from the disgruntled employee of the bank, whereas France reportedly passed on the information on the account holders of the HSBC Bank, Geneva.

Probably, considering the limitations of the TIEA, to counter offshore tax evasion, the US has strengthened domestic legislation by enacting specific laws to counter offshore tax evasion by creating additional sources of information gathering. The US introduced Hiring Incentives to Restore Employment Act (HIRE) providing tax incentives for hiring and retaining unemployed workers, also imposing 30% withholding on payment made to foreign financial institution, unless such institution agrees to adhere to certain reporting requirements with respect to the US account holders. It has also enacted legislation — Foreign Account Tax Compliance Act (FATCA), which is to be implemented from 2014, requiring Non-US banks to report accounts of the US clients to the US Internal Revenue Service. There is also a proposal in the US for enacting additional law, Stop Tax Haven Abuse Act, strengthening FATCA and plugging specific offshore tax evasion schemes. If India could also have such a legislation enforced upon all financial institutions dealing with the Indians, there would be a substantial inflow of relevant information to combat the menace of illegal flow of funds outside India as well as the funds illegally kept outside India.

India may also introduce clauses in all the DTAAs and TIEAs so that there is an automatic flow of information on transactions conducted by Indians in those countries and that no specific request is required to be made justifying the need for information. This will ensure that the information from foreign jurisdictions will flow the same way as tax information is collected within India on a routine basis.The bigger challenge would be to make good use of thedata so obtained by using various data mining techniques.., This could be used to tax offshore transactions by Indians. which otherwise would have escaped taxation by Indian authorities However, this may place a burden on all financial and other institutions dealing with the Indians or theIndian controlled entities to increase their KYC requirements.

Assistance in Collections of Taxes

i. At times it becomes difficult to collect the amount of taxes post assessment when the person is not residing in India. Article (27) of the Model Convention of the OECD and the UN suggests a framework for assistance in the collection of taxes in other countries. This Article provides the related rules under which Contracting States may agree to provide assistance to each other in the collection of taxes.

ii. Though India has entered into the DTAAs with 83 countries; more than 50 DTAAs have no such provision. Hence, it is suggested to incorporate such Articles in all the DTAAs and make similar arrangements with other jurisdictions having no DTAAs with India. Upon the jurisdiction not cooperating, the jurisdiction may be notified under section 94 (A) as non-cooperative jurisdiction.

iii. In order to discourage transactions by a resident-assessee with persons located in any country or jurisdiction, which does not effectively exchange information with India, anti-avoidance measures have been made under the Act by the Finance Act, 2011. New section 94 (A) has been inserted in the Act to specifically deal with transactions undertaken with persons located in such country / region. This section provides an enabling power to the Central Government to notify any country or territory outside India, having regard to the lack of effective exchange of information by it with India, as a notified jurisdictional area. If an assessee enters into a transaction, where one of the parties to the transaction is a person located in a notified jurisdictional area, then all the parties to the transaction shall be deemed to be associated enterprises and the transaction shall be deemed to be an international transaction and transfer pricing regulations shall be applicable to such transactions.

iv. Joining global Forums which aim to provide its member countries with tax related information sharing and the assistance in collection of evaded taxes is another method which assists in bringing to tax funds stashed abroad. India has already become a part of such forums some of which are:

a. Multilateral Convention on Mutual Administrative Assistance in Tax Matters

The Multilateral Convention on Mutual Administrative Assistance in Tax Matters was developed jointly by the Council of Europe and the OECD and was opened for signature by the member states of both organizations on 25 January 1998. This multilateral instrument, which was initially signed by 15 countries, provides for all possible forms of administrative cooperation between states in the assessment and collection of taxes, in particular with a view to combating tax avoidance and evasion. In response to the April 2009 call by the G20 for a global instrument to fight international tax evasion and

avoidance, the Convention has been brought up to the internationally agreed standard on information exchange for tax purposes, in particular by requiring the exchange of bank information on request through an amending Protocol, which entered into force on 1 June 2011. The amended Protocol also provides for the opening of the Convention to all countries. India signed the Convention on 26 January 2012 and ratified it on 2 February 2012, thus becoming the first country outside the OECD and European countries to join it. There are at present 33 signatories to the Convention and 13 of them have ratified it.

This Convention provides many advantages. As more countries sign it, the task of information exchange will get increasingly facilitated. It is likely to be an important instrument for cooperation in the area of assistance in tax collection. By enabling development of automatic exchange of information, this convention supports India's call for standardising automatic exchange as a global standard. A unique feature of this convention is the facility for serving of notices issued by one tax administration through another tax administration. It is also hoped that the convention will facilitate tax examination abroad, which is being included in all TIEAs. The Convention also supports India's demand for sharing of past banking information. As more and more countries join this Convention without reservation, the instrument has the potential of becoming an effective tool for tax cooperation.

b. United Nations Convention against Corruption

On 9 May, 2011 India became the 152nd country to ratify the United Nations Convention against Corruption, which was signed on 9 December 2005. The purposes of this Convention are: (a) to promote and strengthen measures for preventing and combating corruption more efficiently and effectively; (b) to promote, facilitate, and support international cooperation and technical assistance in the prevention of and fight against corruption including in asset recovery; (c) to promote integrity, accountability measures, and the criminalisation of the most prevalent forms of corruption in both public and private sectors. The Convention requires the state parties to criminalise bribery of national public officials, foreign public officials and officials of

public international organizations, embezzlement, misappropriation or other divisions of property by a public official, laundering of proceeds of crime, obstruction of justice, and illicit enrichment. Under the Convention countries should have mechanisms for freezing, seizure, and confiscation of the proceeds of crime and cooperate in criminal matters by extradition and mutual legal assistance to the greatest possible extent. The return of assets is a fundamental objective of this Convention and countries are to afford one another the widest measure of cooperation and assistance in this regard. It prescribes mechanisms for recovery of property through international cooperation for purposes of confiscation. This Convention can help prevent perpetrators of corruption from illegally transferring their wealth abroad and will be an important tool for tackling this menace

On-going Amnesty Scheme

The Income Tax Act may be amended to provide for Voluntary Disclosure Provisions on an on-going basis for persons who wish to disclose any undisclosed incomes at any point of time. Under such provisions, the tax rate may be kept at a rate higher than the maximum marginal rate of tax to cover the Direct and Indirect Taxes evaded and the person making a disclosure should be made to sign a declaration that the money being disclosed is not covered by the provisions of Anti-Money Laundering Act and is not sourced from criminal activities. Thereafter, immunities may be granted from penalties for non-disclosure. This will prevent the flight of undisclosed funds to offshore tax havens. Many countries like Austria, Belgium, Chile, Denmark, Germany, Finland, etc. have such Voluntary Disclosure Provisions in the General Law which provides for payment of taxes and interest on Voluntary Disclosed Incomes and grants immunity from penalties and prosecution.

On-going Amnesty Scheme may eventually facilitate lower tax demands being locked up in litigation and thus leading to more litigation free collection of taxes.

Legislative Changes

Legislative measures to empower the Central Board of Direct Taxes to react speedily when tax evasion structures are discovered are as follows:

One of the most essential pillars to the success of a tax avoidance / evasion scheme is the speed at which it is executed and the entire structure (used in the avoidance of tax) is wound up. Once the structure is wound up, it becomes difficult for the tax administration to recreate the structure for the purposes of a meaningful tax audit / assessment. Hence, it appears reasonable that the Indian tax administration is able to develop a real time response to tax avoidance schemes. This entails cutting time required to legislate anti-avoidance measure. In India, the tax administration has only one opportunity in a year to legislate changes i.e., through the Finance Bill. This often gives the corporate enough time to wind up the structure used in the avoidance of tax and erase the audit trail. As a response to this malaise, it may be advocated that the Taxing Authority / Central Board of Direct Taxes is adequately equipped with kind of an express power to legislate changes which can be ratified / modified at a later date.

Social Measures

Social measures to install the virtues of tax compliance in young minds and to instil deterrence for tax avoidance are as follows;

i. No tax jurisdiction in the world can devise measures to individually tax each and every individual in that tax jurisdiction. It is non-feasible to spot each and every tax evader. The successful tax jurisdictions across the globe are those which have a high degree of tax compliance. In such jurisdictions, there is a deterrence to avoid taxes as people feel that the penalties for tax evasion hard hit financially and people start regarding taxes as a part of their system, therefore, the tax compliance becoming part of civil duty. India also needs such tax compliance from its citizens. In general, people find taxes as a burden imposed on them and try to avoid taxes. This attitude needs to undergo a change if better tax compliance is to be instituted.

ii. Payment of taxes and compliance of tax laws may be made a part of the fundamental duties of every citizen and be taught to children right from the school time. Prospective tax payers may also be sensitised about the ills of tax avoidance and how it would adversely affect their lives. This is likely to t have a substantial impact on the young / grown up minds and transform the individuals into honest taxpaying citizens.

iii. The tax department may also use the public media to showcase the importance of taxes in nation building. The public should be made to feel that they also contribute to the growth of the nation through the taxes they pay.

Conclusion

From the above, it can be concluded that the task of bringing the funds kept outside India to tax is a complex one and cannot be accomplished by a single formula. Thus, all the measures will have to be combined to create an atmosphere where tax evaders having stashed funds outside India are induced to bring back their funds and pay taxes on the same. Tightening of the existing tax laws and effective information exchange to identify the tax evaders is necessary to cause deterrence in the minds of the tax evaders. Thereafter, a voluntary disclosure programme could be implemented to give the tax evaders a final chance to come clean and pay up the taxes on the undisclosed funds kept outside the country.

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Annexures

Annexure 2.1

A REVIEW OF RELATED LITERATURE ON INDIA

Chopra (1982) has provided estimates of the unaccounted income in India for a period of 17 years. The objectives of this paper were twofold. First, is to provide a series on unaccounted income in India for the period 1960-76, and second, is to identify some variables which could explain variations in it over time. According to the author, there has been a secular rise in the unaccounted income of the country; it has risen more than ten-fold in a decade and a half fold from ₹ 716 crore in 1961-62 to ₹ 8,098 crore in 1976-77. The magnitude of unaccounted income, according to some experts, is as high as ₹ 15,000 crore for the year 1980-81. The rise has been particularly dramatic from 1973 onwards. In this study, they have used the macro-approach to estimate unaccounted income using the methodology recommended by Direct Taxes Enquiry Committee referred to as the Committee for brevity. The Committee estimated the amount of unaccounted income by identifying assessable non-salary income. For this purpose, income originating from different sectors is multiplied by (i) the ratio of non-salary income to the income of the given sector, and (ii) the ratio of non-salary income above exemption limit to the non-salary income of the given sector. The difference between the assessable and the assessed non-salary income is the measure of unaccounted income. The methodology used by Kaldor (1956) and Wanchoo Committee has been closely followed by Chopra (1982). The steps for Chopra's methodology are given below:

i. Income by sector of origin from the national income accounts is the beginning point,
ii. It is assumed that there is no question of tax evasion (and therefore of tax evaded income) for incomes originating in agriculture, and, that in all other Sectors, salary incomes are fully reported for income taxation;

iii. For all non-agricultural sectors, the ratio of non-salary income to total income is estimated;

iv. For each sector, the proportion and amount of non-salary income above the income tax exemption limit is estimated;

v. Summation across the sectors yields an estimate of total non-salary income assessable to tax;

vi. Actual non-salary income assessed for income taxation is estimated and subtracted from the above total to obtain the estimate of tax-evaded income for the relevant year.

The results of the study corroborate the hypothesis that tax evasion is more likely the higher the rate of taxation. Further, the results have confirmed the hypothesis that an increase in prices lead to an increase in the proportion of unaccounted income to total income. Furthermore, the results suggested that funds are diverted to agriculture to convert unaccounted income into legal income.

Critical Analysis: There are some limitations of Chopra's study pointed out by Chopra himself and further some other problems are mentioned, discussed by NIPFP report.

First, in this study, it is assumed that the sectoral national income is assumed to provide sound estimates of total income originating in each sector. But, Ghoshet. al.(1981) have shown that the income estimates reported in the official national income estimates may be biased downwards by substantial margins because of tax evasion end related motives in sectors like trade and manufacturing. These are also sectors in which the proportion of non-salary incomes is relatively high. Taken together, these points suggest that the estimates of total assessable non-salary income may substantially below the true levels, which indicates significant under-estimation of tax evaded income.

Second, the assumption of salary income being fully reported for tax is also not practically applicable. There are hidden perquisites plus salary employees augment their incomes through moonlighting which are not reported to the tax authorities and thus tax evasion. But actually

speaking, this is not the evasion on salary incomes; rather a case of evasion on non-salary income.

Third, this study makes an assumption about a few ratios to remain constant over a period. Further, it assumed that the ratio of evaded income to assessable non-salary income remains constant and the ratio of non-salary income to total income of a sector remains constant. For a period of 17 years, there is little reason to believe that these ratios would stay constant. Another, problematic assumption is that the ratio of non-salary income above the exemption limit to total income originating in a sector remains constant. To begin with, the empirical basis for the base year 1961-62 values of these ratios are absent from both the Wanchoo's report and Chopra's article.

There are some other problems with the Chopra's methodology that have been reported by NIPFP report on Unaccounted Income. First, national income estimates do not include estimates of income from illegal occupations, such as smuggling. But, for estimation of tax evaded income, such income ought to be included, since the tax laws require the declaration of all earnings, including those from illegal activities. The same point is pertinent with respect to capital gains which are excluded from national income estimates but need be included in taxable income. Thus, the exclusion of illegal incomes and capital gains imparts a further downward bias to the estimates of assessable income and hence, tax evaded income. Second, the tax exemption limits and deductions vary among corporate and non-corporate income earners, but Chopra's approach failed to distinguish between these two. The tax evasion possibilities and incentives to evade tax differ substantially across these categories. Third, NIPFP report says that data from All India Income Tax Statistics (AIITS) that has been used for computing non-salary incomes actually assessed to tax is actually far from complete owing to the delays in reporting and other reasons.

To sum up, there are some serious problems with the estimates of tax income obtained by Chopra. It is not possible to hazard whether the different sources of bias cancel out or have a discernible net impact upwards or downwards. Nor is it justifiable to take the position that the

estimates correctly indicate the broad orders of magnitude of tax-evaded income and its rough trend overtime. Finally, given the dubious nature of the estimated time-series of unaccounted income, Chopra's econometric efforts to explain his series in terms of other causal variables have to be treated, to say the least, with considerable skepticism. At best, Chopra's study provides a point of departure for further explorations along the fiscal approach.

Gupta and Gupta (1982) study presented estimates of India's unofficial economy on a yearly basis for the period 1967 to 1978. These estimates implicitly revise the GNP, per capita income and other related statistics for this period. This study followed the methodology used by Feige (1990) which relied on the standard Fisherian identity. The application of this method involves the following steps:

i. Compute the total value of monetised transactions PT = MV for a base year when the unreported economy is assumed to be non-existent;
   [M = stock of money, V = transactions velocity and PT = total value of monetized transactions in the economy.]
ii. Observe the ratio of PT to officially measured GNP in the year (since, by hypothesis, there is no unreported economy, GNP will be equal to Y);
iii. Compute the value of total monetised transactions in subsequent years and by applying the ratio computed from (ii) estimate the total nominal income, Y, for the corresponding years;
iv. For each year the difference between the computed value of Y and officially measured nominal GNP yields estimates of the unreported economy. Looked at another way, whenever the ratio of PT to measured GNP exceeds the base year value, the presence of a black economy is signaled.

Following Feige's work, Gupta and Gupta estimated the value of transactions supported by cheques and that by currency. They estimated the value by cheque transactions by multiplying the average stock of demand deposits by their turnover rate. Data on demand deposits were readily available, and information on their turnover rates was available for certain years.

The results of the study indicate that the unreported activity as a proportion of official GNP has grown from 9.5 percent in 1967 to nearly 49 percent by 1978. High taxes have contributed significantly to the growth of unofficial economy. A one percent increase in the overall taxes leads to more than three percent increase in the unofficial economy relative to official economy. Further, the estiates show that when government lowered the marginal tax rates in 1974-75 and coupled this with incentives to declare unaccounted money, the size of the unofficial sector fell. Thus, an implication that emerges from Gupta's study is that the government in India should lower the taxes and remove as many controls as possible on different sectors of the economy. As the size of the black economy was only marginally affected by declaration of emergency in India in June 1975 and introduction of stiff laws to prosecute people operating in this market, it is unlikely that higher penalties in future will affect its size. Furthermore, depending on the tax laws and severity of controls, some economic activity is likely to shift in and out of the legal sector from time to time. All this implies that statistical agencies in India must prepare estimates of reported and unreported sector for an accurate picture of the economy. To this end, they could use or refine the method used in this study.

Critical Analysis: There are serious methodological reasons to doubt the validity of the Feige's approach as applied to India by Gupta and Gupta.

A crucial assumption made in Gupta and Gupta's method relates to the constancy of the ratio of total monetized transactions (PT) to total nominal income (Y). If this ratio changes over time, for reasons other than the growth of a black economy, then the estimates for black economy are undermined and there are many reasons due to which this ratio tends to change with economic development. There can be several reasons for the change in the transaction/income ratio. First, can be the monetisation of economy, i.e., the increasing monetisation increases this ratio also. Second, with development, the density of inter-industry transactions normally increases or, in other words, the input-output matrix for the economy gradually fills up. Thus, the growth of inter-industry transactions, and hence of total transactions can be expected to be more rapid than the growth of nominal value added and thus, this ratio of transactions to income is expected to increase. Third, Gupta's study have themselves pointed out that

economic development will normally be associated with disproportionately higher growth in purely financial transactions, reflecting growing diversification and sophistication in financial and capital markets. This too would tend to increase the ratio of transactions to income over time. Fourth, in an economy with a growing proportion of transfer payments, the ratio of transactions for nominal added value can be expected to increase over time. The growing proportion of economic transactions may be conducted within vertically integrated production units. This would tend to reduce the transaction/income ratio.

Like Feige, Gupta and Gupta also estimated the turnover rates per unit of currency by recourse to the following identity:

$$\text{Turnover rate per year} = \frac{\text{Lifetime transactions of currency note}}{\text{Average life of currency note}}$$

This method freezes the currency turnover rates for the entire period. Thus, the inter-temporal variations in the value of currency transactions are attributable solely to the variations in currency stocks (of different denominations) held by the public.

Next, the method makes no allowance for possible differences in velocity of transactions in accounted and unaccounted economies. The same turnover rates for demand deposits and currency are implicitly assumed to be applicable irrespective of the nature of the transactions.

A careful scrutiny of the national accounts suggests that about half of the officially measured GNP in 1978-79 was in sectors such as agriculture, public administration and defense, electricity, gas and water supply, banking and insurance and railways. These are the sectors in which the incidence of unaccounted economy is generally believed to be negligible. It follows that virtually all of the ₹ 46,867 crore of unaccounted income estimated for 1978-79 by Gupta's was in the remaining sectors for which the total officially measured NDP was less than ₹ 42,000 crore. This, in turn, implies that those responsible for constructing India's official national accounts were managing to account for only about a half of total value-added in those sectors where the black economy is believed to flourish. While this implication is not impossible, it is

certainly implausible. We can say that Gupta and Gupta have made a novel attempt to apply currency model for estimating the size of the unreported economy but the results obtained are certainly implausible.

Gupta and Mehta (1981) have generated estimates of the unreported economy based on the trends in the consumption of electric power in the economy. They followed the physical input approach, which is about identifying a stable relationship between the use of electric power and national output, and then it is checked if the growth of officially GDP can account for the growth of electricity consumption, to the extent it cannot, unreported economic activity is inferred. But NIPFP report has criticized this methodology on several grounds. Most of these are related to Gupta and Mehta's assumption of a fixed-coefficient relationship between power consumption and national output. While this assumption may be plausible for a technical process or even an industrial plant, it is much less at the economy-wide level.

First of all, the value added in sectors like trade and agriculture can expand (or contract) greatly with relatively little change in the demand for electricity. Here, the issue is not of the output-mix of total value added, rather it is a denial of any fixed coefficient, or linear relationship between power consumption and value added in certain major sectors of the economy. And if this is the case, the observed changes in the ratio of total electricity consumption to measured GNP are of no significance.

Secondly, weakness can be attributed to the fact that electricity is not just an intermediate input in production. Much of the residential demand and perhaps some commercial demand fall into the category of final consumption. Such consumption can vary with changes in income, the relative price of electricity, the spread of electricity using consumer goods and so on. The simple point is that changes in final (that is, as a consumer good) consumption of electricity can powerfully influence the aggregate ratio of total electricity consumption to measured GDP, and thus undermine the interpretation of that ratio as an input-output production relation. Sometimes the growth of final consumption of electricity may be the result of deliberate government policy. The period 1960-61 to 1978-79 witnessed massive increase in rural

electrification; while much of this increase could be classified as intermediate consumption of electricity associated with higher production, much could also be categorized as final consumption which improved the quality of rural life.

Thirdly, weakness of Gupta and Mehta's method is that it assumes total electricity production to be equal to total electricity consumption except for transmission losses which are assumed to be a constant proportion. In fact, with the growing emphasis on rural electrification the proportion of transmission losses may have been increasing over time. Fourthly, while Gupta and Mehta allowed for changes in the electricity demand due to technology change and shifts in the composition of output, their actual modeling of these factors is quite unconvincing. Gupta and Mehta's efforts to identify residual power consumption and to a gauge the size of the unreported economy are vulnerable to many questions and doubts.

Bhattacharyya and Ghose (1998) have argued that corruption, in terms of bribes and kickbacks, is primarily generated by firms due to regulatory conditions. To recover the cost of bribery, firms hide their production output which then remains unrecorded in the official statistics. Hence, by estimating the unrecorded income of the industrial sector, it is possible to examine the growth of corruption. A method for estimating sectoral unrecorded income suggested by Bhattacharyya and from the estimated unrecorded income of the industrial sector, they have demonstrated that the large increases in corruption signaled by recent reported cases are justifiable. Their empirical results also suggest that the disaggregated hidden economy estimates are more informative than aggregated estimates. There is a continuous increase in the unrecorded income of the industry sector for the period 1970 to 1985. Examining the yearly estimates, they found that the increase in 1984 to 1985 was only about 25 percent which suggests that due to amnesty, the rate of increase had decreased. The average yearly increase of the unrecorded income of industry sector was about 85 percent during the period 1985 to 1988. After 1988, the rate of increase started slowing down and then went up slightly during 1991-92. Again, these movements can be explained through liberalisation policies taken up by the government of India during 1990-91. The estimates of the study suggested that the initial

effect of liberalization was the reduction of the rate of increase of unrecorded income in the industry sector, but by 1992-93, the initial effect of liberalisation has started to wear off.

Chaudhuri, Schneider and Chattopadhyay (2006)investigated the size of the hidden economy in Indian using state-level data from India over the period 1974/75 to 1995/96. They have attempted to estimate the size of hidden (shadow) economy for fourteen major states of India namely, Andhra Pradesh, Bihar, Gujarat, Haryana, Karnataka, Kerala, Madhya Pradesh, Maharashtra, Orissa, Punjab, Rajasthan, Tamil Nadu, Uttar Pradesh and West Bengal. This study made use of multiple indicators multiple cause approach (MIMIC) to estimate the size of hidden economy. Given the estimates of the size of the shadow economy, they have done empirical investigation to determine the role of socioeconomic, political and institutional factorsexplaining the size of the hidden economy. The approach used by Chaudhuriet al. shows the importance of policy actions in increasing government responsiveness to curb the size of the hidden economy. They have particularly emphasized on the role of election, nature of the governments, literacy, mass media and the impact of liberalization in this context.

The variables considered in Chaudhuri's study are partitioned into two major categories: (1) data on the indicator variables (Grsdp and Temp) and (2) data on cause variables. The real net state domestic product is obtained from various issues of the National Accounts Statistics (Government of India, Ministry of Planning, Department of Statistics), published by the Central Statistical Organization of the Government of India. The employment data for the registered manufacturing industries were compiled from various issues of the Annual Survey of Indian Industries, Ministry of Statistics and Program Implementation, Government of India. The data on cause variables such as tax and expenditure variables of state governments were collected from various volumes of the Reserve Bank of India Bulletin, published by the Central bank of India.

The analysis of the study has shown that after liberalization of the Indian economy in 1991/92, the growth in the size of hidden economy has decreased on an average. The results show that the growth in the size of hidden economy is approximately 4% less in scheduled election years

than in all other years. The study further demonstrated that the growth is significantly lower in those states where the coalition government is in power. An increased growth of newspapers and the literacy rates translate to cleaner governance, e.g. to fewer amounts of shadow economy activities in the economy. For the sample period, the hidden economy for all-India stands at 20.35% of GDP. The size of the hidden economy has increased from 15.39% (1974/75) to 23–21% (1995/96). The states such as Bihar, Gujarat, Madhya Pradesh, Maharashtra, Punjab and Rajasthan had experienced a higher size on an average compared to all-India figure. The authors have also shown that an increased growth of per capita newspaper circulation helps to curb the growth in the size of the shadow economy activities in the economy. This focuses on the importance of free and independent regional presses as key factors for proper functioning of the democracy. The results of the study also demonstrated that the state governments are active during the election to provide a clearer picture of the economy. Elections act as an incentive for politicians to perform. The growth in the size of the hidden economy is lower if the coalition government is in power. The study has provided evidence in favour of liberalization of the Indian economy in order to reduce the growth in the size of the hidden economy.

Bhattacharyya (1999) study presented a brief description of the general method of estimating the hidden economy and appraised the applicability and limitation of the method. The author used currency model to make an estimate of hidden Indian economy over the period 1960-1992. They have presented empirical results demonstrating the relevance of the hidden economy in econometric modeling and government policy formulation. According to the author, the hidden economy by definition is not directly observable; therefore, an indirect procedure is required to estimate it. Until recently, the estimates produced did not pass the basic statistical tests. Thus, he says that an improvement of the estimation procedure is essential for serious analysis of the interdependence of economic activities. This paper provided empirical results showing strong statistical relationships between the hidden economy and other economic activities. The hidden economy estimates for the service sector varies from 14% to 264.2% and these estimates for the industrial sector vary from 42.4% to 793.6%. The observed estimates of the study show that they have reduced drastically from 1960 to 1992. It is apparent that the presence of the hidden economy distorts many standard economic

relations, hence in policy analysis, the hidden economy estimates should be used to make the policies more effective. The co-movement of the hidden economy with other non-observable series makes the estimation of the hidden economy a legitimate exercise to identify certain types of economic problems.

Ghosh, Bagchi, Rastogi and Chaturvedi (1981)explain tends in capital formation, growth of domestic product and capital output ratios for the period 1950-51 to 1978-79. Ghosh*et. al.* (1981) has dwelled on the intriguing phenomenon of the high observed rates of capital formation not being reflected in higher output growth. They considered the possibility that the official data for GDP may reflect significant under-estimation. In providing the estimate for unreported GDP, they do not deploy any complicated methodology, but have simply examined the national accounts, by sector and suggested some orders of magnitude by which output and value added may be under-recorded in certain key sectors. Thus, they hazard that the gross value of output from manufacturing is understated by 10 percent, principally to further the goal of tax evasion. For similar reasons, they suggest that gross value added in trade and other services is underestimated by 15 percent. For, rental from housing they note that the national accounts rely on municipal valuations, which may be grossly understated because of, primarily the prevailing rent control laws. Ghoshet. al. assume rental from housing is underestimated by 20 percent. Combining these assumptions, they estimated unreported GDP to have been about 7-9 percent of current market price GDP in the years 1970-71 to 1977-78.

NIPFP (1985) conducted official study for estimating black money generation. The study defined black money as the aggregate of incomes which were taxable but which were not reported to tax authorities. However, it gave a broader definition of black income and called it unaccounted income for purposes of clarity. The study followed the minimum estimate approach because of the lack of sufficient data. For not being able to ascertain the most probable degree of under-declaration or leakage, it used a degree of under-declaration which could safely be regarded as the minimum in the relevant sector. In several cases, the study also made use of a range rather than a single figure of underestimation.

While preparing the estimate of black income, the study excluded incomes generated through illegal activities like smuggling, black market transactions, and acceptance of bribes and kickbacks. The study has confined itself briefly to the following six areas which are also mentioned in the White Paper on Black Money. These six areas are:

a. Factor incomes received either openly or covertly while participating in the production of goods and services,
b. Black income generated in relation to capital receipts on sale of asset,
c. Black income generated in fixed capital formation in the public sector,
d. Black income generated in relation to the private corporate sector,
e. Black income generated in relation to export, and
f. Black income generated through over invoicing of imports by the private sector and sale of import licences.

The method followed by the Institute is essentially an extension and refinement of the method used by the pioneers/predecessors- Kaldor, Wanchoo Committee and Chopra. The study utilizes different variants of the currency approach and survey method. The results of the study shows the black income generation as a percentage of GDP is 15-18%, 18-21% and 19-21% for the years 1975-76, 1980-81 and 1983-84 respectively. The NIPFP study concluded that total black income generation of 36,784 crore out of a total GDP at factor cost of1,73,420 crore was on the higher side, although it turns out to be less than 30 percent of GDP as against some extravagant estimates placing it at 50 or even 100 percent of GDP. The study suggested with some degree of confidence that black income generation in the Indian economy in 1983-84 was not less than18 per cent of GDP at factor cost or 16 percent of GDP at market prices. Furthermore, the findings based on survey data indicate that personal income tax evasion varies from 68% to 139% of assessed income, in terms of evasion was 3.7% to 8.6% of GDP.

GFI (2010): This report presents an in-depth study of the issue of illicit financial flows (or illegal capital flight) from India using the World Bank Residual model adjusted for gross trade misinvoicing which excludes illicit inflows through export over-invoicing and import under-

invoicing. For reasons enumerated, the method used in this study estimates gross illicit outflows without netting out illicit inflows as in the Traditional method used by economists. As discussed in greater detail in this report, netting out illicit inflows seriously understates the problem of illegal capital flight which worsens income distribution, reduces the effectiveness of external aid, and hampers economic development.

According to the estimates provided, India lost a total of US$213 billion dollars due to illicit flows, the present value of which is at least US$462 billion based on the short-term U.S. Treasury bill rate as a proxy for the rate of return on those assets. However, it is admitted this estimate is significantly understated because economic models can neither capture all the channels through which illicit capital can be generated nor the myriad ways in which the capital can be transferred.

Table A.2.1:

Summary of Estimation of Unaccounted Income in India

Study	Method	Period	Estimate (%of GDP)
Ghosh et al. (1981)	National Accounts and Sectoral analysis	1950/51-1978/79	7-9 percent
Chopra (1982)	Sectoral analysis and wage	1970/71-1976/77	5-10%
Gupta and Gupta(1982)	Currency model	1970/71-1978/79	22-48%
Gupta and Mehta (1981)	physical input approach	1964/65-1978/79	3-20%
NIPFP (1985)	Monetary and Survey approach	1975/76-1983/84	15-21% (for overall economy), and 3.7% to 8.6% (personal income tax , which is 68% to 139% of assessed income)
Bhattacharyya (1999)	Currency model	1960-1992	22% (Growth Varied -14 to 380%)
Schneider et al. (2003)#	MIMIC	1989-2001	17-23%
Chaudhuri et al. (2006)	MIMIC	1974/75-1995/96	17-23% (In states 9-31%)
Schneider, Buehnb,	MIMIC model	1999-2007	20-23%

Montenegro (2010) #			
GFI (2010)^	World Bank Residual model	1950-2008	US$462 billion (illicit flows)
Notes: *1. # cross-country analysis, 2. ^state-wise*			

Annexure 2.2

STYLIZED FACTS OF INDIAN TAXATION

Tax structure of a country is reflection of its stage of development. In the early stages of development, countries depend upon the bases, which are easy to tax. With the development, new and more efficient bases of tax (both direct and indirect) develop. Like other developing countries, there have been many hurdles to structure the optimum tax structure in India. One is regarding the choice of optimum proportion of tax revenue/GDP that should be comparable to developed countries. The other is with reference to the attainment of multiple conflicting objectives like several forms of equity, employment generation, and capital formation. The problems with developing countries have been high proportion of wasteful expenditure, which is neither in harmony with social priorities nor in conformity with objective of economic growth.

In this section, various features of the Indian tax system have been discussed on the criteria of optimum tax structure, like tax-revenue to GDP for direct and indirect components, equity, adequacy, efficiency, simplicity and certainty, and tax evasion.

Tax revenue to GDP

Tax to GDP ratio can be defined as the total government tax collection to the gross domestic product. The higher ratio brings in the financial flexibility in the government fiscal. Further, it means less dependence on debt and foreign finance. The developed countries like Scandinavian countries ((Denmark, Norway and Sweden) have highest tax to GDP ratio in the world. The tax/GDP ratio of European Union is around 20%, for OECD countries it is around 15.45%, for China 8.5%, for Brazil 15.37% and for India 9.39% for the period 2001-2010 (see Figure 6.1). The tax-GDP ratio for the low income countries is approximately 10% and for the middle income countries it is 13%. India's tax-GDP ratio averages out to be similar to low income group countries. Further, like developing countries, the indirect tax base component dominates in Indian tax structure. Only after 2001-02, the share of direct tax has improved. Otherwise, for all

years since 1950s, the percentage of direct tax to GDP has been stagnant at 2-3%. The tax-GDP ratio had been on the peak for the year 2007-08, after which probably due to recession in the economy, there have been fall in the collection (see Figure 6.2). As percentage in total tax revenue, the share of the direct tax has been below 40 percent since 1950's. There had been declining trend in the contribution of direct tax in the 1960's.The Taxation Enquiry Commission report of 1954 became the guiding principle for the tax- policy for two decades. The report emphasized need to raise more revenue through higher taxes, including through greater progressivity of direct taxes. For this reason, the tax rates before 1970 has been to the extent of 93.5% in the tax slab of ₹ 2 lakhs in the year 1970. In 1971-72, the effective top marginal tax rate was 97.2%. Due to the stringent tax policy, the average direct tax share in the decade of 1970 was 19.99% and was reduced to 14.85% in the 1980's.

The Direct Taxes Enquiry Committee report (1971) put forth this matter and pointed out that the high marginal tax rate is the reason to evade taxes by the people. The committee recommended that the effective top tax rate should be 70 percent. In the decade of 1970s, though tax rates were changed following the recommendations of the committee in 1974-75 by reducing the top tax rate to 70%, but more or less, the reforms remained elusive as in 1979-80, the effective top marginal tax rate was 72%. Due to this, there had been significant decline in the direct tax revenue contribution in the 1970-80's. The Chelliah Committee recommendations had significant impact on the contribution of direct taxes to the tax revenue. As since 1992, there is significant reversal of trend in the direct tax contributions (see Figure 6.3). There is discernable impact of tax reforms since 1991. Not only the contribution of direct tax in the total tax revenue has improved but also there is significant improvement in the direct tax to GDP ratio.

The major components of direct tax are personal income tax and the corporate tax, and for indirect tax are excise tax and customs tax. Component wise, excise duty constituted the major proportion (approximately 50 percent) of the total taxes in 1970-80. Over the years, the proportion of excise duties has decreased from the 35-37% in 1980's and 1990's. Since 2007, the share of excise has significantly declined to 26%. For all these years, there has been significant increase in the share of the corporation tax. In the pre-reform period, the

percentage share of corporate tax has been on an average of 16-18%, where as in post-reform period, it has increased to 24% in 2000-01 and has reached to 38% in 2008-09. The customs duties had been the major contributor of tax revenue in the period 1980-1990. Since this tax depends upon the external sector and due to international compulsions, there has been significant reduction in the rates of customs duty. In 1996-97, the proportion of the customs duty had been 45% which has been reduced to 25% to 2005-06. The least contribution had always been made by personal income tax. The personal income tax contributed 4% in 1970-71. Despite, the recommendations of Tax Reforms Committee, due to high marginal tax rate and multiple tax provisions and exemptions, the contribution of the personal income tax reduced to 2.96% in 1988-89. In the post-reforms period, the declining trend showed signs of reversal and since 2000-01, there have been consistent improvement. In 2009-10, the contribution has been 20%. But since 2004-05, the level of contribution has been averaged at 18%, despite of many tax reforms taken in this period. This shows the high tax evasion in the personal income tax category (see Figure 6.4).

Adequacy

A tax system may be considered as adequate if it is sufficiently buoyant, elastic and able to meet expenditure needs of the authorities. If the tax buoyancy is greater than one, the tax system is said to be buoyant. In the post reform period, tax buoyancy for the decade of 1991-2000, has been below one, that is, direct taxes have not been buoyant. Only in the year 1998-99, the direct taxes have tax buoyancy of 3.19. In the 2001-10 decade, direct taxes have been buoyant, other than the years 2003-04, 2006-07 and 2007-08. During these years, tax buoyancy has been 0.30, 0.85 and 0.44 respectively. In the direct taxes, for corporate taxes, there had been periods of very high tax buoyancy followed by period of very low or negative tax buoyancy. For the years 1992-93, 1995-96, 1997-98, 1999-2000, 2003-04, and 2007-08, corporate taxes had negative tax buoyancy, that is, decrease in the revenue generated as compared to previous year. For the year 1998-99, 2001-02, 2004-05, 2008-09, corporate taxes have been highly buoyant. Personal income taxes have been highly buoyant with value 2.0 in the year1998-99. This may be due to personal income tax changes in the year 1997-98, with decrease in entry level tax from 20% to 10% and in the year 1998-99, the tax limit was

increased from ₹. 40,000 toINR. 50,000 (see Table 3). The personal income tax has been tax buoyant since 1998-99 except for the year 2007-08. After 2008-09, there is declining trend in personal income buoyancy. The indirect taxes had been less buoyant than the direct taxes, which show that indirect taxes have been stagnant. The components of indirect tax, union excise tax and customs also have shown the similar trends. Thus, it can be said that, India, needs tax reforms not only in direct taxes but also in indirect taxes. Though, post reform period shows that there is improvement in tax buoyancy of direct taxes (see Figure 6.8).

Efficiency

Efficiency of tax collection pertains to optimum cost of collection for the authority. If the tax structure is complex, compliance to this is burden for both tax payer and tax collector. At times, high cost of compliance act as deterrence for an ordinary individual to comply with norms and evasion or non-compliance is more favoured. The cost of compliance varies between 3.91 percent of tax revenue in the UK in 1986-87 to between 7.9 to 10.8 percent in Australia in the 1990s. Though it is difficult to estimate the cost of compliance particularly in India (due to unavailability of such data), but a few researchers have made an attempt in this regard. Aggarwal (1991), used third party data sources on 4 individual characteristics, ownership of phones, cars or homes and the size of monthly electricity bills, to identify potential non-filers in Faridabad city. Comparing his data to income tax records, he estimated that 89 percent of potential taxpayers did not file returns.

Das-Gupta (2002) based on Das-Gupta and Chatopadhya (2002) estimates (based on CAG and NCAER) found that at the base estimate, non-filer compliance costs work out to be ₹ 10888 million, of which ₹ 7517 million is due to foregone consumption benefits, ₹ 56 million is from expected non-filing penalties and ₹ 3315 million is due to the income loss from distorted investment. This amounts to 3.4 percent of non-corporate income tax collections for the year 2000-01. Though substantial and much higher than Income tax Department administrative expenditure, these costs were dwarfed by compliance costs of income tax filers, even with a 100 percent margin of error.

Based on the survey of 172 tax payers, Das-Gupta (2003) found that estimates of compliance costs are high by international standards even for salary earners and excessive for non-salaried taxpayers equalling, at the median, 130 percent of taxes paid. Costs have been regressive and, for low income and middle income non-salary earners, can be more than double taxes paid even with neglecting bribe costs. Both the incidence of bribe payment and the bribe quantum had been high, even among salary earners, but especially so for non-salary earners. Overall, despite the personal income tax being limited to only around 20 million taxpayers, costs directly borne by taxpayers are estimated at over 0.8 percent of GDP or 49 percent of personal income tax collections. With third party compliance costs this rises to 56 percent of taxes collected. If conservatively "guesstimated" non-filer costs are added, costs further increase to 59 percent of tax revenue. The overall social cost of the personal income tax, adding administration costs and subtracting bribes is 60 percent of tax revenue. Third partycosts of deducting tax at source amounted, in a case study, to 11.8 percent of taxes withheld. Commercial bank costsof receiving and remitting taxes, over and above reimbursement received from the government, were ₹ 363 crore or about 1 percent of tax collections.

There have not been sincere attempts to estimate the cost of compliance after 2001. The tax structure of personal income tax has undergone with series of reforms since 1991. From Table 3, it can be seen that in the earlier three decades of 60's, 70's and 80's, the number of tax slabs had been very high with highest number being 11 slabs. The tax reforms since 1991 reduced the number of slabs to 4 and since 1995-96, there are three slabs. The peak rate was highest in 1970-71 with 93.5% and has been reduced to 40% in 1995-96 and stabilized to 30.9% in 2009-10. The exemption limit has been increased over the years in consonance with increased per capita income of the country. The income at which peak rate applies has also been increased over the years.

Tax Base

From table 1, it can be said that the tax base for personal income tax has been very narrow. In 1996-97, only 1.20% of the population was eligible to pay tax. In 2005-06, it doubled to 2.91%. The number of assesses having income below ₹ 2 Lakhs in 1996-97 were 96.37%, and between ₹ 2-10 Lakhs were 3.13%. The consistent increase in the number of assesses in the category of ₹

2-10 lakhs and in 2006-07, assesses in this category were increased to 9.02% of the total assesses.

Tax Structure and tax reforms in India

As already stated, the tax structure of India is not only guided by the objective of income mobilization but also the achievement of equity. The Taxation Enquiry Commission report of 1954 became the guiding principle for the tax-policy for two decades. The report emphasized the need of raising more revenue through higher taxes, including through greater progressivity of direct taxes. For this reason, the tax rates before 1970 has been to the extent of 93.5% in the tax slab of ₹ 2 lakhs in the year 1970. In 1971-72, the effective top marginal tax rate was 97.2%. Due to the stringent tax policy, the average direct tax share in the decade of 1970 was 19.99% and was reduced to 14.85% in the 1980's. The Direct Taxes Enquiry Committee report (1971) put forth this matter and pointed out that the high marginal tax rate is the reason to evade taxes by the people. The committee recommended that the effective top tax rate should be 70 percent. In the decade of 1970s, though tax rates were changed following the recommendations of the committee in 1974-75 by reducing the top tax rate to 70%, but more or less, the reforms remained elusive as in 1979-80, the effective top marginal tax rate was 72%.

The tax structure of the country had been with multiple tax brackets (as high as 8 income tax slabs in 1984), high marginal tax rate (72% in 1979-80), complex procedures to file the tax, rigid tax penalties but slow judiciary system, delayed refunding, high cost of tax compliance associated with complex laws and by-laws, also multiple provisions of tax exemptions.

The reforms were started in 1980's but consolidated in 1990's with the structural reforms in 1991. The notable reform in the income tax was in 1985, when number of the income tax brackets was reduced to 4 from 8. It was mainly in line with the structural reforms, income tax reforms were taken to overcome the structural hurdles. The main recognition here was on the revenue collection, as it was being recognized that if revenue collection is high, equity can be achieved. Though the basic tax structure – the progressive tax system has been maintained.

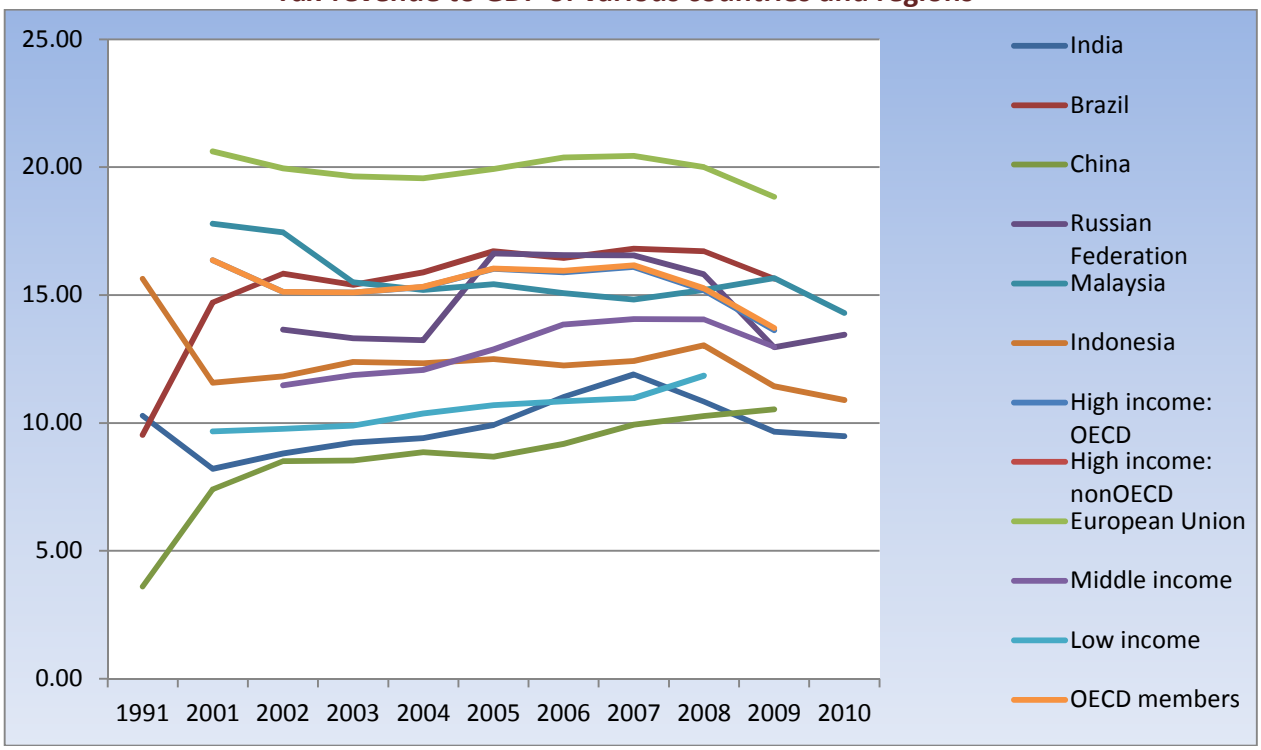
In 1991, Government of India, constituted 'Tax Reforms Committee' headed by Raja J. Chelliah. It submitted its interim report in December 1991and final reports in two parts in 1992 and in 1993. The mandate of the report was to reform the tax system in the country. For the personal income tax, committee recognized that there is necessity of comprehensive tax base and should be in harmony with practical problems of compliance and administrative effectiveness. It also felt the need of bringing 'hard to get' groups like small traders, small manufacturers, contractors, transport operators in the tax net. The committee's recommendations had been the guiding forces for the changes in income tax system for the decade of 1990's. The personal income tax reforms have been on twin-lines one being the streamlining of the tax structure and other being the reforms in the administration and procedural aspects.

The 1992-93 budget reflected the recommendations of Chelliah Committee. The number of income tax slabs was reduced from four to three. The tax rates were simplified to 20-30-40 percent. The exemption limit was set at ₹ 30,000. Presumptive taxation scheme was introduced with ₹ 1400 as the minimum tax as a measure to widen the tax base. Further the tax rates reduced to 10-20-30 percent below the level recommended by Chelliah Committee in 1997-98. Presumptive Taxation system was discontinued, instead of that, new 2-by-4 criteria requiring filing of income tax returns by assesses was introduced, due to the problem of tax evasion. In the next year, the scheme was broadened to 1-by-6 criteria.

The Ministry of Finance constituted two Task Forces, each on direct and indirect tax in 2002, headed by Sh. Vijay Kelkar. . The task force has also been against the yearly tinkering with tax policy in the budgets. According to it, in addition to distorting economic incentives, this also served to clutter the culture of compliance. Over the years, this has led to weak and porous system with complex filing system and complex compliance measures and also enforcement measures. All these incentivize the tax evasion than compliance. The biggest challenge is to bring the 'missing-middle' class in the tax compliance. For this, quality service needs to be provided. Apart from other things, Task force emphasized the computerization of the system. It emphasized the need of web-based logging and communication facility to users. It suggested taking the help to National Science Digital Library (NSDL) to develop and implement TIN (Tax Information network).

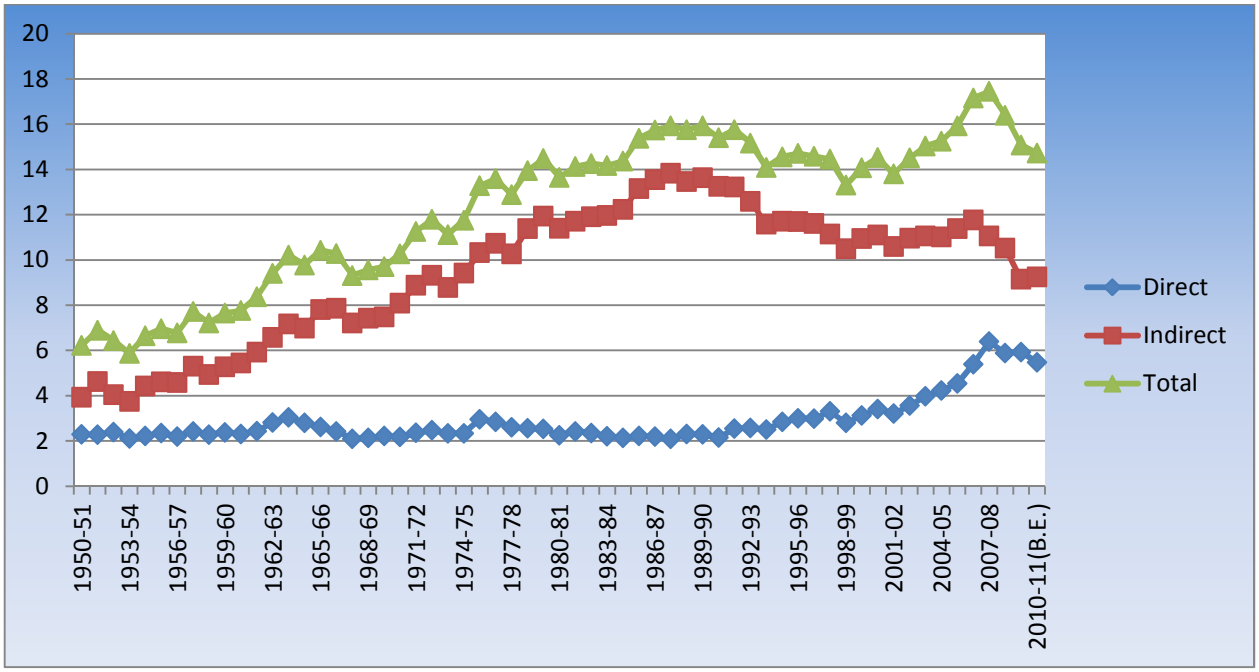
The Task Force recommendations were implemented from 2005-06, when the exemption limit was raised to ₹ one lakh as per the recommendations. There has been 'creeping up' in the exemption limit since then and was raised to ₹ 1.1 lakhs (2006-07), ₹ 1.5 lakhs (2008-09) to ₹ 1.6 lakhs (2009-10).

Figure 6.1:
Tax-revenue to GDP of various countries and regions



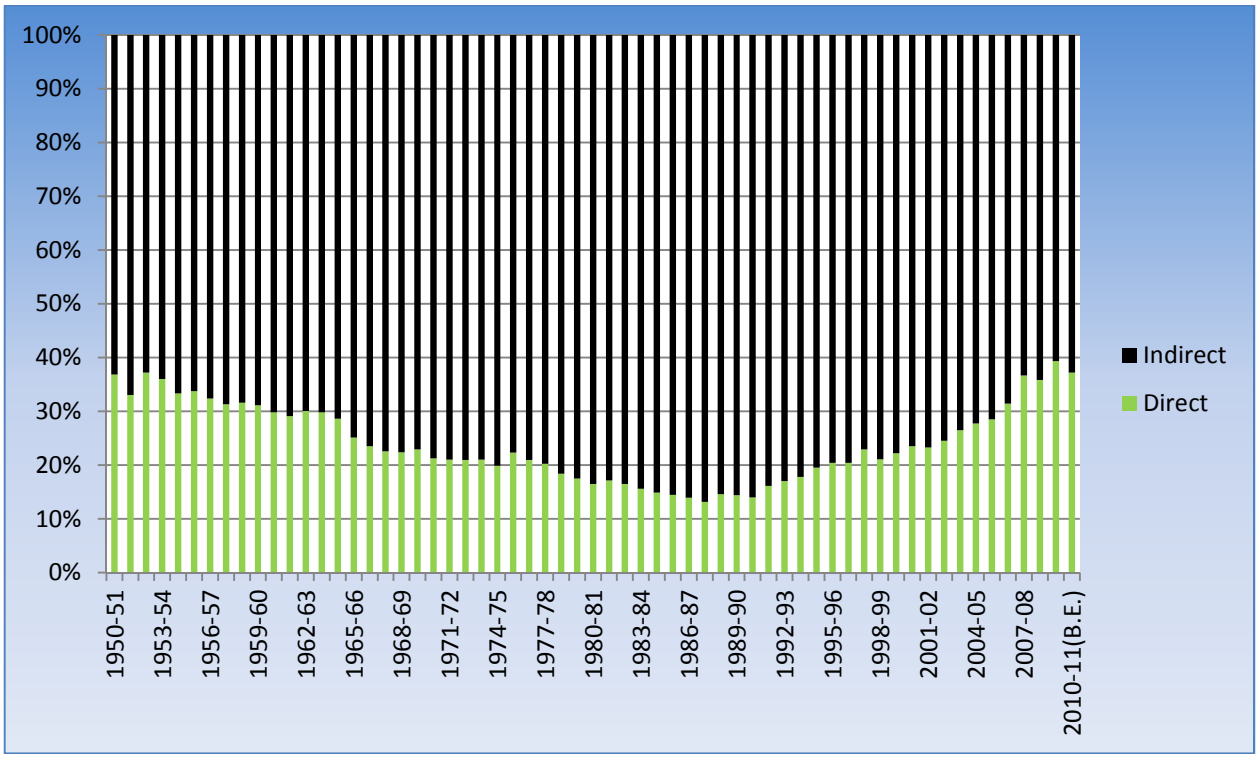
(Source: World Development Indicators from World bank Database)

Figure 6.2:
Tax-revenue to GDP for India



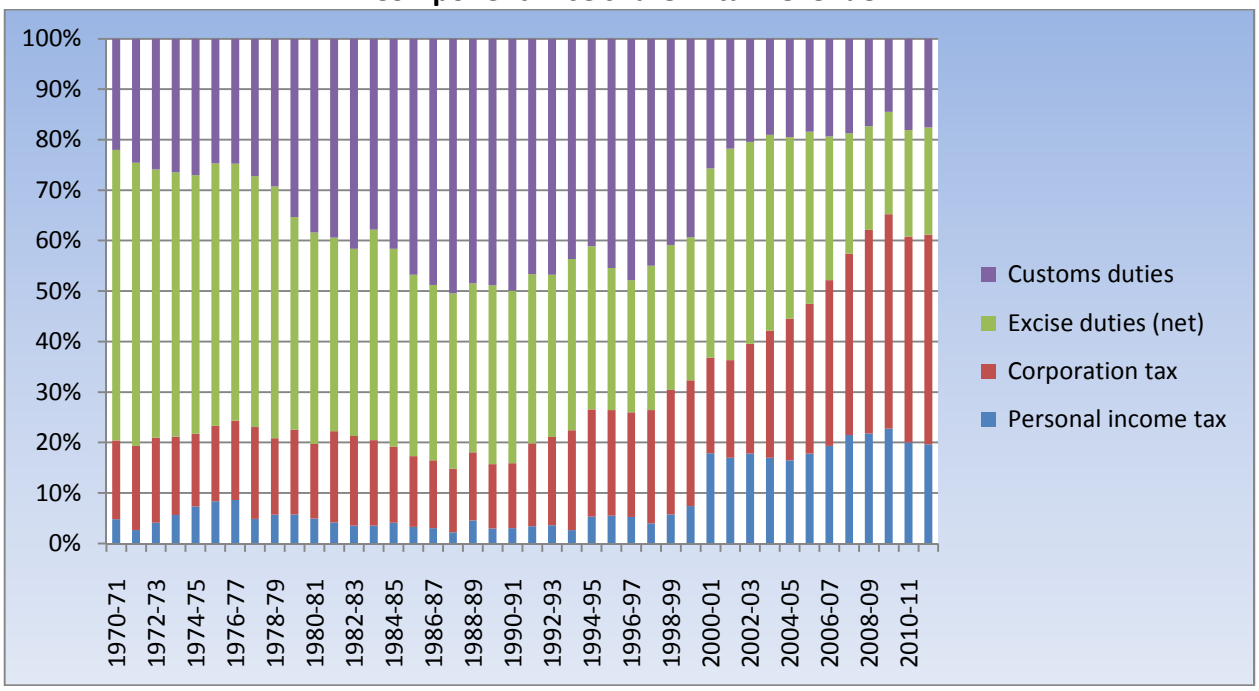
(Source: Indian Public Finance Statistics 2010-11, Department of Economic Affairs, Ministry of Finance, GoI)

Figure 6.3:
Share of Direct and Indirect tax to total tax-revenue



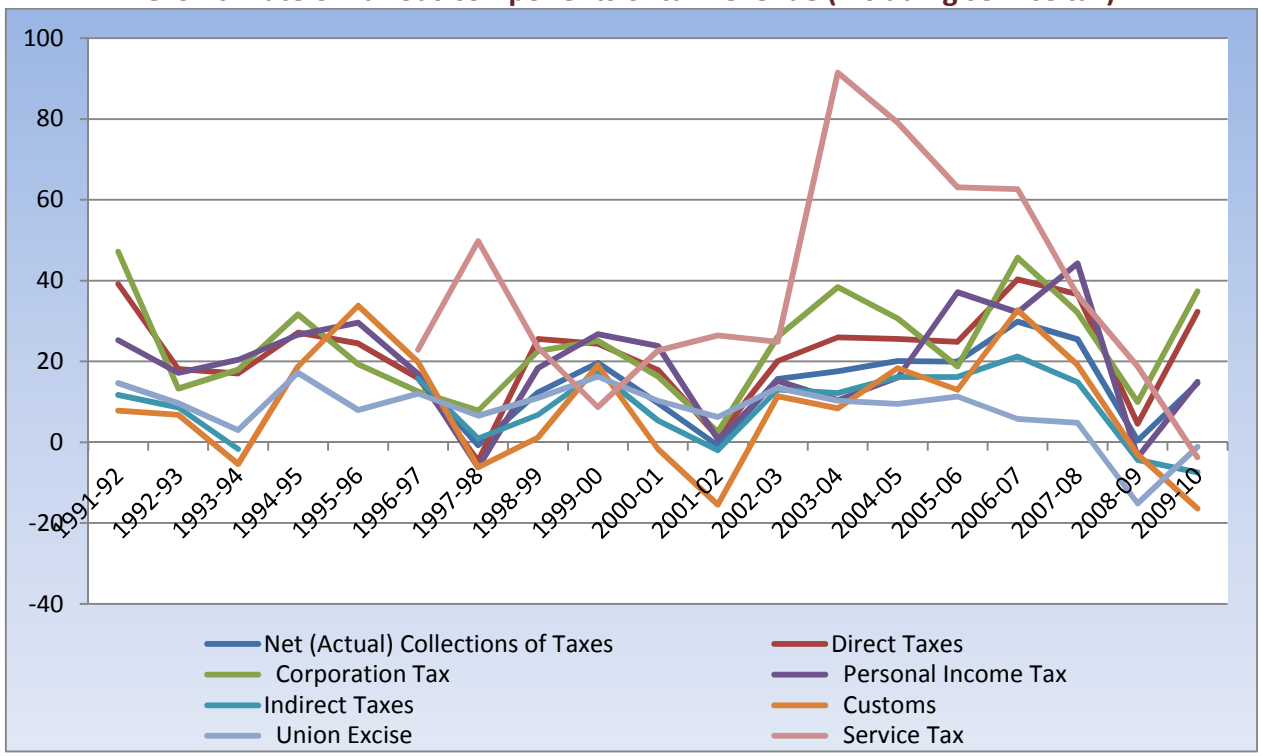
(Source: Indian Public Finance Statistics 2010-11, Department of Economic Affairs, Ministry of Finance, GoI)

Figure 6.4:
Component wise share in tax-revenue



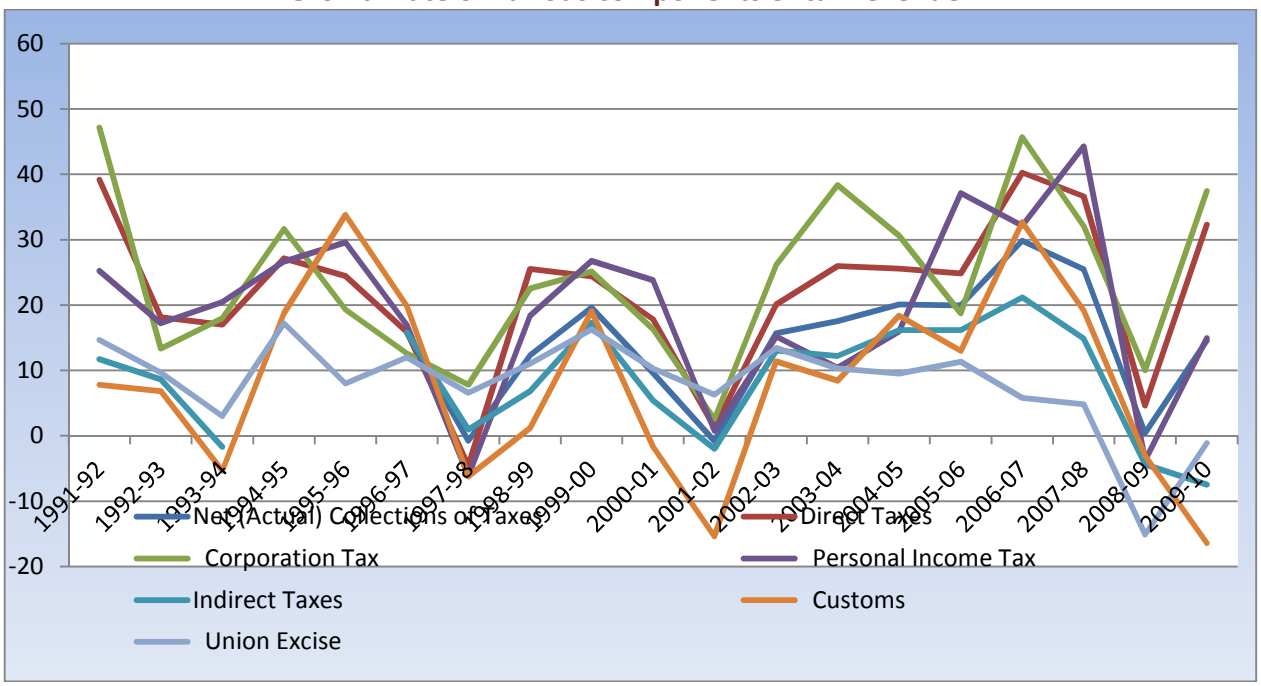
Source: Calculated figures from Handbook of Statistics on Indian Economy 2010-11, RBI India

Figure 6.5:
Growth rate of various components of tax-revenue (including service tax)



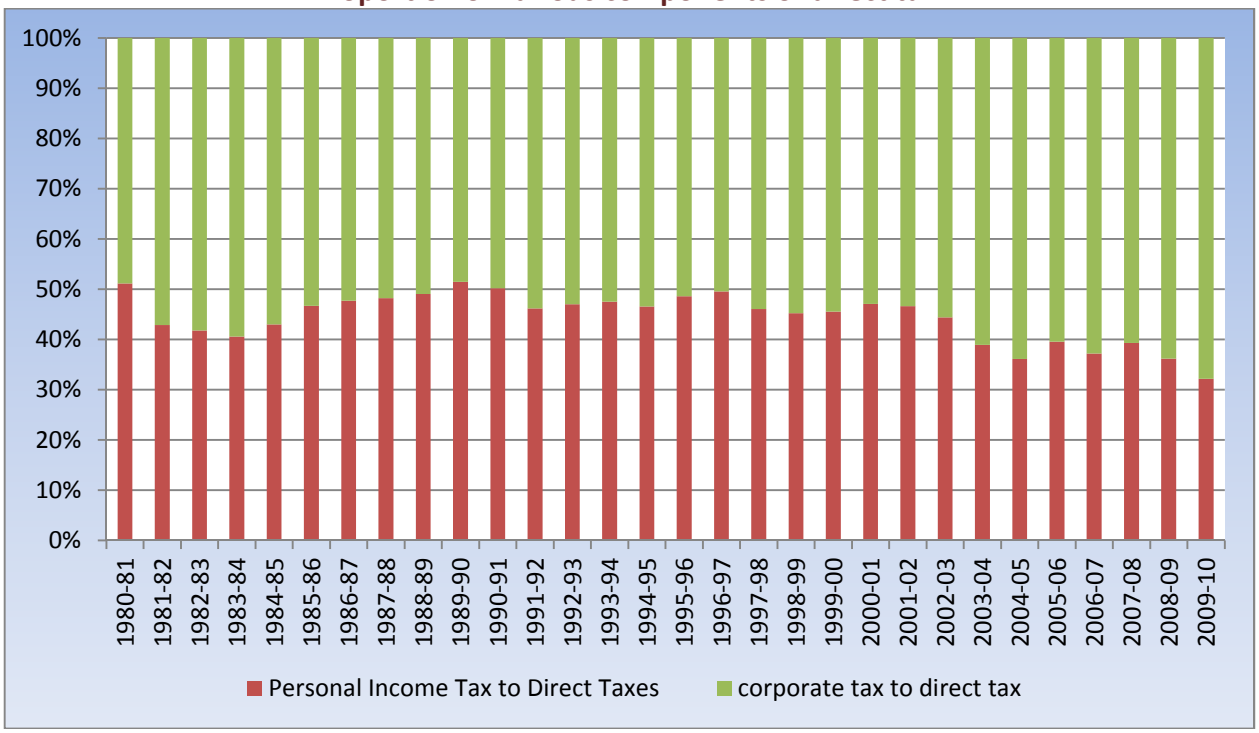
Source: Calculated figures from Handbook of Statistics on Indian Economy 2010-11, RBI India

Figure 6.6:
Growth rate of various components of tax revenue



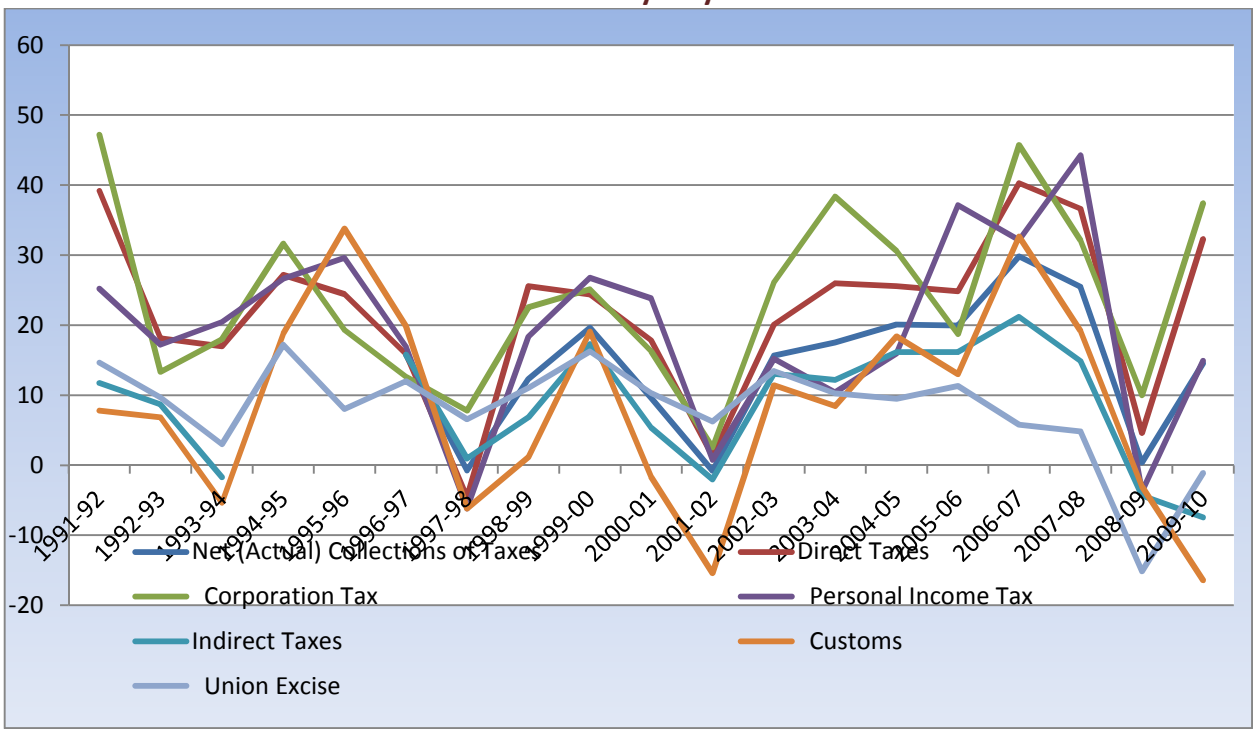
Source: Calculated figures from Handbook of Statistics on Indian Economy 2010-11, RBI India

Figure 6.7:
Proportion of various components of direct tax



Source: Calculated figures from Handbook of Statistics on Indian Economy 2010-11, RBI India

Figure 6.8:
Tax Buoyancy



Source: Calculated figures from Handbook of Statistics on Indian Economy 2010-11, RBI India

Table 6.1:												
Number of assesses in various income groups												
												(in Lakhs)
Year	Income upto ₹ 2 Lakhs			Income Between ₹ 2-10 Lakhs			Income above ₹ 10 Lakhs			Search and Seziure cases	Total	Total % of population paying taxes
	No. of assesses	**% of total**	**%age of Population**	**No. of assesses**	**% of total**	**%age of Population**	**No. of assesses**	**% of total**	**%age of Population**			
1996-97	110.02	96.37	1.16	3.57	3.13	0.04	0.31	0.27	0.0033	0.24	114.16	1.204
1997-98	123.7	95.94	1.28	4.63	3.59	0.05	0.41	0.32	0.0043	0.19	128.93	1.3355
1998-99	163.39	96.34	1.66	5.46	3.22	0.06	0.48	0.28	0.0049	0.26	169.59	1.7226
1999-00	187.45	95.8	1.87	7.49	3.83	0.07	0.58	0.3	0.0058	0.15	195.67	1.9532
2000-01	216.07	95.32	2.12	9.72	4.29	0.1	0.73	0.32	0.0072	0.16	226.68	2.223
2001-02	243.5	94.1	2.34	14.15	5.47	0.14	0.79	0.31	0.0076	0.33	258.77	2.485
2002-03	255.25	90.84	2.42	21.89	7.79	0.21	0.88	0.31	0.0083	2.98	281	2.6328
2003-04	265.46	92.08	2.48	21.67	7.52	0.2	1.05	0.36	0.0098	0.12	288.3	2.6882
2004-05	243.63	90.92	2.24	22.96	8.57	0.21	1.22	0.46	0.0112	0.14	267.95	2.4592
2005-06	258.98	88.1	2.34	27.22	9.26	0.25	5.62	1.91	0.0508	2.13	293.95	2.6385
2006-07	273.3	88.46	2.44	27.87	9.02	0.25	5.79	1.87	0.0516	2	308.96	2.7358

Source: *Compiled from various Compliance Audit reports of Union Govt. on Direct Taxes of Comptroller and Audit General of India*

Table 6.2:						
Tax Buoyancy in the tax revenue of Central government						
Year	*Direct Taxes*	Corporation Tax	Personal Income Tax	*Indirect Taxes*	Customs	Union Excise
1991-92	2.21	0.32	3.36	1.40	0.82	1.75
1992-93	0.54	-0.31	0.73	0.94	0.62	1.27
1993-94	1.00	1.35	0.94	1.30	2.33	0.60
1994-95	0.45	1.86	0.15	0.00	0.43	1.51
1995-96	0.55	-0.26	0.70	0.00	0.61	2.04
1996-97	0.56	0.52	0.66	1.04	0.72	1.31
1997-98	0.18	-1.50	0.80	1.65	1.43	1.80
1998-99	3.19	10.05	1.93	1.09	1.08	1.05
1999-00	0.01	-2.36	0.64	1.44	1.74	1.23
2000-01	1.89	1.93	1.66	1.51	1.00	1.88
2001-02	5.52	3.59	5.62	1.28	1.62	0.93
2002-03	2.53	1.63	1.73	0.65	0.28	0.89
2003-04	0.30	-2.13	1.07	-0.20	0.43	-0.54
2004-05	3.28	10.88	2.61	1.38	1.56	1.44
2005-06	1.52	1.76	1.39	1.56	0.38	2.41
2006-07	0.85	0.56	0.77	0.89	0.36	1.22
2007-08	0.44	-1.48	0.48	0.02	0.54	-0.38
2008-09	1.52	5.06	1.89	0.49	1.00	0.10
2009-10	1.67	3.38	1.45	1.14	1.28	1.10
Source: *Own calculations based on information in Handbook of Statistics on Indian Economy 2010-11, RBI India*						

Table 6.3:					
Evolution of Personal Income tax structure					
Year	Exemption Limit (₹)	Number of Rates	Entry rate (%)	Peak rate (%)	Income at which the peak rate applies (₹)
1949-50	1,500	4	4.69	25	15,000
1955-56	2,000	5	4.93	26.25	15,000
1960-61	3,000	7	3.15	26.25	20,000
1970-71	5,000	11	11	93.5	200,000
1971-72	5,000	11	11	93.5	200,000
1972-73	5,000	11	11	93.5	200,000
1973-74	5,000	11	11	93.5	200,000
1975-76	6,000	8	13.2	77	70,000
1980-81	8,000	8	15	66	100,000
1985-86	18,000	4	25	50	100,000
1990-91	22,000	4	20	56	100,000
1991-92	22,000	4	20	56	100,000
1995-96	40,000	3	20	40	120,000
1997-98	40,000	3	10	30	150,000
1998-99	50,000	3	10	30	150,000
1999-00	50,000	3	10	33	150,000
2000-01	50,000	3	10	35.1	150,000
2001-02	50,000	3	10	30.6	150,000
2002-03	50,000	3	10	31.5	150,000
2003-04	50,000	3	10	33	150,000
2004-05	50,000	3	10	33.66	150,000
2005-06	100,000	3	10	33.66	250,000
2006-07	100,000	3	10	33.66	250,000
2007-08	110,000	3	10	33.99	250,000
2008-09	150,000	3	10	33.99	500,000
2009-10	160,000	3	10	30.9	500,000
2010-11	160,000	3	10	30.9	800,000
2011-12	180,000	3	10	30.9	800,000
Source: *Compiled by Report of the Task Force July 2004, and from budget documents, Various Issues, Ministry of Finance, Govt. of India.*					

Annexure 4.1

Money Laundering 1990-2010 (Case Under FERA/FEMA)									
Sl.No.	Year	No. of		Currency Seized (In Indian ₹ In Crores)		Currency confiscated (In Indian ₹ In Crores)		Fines (in Indian ₹ In Crores)	
		Searches / Raids	Seizures Recoveries	Indian	Foreign	Indian	Foreign	Imposed	Realised
1	1990	2114	1389	7.50	2.00	1.60	1.20	0.00	2.40
2	1991	2319	1482	11.80	3.60	1.10	1.50	0.00	2.80
3	1992	1215	738	3.90	2.50	2.40	2.20	0.00	2.30
4	1993	1234	843	6.70	4.50	3.10	3.00	0.00	3.20
5	1994	1540	1046	9.80	8.10	1.80	2.20	27.80	3.40
6	1995	1175	832	10.20	6.50	1.20	2.30	10.60	2.20
7	1996	1164	868	12.40	7.80	4.00	2.00	78.00	1.60
8	1997	1238	946	11.60	5.10	3.40	2.30	86.80	1.90
9	1998	544	361	7.10	2.30	4.60	1.80	170.20	1.80
10	1999	387	299	4.90	0.80	4.20	5.80	194.30	46.70
11	2000	330	262	3.60	2.20	5.70	4.80	318.40	3.00
12	2001	295	207	1.20	2.70	2.70	4.20	491.10	3.50
13	2002	417	393	0.80	1.20	1.00	4.00	354.40	5.40
14	2003	242	175	6.20	2.20	4.00	2.00	1083.50	5.30
15	2004	78	56	2.60	0.40	6.00	6.90	2518.70	20.00
16	2005	146	106	9.73	0.40	3.95	1.55	1454.66	11.04
17	2006	51	44	4.87	0.38	0.98	0.41	527.71	9.06
18	2007	108	74	11.16	0.55	2.22	0.08	158.43	18.15
19	2008	95	76	16.42	1.00	2.33	0.28	220.80	15.45
20	2009	110	79	17.15	5.44	5.77	2.36	3645.32	12.21
21	2010	123	74	11.74	0.78	1.73	0.49	566.66	7.70
***Source*: Various Issues of Annual Reports, National Crime Records Bureau, India.**									

Annexure 5.1

Figures in Crores

Financial Year	Corporate Tax (Reported)	Effected Tax Return (ETR) in Percentage (%)	Total Income (Reported)	Corporate Sector - Shadow Economy (Index Based on MIMIC Results)	Total Income (Projected)	Corporate Tax (Projected)	**Tax Evasion (Estimated)**	**% in Tax Evasion (Estimated)**	**% Income unreported (Estimated)**
2001-02	36609	40.88	89562.81	100					
2002-03	46172	38.07	121295.4	118.55					
2003-04	63562	32.29	196857.3	160.00					
2004-05	82680	27.56	299998.8	214.28	355490.9	97973.68	**15293.68**	**18.50**	18.49743
2005-06	101277	27.18	372678.9	261.95	434570.1	118096.2	**16819.19**	**16.61**	16.60711
2006-07	144318	26.85	537512.4	375.71	623294.9	167350	**23031.96**	**15.96**	15.95917
2007-08	192911	28.21	683824	472.48	783830.2	221123.4	**28212.37**	**14.62**	14.62455
2008-09	213395	29.87	714415.2	584.25	969255.8	289515.6	**76120.59**	**35.67**	35.67121
2009-10	244725	30.22	809823.6	610.85	1013383	306239.6	**61514.65**	**25.14**	25.13623
2010-11	296377	31.44	942606.7	749.69	1243723	391054.9	**94677.92**	**31.95**	31.9451

Note: *Please see the text for detailed explanation*

Appendices

Appendix 3.1

NATIONAL INSTITUTE OF FINANCIAL MANAGEMENT

Study on Unaccounted Income and Wealth Inside and Outside the Country
Sponsored by CBDT, Ministry of Finance, GOI
QUESTIONNAIRE for REALTY SECTOR

[Officers of Estate /Revenue Deptt/Registrar Office]

[We request you to kindly fill the given Questionnaire. The questionnaire is a part of a research Study sponsored by CBDT, Ministry of Finance. All information supplied would be kept confidential and would be used only for academic purposes. Secrecy of names and designation would be maintained]

IDENTIFICATION PARTICULARS

0.1 City/State: _____ [ ] 0.2 Zone: _____[ ]

0.3 Name of the Respondent: ----------

0.4 Business_____

0.5 Name of the Investigator: _____ 0.6 Date: _____

Q.1 In your opinion is there Unaccounted Income in the Indian realty sector?

Yes No

Q.2 Please rank (Very Severe, Severe, Moderate severe, Not Severe) in order of severity the following problems of realty sector

a) Lack of uniformity in policies and regulations across states. _____

b) High stamp duties in some states. _____

c) Need for obtaining a large number of approvals from the government authorities for construction or transfer of properties. _____

d) Corruption in acquiring land _____

e) Corruption in obtaining approvals which trickles down till the lowest level when the buyer buys the property.

f) Absence of a Real Estate Regulator _____

Q.3 What in your opinion is usually the proportion of cash component in property transactions which goes unaccounted?

- 40-60 per cent ----------
- Less than 40 per cent ----------
- More than 60 per cent ----------

Q.4 The only way to get over the malaise of property undervaluation in realty sector is to slash the stamp duties, which tempts undervaluation of property. Do you endorse this view?

Yes No

Q.5 The various forms of black money generation, ranked according to their weight are as follows:-

Please specify rank

a) Under reporting of price on the sale deed vis-à-vis the price at which the transaction actually occurs _____

b) Payment of bribes to the government authorities to obtain expeditious clearance of the slew of permits and approvals required for construction or transfer ofurban properties

c) Greasing the palms of government authorities to manipulate changes in land use pattern and regularise unauthorised constructions and encroachments _____

d) Misuse of the power of attorney facility in the sale of the property _____

Q.6 Do you think that low circle rates encourage price manipulation in real estate transactions?

Yes No

Q.7 How much is the difference between circle rates and the market rates? Please give us a ballpark figure?

- 20 per cent ----------
- 30-50 per cent ----------
- More than 50 per cent ----------

Q.8 Do you think that the huge gap between actual transaction rates and marked prices can be narrowed down?

Yes No

Q.9 Please indicate the ways in which the gap can be reduced. Please specify rank

i) Lowering of tax rates _____

ii) Incentives for higher declaration of property _____

iii) Revising the circle rates _____

Q.10 In your opinion is the Builder-Politician nexus an important part of the real estate corruption chain?

Yes No

Q.11 How important are some of the measures according to you which can be adopted to clean up the real estate sector [Very important, Important, Moderate, Not important

a) Automated clearance for approving a building plan _____

b) Single window clearance for obtaining approvals _____

c) Online posting of the records of surplus land available for development by the government _____

d) Doing away with the percentage of completion method to motivate the builder _____

e) Setting up a strong and transparent regulator for real estate sector _____

Q.12 The ramifications of black money in the real estate sector, ranked in order of their concern for our country and economy are:-

Please specify rank

a) Deprives the government of tax revenues _____

b) Facilitates money laundering and tax fraud _____

c) Fosters corruption and other related crimes _____

d) Undermines the credibility of the country _____

e) Any Other _____

Much appreciate you for sparing your precious time and giving us your valuable feed back on this subject.

Appendix 3.2

NATIONAL INSTITUTE OF FINANCIAL MANAGEMENT

Study on Unaccounted Income and Wealth Inside and Outside the Country

Sponsored by CBDT, Ministry of Finance, GOI

QUESTIONNAIRE ON DIRECT TAXES

The purpose of this questionnaire is to leverage on the wealth of knowledge and experience of the Senior Tax Officials of the Income Tax Department in ascertaining their views on various aspects relating to unaccounted income.

The results of the surveys will be used to examine causes and conditions that result in generation of unaccounted income through evasion of direct taxes.

Some possible answers to each question are suggested but these answers are not exhaustive. You are requested to rank the suggested answers in order of their importance. Where the proposed answers are insufficient, please expand the answers by putting forward your own suggestion; but a clear ranking of the proposed alternatives is requested wherever possible. The questionnaire also includes some multiple choice questions, where you are requested to select a single choice by filling the bubble corresponding to it.

Thank you in advance for your participation.

1. Whether, according to you, the existing system of scrutiny of returns of income and wealth in this country is an accurate method of assessing income/wealth as per law.

- Yes
- No
- Can't say

If no, it may be due to the following possible reasons; please assign weightage [out of 1-10] to each reason:

- Because filing of return by the assessee is a subjective process in which unaccounted money is excluded by the assessee from return at the outset by not being reported in the return and so is never brought to tax.

- There is no correlation between the information received/gathered by the department and the assessment proceedings of a particular person and voluminous information collected lies unutilized.

- The time-barring limits for assessments presently prescribed in law hardly give the assessing officers any time to make detailed enquires.

- Work load of scrutiny assessments with assessing officers is un-manageable.

- Assessing Officers lack necessary skills for scrutiny and need training and updating.

- Staff/officers of the department are not very savvy with or do not have access to the software/hardware used by the department of data-mining.

- There is a need to further upgrade the software /hardware used by the department for detecting unaccounted income.

- The *quasi*-judicial nature of tax proceedings make them long-drawn process whereby the quantification of tax liability is postponed.

- There is no real machinery with the department to ascertain the identity or whereabouts of an absconding or delinquent assessee and locate his real assets.

- There is a weak prosecution mechanism for tax officers. The prosecution is more harassing to the prosecuting tax officer and it is rare that the guilty are caught.

- Wrong claim of deduction/exemption made in the return, unless visited with penalty, is not treated as tax evasion/concealment.

- Any others (please specify)

2. Do you feel that searches/seizures and surveys are effective tools in bringing to tax unaccounted income?

- Yes
- No
- Can't say

3. If yes, please rank order of importance which you will attach to the following views. Please rank them in order of their importance or gravity on a scale of (1-10)

- Yes, however, Tax authorities should have power to confiscate /arrest the person and or seized goods in course of searches.

- Yes, however, searches and surveys should be conducted after proper reccee and should be more focused and issue-based.

- Yes, however, search and survey should be conducted sparingly in rare cases.

- Yes, however, the post search procedures of assessment and appeals need to be changed as often ultimately there is no worthwhile outcome commensurate with the cost, in terms of man hours and expenditure spent by the department.

- Any other observations please specify.

If no, then please give reasons

4. **(a) What are the methods which in your opinion give rise to generation of unaccounted income? Please rank them in order of their importance or gravity on a scale of (1-10)**

A. GENERAL METHODS

Non filing of tax returns ☐
Non declaration of income in the return
Under reporting of income in the return ☐
Suppression of profits by inflation of expenses ☐
Non maintenance of books of accounts ☐
Falsification of accounts by making incorrect entries ☐
Claiming tax exemptions/deductions not legally allowable ☐
Undervaluation of stock ☐
Shifting tax liability ☐
Trade Mispricing (Under invoicing of imports, over invoicing of exports) ☐
Benami/unaccounted transactions ☐
Others (Please Specify)

B. MULTINATIONAL CORPORATIONS

Routing of transactions through Controlled Foreign Corporation (CFCs) in tax havens ☐
Abusing transfer pricing ☐
Incorporation of shell companies for claiming deductions/exemptions ☐
Layering of contract in case of EPC contracts ☐
Treaty shopping ☐
Any others (Please specify) ☐

(b) **How much in your opinion is contribution of unaccounted income to election related activities?**

< 25%
25-50%
50-75%
75-100%

5. **Which according to you are sectors that generate unaccounted income through tax evasion/avoidance? Please rank them in order of their importance or gravity on a scale of (1-10)**

Capital Markets ☐
Realty Sector ☐

Bullion/Commodity Market
BPO sector
Manufacturing Sector
Trading Sector
Art and film Industry (including advertising, event organizing, etc.)
Mining
Educational Institutions
Professionals (architects, doctors, lawyers, CA, tax consultant, designers)
Pan Masala, Tobacco & Gutka Industry
Financial Services
Trusts, NGO's and Charitable organizations
Any others (Please specify)

6. **Which are the most common methods used to convert unaccounted income and wealth into accounted income and wealth? Please rank them in order of their importance or gravity on a scale of (1-10)**

Show unaccounted income as income earned from agricultural activities
Arrange to receive gifts or loans by transfer of owns assets/income to friends and relatives
Convert unaccounted money into foreign exchange through the black market and have it remitted as gifts from abroad
Buy lottery ticket from the real winner
Convert unaccounted income into foreign exchange through tax havens and bring it back as share capital/loans
Arrange for Hawala loans/buying book entries/share capital and share premium
Benami Transactions
Showing fictitious sale of jewellery
Bogus long term capital gains
Any others (Please specify)

7. **In your opinion what are the most common forms of holding unaccounted income and wealth. Please rank them in order of their importance or gravity on a scale of (1-10)**

Undervalued commercial real estate (land and buildings)
Undervalued residential real estate (land and buildings)
Gold, silver and other precious metals
Diamonds and other gems
Cash
Benami financial investments
Undervalued (or undeclared) assets in business
Undervalued (or undeclared) stocks in business
Undisclosed holdings of foreign assets
Any others (Please specify)

8. **What according to you are the causes leading to generation of unaccounted income? Please rank them in order of their importance or gravity on a scale of (1-10)**

- Lack of will political/administrative for framing effective tax laws ☐
- Undue interference in administration of tax laws ☐
- Falling standards in value system ☐
- Archaic and complex rules and regulations ☐
- Laxed enforcement of tax laws ☐
- Gaps in the interpretation of law between the Appellate authorities and the tax authorities ☐
- Quasi judicial nature of proceeding causing delayed quantification of liability ☐
- High tax rates ☐
- Multiple Taxation ☐
- Cost of tax avoidance being lesser than cost of compliance ☐
- Cumbersome procedure for filing of returns and payment of taxes ☐
- Avoidance of tax as not being a criminal offense ☐
- Any others (Please specify) ☐

9. **What according to you is the most effective way to check growth of unaccounted income? Please rank in order of importance/gravity on a scale of 1-10.**

- Simplifying tax laws and procedures ☐
- Further reducing tax rates ☐
- Improving tax administration ☐
- Imparting training to Staff ☐
- Framing Effective legislation ☐
- Extensively using technology ☐
- Providing in law for imposition of stringent fines/penalties/prosecutions & imprisonment ☐
- Using presumptive methods of taxation ☐
- Random auditing of accounts ☐
- Change in accounting standards for recognition of revenue ☐
- Enlarging scope of TDS ☐
- Restricting cash transactions by restricting limit under section 40A(3) ☐
- Curtailing judicial delays by reducing appellate stages in litigation ☐
- Constituting special courts for tax matters/offenders ☐
- Reducing plethora of taxes and duties levied by state and centre ☐
- Any others (Please specify) ☐

10. **What in your opinion is the best way to bring back unaccounted income inside and outside India in to the mainstream?**

- Granting Tax amnesties to all tax evaders, by way of voluntary disclosures, issue of bearer bonds etc. ☐
- Granting Tax amnesties only to tax evaders who have stashed assets abroad which cannot be ascertained ☐

or brought back
Any others (Please specify)

Details of respondent (optional)

Name	:	
Designation	:	
Years of experience in the Department	:	
Place of Posting	:	

Thank you for taking part in this survey.

Appendix 3.2

NATIONAL INSTITUTE OF FINANCIAL MANAGEMENT

Study on Unaccounted Income and Wealth Inside and Outside the Country

Sponsored by CBDT, Ministry of Finance, GOI

QUESTIONNAIRE ON UNACCOUNTED INCOME/WEALTH

(INDIRECT TAXES)

The purpose of this questionnaire is to leverage on the wealth of knowledge and experience of the Senior Tax Officials of Central Excise, Customs and Service Tax wings of Government of India by collecting their views on various aspects relating to unaccounted income.

The results of the survey will be used to examine causes and conditions that result in generation of unaccounted income through evasion of indirect taxes.

Some possible answers to each question are suggested but these answers are not exhaustive. Where the proposed answers are insufficient, please expand the answers by putting forward your own suggestions; but a clear ranking of the proposed alternatives is requested wherever possible. The questionnaire also includes some multiple choice questions, where you are requested to select a single choice by filling the bubble corresponding to it.

Thank you in advance for your participation.

1. Whether according to you the existing system of tax administration is in conformation with the legislative intention/spirit of law.

- Yes
- No
- Can't say

If no, please rank the reasons:

- Because filing of return by the assessee is a subjective process. The assessee excludes the untaxed income from the return at the outset and this money is never brought to tax.
- Search and surveys operations have become perfunctory exercises which in the ultimate analysis have no worthwhile outcome commensurate with the cost in terms of work-hours and expenditure.
- Correlation between the information received/ gathered by the department and the assessment proceedings of a particular assessee is not established and voluminous information lies unutilized.
- Staff/officers of the department are not very savvy with the latest technological advancements in the department and comfort level with software/hardware used by the department is missing.
- There is a need to further upgrade the software/hardware used by the department for detecting unaccounted income.
- Others (Please Specify)

EXCISE

2. What are the *methods* which in your opinion give rise to evasion of duty in case of Central Excise? Please rank them in order of their gravity on a scale of 1-10.

Not falling within the definition of manufacture or produce
Misclassification of goods
Non-accounting/suppressing of production
Non- registration of manufacturing unit
Undervaluation of goods
Misuse of SSI benefits
Misuse of exemption notifications
Misuse of Jobwork provisions/scheme
Misuse of CENVAT Credit facility
Others, Please specify

3. Which according to you are industries/sectors that generate Unaccounted Income through tax evasion/avoidance in case of Central Excise? Please rank them in order of their gravity on a scale of 1-10.

Pan Masala, Cigarettes and Chewing Tobacco
Iron and Steel and their articles
Automobile and its components
Petrol, Diesel and Furnace Oil
Cement
Others, Please specify

4. Do you think the SSI exemption from payment of excise duty is being misutilised by any of the following. Please rank them in order of their gravity on a scale of 1-10.

Creation of mutiple SSIs
Showing clearances within the limit of 150/400 lacs
Artificial suppression of expansion and growth of the unit/industry

5. Do you think the system of CENVAT Credit is being misutilized

- Yes
- No
- Can't say

If Yes, Please rank the reasons in order of their gravity on a scale of 1-10.

Non maintenance of separate accounts for common inputs used in dutiable/exempted output
Availing CENVAT credit on inadmissible inputs/services
Availing credit on the basis of invalid documents
Availing credit on goods not received from job-workers
Suo-moto availing of CENVAT credit
Misuse of SIONs (Standard Input Output Norms)

SERVICE TAX

6. What are the most common methods which in your opinion give rise to tax evasion in case of Service Tax? Please rank them in order of their gravity on a scale 1-10.

Non-accounting of transactions on account books
Undervaluation of Services
Misuse of self assessment method
Misuse of exemptions
Misuse of CENVAT Credit facility

Non registering of business
Non filing of returns
Service tax collected from consumers but not passed on to the government
Others, Please specify

7. Which according to you are services where large Service Tax evasion/avoidance is observed? Please rank them in order of their gravity on a scale of 1-10.

Telecommunication services
Commercial and Industrial construction
Renting of immovable properties
Business support services
Management, maintenance or repair services
Intellectual Property Rights Service
Others, Please specify

8. Do you think that the tax base should be defined to include all services, with a limited list of exclusions (called as "negative list")?

Yes, there should be only a negative list
No, there should be a list of specified services
There should be a list of well defined specified services along with a negative list
Can't say

CUSTOMS

9. What are the most common methods which in your opinion are being employed for evasion/avoidance of Customs Duty? Please rank them in order of their gravity on scale of 1-10.

Underinvoicing in case of imports
Overinvoicing in case of exports
Misuse of drawback benefits
Wrong classification in case of goods subject to duties like anti-dumping duty, safeguard duty etc..
Misutilization of duty exemption benefits
Misutilisation of export incentive schemes like Advance licence etc.
Others, Please specify

10. Which are the most common schemes in your opinion that are being misutilized for generation of unaccounted money?Please rank them in order of their gravity on a scale of 1-10.

Schemes for Software development
Schemes for Non Mega Power projects
SEZ Scheme
EOU Scheme
Advance Licence
Other export incentive schemes
Others, Please specify

GENERAL

11. What, according to you is the most effective way to deal with Indirect Tax evasion? Please rank in order of gravity on a scale of 1-10.

- Amendment of law to close loop holes/reduce ambiguities and anomalies ☐
- Powers to confiscate/seize goods ☐
- Provisions in law for imposition of stringent fines/ penalties/prosecutions & imprisonment ☐
- Using presumptive methods of taxation ☐
- Random audits ☐
- Others, Please specify ☐

12. How the tax system be made more simplified? Please rank in order of importance on a scale of 1-10.

- Withdrawal of tax exemptions and concessions ☐
- Introduction of TDS/Withholding Tax in case of Service Tax and Central Excise ☐
- Phasing out of tax preferences to SEZ, EOU, Technology parks etc… ☐
- Others, Please specify ☐

13. What according to you are the causes leading to increasing evasion of Indirect Taxes? Please rank in order of gravity on a scale of 1-10.

- Lack of will political/administrative for framing effective tax laws ☐
- Falling standards in value system ☐
- Archaic and complex rules and regulations ☐
- Weak enforcement of tax laws ☐
- Quasi judicial nature of proceedings causing delayed quantification of liability ☐
- High tax rates ☐
- Cost of tax avoidance being lesser than cost of compliance ☐
- Cumbersome procedure for payment of taxes ☐
- Others, Please specify ☐

14. What is your suggestion for bringing a tax regime into existence whereby due taxes are paid by the tax payer? Please rank in order of gravity on a scale of 1-10.

- Reducing rate differentiation and simpler tax structure ☐
- Improving tax administration by simplifying the procedures ☐
- Training of Staff ☐
- Effective legislation ☐
- Increased physical inspection ☐
- Improving enforcement measures by conducting more focused surveys and searches/seizures ☐
- Decreasing tax rates and widening the tax base ☐
- Data matching/cross checking of information amongst various government agencies with use of technology ☐
- Reducing compliance cost (by simplifying procedures, ☐

providing more convenient payment options, etc.)
Extensive use of technology ☐
Curtailing judicial delays ☐
Increasing the staff ☐
Others, Please specify ☐

15. Do you feel that the proposed GOODS AND SERVICES TAX is a good weapon in the fight against black money, given the fact that it is expected to usher in a new tax regime of better transparency and greater compliance?

- Yes
- No
- Can't say

16. Some suggestions to curb the menace

Details of respondent (optional)

Name	:	
Designation	:	
Years of experience in the Department	:	
Place of Posting	:	
Phone No.	:	
Email Id	:	

Thank you for taking part in this survey.

Appendix 4.1

Designated categories of offences with schedule offences under the PMLA		
Sl.No.	**Designated category of offence**	**Name of Act in the Schedule of PMLA**
1	Participation in an organised criminal group and racketeering	Indian Penal Code, 1986 (s.120B - criminal conspiracy) - Part B of the Schedule
2	Terrorism, including terrorist financing	The Unlawful Activities (Prevention) Act, 1967 (ss.10 read with section 3; 11 read with ss.3 and 7; 13 read with s.3, 16 read with s.15, 16A, 17,18,18 A,18 B,19, 20 ,21, 38, 39 and 40) - Part A of the Schedule
3	Trafficking in human beings and migrant smuggling	The Bonded Labour System (Abolition) Act, 1976 (ss. 16, 18 and 20) - Part B of the Schedule The Transplantation of Human Organs Act, 1994 (ss.18, 19 and 20) - Part B of the Schedule The Child Labour (Prohibition and Regulation) Act, 1986 (s.14) - Part B of the Schedule The Juvenile Justice (Care and Protection of Children) Act, 2000 (ss.23 to 26) - Part B of the Schedule The Emigration Act, 1983 (s.24) - Part B of the Schedule The Passport Act, 1967 (s.12) - Part B of the Schedule The Foreigners Act, 1946 (ss.14, 14B and 14C) - Part B of the Schedule
4	Sexual exploitation, including sexual exploitation of children	The Immoral Traffic (Prevention) Act, 1956 (ss.5, 6, 8 and 9) - Part B of the Schedule
5	Illicit trafficking in narcotic drugs and psychotropic substances	The Narcotic Drugs and Psychotropic Substances Act, 1985 (ss15 to 24, 25A, 27A and 29) - Part A of the Schedule
6	Illicit arms trafficking	The Arms Act, 1959 (ss. 25 to 30) - Part B of the Schedule
7	Illicit trafficking in stolen and other goods	The Indian Penal Code, 1860 (ss.411 to 414) - Part B of the Schedule
8	Corruption and bribery	The Prevention of Corruption Act, 1988 (ss.7 to 10 and 13) - Part B of the Schedule
9	Fraud	The Indian Penal Code, 1860, (ss.417 to 424) - Part B of the Schedule
10	Counterfeiting currency	The Indian Penal Code, 1860 (ss.489A and 489B) - Part A of the Schedule

11	Counterfeiting and piracy of products	The Copyright Act, 1957 (ss. 7 to 10 and 13) - Part B of the Schedule The Trade Marks Act, 1999 (ss.103, 104, 105, 107 and 120) - Part B of the Schedule The Information Technology Act, 2000 (ss.72 and 75) - Part B of the Schedule The Biological Diversity Act, 2002 (s.55 read with s.6) - Part B of the Schedule The Protection of Plant Varieties and Farmers' Rights Act, 2001 (ss.70 to 73 read with s.68) - Part B of the Schedule The Indian Penal Code, 1860 (s.255, 257 to 260, 475, 476, 486 to 488) - Part B of the Schedule
12	Environmental crime	The Environment Protection Act, 1986 (ss.5 read with section 7 and 8) - Part B of the Schedule The Water (Prevention and Control of Pollution) Act, 1974 (ss.41(2) and 43) - Part B of the Schedule The Air (Prevention and Control of Pollution) Act, 1981 (s.37) - Part B of the Schedule The Wild Life (Protection) Act, 1972 (s.51 read with ss.9, 17A, 39, 44, 48 and 49B) - Part B of the Schedule
13	Murder, grievous bodily injury	The Indian Penal Code, 1860 (ss.302, 304, 307, 308, 327, 329) - Part B of the Schedule
14	Kidnapping, illegal restraint and hostage-taking	The Indian Penal Code, 1860 (s.364A) - Part B of the Schedule
15	Robbery or theft	The Indian Penal Code, 1860 (ss.392 to 402) - Part B of the Schedule
16	Smuggling	The Customs Act, 1962 (s.135) - Part B of the Schedule
17	Extortion	The Indian Penal Code, 1860 (ss.384 to 389) - Part B of the schedule
18	Forgery	The Indian Penal Code, 1860 (ss.467, 471 to 473) - Part B of the Schedule
19	Piracy	The Suppression of Unlawful Acts against Safety of Maritime Navigation and Fixed Platforms on Continental Shelf Act, 2002 (s.3) - Part B of the Schedule
20	Insider trading and market manipulation	The Securities and Exchange Board of India Act, 1992 (s.12A read with s.24) - Part B of the Schedule

Appendix 4.2

Money Laundering cases						
SL. No.	**Items**	**FY 2006-2007**	**FY 2007-2008**	**FY 2008-2009**	**FY 2009-2010**	**Total**
1	No. of ECIRs	27	15	17	739	798
2	No. of persons arrested	7	-	-	9	16
3	No. of prosecutions filed.	-	-	2	4	6
ECIR: Enforcement Case Information Report = number of investigations.						

Appendix 4.3

Terrorist Financing Cases					
Descriptions	**2006-2007**	**2007-2008**	**2008-2009**	**2009-2010**	**Total**
No. of FR cases registered	17	25	36	27	105
No. of persons accused for FT	54	65	61	51	231
Value of seizure/Attachment of assets (in ₹)	9,690,000	13,640,000	7,173,000	16,506,800 0	47,009,80 0
No. of charge sheet filed	13	7	12	-	32
Whether a provision of the UAPA was invoked.	Yes	Yes	Yes	Yes	-
Status of the trials	12 trials in progress, 1 convicted.	6 pending trials, 1 trial to Commence .	11 pending trials, 1 trial to Commence		
No. of challans filed	-	6	2	-	8
No. of persons convicted		-	-	1108	1
Value of property forfeited (in ₹)	4,900,000	289,000	222,000	-	5,411,000
No. of cases under investigation	4	12	22	28	66

Other terrorist related figures							
Sl No	**Item**	**2006**	**2007**	**2008**	**2009**	**2010**	**Total**
1	Incidents	4551	4053	3859	5051	947	18461
2	Civilians Killed	1480	1269	1360	928	253	5290
3	Security Personnel Killed	415	440	387	446	68	1756
4	Terrorists Killed	1265	1133	1188	1027	217	4830
5	Weapons Seized						
(i)	Assault Rifles	794	756	522	415	106	2593

	(Seized value in million ₹)	47.64	45.36	31.32	24.90	6.30	155.52
	(Forfeited value in million ₹)	34.30	31.30	25.68	19.17	4.79	115.24
(ii)	Small Arms	758	720	1588	1018	78	4162
	(Seized value in million ₹)	39.70	36.00	79.40	50.90	3.90	209.90
	(Forfeited value in million ₹)	14.29	13.32	34.94	20.87	1.56	84.98
(iii)	Rocket Launchers	31	5	20	11	3	70
	(Seized value in million ₹)	3.10	0.50	2.00	1.10	0.30	7
	(Forfeited value in million ₹)	2.70	0.35	1.46	0.99	0.25	5.746
(iv)	Grenades	2491	1856	1555	1435	346	7683
	(Seized value in million ₹)	12.50	9.30	7.80	7.20	1.70	38.5
	(Forfeited value in million ₹)	2.88	2.33	1.48	1.44	0.43	8.547
(v)	Explosives (kilograms)	1879	990	575	733.5	576	4753.5
	(Seized value in million ₹)	9.4	5	3	3.7	2.9	24
	(Forfeited value in million ₹)	3.102	1.4	0.9	1.073	1.015	7.49

Appendix 4.4

Analysis of STRs					
	2006-2007	2007-2008	2008-2009	2009-2010	Total
STR Received	817	1916	4409	5856	12998
Processed	646	2001	4019	5120	11786
Disseminated	391	935	2270	3154	6750
Law Enforcement Agencies	338	885	2319	3115	6657
Intelligence Agencies	60	49	90	103	302
Regulators & others	30	34	41	90	195
Total	**428**	**968**	**2450**	**3308**	**7154**

Details of STRs disseminated to various agencies					
Agency	2006-2007	2007-2008	2008-2009	2009-2010	Total
Directorate of Enforcement (ED)	35	68	90	132	325
Central Board of Direct Taxes (CBDT)	254	677	1766	2 520	5 217
Central Board of Excise and	10	14	26	27	77
Customs (CBEC), Directorate of Revenue Intelligence (DRI) and Directorate General of Central					
Excise Intelligence (DGCEI)					
Narcotics Control Bureau (NCB)	3	2	1	15	21
Ministry of Home Affairs (MHA) and Intelligence Agencies	58	51	97	104	310
Ministry of Company Affairs (MCA), Serious Fraud Investigation Office (SFIO)	6		5	5	16
Central Bureau of Investigation (CBI)	24	83	46	37	190
State Governments	12	42	378	413	845
Reserve Bank of India (RBI)	1	2	5	15	23
Securities and Exchange Board of India (SEBI)	27	35	30	47	139
Insurance Regulatory and Development Authority of India (IRDA)		1	6	4	11
Others		6	4	3	13
Total	**430**	**981**	**2 454**	**3 322**	**7 187**

Appendix 4.5

Total Number of Currency Declaration Forms (CDFs)					
2005-2006	**2006-2007**	**2007-2008**	**2008-2009**	**2009- 2009**	**Total**
8310	8592	10064	9573	4960	41499

Appendix 4.6

Fines imposed under FEMA and Customs Act in cases of non declaration or misdeclaration of currency				
Financial year	**No. of cases involving non declaration or misdeclaration of currency**	**Value of foreign currency in ₹**	**Redemption fine imposed in ₹**	**Personal Penalty imposed in ₹**
2006-2007	68	829000	101000	146000
2007-2008	70	1187000	279000	190000
2008-2009	52	997000	110000	501000

Seizures of Indian and Foreign Currency				
	2007-2008		**2008-2009**	
	No. of cases	**Value in ₹**	**No. of cases**	**Value in ₹**
Indian currency	194	16453500	255	42976570
Foreign currency	552	111578950	606	76840990

Appendix 6.1

UNITED STATES OF AMERICA OFFSHORE VOLUNTARY DISCLOSURE PROGRAM (OVDP), 2009

Introduction to the Scheme

This scheme serves two purposes

a. To bring taxpayers those have used undisclosed foreign accounts and undisclosed foreign entities to avoid or evade tax into compliance with tax laws.
b. Information gathered to be used to further improve the understanding of how foreign accounts and foreign entities are promoted as ways to avoid tax. Also to develop additional strategies to prevent promoters and facilitators from lobbying new clients.

Internal Revenue Service (IRS) also has a Voluntary Disclosure Practice, under which it takes into account the timely, accurate and complete voluntary disclosures made by the taxpayer, in deciding whether to recommend or not to the Department of Justice for criminal prosecution.

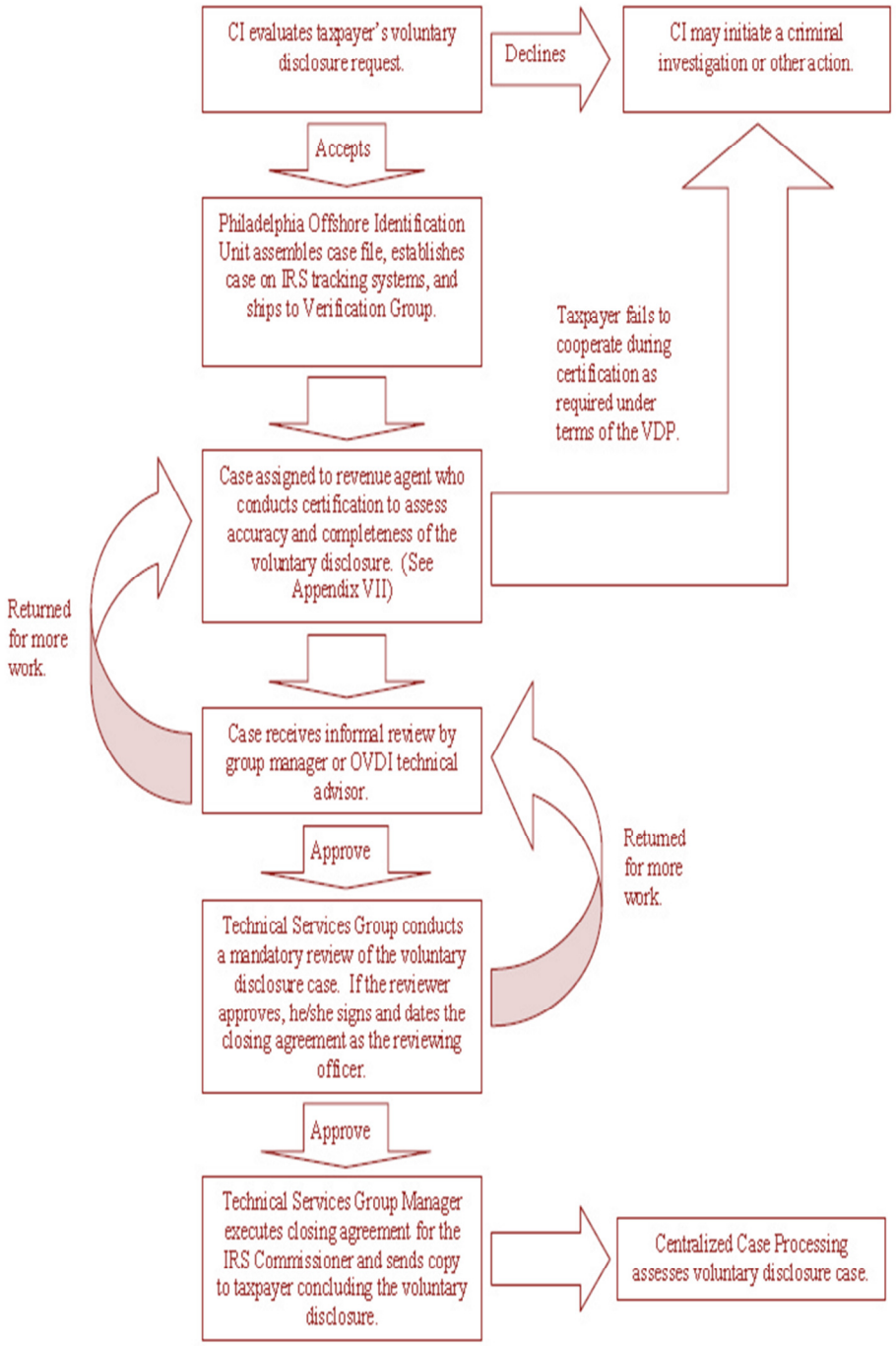
Features of the Scheme

Any taxpayer taking benefit under this scheme will have to comply with the following conditions

- File a tax return, if not filed, or amend any inaccurate returns filed during the previous 6 years i.e., 2003 – 2008.
- The following forms must be filed
  1. Copies of original and amended federal income tax returns for tax period covered by the voluntary disclosure;
  2. Complete and accurate amended federal income tax returns for all tax years covered by the voluntary disclosure;
  3. An explanation of previously unreported or underreported income or incorrectly claimed deductions or credits related to undisclosed foreign accounts or undisclosed foreign entities, including the reason(s) for the error or omission;
  4. Complete and accurate amended information returns required to be filed by the taxpayer for all tax years covered by the voluntary disclosure, for which the taxpayer requests relief; and
  5. Complete and accurate details for foreign accounts maintained during calendar years covered by the voluntary disclosure.

- Payment to be made
  1. Tax on income @ 35% plus interest,
  2. An accuracy-related penalty @ 20% on amount of tax payable, and
  3. An additional penalty @ 20% of the highest aggregate balance in foreign bank accounts/ entities or value of foreign assets during the period covered by the voluntary disclosure.
- Benefits of the scheme If the taxpayer is not covered under this scheme, then following are the possible liabilities for the taxpayer
  1. The tax and accuracy-related penalty, plus interest, as described above.
  2. Report of Foreign Bank and Financial Accounts (FBAR) penalties for wilful failures to file complete and correct information can be as high as the greater of $100,000 or 50% of the total balance of the foreign account per violation.
  3. Potential of having fraud penalty applicable @ 75%,
  4. Non-wilful violations that the IRS determines were not due to reasonable cause are subject to a $10,000 penalty per violation,
  5. The potential of substantial additional information return penalties if the foreign account or assets is held through a foreign entity such as a trust or corporation and required information returns were not filed, and
  6. Criminal prosecution leading to criminal charges and civil penalties.
- Taxpayers have to cooperate in the voluntary disclosure process, including providing information on offshore financial accounts, institutions and facilitators, and signing agreements to extend the period of time for assessing liabilities and FBAR penalties.
- TheVoluntary Disclosure Practice requires an accurate and complete disclosure. Consequently, if there are undisclosed income tax liabilities from domestic sources in addition to those related to offshore accounts and assets, they must also be disclosed in the OVDP.
- The terms of this program require the taxpayer to pay the tax, interest, and accuracy-related penalty, and, if applicable the failure to file and failure to pay penalties with their submission. However, it is possible for a taxpayer who is unable to make full payment of these amounts to request the IRS to consider other payment arrangements.

Offshore Voluntary Disclosure Program Steps



Source Treasury Inspector General for Tax Administration's report on The 2009 Offshore Voluntary Disclosure Initiative

Offshore Voluntary Disclosure Initiative (OVDI), 2011

Introduction to the Scheme

This scheme was a follow up for the Offshore Voluntary Disclosure Program, 2009. Most of the objective, features, procedures and conditions of the scheme remained unchanged from Offshore Voluntary Disclosure Program introduced in the year 2009.

Features of the Scheme

The conditions to be fulfilled and the procedure that had to be followed was same as in the case of Offshore Voluntary Disclosure Program, 2009. The following were the differences between the schemes

- A period of 8 years was covered under the scheme. i.e., 2003 – 2010
- The additional penalty, which was previously levied @ 20% was raised to 25%,
- Special cases for applicability of reduced penalty
    1. In case of taxpayers whose highest aggregate account balance (including the value of foreign assets) in each of the years covered under the scheme is less than $75,000, then the penalty will be levied at a reduced rate of **12.5%**.
    2. Taxpayers making voluntary disclosures who fall into one of the three categories described below will qualify for a **5%** offshore penalty
- Taxpayers who meet all four of the following conditions
    (a) Did not open or cause the account to be opened (unless the bank required that a new account be opened, rather than allowing a change in ownership of an existing account, upon the death of the owner of the account);
    (b) Have exercised minimal, infrequent contact with the account;
    (c) Have, except for a withdrawal closing the account and transferring the funds to an account in the United States, not withdrawn more than $1,000 from the account in any year for which the taxpayer was non-compliant; and
    (d) Can establish that all applicable U.S. taxes have been paid on funds deposited to the account (only account earnings have escaped U.S. taxation).
- Taxpayers who are foreign residents and who were unaware they were U.S. citizens.
- Taxpayers who are foreign residents and who meet all three of the following conditions for all of the years of their voluntary disclosure
    (a) Taxpayer resides in a foreign country;
    (b) Taxpayer has made a good faith showing that he or she has timely complied with all tax reporting and payment requirements in the country of residency; and
    (c) Taxpayer has $10,000 or less of U.S. source income each year.

Offshore Voluntary Disclosure Scheme, 2012

Introduction to the Scheme

IRS launched the new Offshore Voluntary Disclosure Program 2012 to bring back the unaccounted illicit income into the country.

The IRS's prior Offshore Voluntary Disclosure Program (2009 OVDP), and Offshore Voluntary Disclosure Initiative (2011 OVDI) demonstrated the value of a uniform penalty structure for taxpayers who came forward voluntarily and reported their previously undisclosed foreign accounts and assets. These initiatives enabled the IRS to centralize the civil processing of offshore voluntary disclosures and to resolve a very large number of cases without examination.

Features of the Scheme

- The 2012 OVDP has a higher penalty rate than the previous program of 27.5%, but offers clear benefits to encourage taxpayers to disclose foreign accounts now rather than risk detection by the IRS and possible criminal prosecution.
- Unlike the 2009 OVDP and the 2011 OVDI, there is no set deadline for taxpayers to apply.
- It demonstrates the value of a uniform penalty structure for taxpayers who come forward voluntarily and reported their previously undisclosed foreign accounts and assets.
- The terms of this program could change at any time going forward. For example, the IRS may increase penalties or limit eligibility in the program for all or some taxpayers or defined classes of taxpayers – or decide to end the program entirely at any point
- United States citizens, residents and certain other persons must annually report their direct or indirect financial interest in, or signature authority (or other authority that is comparable to signature authority) over, a financial account that is maintained with a financial institution located in a foreign country if, for any calendar year, the aggregate value of all foreign accounts exceeded $10,000 at any time during the year.
- Taxpayers must also report various transactions involving foreign trusts, including creation of a foreign trust by a United States person, transfers of property from a United States person to a foreign trust and receipt of distributions from foreign trusts. This return also reports the receipt of gifts from foreign entities. The penalty for failing to file each one of these information returns, or for filing an incomplete return, is the greater of $10,000 or 35% of the gross reportable amount, except for returns reporting gifts, where the penalty is 5% of the gift per month, up to a maximum penalty of 25% of the gift.

- United States persons who are officers, directors or shareholders in certain foreign corporations (including International Business Corporations) are required to report information to IRC.
- Taxpayers are required to report transfers of property to foreign corporations and other information.

Outcome of the Schemes

Although the details of the outcome of these schemes are not available individually, the Internal Revenue Service has issued a statement on 26 June, 2012 outlining the success of the schemes. The following are the facts and figures given in the statement

a) The offshore voluntary disclosure programs have so far resulted in the collection of more than $5 billion in back taxes, interest and penalties

b) Number of disclosures made under the first two programs, i.e., Offshore Voluntary Disclosure Program, 2009 and Offshore Voluntary Disclosure Initiative, 2011, is 33, 000. In addition, another 1, 500 disclosures have been made under Offshore Voluntary Disclosure Scheme, 2012 announced in January.

Conclusion

From the above it can be concluded that bringing to tax the funds stashed abroad in tax havens is a complex task for any country's government and cannot be achieved by one single formula. Although the Offshore Voluntary Disclosure Schemes are a good way to bring to tax the unaccounted wealth stashed abroad by providing a uniform penalty structure for taxpayers who voluntarily come forward.

The above study gives an overview of different schemes adopted by the UK and USA for bringing to tax the unaccounted money and assets kept in tax havens by citizens of the countries for the purpose of avoiding tax liabilities. The results of the scheme were as per the targets set by the tax departments of the respective countries. But still, the collection of the tax made under these schemes was nothing when compared with the overall tax collection by the government of the countries.

Hence, other than these corrective measures adopted by the countries, government should implement other preventive measures which create an atmosphere where tax evaders who have their funds stashed in tax havens are induced to bring back their funds and pay the taxes on the same.

UNITED KINGDOM
OPTIONAL DISCLOSURE FACILITY (ODF), 2007

Introduction to the Scheme

Her Majesty's Revenue and Customs (HMRC) obtained a large amount of very detailed information relating to offshore bank accounts held by individuals living in the UK

i. From 5 major UK banks that included **Barclays Bank, HSBC, Royal Bank of Scotland, Holding company for Bank of Scotland (HBOS) and Lloyds TSB** after a landmark court decision in the UK against Barclays Bank which allowed HMRC to access the computer banking records of British banks holding offshore banking records in mainland Britain

ii. Under the EU savings directive.

To tackle the sheer quantity of information which became available, HMRC introduced this fast-track procedure to settle the outstanding liabilities of individuals with a guaranteed level of penalty.

Features of the Scheme

1. Intended to give taxpayers who have not declared income associated with an offshore account a fast-track method of settling their outstanding liabilities with a guaranteed 10% penalty level.
2. Not an amnesty, but a facility designed to help people come forward and pay any arrears of tax and not intended to allow taxpayers to escape paying any liabilities which are legally due.
3. Facility involved a two-part procedure, each governed by its own time limits

Notification of intention to disclose

- Simple process to get the taxpayer into the system and issue a disclosure reference number
- Only very basic information (name and address, etc.) required
- Does not commit the taxpayer to disclose anything

Make the Discloser

- Make a full disclosure of all outstanding liabilities for the past 20 years
- Taxpayer required entering into a formal contract settlement and signing a declaration that the disclosure is, to the best of his knowledge and belief, correct and complete.
- Provide details of offshore accounts relevant to the disclosure.

4. HMRC then did an in-depth audit of the supporting documents and accuracy of the figures before accepting or rejecting the disclosure.
   i. If disclosure accepted, that is the end of the matter
   ii. If not accepted, a formal enquiry or other form of intervention opened in the usual way
1. Payment to be made
   i. Taxes due at normal rates
   ii. Interest on late payment
   iii. Penalty @ 10% (No penalty if amount due is less than £1000)

Outcome of the Scheme

Yield generated from ODF Settlements	£ 400 million
Yield generated from follow up activity for ODF	£ 98 million

Enquiries that are still open are being pursued to conclusion.

New Disclosure Facility (NDO), 2009

Introduction to the Scheme

The 2009 New Disclosure Facility (NDO) was designed to provide one final opportunity for UK based individuals and businesses, with unpaid tax linked to an offshore account or asset, to make a disclosure and put their affairs in order.

Features of the Scheme

This scheme was a follow up scheme to the Offshore Disclosure Facility introduced in 2007 and process was similar.

The only difference being that penalty of 10% is to be offered for full disclosure in cases where there was 'no previous opportunity' but the taxpayers who did not disclose under the ODF may do so under the NDO with unpaid tax attracting penalties at a rate of 20%.

Outcome of the Scheme

Yield generated from NDO Settlements	£ 85 million
Yield generated from follow up activity for NDO	£ 12 million
Number of Disclosures	5, 500

Liechtenstein Disclosure Facility (LDF), 2009-2016

Introduction to the Scheme

The Government of Liechtenstein has committed to introduce a taxpayer assistance and compliance programme under which financial intermediaries in Liechtenstein will need to be satisfied that, where appropriate, clients are declaring Liechtenstein investments to HMRC.

Features of the Scheme

The facility has been introduced to help UK taxpayers with undeclared investments in Liechtenstein to come forward and get their past and future tax affairs on the right footing. By coming forward under LDF, they will be able to take advantage of a number of special terms

- a 10% fixed penalty on the underpaid liabilities (full interest will have to be paid)
- no penalty where an innocent error has been made
- assessment period limited to accounting periods/tax years commencing on or after 1 April 1999
- the option to choose whether to use a single composite rate of 40 per cent or to calculate actual liability on an annual basis
- assurance about criminal prosecution
- single point of contact for disclosures

Payment to be made

1. Taxes due at normal rates or composite rate option of 40%
2. Interest on late payment
3. Penalty @ 10% (@20% if previously covered under ODF and no penalty if unpaid liability disclosed is less than £1000)

Outcome of the Scheme

Yield Generated from LDF Settlements	£ 330 million
Payments made in LDF cases not yet settled	£ 92 million
Number of Disclosures	1, 874

Upto July 2012

Appendix 6.2

UNITED KINGDOM – SWITZERLAND DEAL

In May 2013, UK savers with accounts in Switzerland will be faced with the prospect of having to make a one-off payment to HMRC (19-34 per cent of their accounts), or allowing information about their accounts to be handed over.

The purpose of making the one-off payment is to allow those who had not declared the account previously to HMRC to make good their past tax liabilities, but without having to reveal their identities. This "anonymous" option is at the heart of the Swiss strategy for negotiating tax agreements with other countries – it is seen by the Swiss banking community and Government as the best way to preserve the financial privacy of their clients while at the same time ensuring that they are tax compliant.

From 2013, UK savers with accounts in Switzerland will have to choose between a forced withholding tax, or having their invisibility cloak lifted and information about their accounts disclosed to HMRC. If they choose the withholding tax option, UK savers will face tax at a rate just under the current top rate of tax in the UK (at 48 per cent for income, 40 per cent for dividends and 27 per cent for capital gains). These lower levels have been justified as the tax will be deducted earlier than it would normally be due. If the saver opts for this withholding tax, HMRC will consider it quits and clients will not have to provide any more information.

Savers with a Swiss account that have vigilantly declared it to HMRC in the past of course will not need to pay either the one-off payment in 2013 or future withholding tax. To make sure of this, they will need to agree to allow their bank to exchange information with HMRC. HMRC is likely to use this information to check whether a UK taxpayer has been properly paying tax in relation to their Swiss accounts

THE GERMAN INITIATIVE

i. Swiss bank secrecy – which has helped the country build a $2-trillion offshore financial centre – has come under heavy pressure in recent years as cash-strapped governments have sought to fight tax evasion.

ii. Citizens of neighbouring Germany have an estimated 150 billion Swiss francs ($203 billion) hidden in secret accounts.

iii. Germany is one of the first countries to have a deal that can set a model for agreements between Switzerland and other countries. Existing funds will be taxed at a rate between 19 and 34 per cent, based on how long the money has been stashed away and the rate of capital gains. Future investment income and capital gains will be taxed at a rate of 26.375 percent, in line with the current flat-rate withholding tax in Germany.

iv. Switzerland's two biggest banks -- UBS (UBSN.VX) and Credit Suisse (CSGN.VX) -- welcomed the deal, but Thomas Eigenthaler, head of the German tax trade union, slammed the deal stating that "The retroactive tax actually presents a discount (to taxes in Germany) and is a slap in the face of tax payers who were honest and always paid the full rate, and it will also be a big disappointment for those who actually denounced themselves as evaders and had to pay a higher rate," .

v. By introducing a withholding tax on income at source, the deal allows Switzerland to preserve most client confidentiality and head off the automatic exchange of information, which the European Union has been trying to deepen in the bloc.But Switzerland has agreed to cooperate more readily in the hunt for tax cheats in exchange for Germany's agreement not to buy any more stolen bank data, an issue which had soured ties. Germany also agreed not to take legal action against the employees of Swiss banks.German officials will be allowed to put in 750-999 requests with their Swiss counterparts in a two-year period, if they have good grounds to suspect cases of tax dodging, but will not be able to pursue any large-scale "fishing expeditions."

vi. To ensure Germans step forward and settle their bills with the tax man, Swiss banks will have to pay 2 billion francs up front, much less than some figures that had been circulated which were seen as too much for the big banks to bear.

vii. UBS and Credit Suisse will probably fork out the bulk of the payment, with the remainder coming from smaller players. The aim is for the banks to be credited if their clients step forward.

viii. The SBA estimates the deal hands Swiss banks a compliance bill in the mid-three-digit millions of francs. Swiss banks have also come into the crosshairs of U.S. authorities. In 2009, the Swiss government cut a deal with Washington to hand over the details of 4,450 UBS accounts in return for the dropping of a damaging lawsuit against the bank.

Switzerland – Austria Tax Deal

Switzerland has also struck deals with Austria to tax their citizens' accounts without revealing their identities, which it hoped would be blueprints for other countries in Europe, including Greece and Italy. Credit Suisse Group could see clients in Western Europe withdraw up to a net $37-billion (U.S.) in the next few years as Switzerland bows to pressure to stop foreigners using secret offshore accounts to evade taxes.

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