

**Tax System Reform in India:
Achievements and Challenges Ahead**

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ABSTRACT

Indian tax system evolved to conform to the public sector dominated import substituting industrialisation for almost 45 years after independence had to be reformed to facilitate the liberalised open economy. This has necessitated reorientation of the tax system from being merely a revenue instrument which was often selective, discretionary, differentiated and confiscatory to the one that is revenue and at the same time, minimises resource distortions. The problem of reforming the tax system since economic liberalisation was initiated was compounded by the need to raise revenues in the short run and enhance revenue productivity in the medium term to contain large persisting fiscal deficits and imperatives to offset revenue losses from reductions in import duties.

Tax reform in India has borne the domestic brand. Yet, in many ways, it resembles the best practice approach of broadening the base, reducing the rates, reducing rate differentiation and keeping the system simple. It has come a long way from the narrow based, complicated and confiscatory structure that thwarted the incentives to the one that is far more efficient. Despite flip flop from year to year, the thrust and direction of reforms have been to improve revenue productivity while minimising distortions. The last few years have also seen emphasis on improving the tax administration and information system. The reform to convert the state level sales tax into a destination based VAT this year is a major initiative.

Despite reforms in the last decade and a half, considerable distance has yet to be covered for making the tax system broad-based, productive and efficient. In corporate tax, excise, customs and sales taxes, almost 40 per cent of revenue comes from diesel and petrol. This lopsided revenue generation has efficiency costs. The personal income tax continues to be narrow based. The improvement in revenue productivity although is often attributed to reduction in the marginal tax rates, was more due to the administrative measure of extending the scope of tax deduction at source than better compliance from lower rates. Reform in the sales tax has only just begun and in some ways design of the state VAT leaves much to be desired. Besides, phasing out the central sales tax and other impediments to the common market are the major challenges yet to be faced. The recent reforms in tax administration have brought in a lot of hope in improving revenue productivity and improving horizontal equity and, hopefully, that will provide the elbow room necessary for calibrating future reforms.

Tax System Reform in India: Achievements and Challenges Ahead

“Just as it is impossible not to taste honey or poison that one may find at the tip of one’s tongue, so it is impossible for one dealing with the government funds not to taste, at least a little bit, of the King’s wealth.” (Kautilya, Arthashastra).

I. Introduction

Reforming the tax system is critical to achieve fiscal consolidation, minimise distortions in the economy and to create stable and predictable market environment for the markets to function. Not surprisingly, the wave of tax reforms across the world that began in the mid 1980s accelerated in the 1990s motivated by a number of factors. In many developing countries, tax policy was used as the principal instrument to correct fiscal imbalances (Ahmad and Stern, 1991). In others, the transition from centralised planning to market required wide ranging tax reforms. Besides efficiency considerations, these tax reforms had to address the issue of replacing public enterprise profits with taxes as a principal source of revenue and aligning tax policy to the development strategy. An important reason, however, was internationalisation of economic activities. The sharp reduction in tariffs accompanying globalisation required that an appropriate source of revenue to replace this had to be found. On the other, globalisation emphasised the need to minimise both efficiency and compliance costs of the tax system.

The reforms in Indian tax system in some respects are unique. Unlike most developing countries which were guided in their tax reforms by multilateral agencies, Indian tax reforms have borne the domestic brand largely in response to changes in the development strategy over time while keeping in tune with the institutional arrangements in the country. Thus, even when the government sought assistance from multilateral financial institutions, the recommendations of these institutions did not directly translate into an agenda for tax reform. Despite this, the tax system reforms were broadly in conformity with international trends and advice proffered by the expert groups and was in tune with international best practices.¹

Over the years, tax policy in the country has evolved in response to the development strategy and its changes. In the initial years, the tax policy was directed to

increase the level of savings, transfer available savings for investment as envisaged by plan strategy and the need to ensure a fair distribution of incomes, to correct inequalities arising from the oligopolistic market structure created by the co-existence of private and public sector and the existence of other instruments of planning such as licensing system, exchange control, administered price determination (Bagchi and Nayak, 1994).

The role of history and institutions in the country was also important in shaping the tax system. Indeed, the assignment system in the federal polity has impacted on the tax structure and administration. This has also made encompassing, comprehensive and co-ordinated tax reforms difficult. The system of planning also introduced selectivity and discretion in tax structure and its implementation. This eroded the tax base further, created special interest groups and introduced 'negotiated settlement' in the tax system. Again, in a closed economy, inefficiencies did not matter and relative price distortions and disincentives did not warrant much consideration in the calibration of tax policy.

The Indian tax reform experience can provide useful lessons for many countries due to the largeness of the country with multilevel fiscal framework, uniqueness of the reform experience and difficulties in calibrating reforms due to institutional constraints. These, by themselves, are important enough reasons for a detailed analysis of the tax system in India. Unfortunately, unlike in many developed countries where major tax reform initiatives were followed by detailed analysis of their impact, there are no serious studies analysing the economic impact of tax reforms in India².

This paper analyses the Indian tax system involving its structure as well as operations. In section 2, the evolution of Indian tax system and the impact of historical and institutional factors in shaping Indian tax policy are discussed. The trends in tax revenue are presented in Section 3 and these point towards a relative stagnancy and deceleration in tax revenues at both Central and State levels. Section 4 analyses the reasons for the stagnancy in revenues at Central and State levels. This is followed by an exploratory discussion on the possible efficiency and equity implications of tax system. The final section presents directions for further reforms.

II. *Evolution of Indian Tax System:*

II.1 The assignment system:

The constitutional assignment of tax powers provided the basic framework for the tax system in independent India. The tax assignment followed the principle of separation. It assigned the major broad based and mobile tax bases to the Centre. These are taxes on non-agricultural incomes and wealth, corporation tax, customs duties and excise duties on manufactured goods. States' tax powers include taxes on agricultural incomes and wealth, sales taxes, excises on alcohol, taxes on motor vehicles, passengers and goods, stamp duties and registration fees on transfer of property and taxes and duties on electricity. Of these, sales tax is the most important and contributes 60 per cent of states; tax revenue. They also have powers to levy taxes on entertainment, taxes on professions, trade, callings and employment and these have been either exercised by the states themselves or have been assigned to local bodies. The state list also includes property tax and tax on the entry of goods into a local area for consumption, use or sale and these have been assigned to local bodies.

The evolution of tax policy within the framework of public sector based, heavy industry dominated, import substituting industrialisation strategy has had several implications. First, tax policy was directed to raise resources for large resources for public consumption and investment without regard of efficiency implications. Second, the objective of achieving socialistic pattern of society on the one hand and the attempt to tax large oligopolistic rents generated by the system of licences, quotas and restrictions on the other called for a steeply progressive tax structure. Third, pursuit of multiplicity of objectives complicated the tax system with adverse effects on both efficiency and horizontal equity. This also opened up large avenues for evasion and avoidance of taxes. Fourth, the above considerations complicated the tax system and selectivity and discretion became a legitimate part of the tax policy and administration. Fifth, the influence of special interest groups, changing priorities and lack of information system and scientific analysis led to ad hoc and often, inconsistent calibration of policies. Finally, poor information system was both the cause of selective application of the tax system and its effect.

II.2 History of Tax reforms

The systematic attempt to evolve a tax system in independent India started with the implementation of the report of the Taxation Enquiry Commission (India, 1953). In fact, this is the first comprehensive attempt to review the tax system. This provided the backdrop for the generation of resources for the Second Five Year Plan (1956-60), and was required to fulfil a variety of objectives such as raising the level of savings and investment, effecting resource transfer from private to public sector and achieving a desired state of redistribution. It was a comprehensive attempt to design the tax system for the country and covered central, state as well as local taxes.

Since then, there have been a number of attempts, most of them partial, to remedy various aspects of the tax system. Given that in the early 1950s the level of saving was just about 10 per cent of GDP, the expenditure tax was levied on the recommendation of Kaldor Committee (India, 1956) as a measure to curb consumption. However, this had to be withdrawn in 1957-58 as it did not generate the expected revenues. With the adoption of planned development strategy in a mixed economy framework, raising more resources and achieving the desired state of redistribution became an obsession and this caused the policy makers to design the income tax system with confiscatory marginal rates. The consequent disincentives and high rate of return on tax evasion, low probability of detection and the ineffective legal system that failed to impose penalty within a reasonable time period, led the Direct Taxes Enquiry Committee (India, 1971) to recommend significant reduction in marginal tax rates. On the indirect taxes side, a major simplification exercise was attempted by the Indirect Taxes Enquiry Committee (India, 1977), though its implementation was not initiated until 1986.

Systematic and comprehensive attempts to reform the tax system at the central level started only after market based economic reforms were initiated in 1991. The Tax Reforms Committee (India, 1991) laid out a framework and a roadmap for reform of direct and indirect taxes as a part of the structural reform process, following the unprecedented economic crisis. The paradigm of reform adopted by the TRC was in keeping with the best practice approach of broadening the base, lowering marginal tax

rates, reducing rate differentiation, simplifying the tax structure and adopting measures to make the administration and enforcement more effective. The reforms were to bring about revenue neutrality in the short term and enhance revenue productivity in the medium and long term. The overall thrust of the TRC was to (i) decrease the share of trade taxes in total tax revenue; (ii) increase the share of domestic consumption taxes by transforming the domestic excises into VAT and (iii) increase the relative contribution of direct taxes.

The important proposals put forward by the TRC included reduction in the rates of all major taxes, i.e., customs, individual and corporate income taxes and excises to reasonable levels, maintain progressivity but not such as to induce evasion. The TRC recommended a number of measures to broaden the base of all the taxes by minimising exemptions and concessions, drastic simplification of laws and procedures, building a proper information system and computerisation of tax returns, and revamping and modernisation of administrative and enforcement machinery. It also recommended that the taxes on domestic production should be fully converted into a value added tax, and it should be extended to the wholesale level in agreement with the States, with additional revenues beyond post-manufacturing stage passed on to the State governments.

The analytical basis for the reform in the new millennium was provided by task force reports on the reform of direct and indirect taxes (India, 2002) and the report of the task force on the implementation of the Fiscal Responsibility of Budget Management Act, 2003 (India, 2004). In many ways the reform since 1991, with emphasis on simplicity and efficiency make marked departure from the past. In fact, the task force reports build on the recommendations of the TRC.

Reform of Direct Taxes:

At the central level, the income tax was evolved as a principal instrument to bring about redistribution until mid 1970s. Thus, in 1973-74, the personal income tax had eleven tax slabs with rates monotonically rising from 10 per cent to 85 per cent. When the surcharge of 15 per cent was taken into account, the highest marginal rate for persons

above Rs. 200,000 income was 97.5 per cent. Combined with the highest wealth tax rate of 5 per cent, the total tax payable at the highest bracket was more than 100 per cent.

In the case of company taxation, the classical system of taxation involved the taxation of the profits in the hands of the company and the dividends in the hands of the shareholders. The distinction was made for widely held companies and different types of closely held companies and the tax rate varied from the base rate of 45 per cent to 65 per cent in the case of some widely held companies. Although nominal rates were high, the effective rates were substantially lower due to generous tax preferences such as depreciation and investment allowance. In fact some companies were able to make use of generous tax preferences to bring down tax liability to zero.

The Direct Taxes Enquiry Committee (India, 1971) attributed the large scale tax evasion to the confiscatory tax rates and in keeping with its recommendation marginal rates were reduced to 77 per cent including the surcharge. The highest marginal rate was further brought down to 66 per cent and the highest wealth tax rate was reduced from 5 per cent to 2.5 per cent in 1976-77. However in 1979-80, the surcharge on income tax was increased as also the wealth tax rates reached the maximum of 5 per cent. The major simplification and rationalisation initiative, however, was in 1985-86 when the number of tax slabs were reduced from eight to four and the highest marginal tax rate was brought down to 50 per cent and wealth tax rates to 2.5 per cent.

The last wave of reforms in personal income taxation was initiated on the basis of the recommendations of the Tax Reform Committee (India, 1991). The tax rates were considerably simplified to have three slabs beginning with a rate of 20 per cent, a middle rate of 30 per cent and the maximum rate of 40 per cent in 1992-93. The financial assets were excluded from wealth tax and the maximum marginal rate was reduced to one per cent. Further reduction came in 1997-98 when, the three slab rates were brought down further to 10-20-30 per cent. In subsequent years, exigencies of revenue have led to adding surcharge and a two per cent primary education cess on all taxes.

In the case of corporate taxation too, the basic rate was brought down to 50 per cent, and rates applicable to different categories of closely held companies were unified

at 55 per cent. Following the recommendations of TRC, the distinction between closely held and widely held companies was done away with and the tax rates were unified at 40 per cent in 1993-94. In 1997-98, when personal income tax rate was reduced, the company rate was brought down to 35 per cent and the levy of 10 per cent dividend tax was shifted from individuals to companies. The subsequent years have seen lack of direction in the measures adopted. The dividends tax rate was increased to 20 per cent in 2000-01, reduced again to 10 per cent in 2001-02 along with reversal to the classical system of taxing it in the hands of the shareholders and the policy was reversed once again in 2003-04 with the levy of the tax on the company.

A major problem with the is the generous tax preferences. In the case of personal income tax The Advisory Group on Tax Policy and Tax Administration lists the incentives in 25 pages of its report (India, 2001, pp. 125-150) and the Task Force on Tax Policy ad Tax administration also makes a detailed list of these concessions. These include incentives and concessions for savings, for housing, retirement benefits, investment in and returns from certain type financial assets, investments in retirement schemes and income of charitable trusts. There are a variety of tax preferences that have not only distorted the after tax rates of return on various types of investments in unintended ways but also has significantly eroded the tax base.

The major tax preferences in the case of corporate tax were investment allowance and depreciation allowance. In addition, tax incentives were also provided for locating in backward areas. The result of these preferences were that there evolved a set of companies which planned their activities to take full advantage of the generous concessions to fully avoid the tax. This form of tax avoidance by 'zero-tax' companies was sought to be eliminated by introducing the Minimum Alternative Tax (MAT) in 1997-98. Even as companies can take advantage of the tax preferences, they are required to pay a minimum of 30 per cent tax on their book profits. In subsequent years, a provision has been incorporated to allow these companies paying a MAT to take partial credit of MAT against income tax liabilities in following years.

II.1.1. Reform of Indirect taxes:

II.1.1.1. Union Excise Duties:

The structure of excise duties by the middle of 1970s was complex and highly distortionary. Tax structure of tax was a mix of specific and ad valorem, and on the latter alone there were 24 different rates varying from 2 to 100 per cent (excluding tobacco and petroleum products which were taxed at higher rates). In effect, this was a manufacturers' sales tax administered on the basis of goods cleared from the godowns. "Cascading" from the tax resulted not merely from its pre-retail nature but also because it was levied on inputs, capital goods as well as final consumer goods. The tax system was complex and opaque and the detailed analysis by Ahmad and Stern (1983) showed significant variation in the effective rates.

The report of Indirect Tax Enquiry Committee (India, 1977) recommended that conversion of specific duties into ad valorem, unification of tax rates and introduction of input tax credit to convert the tax into a manufacturing stage value added tax (MANVAT), but it was not implemented until 1986-87. Then, all of a sudden the value added tax was implemented in a modified form (MODVAT). This was a strange combination of taxation based on physical verification of goods with provision of input tax credit. The coverage of the credit mechanism too evolved over time - starting with a few commodities, it covered all commodities and incorporated comprehensive credit in by 1996-97. Not surprisingly this piecemeal and gradualist approach led to decline in the tax-GDP ratio after reforms.

Further reform impetus on Excise duties came with the implementation of the recommendations of the TRC. The measures included gradual unification of rates, greater reliance on account based administration. In 1999-00, almost 11 tax rates were merged into three with a handful of "luxury" items subject to two non-vatable additional rates (6 and 16 per cent). These were further merged into a single rate in 2000-01 to be called a Central VAT (CenVAT), along with three special additional excises (8 per cent, 16 per cent and 24 per cent) for a few commodities.

II.1.1.2. Customs Duties:

Contrary to the general patterns seen in low income countries where international trade taxes contribute bulk of the revenues, revenue from this source was not very large in the initial years of independent India (Chelliah, 1986) due to quantitative restrictions on imports. Further, high and differentiated tariffs and setting the rates varying with the stage of production (lower rates on inputs and higher rates on finished goods) and income elasticity of demand resulted in not only high and varying effective rate of protection, but also premium for inefficiency and unintended distortions in the allocation of resources.

By the middle of 1980s, the tariff rates were extremely high and the structure complex. The Long Term Fiscal Policy (LTFP) presented in the Parliament in 1984-85 emphasised the need to reduce tariffs, have fewer rates and greater uniformity and reduce and eventually eliminate quantitative restrictions on imports. However, for reasons of revenue, the tariffs were raised and the weighted average rate increased from 38 per cent in 1980-81 to 87 per cent in 1989-90 (India, 1991). Further, although dismantling of quantitative restrictions began in the latter half of the 1980s, tariffs were kept at high levels. Thus, by 1990-91, the tariff structure was highly complex varying from 0 to 400 per cent, Over 10 per cent of imports were subject to more than 120 per cent. Wide ranging exemptions granted by issuing notifications made the system complex and was a reflection of the influence of various special interest groups on the tax policy.

The recommendation of TRC in regard to the reform of important duties was the weakest. It recommended tariff rates of 5, 10, 15, 20, 25, 30 and 50 to be achieved by 1997-98. The tariff rate was to vary directly with the stage of processing of commodities, and among final consumer goods, with income elasticity of demand (higher rates on luxuries). Excessive rate differentiation (seven rates) and setting degree of protection depending on the stage of processing has been criticised by Joshi and Little (1996, p. 74) when they state, "...this is a totally unprincipled principle, for it has no foundation in economic principles". The proposed tariff structure would have caused high differences in effective rates and provided higher degree of protection to inessential commodities.

The reform of import duties in earnestness actually started in 1991-92 when all duties above 150 per cent were reduced to this level to be called the “peak” rate, which was brought down in the next four years to 50 per cent by 1995-96. Along with relaxation of quantitative restrictions on imports and exchange rate depreciation, the change in the tariffs constituted a major change in the foreign trade regime in the country.

II.1.1.3. Service Tax

An interesting aspect of the assignment system in India is that except in the case of a few specified services assigned to the states such as entertainment tax, passengers and goods tax and electricity duty, the services were not specifically assigned either to the centre or to states. This violated the principle of neutrality in taxing consumption as it discriminated against the goods. As services are relatively more income elastic, the tax system was also rendered less progressive. Even more important argument for taxing services is to enable a co-ordinated calibration of a consumption tax system on goods and services as in the production chain, services enter into goods and vice-versa.

The introduction of tax on services at the central level began in 1994-95 with three services namely, non-life insurance, stock brokerage and telecommunications. The list was expanded in succeeding years to include over 80 services at present. Although initially taxed at 7 per cent the rate was increased to 10 per cent in 2002-03. The Expert Group on Taxation of Services (India, 2001) recommended the extension of the tax to all services along with the provision of input tax credit for both goods and services and subsequently, integration with the central VAT (CENVAT) on goods. However, the government is yet to implement general taxation of services though, input tax credit for goods entering into services and vice versa has been extended.

State level tax reforms:

Tax reforms at the state level have not coincided with those at the centre. While individual state governments tried to appoint committees from time to time and reform their tax structures, there was no systematic attempt to streamline the reform process even after 1991 when market oriented reforms were introduced. Most of the reform attempts

were ad hoc and were guided by exigencies of revenue rather than attempts to modernise the tax system. Indeed, systematic studies were commissioned to show their reform orientation, but the recommendations were hardly implemented³. The pace of tax reforms in the States accelerated in the latter half of the 1990s with increasing pressures on their budgets and, in some cases, due to the conditionalities imposed by multilateral lending agencies or to meet the targets set by the medium term fiscal reforms facility. The major landmark in tax reform at the state level was in simplifying and rationalising the sales tax system the introduction of value added tax in 21 states from April 1, 2005.

Recent Reforms in the tax system

The recent reforms are, in fact, a continuation of the reforms initiated in 1991. In this sense, tax reform in India has been gradual and although not always consistent from year to year, the overall direction has been to broaden the tax bases, reduce the rates, reduce rate differentiation and make the tax system simple and transparent.

As regards the personal income taxes, the rates of personal income tax have remained stable since 1997-98. Thus, the three rates of personal income tax at 10, 20 and 30 per cent have continued till date with some changes in the associated tax brackets. The surcharge at the rate of 5 per cent of the tax payable imposed in the wake of the Kargil war in 2002-03 on all income tax assesseees was discontinued in 2003-04, but a separate surcharge of 10 per cent of the tax payable was imposed on all tax payees having taxable income above Rs. 0.85 million, which was raised to Rs. 1 million in the budget of 2005-06. Although the exemption limit remained at Rs. 50000 since 1998-99, the generous standard deduction, exemption of dividend and interest on government securities upto specified limits effectively increased the threshold substantially. The 2005-06 budget raised the exemption limit to Rs. 100,000 and marginal changes were made in the tax brackets. The exemption limit for women was increased to Rs. 135,000 and for senior citizens, Rs. 150,000. Alongside increasing the exemption limit, the standard deduction was abolished. In addition, savings in superannuating schemes upto Rs. 100,000 was made deductible from the taxable income.

In order to capture perquisites provided by companies to their employees, the Income Tax Act has a provision to assess the value of such identifiable benefits and incorporate the same into the taxable income of the individual. The budget for 2005-06 goes a step further and classifies a range of other expenses by the company, which provide indirect benefits to the entire group of employees. These benefits are to be taxed through a Fringe Benefits Tax, to be paid by the employee at 30 per cent and include a pre-determined proportion of a wide range of expense by the company, including entertainment, conference, employee welfare, sales promotion, including publicity, conveyance, tour and travel, including foreign travel expenses, use of telephone.

In the case of corporate income taxes too the tax structure has remained stable since 1997-98 when the rate was brought down to 35 per cent. On the issue of taxing dividends however, there has been frequent changes and lack of direction. In 1997-98, the 10 per cent dividend tax was shifted from individuals to companies. The rate was increased to 20 per cent in 2000-01, reduced again to 10 per cent in 2001-02 and the tax was shifted back to the shareholders. The policy was reversed once again in 2003-04 with the levy of the tax on the company. In the 2005-06 budget, the corporate income tax was reduced to 30 per cent on domestic companies. A surcharge of 10 per cent is also chargeable. The depreciation rate, however, has been reduced to 15 per cent in the case of general plant and machinery, but initial depreciation is set at 20 per cent, thereby reducing the overall benefit of reduction in corporate income tax rates.

In the case of import duties, there has been a drastic reduction in both the average and peak tariff rates. In 1990-91, the unweighted average nominal tariff was 125 per cent and peak rate was 355 per cent. These were progressively reduced over the years. Thus, the peak rate was reduced to 30 per cent in 2002-03 and further to 25 per cent in 2003-04. The reform in tariffs was not always consistent, but over the years, the direction has been to reduce the rates and reduce their dispersion. However, the pattern of tariffs with the rates varying with the stage of processing has continued and this has caused very high effective rates on assembling of consumer durable and luxury items of consumption. There is also considerable scope for phasing out exemptions including end use and project based exemptions.

There has been considerable simplification and rationalisation of union excise duties as well. Besides reduction in the number of rates, the tax has been progressively converted from specific duties into ad valorem levy. The facility of providing credit on input taxes under the CENVAT too has been progressively extended to cover about 80 per cent of the taxed commodities. The poor information system has been a problem and has led to misuse of input tax credit facility and this has led the government to restrict the CenVAT credit to 95 per cent. At the same time with the inclusion of input tax credit facility to the tax on services a further step was taken in integrating the two taxes.

The most important ongoing reform in recent years is in tax administration. Expansion of the scope of tax deduction at source (TDS) is one of the significant measures to reach the 'hard to tax' groups. Further, every individual living in large cities covered under any one of the six conditions (ownership of house, cars, membership of a club, ownership of credit card, foreign travel, and subscriber of a telephone connection) is necessarily required to file a tax return. While the issue of permanent account numbers (PAN) has been simplified by outsourcing it to the UTI Investors' services Ltd., the work on Tax Information Networking (TIN) has been outsourced to the National Securities Depository Ltd (NSDL). Strengthening the information system through the TIN, its processing and matching the information from various sources on a selective basis is an important initiative, that is likely to improve tax compliance.

By all accounts, there has been considerable simplification and rationalisation of the tax system at the central level in 2005 although these reforms are neither uniform nor consistent and is the system far from being perfect (Acharya, 2005). There are still areas requiring reforms and these will be discussed later.

Reforms in State tax systems:

The most important reform initiative in the case of the States is the replacement of the cascading type sales tax with the state level VAT. While significant progress has been made in converting central excise duties into a manufacturing stage VAT, the reform in the states' sales tax systems has lagged behind. This is critical for minimising

distortions, for they contribute over 60 per cent of states' tax revenues and to evolve a co-ordinated consumption tax system in the country.

A systematic discussion on co-ordinated consumption tax system was initiated in the Report on Reform of Domestic Trade Taxes in India prepared by the NIPFP (1994). The report favoured the conversion of the prevailing sales taxes to VAT parallel to the central manufacturing stage VAT. There are a number of arguments for replacing the prevailing state sales tax with destination based VAT. Therefore, the decision to transform the states' sales tax systems into a destination based retail stage VAT from April, 2005 is opportune. However, the reform in April, 2005 is only a transitional measure; it extends the sales tax up to the retail stage with credit allowed of taxes paid on purchases for all intra-state purchases. Inter-state sales tax will continue to be levied until it is phased out in the next two years.

The VAT reform adopted in April 2005, levies the tax at two rates namely, 4% and 12.5% (except for bullion and specie and precious metals, which are taxed at 1%). Basic necessities (about 75 items) are exempted. Petrol and diesel (which contribute about 40% of sales tax) are kept outside the VAT regime and a floor rate of 20% sales tax will be levied on them. All dealers upto Rs. 500,000 are exempted. Those with the turnover above Rs. 500,000 but below Rs. 5 million will be required to pay the simplified tax at 2 per cent of the turnover, but they do not constitute a part of the VAT chain unless they voluntarily register and pay the tax at the prescribed rates. The regular VAT dealers are those above Rs. 5 million turnover and they are required to register for VAT. They may, however, voluntarily register as regular VAT dealers

As mentioned earlier, the tax credit mechanism operates in full only in the case of intra-state sale. In inter-state transactions, the exporting state is supposed to give input tax credit for purchases made locally, against the collection of CST. The tax credit of CST in the importing state, or other mechanisms of zero-rating of inter-state sales, will be extended after two years when the CST in its present form will be phased out. In the mean time, information system for inter-state trade will be built up and ICICI Infotech has been contracted to undertake the task.

III. Trends in Indian Tax Revenues

This section presents an analysis of the trends in tax revenue in India. The paper focuses on the changes in the level and composition of tax revenue since 1991 when systematic reforms were set in motion. The analysis shows that despite initiating systematic reforms, the revenue productivity of the tax system has not shown appreciable increase and the decline the tax ratio due to reduction in customs duty could not be compensated by internal indirect taxes.

The trends in tax revenue in India show four distinct phases (Rao, 2000) (Table 1; Figure 1). In the first, there was a steady increase in the tax-GDP ratio from 6.3 per cent in 1950-51 to 16.1 per cent in 1987-88. In the initial years of planning, increase in tax ratio was necessitated by the need to finance large public sector plans. Thus, the tax ratio increased from a mere 6.3 per cent in 1950-51 to 10.4 per cent in 1970-71 and further to 13.8 per cent in 1980-81. The increase continued until it peaked to 16.1 per cent in 1987-88 (Figure 1). The buoyancy of the tax in later years of the phase was fuelled by the economy attaining a higher growth path and progressive substitution of quantitative restrictions with tariffs following initial attempts at liberalisation in the late 1980s.

The second phase started with the economic recession following the severe draught of 1987 and was marked by stagnancy in revenues until 1992-93. However, triggered by the pay revision of government employees, expenditure-GDP ratio increased significantly after 1988-89 and this caused serious fiscal imbalances leading to the unprecedented economic crisis in 1991 (Table 2). The subsequent adoption of stabilisation of structural adjustment program led to sharp reduction in import duties. Thus, in the third phase, the tax ratio declined from 15.8 per cent in 1991-92 to the lowest level of 13.4 per cent in 1997-98 and fluctuated around 13-14 per cent until 2001-02 even as the deficits continued to be high. The subsequent period has seen attempts to increase the tax ratio to mainly to contain the level of deficits. Thus, tax – GDP ratio increased by over one percentage point in the tax ratio to 15.2 per cent in 2003-04 (revised estimates for the Centre and budget estimates for the states). The aggregate tax –GDP ratio is yet to reach the levels that prevailed before systematic tax reforms were initiated in 1991.

Interestingly, the trends in tax ratios of direct and indirect taxes follow different paths. In the case of the former, the tax ratio remained virtually stagnant throughout the forty year period from 1950 to 1990 at a little over 2 per cent of GDP. Thereafter, coinciding with the reforms marked by significant reduction in the tax rates and simplification of the tax structure, the direct taxes increased sharply to over 4 per cent in 2003-04 and expected to be at about 4.5 per cent in 2004-05. In contrast, much of the increase in the tax ratio during the first 40 years of planned development in India came from indirect taxes, which as a proportion of GDP increased by over three times from 4 per cent in 1950-51 to 13.5 per cent in 1991-92. However, in the subsequent period, it declined to about 10.6 per cent before recovering to a little over 11 per cent. The decline in the tax ratio in recent years was mainly due to lower buoyancy of indirect taxes.

Interestingly, fluctuations in the tax ratio are seen mainly at the central level. Central revenues constitute about 60 per cent of the total tax revenues and therefore, fluctuations in central tax ratio impacts significantly on the aggregate tax ratio. The tax ratios at both central and state levels increased sharply during the period from 1950-51 to 1985-86. Thereafter, the tax ratio at the state level was stagnant at about 5.5 per cent until 2001-02 and then increased marginally to 6 per cent in 2003-04. In contrast, the central tax ratio continued to increase and peaked in 1987-88 to remain at that level until the fiscal crisis of 1991-92. In subsequent years, there was a sharp decline until 2001-02 followed by recovery to the pre-1991 level in 2004-05 (revised estimates). Within the central level, the share of direct taxes increased from 20 per cent in 1990-91 to over 43 per cent in 2004-05. As mentioned earlier, the increase in the tax ratio until the end of the 1980s was due to indirect taxes, but in subsequent years increase in direct taxes arrested the sharp decline indirect taxes.

Analysis of Central Taxes

As mentioned earlier, over 60 per cent of aggregate tax collections in the country is effected at the central level as all broad based taxes excluding the sales tax has been assigned to it. Further, since the trends in central taxes have been decisive in determining the overall trends and therefore, it is useful to examine these in greater detail.

Bird (1993), after observing tax reforms in many countries states, "...fiscal crisis has been proven to be the mother of tax reform" and Indian experience fits into this. However, unlike reforms undertaken in response to crises which are often ad hoc and are done to meet immediate exigencies of revenue, tax reform in India was undertaken after a detailed analysis. Interestingly, contrary to expectations, the period after the introduction of reforms has seen decline in the tax-GDP ratio from 10.3 per cent in 1991-92 to 8.2 per cent in 2001-02 at the central level, before it recovered to about 10 per cent in 2004-05. This has prompted many to ask whether the tax reforms caused the decline in the tax-GDP ratio. The contrary view can be that the ratio declined in spite of the reforms.

The disaggregated analysis of the trends in central tax revenue presented in table 3 (Figure 3) shows that sharpest decline in the tax –GDP ratio was in indirect taxes – both customs duties and central excise duty. The former declined by about 1.8 percentage points from 3.6 per cent in 1991-92 to 1.8 per cent in 2004-05 and the decline in the latter was by one percentage point from 4.3 per cent to 3.3 per cent during the period. Interestingly, the tax ratio from both the taxes declined up to 2001-02 and have stabilized at that level and indicators are that while the customs may continue to decline as tariff levels are further brought down, the tax ratio from internal indirect taxes are likely to increase if reforms towards improving the coverage of service tax and its integration with CenVAT is undertaken and significant improvement in tax administration is achieved.

In contrast to indirect taxes, there has been a significant increase in the revenue from direct taxes. In fact, since the reforms were introduced, the direct tax-GDP ratio more than doubled from about 2 per cent in 1991-92 to 4.3 per cent in 2004-05. The increase was seen both in personal income and corporate income taxes, the tax-GDP ratio in the latter increasing by more than three times from 0.9 per cent in 1991-92 to 2.7 per cent in 2004-05. The revenue from personal income tax increased from 0.9 per cent to 1.6 per cent during the period.

The decline in the share of customs revenue is certainly to be expected when the tariff rates are significantly brought down in the wake of external liberalisation. In fact, the decline could have been even faster but for the hesitancy on the part of the Finance

Ministry to reduce the tariffs even more, mainly due to the demands of the domestic industry. To some extent it was expected that increasing imports due to liberalisation will offset the effect of rate reduction. However, increase in imports after liberalisation (Panagariya, 2005) was not enough to balance the revenues.

The declining trend in excise duties throughout the 1980s was due to the fact that the rate structure assumed when input tax credit was allowed was perhaps not revenue neutral. Continued exemption of small scale sector and widespread use of area based exemptions are other important reasons for the decline in the excise duties. In addition, due to poor information system, it was possible to claim excessive input tax credit. Since 1997-98, it is also seen that over 75 per cent of the increase in the GDP is attributable to the growth in the services sector, and the manufacturing sector has been relatively stagnant, implying an automatic reduction in the ratio of taxes on manufacturing base as a percentage of total GDP.

In contrast to indirect taxes, the revenue from direct taxes has shown a steady increase. Revenues from both personal income tax and corporate income tax have increased over the years. The major reason attributed for the increase is the improved tax compliance arising from reduction in marginal tax rates. Of course, there is some independent evidence on the improvement in tax compliance since 1991 (Das-Gupta and Mookherjee, 1997, Das-Gupta, 2002).

Level, Composition and trends in state taxes

Table 4 presents the trends in states' tax revenues. It is seen from the table that the revenue from state taxes as a ratio of GDP was virtually stagnant throughout the 1990s fluctuating around 5 to 5.7 per cent. In fact, from 1994-95, the tax ratio declined to bottom out at 5.1 per cent in 1998-99, the year in which the states had to revise the pay scales exacerbating their fiscal problems. In subsequent years, there has been a steady improvement in the tax ratio to touch 6 per cent in 2003-04.

Of the different state taxes, sales tax is predominant and constitutes about 60 per cent of total state tax revenues. Therefore, not surprisingly, the overall trend in states' tax

ratio follows closely the trends in sales tax revenue. The revenue from sales tax after reaching a low of 3.1 per cent in 1998-99, has increased marginally to 3.5 per cent in 2000-01. It has remained at that level thereafter. Any attempt to improve the revenue productivity of states' tax system has to deal with the reform of sales taxes. Therefore, the recent move towards destination based VAT is extremely important.

State excise duty is a sumptuary tax on alcoholic products. On this, there has always been a problem of balancing regulatory and revenue considerations. The major components of the tax come from arrack, country liquor and 'India Made Foreign Liquor' (IMFL) including beer. The duty collected is by way of licence fee on the sale/auction of vends and taxes on consumption. The problem in regard to country liquor is the brewing and consumption of illicit liquor. This has not only caused loss of revenue, but has been an important health hazard. As regards IMFL, in one of the states it was estimated that actual evasion of the tax may be as high as three times the revenue collected (Karnataka, 2001). The way to deal with this problem has more to do with strengthening the tax administration and information system and less to do with the structure of the tax.

The principal source of stamp duties and registration fees is from the sale of immovable property transactions. The most important problem afflicting this tax is undervaluation of the value of the property transacted. A part of the reason for this lies in the high rates of tax. Undervaluation of immovable property is aided by the lack of organised market. Development of organised market for urban immovable property transactions is hindered by the high rate of stamp duties and registration fees and other policies such as rent control act and urban land ceiling act. In fact, until recently, the tax rates were as high as 12 to 15 per cent on the value of transactions (NIPFP, 1996). Many of the states which reduced the rates have found the typical working of the "Laffer curve" phenomenon and have started reforms to reduce the rates in this direction. In Karnataka for example, the tax rate was reduced from 16 per cent in 2001-02 to 8 per cent in 2002-03 and witnessed 30 per cent growth of revenue from stamp duties during the period.

At the local level there are two taxes of some significance. These are the taxes on property and in some states, Octroi levied by urban local bodies. The major problem

with urban property taxes, like in the case of registration fees is undervaluation. Alternative models of reform – of using the capital value or rental value for valuing the property have been suggested. The ultimate reform depends on the development of organised property. In most cases the recommendations suggested have been to use the guided value determined in some independent manner. As regards Octroi, this check-post based levy is not only impeding internal trade and violating the principle of common market, but also is a source of corruption and rent seeking.

IV. Analysis of the Trends and Economic Impact of the Tax System

In this section, the observed trends in different central and state taxes is explained in greater detail and the possible efficiency and equity implications of different taxes is analysed. Specifically, the analysis seeks to raise a number of questions. These include, has tax compliance improved over the years in response to reduction in marginal tax rates? What other factors influence revenue productivity of the tax system? What are the efficiency and equity implications of the tax system?

IV.1. Personal Income Tax (PIT):

As shown in the previous section, the revenue productivity of the personal income tax has improved after comprehensive tax reform was initiated in 1991. Interestingly, increase in revenue productivity was seen even as the growth of GDP itself decelerated. Therefore, it is natural to attribute the increase in revenue productivity to improvement in tax compliance arising from reduction in marginal tax rates in 1991-92 and 1996-97. While it is inappropriate to explore the statistical significance of the relation between the effective tax rates⁴ and the PIT collections as a proportion to GDP, given the small size of the sample, such an exercise does give a flavour of the sign of the coefficient. Interestingly, the relation appears to be negative, whichever be the reference income group considered, i.e., the decline in the tax rate is associated with an increase in the income tax collections as a ratio of GDP, suggesting some applicability of the Laffer curve. In fact, Dasgupta and Mookherjee (1997) draws some tentative, but important conclusion of improved compliance of the tax system. In a more recent analysis Das-

Gupta (2002) based on 16 different structural, administrative and institutional indicators concludes that the performance of the tax system has shown improvement: tax compliance has indeed improved after the reduction in marginal tax rates.

While the association between tax rates and improvement in tax performance is indisputable, it is not appropriate to attribute improvement in revenue productivity of the personal income tax since 1996-97 solely or even mainly to reduction in the marginal rate of tax. The information presented in Table 5 shows that the main reason for the increase in revenues is the extending the scope of tax deduction at source. The proportion of tax deducted at source (TDS) actually declined from 42 per cent to 22 per cent of total revenue collections in 1994-95, but increased to over 50 per cent in 1996-97 and further to 67 per cent in 2001-02 before declining marginally to 64 per cent in 2003-04. This again is not due to extension of TDS to other incomes, but simply to the increase in the salary component of TDS. The TDS in salaries in 1992-93 constituted only 25 per cent of the total TDS, and it increased to 50 per cent in 1999-2000 before declining to 41 per cent, as TDS from payments to non-residents and to contractors increased substantially. Thus, the trend in TDS suggests that the improved compliance is largely explained in terms of improved coverage or greater effectiveness of TDS as a tool for collecting taxes.

It is important to understand the impact of reduction in the marginal tax rate and reduction in the number of rate categories since 1991-92 on the overall progressivity of the tax system. We have tried to work out the impact of changes in the rate structure on the effective tax rates faced by different income groups over time⁵. This is important since, given indirect taxes are often argued to be lacking in progressivity, the job of delivering progressivity to the tax system is often assigned to personal income tax.

Detailed analysis of effective tax rate on individuals belonging to different income levels shows that the effective tax rates among income tax payers have been converging over the years indicating reduction in progressivity among income tax payers. However, from this it should not be inferred that progressivity has declined and overall equity in the tax system has worsened over the years. Surely in 2003-04, as many as 28.8 million people pay income tax as compared to 3.9 million in 1989-90 and the tax paid by

them now has doubled from less than one per cent of GDP to 2 per cent of GDP. The increase in the number of taxpayers indicates improvement in horizontal equity and the fact that larger proportion of incomes are subject to tax now represents improvement in vertical equity as well (Rao and Rao, 2005).

Corporate Income Tax:

As mentioned earlier, of the four major taxes considered, the revenue from the corporation tax grew at the fastest rate during the 1990s. As a ratio of GDP, the revenue from the tax increased by three times from 0.9 per cent in 1990-91 to 2.7 per cent in 2003-04. This happened in spite of reduction in the rates. The reforms, as discussed earlier, comprised of doing away with the distinction between closely held and widely held companies, reduction in the marginal tax rates to align it with the top marginal tax rate of personal income tax, rationalising tax preferences – investment allowance and depreciation allowance to considerable extent. In addition, the introduction of MAT has also contributed to the revenues.

It would be instructive to analyse the contribution of different sectors to corporation tax revenue. The analysis of data in the sector-wise contribution of corporation tax from the prowess database⁶ which accounts for about two-thirds of the corporate tax collections shows that the manufacturing sector in 2004-05 paid about 40 per cent of the tax. Within this sector, the petroleum sector contributed the bulk (12.5 per cent) followed by chemicals (6.5) and basic metal industry (6.1). In contrast, the contribution of textiles is just about 0.5 per cent. In fact, in 1994-95 industries such as chemicals, machinery, transport equipment contributed overwhelming proportion of corporation tax, but their share declined sharply over the years (Rao and Rao, 2005).

Another important issue examined here refers to the contribution of the public sector enterprises to the corporation tax. Curiously, after liberalisation, the share of public enterprises has increased considerably over the years. In the initial stages of liberalisation, the share actually fell from 23 per cent in 1990-91 to 19 per cent in 1994-95, but thereafter, it increased to 38 per cent in 2002-03. In other words, over 50 per cent of the corporation tax in 2003-04 was collected from public enterprises (Rao and Rao,

2005). This may partly be due to their lack of elaborate tax planning to minimise the incidence of taxes unlike the private sector.

Union Excise Duties:

Declining tax-GDP ratio of Union excise duties is truly a matter of concern. The reforms in union excise duties rather than improving the revenue productivity have led to its decline over the years. Although during the last few years the revenue-GDP ratio from the tax has been stagnant at 3.3 per cent, it is significantly lower than the ratio in 1991-92 (4.1 per cent).

Not only that the revenue productivity of Union excise duty has declined over the years, even the composition shows increase in revenue concentration particularly towards commodities which would be used in further production. Independent operation of excise and sales tax systems and confining the tax to goods and to the manufacturing stage alone does not remove cascading and final products in the manufacturing stage are not necessarily final consumer goods.

The commodity wise revenue collections from Union excise duty bring out efficiency and equity implications of the tax system. One of the most important features is the commodity concentration. Just five groups of commodities namely petroleum products, chemicals, basic metals, transport vehicles and electrical and electronic goods together contribute to 75 per cent of total revenue collections from excise duty. It is normally expected that over the years, with diversification in manufacturing, the commodity concentration in excise duty should reduce. Contrarily, the commodity concentration has only increased over the years with a single group, petroleum products contributing to over 40 per cent of the union excise duty collections, with more than three times increase in share over a 13 year period. This imposes disproportion tax burden on different sectors of the economy. Besides, this type of commodity concentration does not allow objective calibration of policies in regard to excise duties as the Finance Ministry would not like to lose revenue from this lucrative source.

Another important feature excise duties is that overwhelming proportion of the duties is collected from commodity groups which are in the nature of intermediate products. Besides petroleum products, a significant proportion of which is used in transportation of goods and persons involved in or related to other manufacturing, the taxes on all goods serving as inputs to service providers, especially of services used as inputs to manufacturing activities, contribute to cascading and add to the production cost. Transport vehicles and related industries are another such industry. These are a source of significant inefficiency in the system. This also makes it difficult to speculate on the distribution of tax burden in terms of different income classes as it is difficult to speculate on the effect of the tax on different manufacturing enterprises and its effects on employment and incomes.

A striking feature of the excise duty is that like corporation tax, a predominant proportion - almost 42 per cent of total collection is paid by public sector enterprises. Also, this component of revenue has wide fluctuations from year to year. It reached the highest share of 53 per cent in 1999-2000, and the lowest in 2001-02 at just about 30 per cent. The fluctuations are due to the fluctuations in administered prices on items such as steel, coal, minerals and ores and petroleum products. The last one also varies with international prices. In other words, the revenue from excise duties, which constitutes an important source of revenue, is fluctuates widely depending upon pricing and output decisions of the government and given the significant dependence on this sector, the ability of the PSUs to forge an independent pricing policy too could be compromised. .

Customs Duties:

The most important and in many ways far reaching reforms have been in the case of customs tariffs. Since 1991, imports subject to quantitative restrictions constituted 90 per cent of total imports, and these restrictions have been virtually done away with. The import weighted tariff rates have been reduced from 72 per cent in 1990 to 15 per cent at present. The peak rate of import duty too has been brought down from over 150 per cent in 1991 to less than 20 per cent at present (Virmani et. al, 2004).

From efficiency point of view, differentiating tax rates varying with the stage of production continues to be a problem. The rates on raw materials and intermediate goods continue to be lower than those on consumer goods and capital goods and even the recent task force on Reform of Indirect Taxes (India, 2002) has followed the same principle.

The commodity group wise analysis of customs shows that despite external liberalisation, almost 60 per cent of the duty comes from only three commodity groups namely, machinery (26.6 per cent), petroleum products (21 per cent) and chemicals (11 per cent). Further, overwhelming proportion (over 75 per cent) of the duty is collected from either machinery or basic inputs or intermediate goods. Thus, liberalisation, contrary to the fear, has not led to massive inflow of consumer goods (Rao and Rao, 2005). This also implies that reducing the duties further and imparting greater uniformity would be beneficial to the economy (Virmani et. al. 2004).

V. Towards Further Reforms in the Tax System:

In the last few years, reforming the central tax system has received considerable focus. The Advisory Group on Tax Policy and Administration for the Tenth Plan (India, 2001) and the Kelkar Task Force (KTF) reports on Direct and Indirect Taxes (India, 2002) and more recently the KTF on the implementation of the FRBM Act (India, 2004) have comprehensively examined the tax system and made important recommendations to reform. While there are differences relating to some of the specific recommendations as compared to the TRC, there is broad agreement on the direction and thrust of reforms and on the emphasis placed on the reform of tax administration.

Reform of central taxes:

The reforms with regard to personal income tax will involve further simplification of the tax system. This includes withdrawal of tax exemptions and concessions given for specified activities, abolition of surcharge and further simplification of the tax. In fact, there is considerable virtue in having a single tax rate with an exemption limit as many transitional economies have found. The ability of income tax system to bring about

significant redistribution through tax policy is limited and it is increasingly being realised that equity should focus on increasing the incomes of the poor rather than reducing the incomes of the rich and this objective is better achieved by expenditures on human development and not through the tax system (Harberger, 2003, Bird and Zolt, 2005). Yet, moving towards a single rate of tax may not be politically feasible at this juncture.

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. Similarly, the present rate of depreciation allowance, even after the reduction in 2005-06 is quite generous and needs to be reduced to more realistic levels and the rate should be aligned with that of marginal tax rate on personal income tax. There has been a lot of flip flop in regard to taxation of dividends from one year to another. The most satisfactory solution in this regard is to have partial integration of the tax with personal income tax.

With regard to import duties, the reform will have to move in the direction of further reduction and unification of the rates. As most non-agricultural tariffs fall between zero and 15 per cent, a uniform tariff of 10 per cent would considerably simplify and rationalise the systems (Acharya, 2005). Equally important is the need to get rid of plethora of exemptions and concessional treatment to various categories including project imports. In fact, a minimum tariff of 5 per cent on all exempted items would rationalise the duty structure and help the cause of revenue as well.

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. Similarly, various exemptions given to project imports have significantly eroded the tax base. Another important reform area is to fully integrate the CENVAT with the taxation of services (India, 2001).

V.2. Evolving Coordinated consumption tax system:

One of the most important reforms needed in indirect tax system is to evolve a co-ordinated consumption tax system for the country (Rao, 1998). This is necessary to ensure that the tax burden is distributed fairly between different sectors and between goods and services. The reform should also improve the revenue productivity, minimise relative price distortions and above all, ensure a common market in the country.

This involves co-ordinated calibration of reforms at central, state and local levels. At the centre, as mentioned above, the first step is to evolve a manufacturing stage VAT on goods and services. At the state level, converting the sales tax into VAT should be completed by allowing input tax credit not only for intra-state sales and purchases but also for inter-state transactions. Also, appropriate mechanisms will have to be found for enabling the states to levy the tax on services and integrating it with the VAT on goods, so as to arrive a comprehensive VAT. An important problem in this regard is devising a system for taxation of services with an inter-state coverage.

The local level indirect tax reform relates to the abolition of octroi. There is no place for octroi in any modern tax system. The problem however, is of finding an appropriate substitute. In every country, property tax is a mainstay of local body finances and reform in this area should help in raising revenue productivity. Yet, this may not suffice. In this situation, the better option is to allow the local bodies to piggyback on the VAT collections in urban local body jurisdictions. This way, it will avoid cascading of the tax and minimise exportation of tax burden by the urban local bodies to non-residents.

V.3. Reform in tax administration:

In India, the poor state of tax administration has been 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. Not only that this rendered proper analysis of taxes to provide adequate analytical background to calibrate changes in tax structure, but also it made proper enforcement of the tax difficult. Thus the changes in the tax structure had to be made in an ad hoc manner.

The consequence of this has been the high compliance cost. The only estimate of compliance cost by Das-Gupta (2004a, 2004b) of both personal income and corporation tax shows that in the case of personal income tax it is as high as 49 per cent of personal income tax collections and in the case of corporate tax, between 6 and 15 per cent of the tax paid, with the bulk being legal costs of compliance. While these estimates should be taken with a note of caution, the important point to note is that the compliance cost of collecting taxes in India is extremely high.

High compliance cost combined with poor state information system has led to continued interface of taxpayers with officials, negotiated payment of taxes, corruption and rent seeking and low levels of tax compliance. An important indication of the poor information system is that even as the coverage of TDS was extended over the years, information was not assembled even to check whether those deducting the tax at source actually filed the returns. As the CAG report for 2003-04 states, of the 0.63 million returns to be filed by TDS assesseees, only 0.50 million or were filed or more than 40 per cent of the TDS assesseees did not file the returns. Even this is vast improvement over the previous year when 80 per cent of the TDS assesseees did not file the returns.

The recent initiatives on building the computerised information system in direct taxes follow from the recommendations of the KTF. The Central Board of Direct taxes (CBDT) outsourced the function of issuing permanent account numbers (PAN) . The Tax Information Network (TIN) has been established by the National Securities Depository Limited (NSDL). The initial phase has focussed on ensuring that TDS assesseees do in fact file the returns, and matching and cross-checking the information from banking and financial institutions to ensure that the taxes paid according to the returns are in fact credited into government accounts in the banks. The Online Tax Accounting System (OLTAS) was operationalised in July 2004. This has helped expedite the number of refunds from 2.6 million in 2002-03 to 5.6 million in 2003-04. Not surprisingly, in the last four years revenue from direct taxes increased at over 20 per cent per year.

Similar initiatives have been taken in regard to indirect taxes as well. The customs e-commerce gateway (ICEGATE), Customs Electronic Data Interchange system

ICES) have helped to improve the information system and speed up the clearance processes. In 2003-04, ICES handled about 4 million declarations in automated customs locations which constituted about 75 per cent of India's international trade. Progress has been made in building capacity in modern audit systems and computerised risk assessment with assistance from Canadian International Development Agency (CIDA).

Another critical element in tax administration is the networking of the information from various sources. As mentioned earlier, systems have to be evolved to put together information received from various sources to quantify the possible tax implications from them in a judicially acceptable manner to improve tax enforcement. In the first instance, the information networking should get the data from various sources such as banks and financial institutions on various assessees. In the second, there must be meaningful exchange of information between the direct and indirect tax administrations. In the third, it is necessary to exchange information between central and state taxes. Building computerised information system will help to improve enforcement of taxes.

VI. Concluding Remarks:

The foregoing analysis shows that there has been a significant progress in tax reforms in recent years and that has helped to enhance the tax-GDP ratio close to the levels that prevailed prior to reducing customs. This, however, is only the beginning and considerable distance in reforming the tax system is yet to be covered. The tax system reform including reform in administration is a continuous exercise.

The reforms will have to continue not only at the centre, but also at state and local levels as well. One important objective of subnational reform is to ensure common market in the federation. It is also necessary that consumption taxes should be calibrated in a co-coordinated manner in the spirit of co-operative federalism. Domestic and external trade taxes should also be calibrated to ensure the desired degree of protection to industry and the desired burden of consumption taxes to the community.

Broadening the base of both central and state taxes and keeping the tax structures simple are important international lessons to be adopted in calibrating further reforms.

Phasing out small scale industry exemptions, minimizing exemptions and concession to industries in the services sector, minimizing discretion and selectivity in tax policy and administration are all important not only for the soundness of the tax system but to enhance its acceptability and credibility.

Despite significant reduction in customs duty, India is still is a highly protected economy. Further reduction in tariffs and its unification is necessary. This would certainly entail loss of revenue and revenue from other taxes will have to compensate this. The conversion of sales taxes into the destination based consumption type VAT by the states initiated in April 2005, will have to be carried out with vigor. This would require complete phasing out the central sales tax. Finalizing the mechanism to relieve taxes on inter-state transactions and building a proper information system for the purpose, is therefore, extremely important.

The most important reform is in tax administration. It is important to reiterate that “Tax administration is tax policy” (Cassenegra, 1990). Making a transition to information based tax administration, online filing of tax returns, compiling and matching information are extremely important. A large taxpayer unit should be established to not only to compile information, collate it and match it but also should assist these taxpayers and help them to reduce their compliance costs.

Footnotes

¹ Richard Bird (1993, p.2721) reviewing the three volume Report of the Tax Reform Committee states, “ The three reports on tax reform in India ...generally offer clear and sound guidance as to what can and should be done...”.

² In U.S for example, there have been several studies analyzing the impact of Tax Reform Act, 1986. For detailed review of these studies, see Auerback and Slemrod, (1997).

³ The NIPFP had undertaken several studies on the tax systems in various states since 1980 and this included Assam, Bihar, Kerala, Madhya Pradesh, Punjab and Tamil Nadu, Uttar Pradesh had a tradition of appointing a tax reform Committee every five years. Sometimes, the studies were repeated after some years. There is no evidence to show that the recommendations of these studies were considered at all.

⁴ A discussion of effective tax rates for different income groups is presented later on in this section.

⁵ The effective rates of tax referred to here are not related to the income tax statistics, since what we are talking about here is the effective rate of tax faced by any given tax payer. Therefore, to arrive some idea of the same, without building into the computation, any of the tax rebates and deductions or exemptions, the basic tax structure is used along with alternative base incomes to compute the implication of the tax rates and slabs. The computations do take into account the effect of Standard deductions and surcharges. .

⁶ Prowess database is generated by the centre for Monitoring India Economy, a private sector company.

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TABLES

Table 1 Fiscal Trends in India

(Percentage of GDP)

Year	Revenue Deficit* (Centre)	Fiscal Deficit (Centre)*	Primary Deficit	Debt stock	Tax Ratio (Centre)	Tax Ratio States	Tax Ratio (Total)	Transfer to States
1981-82	(-) 0.60	6.4	4.1	46.4	9.4	4.9	14.3	
1985-86	1.8	8.8	5.7	51.9	10.6	5.3	15.6	
1990-91	4.2	9.3	4.9	61.4	10.1	5.3	15.4	4.9
1995-96	3.2	6.5	1.6	60.1	9.4	5.4	14.8	4.3
1996-97	3.6	6.3	1.1	58.0	9.5	5.2	14.7	4.3
1997-98	4.2	7.2	2.0	56.5	9.1	5.3	14.5	4.9
1998-99	6.4	9.0	3.6	58.6	8.3	5.1	13.4	3.7
1999-00	6.3	9.5	3.8	58.9	8.9	5.3	14.2	3.8
2000-01	6.5	9.2	3.3	61.5	9.0	5.6	14.6	3.9
2001-02	6.9	9.6	3.4	63.2	8.2	5.6	13.8	3.8
2002-03	6.7	9.9	3.4	69.5	8.8	5.9	14.6	3.8
2003-04	5.8	9.2	2.9	72.4	9.2	6.0	15.2	

Note: RE: Revised estimates.

Source: 1. Public Finance Statistics, Ministry of Finance, Government of India.

2. Annual Report, Reserve bank of India, 2002-03.

	Centre			States			Total		
	Direct	Indirect	Total	Direct	Indirect	Total	Direct	Indirect	Total
1950-51	1.8	2.3	4.1	0.6	1.7	2.2	2.3	4.0	6.3
1960-61	1.7	3.5	5.2	0.6	2.0	2.7	2.3	5.5	7.9
1970-71	1.9	5.1	7.0	0.3	3.1	3.4	2.2	8.2	10.4
1980-81	2.1	7.1	9.2	0.2	4.4	4.6	2.3	11.5	13.8
1985-86	2.0	8.3	10.3	0.2	5.0	5.3	2.2	13.3	15.6
1987-88	1.9	8.7	10.6	0.2	5.2	5.4	2.1	14.0	16.1
1990-91	1.9	8.2	10.1	0.2	5.1	5.3	2.2	13.3	15.4
1991-92	2.4	8.0	10.3	0.2	5.3	5.5	2.6	13.3	15.8
1995-96	2.8	6.5	9.4	0.2	5.2	5.4	3.0	11.7	14.8
2000-01	3.3	5.8	9.0	0.2	5.4	5.6	3.4	11.2	14.6
2001-02	3.0	5.2	8.2	0.2	5.4	5.6	3.2	10.6	13.8
2002-03	3.4	5.4	8.8	0.2	5.7	5.9	3.5	11.1	14.6
2003-04*	3.8	5.4	9.2	0.2	5.8	6.0	4.0	11.2	15.2
2004-05#	4.3	5.6	9.9	Na	na	na	na	na	na

Note: * Actual for the centre and revised estimate for States. #Revised estimates for Centre.

n.a: not available.

Source: Public Finance Statistics, 2003-04. Ministry of Finance, Government of India.

	PIT	CIT	Direct Tax	Customs	Excise	Indirect	Total	GDP
Per Cent of GDP								
1985-86	1.0	1.1	2.1	3.6	4.9	8.8	10.9	100
1990-91	0.9	0.9	2.0	3.6	4.3	8.2	10.1	100
1995-96	1.3	1.4	2.8	3.0	3.4	6.5	9.4	100
2000-01	1.5	1.7	3.3	2.3	3.3	5.8	9.0	100
2001-02	1.4	1.6	3.0	1.8	3.2	5.2	8.2	100
2002-03	1.5	1.9	3.4	1.8	3.3	5.4	8.8	100
2003-04	1.5	2.3	3.8	1.8	3.3	5.4	9.2	100
2004-05	1.6	2.7	4.3	1.8	3.3	5.6	9.9	100
2005-06	1.9	3.1	5.0	1.5	3.5	5.5	10.5	100
Per cent of Total Tax Revenue								
1985-86	9.2	10.1	19.3	33.0	45.0	80.7	100	
1990-91	9.3	9.3	19.2	35.9	42.6	80.8	100	
1995-96	14.0	14.8	30.2	32.1	36.1	69.8	100	
2000-01	16.8	18.9	36.2	25.2	36.3	63.8	100	
2001-02	17.1	19.6	37.0	21.5	38.8	63.0	100	
2002-03	17.0	21.3	38.4	20.7	38.1	64.5	100	
2003-04	16.3	25.0	41.3	19.1	35.7	61.3	100	
2004-05*	16.6	27.1	43.9	18.4	32.9	56.1	100	
2005-06#	17.9	29.9	47.9	14.4	32.8	52.1	100	

Note: * Revised Estimates; # budget estimates

Source: Estimate of Revenues, Central Budget (various years).

Table 4
Trends in State Level Taxes

Year	(Per cent of GDP)							
	Direct taxes*	Sales Tax	State Excise duty	Stamps and registration	Taxes on transport	Other indirect taxes	Total Indirect taxes	Total taxes
1985-86								
1990-91	0.2	3.2	0.9	0.4	0.5	0.3	5.1	5.5
1995-96	0.2	3.0	0.7	0.5	0.4	0.5	5.2	5.4
1996-96	0.2	3.2	0.7	0.5	0.4	0.3	5.1	5.2
1997-98	0.1	3.2	0.8	0.5	0.4	0.3	5.2	5.4
1998-99	0.1	3.1	0.8	0.4	0.4	0.3	5.0	5.1
1999-00	0.1	3.2	0.8	0.4	0.4	0.3	5.2	5.3
2000-01	0.2	3.5	0.8	0.4	0.4	0.4	5.4	5.7
2001-02	0.2	3.4	0.8	0.5	0.5	0.4	5.4	5.7
2002-03	0.2	3.5	0.8	0.6	0.5	0.3	5.7	5.9
2003-04	0.2	3.6	0.8	0.5	0.6	0.3	5.8	6.0

Source: Public Finance Statistics, Ministry of Finance, Government of India

Table 5
Contribution of TDS to Revenue, Personal Income Tax

	Tax Deduction at Source (%)	Advance Tax (%)	Gross Collections (Rs crore)	Refunds (Rs crore)
1990-91	41.75	36.00	6188.37	827.74
1991-92	48.22	33.29	7523.97	794.79
1992-93	42.91	33.45	9060.79	1165.44
1993-94	19.65	51.77	14106.25	4045.96
1994-95	22.18	56.87	17178.72	3357.76
1995-96	22.21	50.01	22949.61	6462.48
1996-97	50.87	27.30	20042.48	1808.49
1997-98	50.87	24.10	19270.19	2169.60
1998-99	52.44	23.59	22411.98	2171.83
1999-00	53.69	24.58	28684.29	3029.79
2000-01	63.22	20.89	35162.61	3398.63
2001-02	67.10	19.23	35358.00	3354.00
2002-03	65.55	20.26	42119	5253
2003-04	64.03	20.04	48454	7067

Source: Report of the Comptroller and Auditor General (Direct Taxes) (various years), Government of India, 2005.

GRAPHS

Figure 1:
Trends in Direct and Indirect Taxes

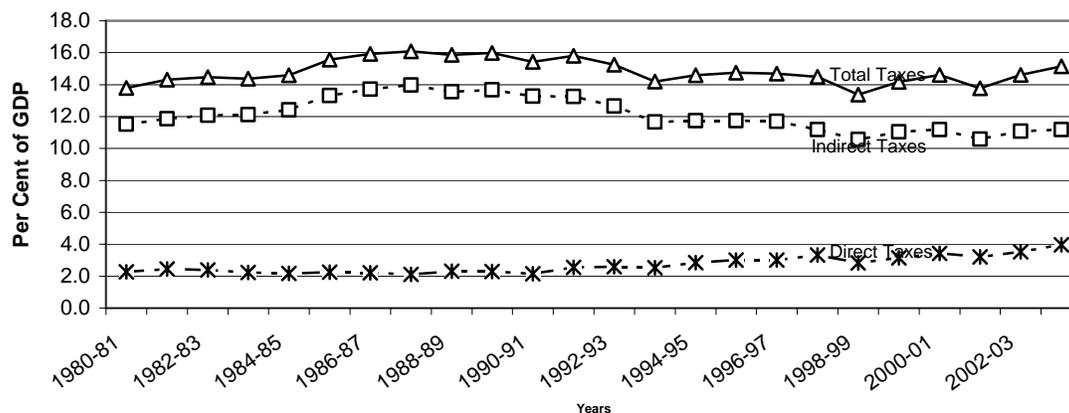


Figure 2: Trends in Tax Revenue- Centre and States

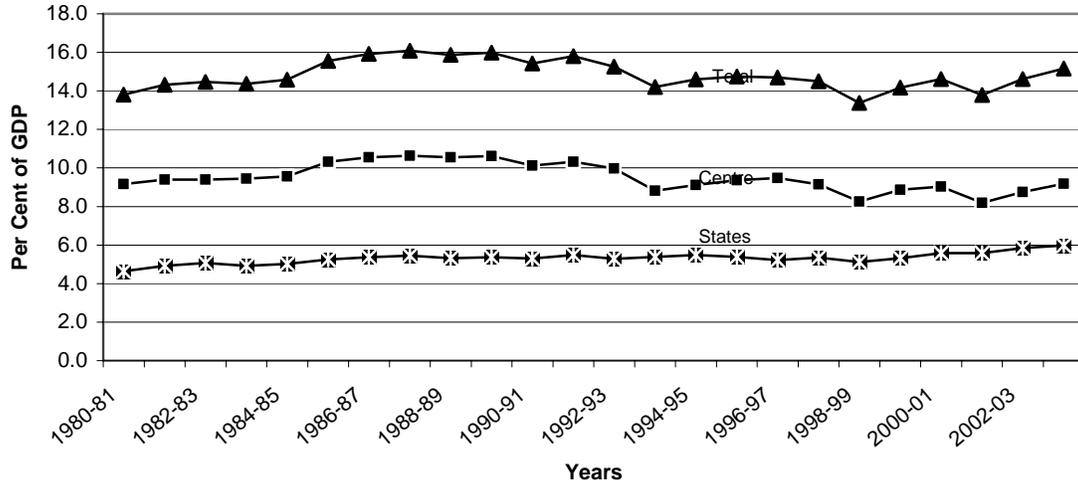


Figure 3: Percent of Central Taxes to GDP

