Trends and Issues in Tax Policy and Reform in India

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The Setting

World over, tax systems have undergone significant changes during the last 20 years as many countries across different ideological spectrum and varying levels of development have undertaken reforms. The wave of tax reforms across the world that began in the mid 1980s actually accelerated in the 1990s motivated by a number of factors. In many developing countries, pressing fiscal imbalance was the driving force. Tax policy was employed as a principal instrument to correct severe budgetary pressures (Ahmad and Stern, 1991). In others, the transition from plan to market necessitated 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 change the development strategy. Another motivation was provided by the internationalisation of economic activities arising from increasing globalisation. While the hand, this has entailed significant reduction in tariffs and replacement

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had to be found for this important and relatively easily administered revenue source, on the other, globalisation emphasised the need to minimise both efficiency and compliance costs of the tax system. The supply side tax reforms of the Thatcher-Reagan era also had their impact on the tax reforms in developing countries.

The evolution of Indian tax system was motivated by similar concerns and yet, in some ways, it is different and even unique. Unlike most developing countries, which were guided in their tax reforms by multilateral agencies, Indian tax reform attempts have largely borne a domestic brand. They have been calibrated in response to changes in the development strategy over time while keeping in tune with the institutional arrangements in the country.[1] 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 expert groups and was in tune with international best practices.[2]

Inevitably, tax policy has evolved in the country in response to changing development strategy over the years. In the initial years, the tax policy was guided by a large number of demands placed on the government (Bagchi and Nayak, 1994). They can be summarised into the need to increase the level of savings and investment in the economy and hence stimulate growth and the need to ensure a fair distribution of incomes. These meant an effort to raise taxes from those with an "ability to pay", with little regard for the efficiency implications of the chosen instruments for the purpose.

The role of history and institutions was also important in shaping the tax system in the country. Indeed, the nature of federal polity, assignment of tax powers and tax sharing arrangements have impacted on the incentives for revenue mobilisation and the structure and administration of the taxes in both central and state governments. The overlapping tax systems have made it difficult to have encompassing, comprehensive and co-ordinated tax system reforms. Another legacy of planning is selectivity and discretion both in designing the structure and in implementation of the tax system. These contributed to erosion of the tax base, created powerful special interest groups, and introduced

'negotiated settlement' to the tax system.[3] In a closed economy, inefficiencies did not matter and relative price distortions and disincentives to work, save and invest did not warrant much consideration.

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 India.[4]

This paper undertakes the analysis of the Indian tax system. It details the evolution of the tax system and its reform over the years and analyses its efficiency and equity implications. In section 2, alternative models of tax system reform are presented with a view to identifying the best practice approach followed in tax system reforms. Surely, in a democratic polity, it is difficult to achieve the ideal and yet, the framework helps to keep the focus on further reforms. Section 3 analyses the evolution of Indian tax system and the impact of historical and institutional factors in shaping Indian tax policy. The trends in tax revenue are presented in section 4 and these point towards a relative stagnation and deceleration in tax revenues at both central and state levels. Section 5 analyses the reasons for the stagnation 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.

2. Changing Paradigms of Tax Policy and Reform

In the literature on tax design and reform, the thinking on what constitutes the best tax system and an implementation strategy to achieve it have undergone considerable change over the years mainly due to the changing role of the state in development and internationalisation of economic activities (Bird and Oldman, 1990; Gillis,

1989; Boskin and McLure, 1990). Design of tax policy and reform of an existing tax regime can be two distinctly different exercises, not always generating the same set of results. It is possible to argue that the objective of tax reform should be to chart the course for taking a given tax regime to one "optimally" designed. However, history of the existing system, as well as political and administrative constraints could place limits on such a transition path. For instance, a comprehensive consumption tax of the VAT variety might be best implemented at the national level, so as to avoid issues relating to treatment of inter-state taxation. But the assignment of tax powers in India could make that transition difficult, if not impossible. Reform, therefore, might have to explore other alternatives such as dual VAT.

One important school of thought, which focuses on the design of a tax system, is optimal taxation. This school of thought recognises the difficulties of achieving the first best and emphasises the need to minimise the deadweight losses in exploring the second best solutions. Here one can distinguish two key approaches. First, based on the assumption that government is all-powerful, fully informed, benevolent and driven by efficiency consideration, derives the following result: to minimise the excess burden of raising given amount of revenue, consumption should be taxed and the optimal rate of tax on individual commodities should be related to the direct and cross-price elasticities of demand. In the special case when the compensated cross price elasticities are zero, the optimal tax rate is inversely proportional to the direct compensated price elasticity of demand (Ramsey Rule). The lower the compensated price elasticity of demand, the smaller the movement away from the undistorted first-best optimum in response to the tax so that it pays to tax the lower-elasticity goods at higher rates. Since tax structures designed on these principles would involve taxing necessities, the need to address distributional concerns becomes paramount (Stern, 1987). Incorporating distributional considerations into this paradigm brought in discussions of optimal income tax, applications of which interestingly do not support sharply progressive tax structures.

The second approach recognises that the government typically lacks the information on elasticities and is subject to lobbying when it is willing to tax different goods at different rates. Associated with the names of Harberger (1990) and Hatta(1986), this approach leans more heavily towards taxing consumption at uniform rates across goods. According to this school, while efficiency (and distribution weights) is

clearly desirable in the design of tax policy, administrative capacity, attention to local institutions and political realities are equally, if not more, important. The principal concern is not to design a system that will be 'optimal', but adopt the system that will minimise tax-induced distortions and at the same time, is administratively feasible and politically acceptable. The basic Harberger reform package for developing countries that are price takers in the international market consists of, *inter alia*, uniform tariff and a broad-based Value Added Tax (VAT). Panagariya and Rodrik (1992) examine the rationale for uniformity in the context of import tariffs and argue that while the case for uniform tariffs is not watertight, uniformity minimises the pressures for favourable (lower) rates on some goods over others. The commitment to a uniform tax rate introduces a free-rider problem for industries to lobby for lower rates for themselves (since such lower rates are then extended to everyone).

While the literature has focused more on the former, it has played limited role in actual tax-policy formulation. The second approach, combined with administrative cost considerations emerges to be a closer approximation of the approach of tax-policy practitioners. The thrust of most tax-policy advice within this approach is to enhance revenue productivity of the tax system while minimising relative price distortions. This involves efforts to broaden the tax base, lower the rates and reduce rate differentiation of both direct and indirect taxes. Adoption of uniform tax rate has been an important feature of practical approaches to tax reform (Rao, 1992). A broader base requires lower rates to be levied to generate a given amount of revenue. It also helps to ensure horizontal equity, is desirable from the political economy point of view as elimination of exemptions and concessions reduces the influence of special interest groups on tax policy and reduces administrative costs. Lower marginal rates not only reduce disincentives to work, save and invest, but also help to improve tax compliance. The preference for broad based and uniform rates of taxation, thus, is guided by the need to eliminate an arbitrary array of tax differentials determined more by special interest group politics than pursuit of economic efficiency. Further, the limited infrastructure and capacity of tax administrations in developing countries constrain them from effectively administering complicated tax regimes. Broad-based systems of taxation based on uniform rates are a mechanism for providing stability and simplicity to the tax system.

The introduction of VAT is an important component of recent tax reform packages in most of the countries, especially in the context of declining emphasis on import tariffs. Keen and Ligthart (2002) show that in small open economies any revenue neutral tariff cut accompanied by price neutral destination based VAT will enhance both net revenue and welfare. While, this result is contested, especially in the context of developing economies with significant informal sectors, the debate does not extend to cases where VAT seeks to replace a cascading type of sales tax or broad-based excise duty. Further, in large economies, complete replacement of revenue from international trade taxes by VAT may not be possible since it might be associated with unacceptably high tax rates and even if it were, the revenue may not accrue to the central government in a federal set up like India where the states have traditionally held the power to levy sales tax Rajaraman (2004), implying thereby the need to explore all other alternatives.

In many countries, reason for levying the VAT has as much, if not more, to do with replacing the cascading type sales taxes, which are often, confined to the manufacturing stage than to substitute import duties as a source of revenue. In many cases the expansion of tax base accompanying the VAT both due to extending of the tax to stages subsequent to manufacturing, as also the self-enforcing nature of the tax have led to higher revenue productivity. Often, this has strengthened the information base for tax administration resulting in improved compliance in other taxes and thereby enhancing overall productivity of the tax system.[5] Thus, as argued by Bird (2005), although VAT is not necessarily a “money machine”, if the tax is administered properly, the conventional conclusion that this is the best way to make up for the revenue loss from trade liberalisation holds.

Some recent theoretical explorations have argued that the VAT being a tax on the formal sector of the economy, and combined with weak administration, help the spread of informal economy which is not conducive for development (Emran and Stiglitz, 2004a, 2004b; Hines, 2004; Gordon and Wei, 2005). This issue, however, is also applicable to many other taxes levied in developing countries. In fact, most taxes in developing countries are levied on the formal sector. In the context of tariffs, it has been shown that smuggling – the informal sector counterpart in the case of imports – will lower both revenue and welfare (Bhagwati and Hansen, 1973; Martin and Panagariya, 1984). Besides, by being in the non-formal sector, the economic agent will have to contend

with high transaction costs. The extent to which VAT encourages non-formal sector will also vary from country to country. Besides, the formal sector has dynamism of its own as it opens up avenues to expand businesses.[6]

Another critique of the appropriateness of the VAT in developing countries is based on the market structures. Das-Gupta (2004) argues that, under imperfect competition, since neither the gains from input-tax credit nor the entire tax burden need be passed on to the consumer, a turnover tax may be both revenue superior and welfare superior to a VAT. This result, however, is based on a static framework. In a dynamic context, the taxpayers in this system can vertically integrate thereby avoiding taxes and potentially undermining production efficiency. Further, such a tax regime would perpetuate tax spillovers both across jurisdictions within the country and across international borders. The former would violate the common market principles, while the latter would undermine the competitiveness of the domestic industry.

Thus, as stated by Bird (2005), "One may criticise VAT in both theory and practice, and much more such analysis and criticism is not only to be expected but also welcomed. In the end, VAT almost certainly works better both in theory and practice in most countries than any feasible alternative". Again, as Bird states, "…the most basic lesson ….from experience to date with implementing VAT in developing and transitional economies (DTE) is … that doing it right is in most respects a matter more of art than of science. ….the behaviour of the informal sector depends, as some recent literature (Gerxhani, 2004) suggests, largely on the interaction between formal institutions such as the tax administration and the prevalent norms and customs in a country…."

Apart from concerns of efficiency, tax policy has often been guided by the need to pursue the objective of redistribution. Most policy analysts in the 1950s and 1960s assigned redistribution a central focus in tax policies and considered that an ideal tax system should have a highly progressive personal income tax combined with a high corporate income tax. In fact, in the 1950s and the 1960s, the marginal rates of personal income taxes were set at confiscatory levels. This was not merely an obsession in countries with interventionist strategies such as India but was fashionable even in countries such as the U.S.A. and U.K. In these countries, marginal income tax rates were set at over 90 percent

immediately after the Second World War (Harberger, 2003). In U. S. A., the tax rate of over 90 percent existed even until 1963.

There were three important factors that have led to moderation in the pursuit of redistribution through tax policy. First, experiences have shown that highly progressive tax systems have done little to reduce inequality in developing countries as they are neither progressive nor comprehensive.[7] The empirical studies in U. S. A (Pechman, 1985) and Chile (Engel Eduardo *et. al.,* 1999) have shown that the extent of income redistribution and reduction in inequality achieved by the tax systems were insignificant. Second, a redistributive tax system can impose additional cost on the economy, which includes administrative costs, compliance costs, economic efficiency costs and political costs. Third, the focus of equity in fiscal policy itself has shifted from 'reducing the incomes of the rich' to 'increasing the incomes of the poor' and in this, the alternative approach of using expenditure programmes for poverty alleviation have attracted greater attention. (Harberger, 2003; Bird and Zolt, 2005).

In practice the design of a tax system for developed countries today would rely largely on consumption taxes (VAT) on all goods and services applied at a more or less uniform rate. However, in the presence of large informal sector and constraints in implementing effective expenditure based redistribution measures, it may be necessary to have a combination of income and consumption taxes, the latter covering all goods and services, at fairly uniform rates. But such an option may not be easily available, with a tax system already in place. The task, therefore, is to reform the existing tax system so as to minimise the excess burden of taxation within the broad contours of the existing system. This involves reforms of all major taxes at the centre, state and local levels. The direction of reform as guided by the literature on tax reforms in developing countries include:

- scaling down of and possible elimination of trade taxes over time;
- reform of existing domestic indirect taxes to transform them into comprehensive consumption taxes on goods and services: this should cover both national and sub-national taxes;
- a moderately progressive personal income tax; and
- corporate income tax at a rate equivalent to the highest marginal rate of personal income tax.

Probably, the most important aspect of the advice given to developing countries in designing their tax systems is that the administrative dimension should be kept at the centre rather than periphery of reform efforts. The poor administrative capacity creates a wedge between the structure of the tax on paper and what actually works in practice. Apart from eroding revenue productivity, this results in the perpetuation and even spread of non-formal economy, significant dead-weight losses, and violation of horizontal equity.

Tax policy, or for that matter any policy stands on the tripod of 'architecture', 'engineering' and 'management' (Bird and Zolt, 2005). 'Architecture' provides the design of the tax system to be achieved and this is guided by the objectives of tax policy. 'Engineering' provides the mechanics to achieve it and these are provided by the nature of institutions and systems involved in tax collection. 'Management' provides implementation strategy and action and this *inter alia*, depends on the political support and vision, nature of administration and information system. All the three legs of the tripod are interdependent. A tax policy is only as good as it is administered and therefore, it is important to design the tax system keeping the administrative capacity in mind. Similarly, the nature of tax institutions and systems will have to be adapted keeping in view the design of the tax system and implementation capacity. Further, administrative capacity should be continuously augmented to keep pace with changing requirements of tax policy. In other words, reform of the tax system involving both its structure and operations is a continuous process and has to be calibrated constantly. A complementary action in this regard is the building of proper information system.

3. Evolution of Indian Tax System

The basic framework for the tax system in independent India was provided in the constitutional assignment of tax powers. The important feature of the tax assignment is the adoption of principle of separation in tax powers between the central and state governments. It assigned the major broad based and mobile tax bases to the centre and these included taxes on non-agricultural incomes and wealth, corporation income tax, customs duties, and excise duties on manufactured

products. Over the years, the last item has evolved into a manufacturers' VAT on goods. The major tax powers assigned to the states include taxes on agricultural incomes and wealth, sales taxes, excises on alcoholic products, taxes on motor vehicles, passengers and goods, stamp duties and registration fees on transfer of property, and taxes and duties on electricity. They also have powers to levy taxes on entertainment, taxes on professions, trade, callings and employment and these have been exercised by the states themselves in some states and in others they have been assigned to local bodies. Although the state list also includes tax on property and tax on the entry of goods into a local area for consumption, use or sale, these have been assigned to local bodies. The central government levied tax on selected services on the basis of the residuary entry in the Union list from 1994, but in 2003, power to tax services was specifically assigned to it.[8]

Tax policy in India has evolved as an important component of fiscal policy which had to play a central role in the planned development strategy. In particular, tax policy was the principal instrument to transfer private savings for public consumption and investment (Bagchi and Stern, 1994). It was also employed to achieve a number of other objectives including encouraging savings and investment, bringing about reduction in inequalities of income and wealth, fostering balanced regional development, encouraging small scale industries on the assumption that they are employment intensive and influencing the volume and direction of economic activities in the country.

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 and increasing requirements of public consumption and investment irrespective of the efficiency implications it entailed. Second, the objective of achieving socialistic pattern of society on the one hand and the large oligopolistic rents generated by the system of licences, quotas and restrictions on the other, necessitated steeply progressive tax structure in both direct and indirect taxes. Third, pursuit of multiplicity of objectives enormously complicated the tax system with adverse consequences on efficiency and horizontal equity. This also opened up large avenues for evasion and avoidance of taxes. The disregard for efficiency considerations was a part of import substituting industrialisation strategy. Fourth, all of the above required not only differentiation in tax rates based on arbitrary criteria but also

legitimised selectivity and discretion in tax policy and administration. This gained legitimacy from the plan priorities. Once selectivity and discretion were accepted as legitimate, it mattered little whether these were exercised as intended. This provided enough scope for the special interest groups to influence 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 as well as its effect.

This section summarises the evolution of the major central taxes and provides an overview of the state taxes, i.e., personal income and corporate tax among direct taxes and excise duty, customs duty and service tax among the indirect taxes for the central government. At the state level, the major initiative in recent times is the introduction of VAT, and the discussion limits itself to this measure.

3.1 Reform of Central Taxes

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. It 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. Although the report of the Commission was available in 1953-54, given the ideological orientation of the Second Five Year Plan (1956-60), Nicholas Kaldor was invited from Cambridge to produce a report on Indian Tax Reform. This report was used (rather incompletely) to raise resources for the Second Five Year Plan. The implementation of the expenditure tax on the recommendation of Kaldor (India, 1956) was intended to curb consumption and raise the level of saving which was abysmally low at about 10 percent of GDP. 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

policymakers 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 which 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). Implementation of the important recommendations, however, 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 the tax system, both direct and indirect. 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, 2004b). In many ways the reforms since 1991, with emphasis on simplicity and efficiency make marked departure from the past. In fact, the task force reports which build on the recommendations of the TRC, are summarised below.

Recommendations of the Tax Reform Committee (TRC)

Tax reform since 1991 was initiated as a part of the structural reform process, following the economic crisis of 1991. In keeping with the best practices approach, the TRC adopted an approach of combining economic principles with conventional wisdom in recommending comprehensive tax system reforms. There are three parts in the report. In the first interim report, the committee set out the guiding principles of tax reform and applied them to important taxes namely, taxes on income and wealth, tariffs and taxes on domestic consumption. The first part of the final report was concerned mainly with the much-neglected aspect of reforms in administration and enforcement of both direct and indirect taxes. The second part of the report dealt with restructuring the tariff structure. In keeping with the structural adjustment of the economy, the basic principles taken in the recommendations were to broaden the base, lower marginal tax rates, reduce rate differentiation, simplify the tax structure and undertake measures to make the administration and enforcement of the tax more effective. The reforms were to be calibrated

to bring about revenue neutrality in the short term and to enhance revenue productivity of the tax system 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 a thorough 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.

In the case of customs, the TRC recommended the tariff rates of 5, 10, 15, 20, 25, 30 and 50 to be achieved by 1997-98. This meant a considerable rationalisation from the prevailing structure with more than 100 rates ranging upto 400 percent. 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). At hindsight, it is easy to criticise the excessive rate differentiation (seven rates) and according some degree of protection depending on the stage of processing. Thus, Joshi and Little (1996, p. 74) state, "….this is a totally unprincipled principle, for it has no foundation in economic principles" as in addition to continued complexity, the proposed tariff structure creates very high differences in effective rates and provides higher degree of protection to inessential commodities.

The TRC recommendation also falls much short of developing a co-ordinated domestic trade tax system in the country. This, in a sense, is understandable, as it had no mandate to go into the state level taxes. However, the committee was aware of the serious problems of avoidance and evasion in respect of sales taxes levied by the states predominantly at the manufacturing stage. Therefore, it did recommend

the extension of the central VAT to the wholesale stage with the revenues from the extended levy assigned to the States.

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. While the above description gives a broad account of the history of tax reform, it is important to understand the evolution of the tax structure in respect of each of the major taxes. The following provides the evolution of each of the major central taxes namely, personal income tax, corporation income tax, union excise duties and customs.

3.2 Reform of Direct Taxes

At the central level, the changes in the income tax structure until the mid 1970s were largely *ad hoc* dictated by the exigencies. The tax policy was central to the task of bringing about a socialistic pattern of society, and in 1973-74, the personal income tax had eleven tax slabs with rates monotonically rising from 10 percent to 85 percent. When the surcharge of 15 percent was taken into account, the highest marginal rate for persons above Rs. 0.2 million income was 97.5 percent.[9] In fact, increase in income tax rates to confiscatory levels was completed immediately after the split in the Congress party in 1969 and this seems to be a part of projecting the pro-left image of the party.[10]

The policy was similar in the case of company taxation. The classical system of taxation involved taxation of the profits in the hands of the company and dividends in the hands of the shareholders. A 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 percent to 65 percent in the case of some widely held companies. Although nominal rates were high, the effective rates were substantial lower owing to generous provision for depreciation allowance and investment allowance. In fact, some companies were able to make use of generous tax preferences such that they did not pay any corporate tax year after year.

The *Direct Taxes Enquiry Committee* (India, 1971) succinctly brought out the impact of the confiscatory tax system. It attributed the

large scale tax evasion to confiscatory tax rates and recommended the reduction in marginal rates to 70 percent. This was implemented only in 1974-75, when the tax was brought down to 77 percent including a 10 percent surcharge. However, simultaneously the wealth tax rates were increased. The marginal rate was further brought down to 66 percent and the wealth tax rate was reduced from 5 percent to 2.5 percent in 1976-77. In 1979-80, the surcharge on income tax was increased as also wealth tax rates reached the maximum of 5 percent. 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 percent and wealth tax rates to 2.5 percent.

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

In the case of corporate taxation too, the basic rate was brought down to 50 percent, and rates applicable to different categories of closely held companies were unified at 55 percent. 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 percent in 1993-94. In 1997-98, when personal income tax rate was reduced, the company rate was brought down to 35 percent and the levy of 10 percent 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 percent in 2000-01, reduced again to 10 percent in 2001-02 alongwith reversal to the classical system of taxing it in the hands of shareholders and the policy was reversed once again in 2003-04 with the levy of the tax on the company.

A major problem that has haunted the tax system and reduced the tax base 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 and Tax Administration* (India, 2002) makes a detailed list of these concessions. These include incentives and concessions for savings, housing, retirement benefits, investment in and returns from certain type of financial assets, investments in retirement schemes and income of charitable trusts. These tax preferences have not only distorted the after-tax rates of return on various types of investments in unintended ways but also 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 minimised by introducing the `Minimum Alternative Tax' in 1996-97. Even as companies can take advantage of the tax preferences, they are required to pay a tax on 30 percent of 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. Since MAT meant that a lot of the other preferences accorded in the tax statute like accelerated depreciation were not available to the unit, the partial credit mechanism seeks to dilute the incidence of MAT on units which are only temporarily coming into the purview of MAT.

A noticeable trend is that while until the mid 1990s tax reforms were calibrated on the basis of a consistent theoretical framework, some of the subsequent changes were *ad hoc*. The prime example of this is that of introduction of the MAT instead of phasing out tax preferences. Fixing the rate of profits tax higher than the highest marginal rate of personal income tax is another example. Similarly, with a view to improve tax compliance and create an audit trail, the securities transactions tax was introduced in April, 2004 and cash withdrawal tax at 0.1 percent on all cash withdrawals above Rs. 25,000 from current accounts of commercial banks was introduced in April, 2005. The measures however, are retrograde. The former hinders the development of stock market and discriminates against investments in shares. The latter will put enormous inconvenience to small and medium sized firms,

which have to withdraw large amounts of cash even to pay the salaries of their employees.[11]

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 percent have continued till date with some changes in the associated tax brackets. The surcharge at the rate of 5 percent of the tax payable imposed in the wake of the Kargil war in 2002-03 on all income tax assesses was discontinued in 2003-04, but a separate surcharge of 10 percent of the tax payable was imposed on all tax payers having taxable income above Rs. 0.85 million, which was raised to Rs. 1 million in the budget of 2005-06. Further, all taxes are topped up by 2 percent education cess from 2004-05 onwards. Although the exemption limit remained at Rs. 50,000 since 1998-99, the generous standard deduction, exemption of dividend and interest on government securities upto specified limits effectively increased the threshold substantially. The 2004-05 budget did not raise the exemption limit but provided that those with income less than Rs. 1,00,000 need not pay the tax, but retained the existing tax brackets. This gave rise to a peculiar problem— those with taxable incomes more than Rs. 100,000 were left with lower after tax incomes when compared with those with incomes marginally lower than Rs. 100,000. Therefore, modifications had to be made in the *Finance Act* providing for a rebate when the income was in excess of Rs. 1,00,000, a rebate equivalent to the difference between the amount of tax payable and the amount of income in excess of Rs. 1,00,000. The budget for 2005-06 raised the exemption limit itself to Rs. 1,00,000, abolished standard deduction and made marginal changes in the tax brackets. The exemption limit for women was increased to Rs. 1,35,000 and for senior citizens, Rs. 185,000. The savings in superannuating schemes up to Rs. 1,00,000 was made deductible from the taxable income.

The *Income Tax Act* has a provision to assess the value of identifiable perquisites provided by companies to their employees and include the same in 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 perquisites to the entire group of employees, but are not directly assignable to any single employee. These benefits are to be taxed through a `Fringe Benefits Tax' to be paid by the employer at 30 percent. These include a pre-determined proportion of a wide range of expenses by the company, such as,

entertainment, conference, employee welfare, sales promotion including publicity, conveyance, tour and travel, including foreign travel expenses and 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 percent. On the issue of taxing dividends, however, there have been frequent changes and lack of direction. In 1997-98, the 10 percent dividend tax was shifted from individuals to companies. As mentioned above, there was lack of consistency in the treatment of tax on dividends. In 2005-06, corporate income tax was reduced to 30 percent on domestic companies. A surcharge of 10 percent (without any conditions regarding installed capacity increases) is also chargeable. The depreciation rate, however, has been reduced to 15 percent in the case of general plant and machinery, but initial depreciation is set at 20 percent, thereby reducing the overall benefit of reduction in corporate income tax rates.

The most important 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, alongwith processing and matching the information from various sources on a selective basis is an important initiative, that is likely to improve tax compliance.

3.3 Reform of Indirect Taxes

Union Excise Duties

After independence, in order to raise revenues excise duty was levied on selected goods. Over the years, as the revenue requirement increased, the list of commodities subject to tax was expanded. In doing so, in the initial years the emphasis was to include raw materials and

intermediate goods rather than final consumer goods for reasons of administrative convenience (India, 1977). However, in later years with greater pressure to raise revenues final consumer goods were included. In 1975-76, the tax was extended to all manufactured goods.

The structure of excise duties by the middle of 1970s was complex and highly distortionary. Some commodities were subject to specific duties and others to *ad valorem* taxes, and on the latter alone there were 24 different rates varying from 2 to 100 percent (excluding tobacco and petroleum products which were taxed at higher rates). The process of conversion of specific duties was more or less completed by 1993-94; however, this did not imply a decrease in the number of rates.[12] This led to several classification disputes. 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.

Although the *Indirect Tax Enquiry Report* (India, 1977) provided a detailed analysis of the allocative and distributional consequences of Union Excise Duties, its recommendations were not implemented for almost a decade until 1986-87. The rationalisation recommendations included conversion of the specific duties into *ad valorem*, unification of rates and introduction of input tax credit to convert the cascading type manufacturers' sales tax into a manufacturing stage value added tax (MANVAT). The interesting part of the reform was that there was virtually no preparation and the introduction of MODVAT was a "learning by doing" process. This was a strange combination of taxation based on physical verification of goods with provision for input tax credit. The coverage of the credit mechanism too evolved over time – it started with items from select chapters on both the inputs side and the output side, where the credit mechanism was based on a one-to-one correspondence between inputs and outputs. It was only by 1996-97, however, that it covered majority of commodities in the excise tariff and incorporated comprehensive credit. Nowhere else in the world can one find VAT introduction so complicated in its structure and so difficult in its operations and so incomplete in its coverage. In fact, the revenue from the tax as a ratio of GDP showed a decline after the introduction of MODVAT.

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%). These were further merged into a single rate in 2000-01 to be called a Central VAT (CenVAT), along with three special additional non-vatable excises (8%, 16% and 24%) for a few commodities. Further, the base of the tax was widened – some exemptions were replaced by a tax at 8 percent. Some simplification of the tax on small scale sector was also attempted — they could either avail exemption or pay tax at a concessional rate of 60 percent of tax due, with access to the tax credit mechanism. This option however was withdrawn from the budget of 2005-06.

Customs Duties

Contrary to the general patterns seen in low income countries where overwhelming proportion of revenues is raised from international trade taxes, revenue from this source was not very large in the initial years of independent India (Chelliah, 1986). This is explained by the quantitative restrictions placed on imports. In addition, high and differentiated tariffs and with rates varying with stage of production (lower rates on inputs and higher rates on finished goods) and income elasticity of demand (lower rates on necessities and higher rates on luxury items of consumption) resulted not only in high and widely varying effective rates of protection, but provided larger premium for inefficiency and unintended distortions in the allocation of resources.

By the mid 1980s, the tariff rates were very high and the structure complex. The Long Term Fiscal Policy (LTFP) presented in the Parliament in 1985-86 emphasised the need to reduce tariffs, have fewer and more uniform rates, and reduce and eventually eliminate quantitative restrictions on imports. The reforms undertaken, however, were not comprehensive. Rationalisation in the rates was attempted for specific industries such as capital goods, drug intermediates, and electronic goods. In fact, contrary to the LTFP recommendations, the tariffs were raised for revenue reasons and the weighted average rate increased from 38 percent in 1980-81 to 87 percent in 1989-90 (India, 1991). Thus, by 1990-91, the tariff structure was highly complex varying from 0

to 400 percent; over 10 percent of imports were subject to more than 120 percent. Wide ranging exemptions granted by issuing notifications made the system complex and was a reflection of the influence of various special interest groups on tax policy.

The reform of import duties in earnestness actually started in 1991-92 when all duties above 150 percent were reduced to this level to be called the "peak" rate, which was brought down in the next four years to 50 percent by 1995-96 and further to 40 percent in 1997-98, 30 percent in 2002-03, 25 percent in 2003-04 and finally to 15 percent in 2005-06 for non-agricultural goods. 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.

The number of major duty rates was reduced from 22 in 1990-91 to 4 in 2003-04. Of course, some items are outside these four rates, but 90 percent of the customs is collected from items under the four rates. At the same time, a special additional duty (SAD) was imposed on the rationale that if the commodity was domestically produced and sold on inter-state sale, it would have attracted the tax rate of 4 percent. This was however, abolished in January, 2004 and subsequently reintroduced in 2005-06, with a maximum rate of 4 percent and called CVD. Thus, the direction of reforms was not always consistent, but over the years, the attempt has been to reduce the rates and reduce their dispersion. However, the pattern of tariffs with the rates varying with every stage of processing has continued and this has caused very high effective rates of protection on assembling of consumer durables and luxury items of consumption.

Service Tax

An interesting aspect of the tax assignment system in India is that barring 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 to either the centre or the states and therefore, consumption tax system largely remained untouched. This violated the principle of neutrality in consumption as it discriminated against the goods component of consumption. As services are relatively more income elastic, the tax system is rendered less progressive when these are not taxed. 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*.

Although there is no specific entry in the central list to tax services, the central government levied tax on three services namely, non-life insurance, stock brokerage and telecommunications in 1994-95. The list was expanded in succeeding years to include over 80 services at present. Although initially taxed at 5 percent the rate was increased to 8 percent in 2003-04 and further to 10 percent in 2004-05. *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 CenVAT. These reforms eventually were to evolve a manufacturing stage VAT. The exceptions were to be two small lists – one, a list of exempt services and the second, a negative list of services, where tax credit mechanism would not cover taxes paid on these services. The recommendation on the levy of general taxation of services has not been implemented and the tax continues to be levied on selective services. However, the recommendation pertaining to the extension of input tax credit for goods entering into services and *vice versa* has been implemented.

3.4 State Level Tax Reforms

Tax reforms at the state level were not coordinated 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. In some cases, even when systematic studies were done, the recommendations were hardly implemented.[13] The pace of tax reforms in the states accelerated in the latter half of the 1990s when there were increasing pressures on their budgets and, in some cases, owing to the conditions imposed by multilateral lending agencies or to meet the targets set by the medium term fiscal reforms facility. A major landmark in co-ordinated tax reform at the state level was in simplifying and rationalising the sales tax system since the beginning of this decade and the introduction of value added tax in 21 states from April 1, 2005, in place of the existing cascading type sales tax .

While a good deal of progress has been made in reforming the union excise duties into a manufacturing stage VAT, the reform in the states' sales tax systems has lagged behind. These reforms are critical from the viewpoint of efficiency, for, they contribute over 60 percent of states' tax revenues. Besides, in order to evolve a co-ordinated consumption tax system in the country, it is important to calibrate the reforms in the sales tax systems alongside reforming the central excise duty regime.

A systematic discussion on evolving a coordinated consumption tax system in the country was initiated in the report on *Reform of Domestic Trade Taxes in India* prepared by the NIPFP (1994). The report examined alternative models for a coordinated consumption tax system for India and studied the feasibility of (i) centralising sales taxes and unifying the levy with excise duties; (ii) giving the states the power to levy all domestic indirect taxes with a corresponding reduction in tax devolution; and (iii) evolving an independent dual VAT at central and state levels with no credit to be paid for the payment of the central taxes by the states and *vice versa*. The report favoured the last solution as the most practicable in Indian context as it maintains a balance between sub-national fiscal autonomy and central government's fiscal capacity to undertake any desired inter-state redistribution. Similar conclusion was reached earlier by Burgess and Stern (1993) as well, while subsequent analysis of Joshi and Little (1996) favours either centralisation or assigning of all indirect taxes either to the centre or to the states. However, considerations of fiscal autonomy and demands on the central government to effect sizeable inter-regional resource transfers as well as the political acceptability have tilted the decision in favour of the dual VAT scheme as a medium term goal (NIPFP, 1994; Rao, 1998). While the desirability of having a centralised goods and services tax from the viewpoint of evolving a harmonised consumption tax system is not disputed, this can be taken only as a long term goal. In the medium term, as a part of the initiative to introduce dual VAT, it has been decided to convert the cascading type of state level sales taxes into a destination-based VAT.

There are a number of arguments for replacing the prevailing state sales tax with destination based VAT. In most states, sales taxes are levied at the first point and this pre-retail tax makes the base narrow. The multiplicity of rates made the tax system complex. The taxation of

inputs and capital goods contribute to cascading, vertical integration of firms and opaqueness. In an imperfect market characterised by mark-up pricing, the taxes on inputs and capital goods results in a tax on tax, and mark up on the tax with consumers paying much more than the revenues collected by the government. Inter-state competition in providing liberal tax incentives, besides distorting resource allocation involved significant cost to the exchequer in tax expenditures. The tax on inter-state sale combined with input and capital goods taxation have caused significant inter-state tax exportation from rich to poorer states. In addition, in many states, the urban local bodies impose a tax on the entry of goods into a local area for consumption, use or sale.[14] With this, there are taxes on both exports from one state to another and on imports into urban local body jurisdiction. Thus the country was divided into several tariff zones, limiting the scope and the gains from a common market. Above all, with independent and overlapping commodity tax systems at central and state levels, co-ordinated and harmonised development of domestic trade taxes has become difficult.

As a part of the dual VAT design, therefore, the study group recommended the levy of a separate destination-based, consumption type retail stage VAT in place of the existing sales taxes by the states. In order to persuade the states to rationalise their tax systems on the lines recommended by the study group, the Government of India appointed a State Finance Ministers' Committee. The committee made recommendations to switch over to the VAT in a given time frame in stages. Eventually the committee was transformed into the Empowered Committee of State Finance Ministers. It recommended adoption of the floor rates by the states to minimise the "race to the bottom". The committee also recommended adoption of VAT in 2003, which was repeatedly postponed, until April 2005, when 21 states finally switched over to VAT.

Although characterised as adoption of VAT, the reform in April, 2005 only extends the sales tax up to the retail stage with credit allowed of taxes paid on inter-state purchases for all intra-state sales, and inter-state sales. Inter-state sales tax, i.e., central sales tax will continue to be levied in the same form in the initial years of the introduction of the new tax. It is proposed to phase out the inter-state sales tax in the next two years. In this sense, the reform is only a transitional measure to achieve the ultimate objective of having a destination based retail stage VAT.

The salient features of the VAT levied in the states from April, 2005 are summarised in the following:

- The tax is levied at two rates namely, 4 percent and 12.5 percent (except for bullion and specie and precious metals, which are taxed at 1%). Basic necessities (about 75 items) are exempted. Most items of common consumption, inputs and capital goods (about 275) are taxed at 4 percent and all other items are taxed at 12.5 percent. Petrol and diesel (which contribute about 40% of sales tax) are kept outside the VAT regime and a floor rate of 20 percent sales tax will be levied on them.
- The facility of tax credit covers both inputs/purchases as well as capital goods for manufacturers as well as dealers. As regards capital goods, credit for taxes paid can be availed against sales over three years.
- 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 locally made purchases, 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, an information system for inter-state trade will be built up and *ICICI Infotech* has been contracted to undertake the task.
- The central government has agreed to compensate for any loss of revenue during the first three years of the introduction of tax on rates of 100 percent, 75 percent and 50 percent respectively. The loss will be calculated by estimating the difference between the projected revenue from sales tax on the 2004-05 base and the actual revenue collected. The projected revenues will be estimated by applying the average of the best three years' growth rates during the last five years.
- Tax incentives given to new industries by different states could be continued so long as they do not break the VAT chain. Many states propose to convert tax holidays into deferment of the tax.
- All dealers having turnover above Rs. 5,00,000 would be required to register for VAT. However, the states may levy a simple turnover tax not exceeding 2 percent on those dealers having upto Rs. 5 million turnover. They need not keep detailed accounts of their transactions. But, these small dealers will not be a part of the VAT

chain and no credit will be available for the taxes paid on purchases from these dealers. They may, however, voluntarily register as regular VAT dealers.

Altogether, the commitment to implement VAT has been made by 18 states and 5 union territories from April, 2005. Haryana has already implemented the VAT from April, 2004, but with three main rates (4%, 10% and 12%). Eight states including Gujarat, Madhya Pradesh, Tamil Nadu and Uttar Pradesh have stayed out of the system.

Issues of Design and Implementation

The introduction of VAT is a major reform exercise and it is not surprising that the measure would lead to some confusion and uncertainty. However, there are two sets of issues that need to be highlighted: (a) the *ad hoc* manner of introduction of the tax, captured in the lack of preparedness on the part of many of the states on the one hand, and lack of firm decisions on the design and structure of the tax, even a few months after the introduction of the new tax. Educational and awareness programmes for the dealers and public at large have been generally inadequate in several states. Some states started off the new regime without any rules and forms in place. Even the tax officials are not clear about many issues. In other words, this switchover can in no terms be called a planned switchover. (b) Certain shortcomings in the design of the tax are summarised below:

- The difference of 8.5 percentage points between the tax rates on inputs and outputs (4% and 12.5%) tend to reduce tax compliance. In fact, it is inappropriate to specify a lower rate on inputs in a VAT system because, in any case, full credit is available for taxes paid on inputs used in the production against the tax payable on final product. Many commodities are used as inputs as well as final consumer goods and the lower rate implies a loss of revenue on the latter kind of transactions. A manufacturer might prefer to pay the input tax at 4 percent, suppress his sale and evade the tax on the final product as the difference between the tax payable on the outputs and the tax paid on inputs is large. In fact, no country in the world operating VAT permits concessional treatment of inputs. The large tax differential also encourages large scale lobbying to shift more items from the higher rate to the lower rate category. In fact,

from the viewpoint of better tax compliance, it would have been better to choose rates like 4 percent and 10 percent.

- It would have been better to stipulate the two tax rates as floor rates rather than uniform rates. The only condition should have been that no state should levy the tax at more than two rates and the items under the two categories could have been specified. This would have provided a degree of autonomy to the states and potentially reduced the need for compensation.
- Another important issue is the application of VAT on maximum retail price (MRP) at the first point on pharmaceuticals and drugs in West Bengal and Maharashtra. The rationale for this is that there cannot be value addition at subsequent stages once the MRP is taken as the base. This goes against the principle of VAT — of collecting the tax at different stages of value added with credit given to the tax paid at the previous stage. Further, this would put in place two different mechanisms for taxation within the same state, as also for a given dealer, a complication both for administration and compliance.

Further work required to ensure successful implementation of the VAT is discussed in section 5.

4. Trends in Indian Tax Revenues

This section presents an analysis of the trends in tax revenue in India. After examining the aggregate trends, the analysis is extended to the trends in direct and indirect taxes at central and state levels. The section focuses on the changes in the level and composition of tax revenue since 1991 when systematic reforms were first set in motion. The analysis shows that despite initiating systematic reforms, the revenue productivity of the tax system has not shown any appreciable increase and the decline in 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 (Table 1; Figures 1 and 2). In the first, there was a steady increase in the tax-GDP ratio from 6.3 percent in 1950-51 to 16.1 percent in 1987-88. In the initial years of planning, increase in tax ratio was necessitated by the need to finance large public sector plans. It was possible to

increase the ratio from a low base in the initial years. In addition, increasing imports and extension of manufacturing excises to raw materials and intermediate goods and later, to all manufactured goods increased the buoyancy. Thus, the tax ratio increased from a mere 6.3 percent to 10.4 percent in 1970-71 and further to 13.8 percent in 1980-81. The increase continued until it peaked to 16.1 percent in 1987-88. The buoyancy of the tax in later years in this phase was fuelled by the economy attaining a higher growth path and progressive substitution of quantitative restrictions with protective tariffs following initial attempts at liberalisation in the late 1980s.

The second phase began with the recession caused by the severe drought of 1987 and was marked by stagnation in revenues. This was followed by a decline in the tax ratio following the economic crisis of 1991 and the subsequent reforms in the tax system, particularly, reduction in tariffs. Thus, in the third phase, the tax ratio declined from 15.8 percent in 1991-92 to the lowest level of 13.4 percent in 1997-98 and fluctuated around 13-14 percent until 2001-02. The subsequent period has seen increase by over one percentage point in the tax ratio to 15.2 percent 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 percent 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 percent in 2003-04 and is expected to be at about 4.5 percent 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 percent in 1950-51 to 13.5 percent in 1991-92. However, in the subsequent period, it declined to about 10.6 percent before recovering to a little over 11 percent. The decline in the tax ratio in recent years was mainly due to lower buoyancy of indirect taxes.

Table 1 : Trends in Tax Revenue in India

(percent of GDP)

	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.

Figure 1: Trends in Direct and Indirect Taxes

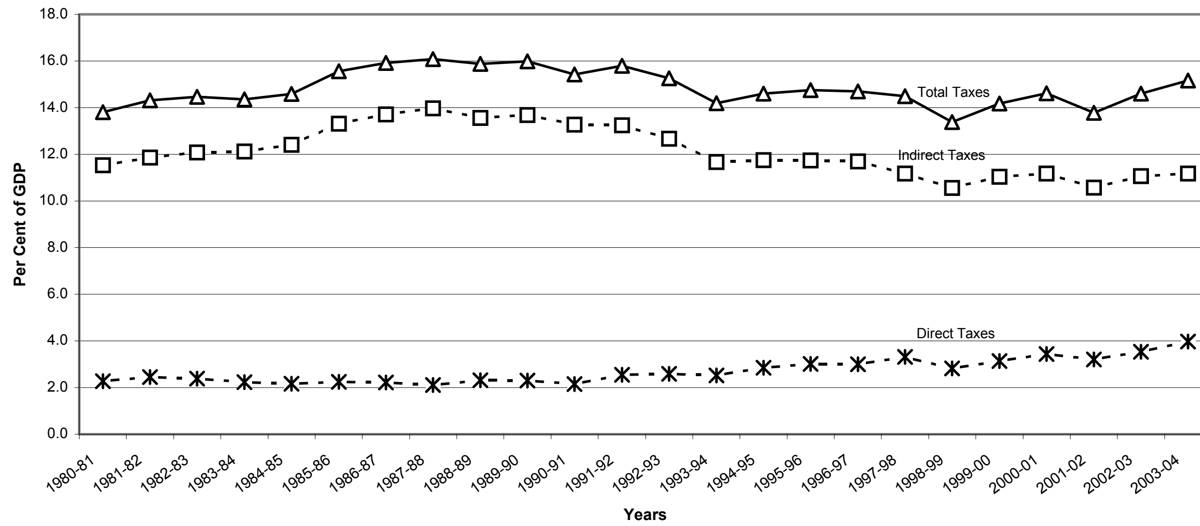
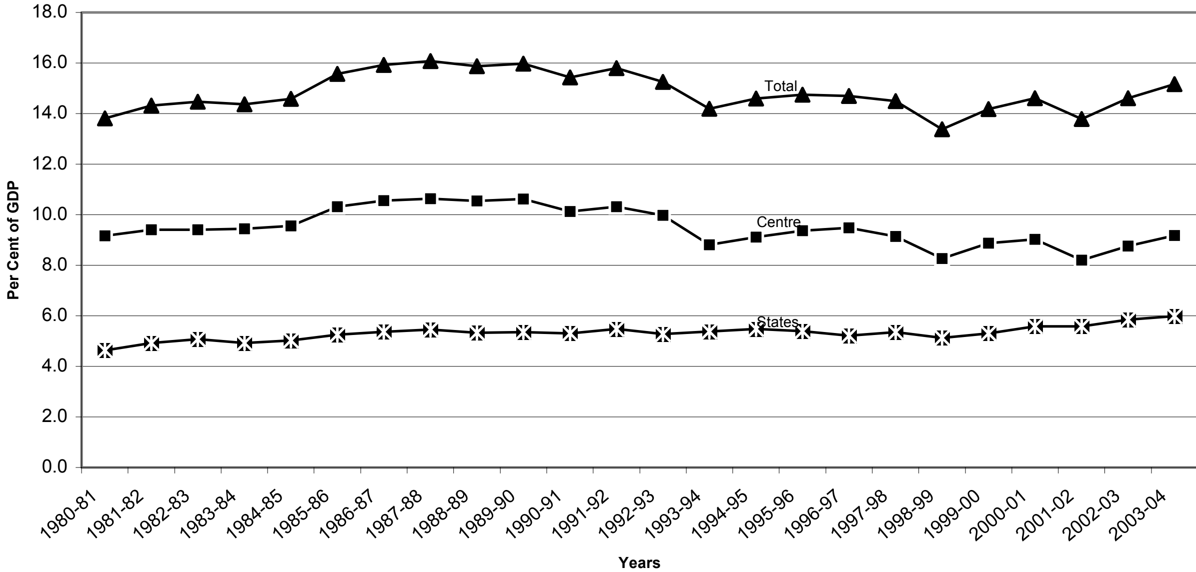


Figure 2: Trends in Tax Revenue- Centre and States



The decline in the tax ratio observed above since 1987-88 has occured mainly at the central level. As central revenues constitute about 60 percent of the total tax revenues, fluctuation in central tax ratio impacts significantly on the aggregate tax ratio in the country. Notably, tax ratios of both central and state governments increased sharply during the period 1950-51 to 1985-86. Thereafter, the tax ratio at the state level was virtually stagnant at about 5.5 percent until 2001-02 and thereafter showed a marginal increase to about 6 percent by 2003-04. In contrast, the central tax ratio increased to reach the peak in 1987-88, and remained at that level until the fiscal crisis of 1991-92. Subsequent years have seen a sharp decline of over two percentage points to GDP until 2001-02 and thereafter it recovered almost to the pre-1991 level in 2004-05 (revised estimates). Within the central level, the share of direct taxes has shown a steady increase from less than 20 percent in 1990-91 to over 43 percent in 2004-05. While as mentioned earlier, the increase in the tax ratio until the end of the 1980s was mainly due to the buoyancy of indirect taxes, in subsequent years increase in the tax ratio from direct taxes arrested the sharp decline seen in the tax ratio from indirect taxes.

4.1 Analysis of Central Taxes

Interestingly, the comprehensive tax reform at the central level was the direct consequence of economic crisis. As Bird (1993) after observing tax reforms in many countries states, "…fiscal crisis has been proven to be the mother of tax reform". However, unlike most *ad hoc* reforms undertaken in response to economic crises, the tax reforms in India were undertaken after a detailed analysis and the reform package introduced in 1991 was systematic and the direction of reforms has continued. In fact, contrary to expectations, the period after the introduction of reforms has seen a decline in the tax — GDP ratio from 10.3 percent in 1991-92 to 8.2 percent in 2001-02 at the central level, before it recovered to about 10 percent in 2004-05. This has prompted many to ask whether the tax reforms caused the decline in the tax-GDP ratio. The contrary view is that the ratio declined in spite of the reforms.

The disaggregated analysis of the trends in central tax revenue presented in table 2 (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 percent in 1991-92 to 1.8 percent in 2004-05 and the decline in the latter was by one percentage point from 4.3 percent to 3.3 percent during the period. Interestingly, the tax ratio from both the taxes declined up to 2001-02 and have stabilised 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 the 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 percent in 1991-92 to 4.3 percent 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 percent in 1991-92 to 2.7 percent in 2004-05. The revenue from personal income tax increased from 0.9 percent to 1.6 percent during the period.

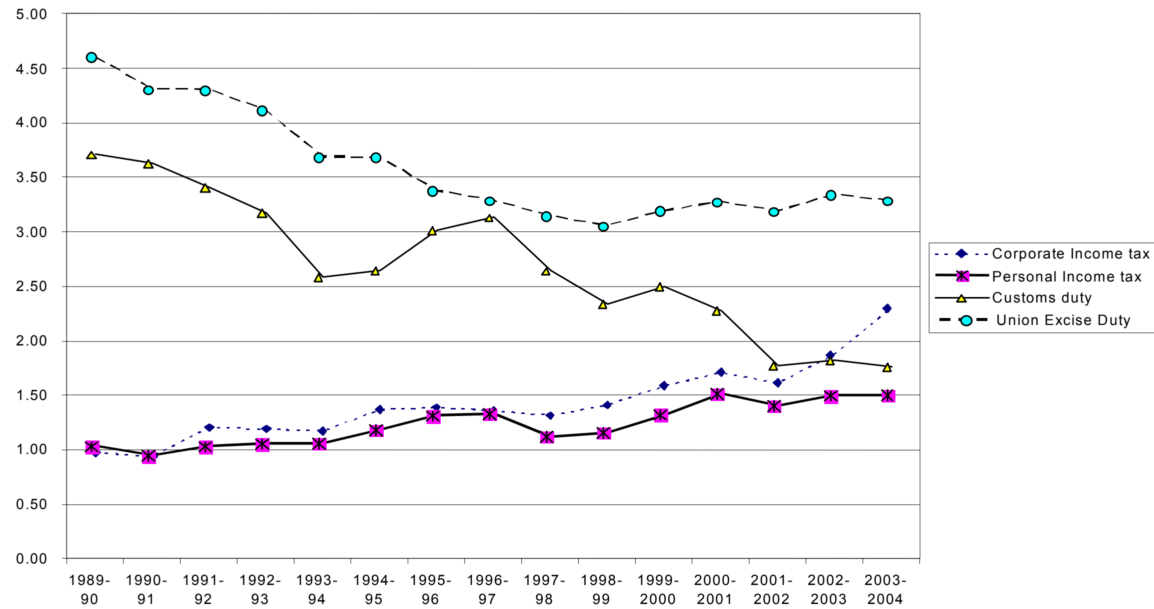
The steady increase in the tax – GDP ratio in direct taxes has resulted in increase in its share in total taxes. In 1991-92, direct taxes constituted less than one fifth of the total tax revenue of the central government. In 2004-05, it increased to 44 percent and in 2005-06, it estimated at 48 percent. Commensurately, there has been a decline in the share of indirect taxes, from 80 percent in 1991-92 to 56 percent in 2004-05. The customs duties which constituted 36 percent of central tax revenue in 1991-92 contributed just about 18 percent in 2004-05, while the share of central excise duty share declined from 43 percent to 33 percent.

Table 2 : Level and Composition of Central Tax Revenue

	PIT	CIT	Direct Tax	Customs	Excise	Indirect	Total	GDP
				Percent 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
				Percent 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).

Figure 3: Percent of Central Taxes to GDP



The decline in the share of customs revenue is certainly to be expected when the tariff rates are sharply 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 due to the demands of the domestic industry. The declining trend in customs revenue is likely to continue. In fact, it was expected that increasing imports due to liberalisation will offset the effect of rate reduction, i.e., rate reduction being offset by base expansion. However, although imports have shown a significant increase after liberalisation (Panagariya, 2005), it was not enough to balance the revenues. One reason for this could be the large scale exemptions. Although the coverage of exemptions has not been expanded in a major way, the expansion in the base that should have accompanied a reduction in the rates of tax was not accomplished through reduction in the exemptions.

The declining trend in excise duties throughout the 1980s was due to the fact that the rate structure implemented when input tax credit was allowed was perhaps not revenue neutral. Continued exemption of small scale sector and increase in the turnover limit to define the small scale upto a turnover of Rs. 1 crore, widespread use of area-based exemptions are other important reasons for the decline in the excise duties. Equally, if not more important is the fact that due to the poor information system, it was possible to claim excessive input tax credit. Further, since 1997-98 over 75 percent of the increase in the GDP is attributable to the growth of service 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. There are no rigorous studies, though the increase in revenue from personal income tax since 1996-97 is attributed to improved 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).

4.2 Level, Composition and Trends in State Taxes

Table 3 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 percent. In fact, from 1994-95, the tax ratio shows a decline to bottom out at 5.1 percent 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 percent in 2003-04.[15]

Table 3 : Trends in State Level Taxes

(percent of GDP)

Year	Direct taxes*	Sales Tax	State Excise duty	Stamps and registrat ion	Taxes on trans- port	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
1991-92	0.2	3.4	0.9	0.4	0.5	0.4	5.4	5.7
1992-93	0.2	3.2	0.9	0.4	0.5	0.3	5.1	5.5
1993-94	0.2	3.3	0.9	0.4	0.5	0.3	5.2	5.5
1994-95	0.2	3.3	0.8	0.5	0.5	0.3	5.3	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

Of the different state taxes, sales tax is predominant and constitutes about 60 percent 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 percent in 1998-99, has increased marginally to 3.5 percent in 2000-01. It has remained at that level thereafter. Any attempt to improve the revenue productivity of states' tax system, therefore, is inextricably

intertwined with the reform of sales tax system and in this respect, the recent reform of moving towards a destination based VAT is extremely important.

State excise duty is a sumptuary tax on alcoholic products. In some states, in addition to the state excise duty, a good proportion of the tax is collected from sales of alcoholic products. In regard to this tax, there has always been a problem of balancing regulatory and revenue considerations. The major components of the tax come from arrack and country liquor on the one hand and 'India Made Foreign Liquor' (IMFL), including beer on the other. The duty is collected by way of licence fee on the sale/auction of vends and taxes on the consumption of liquor. The problem in regard to country liquor has been the brewing and consumption of illicit liquor and this has not only caused loss of revenue, but has been an important health hazard. As regards IMFL, the Karnataka Tax Reforms Committee estimated that the actual evasion of the tax may be as high as three times the actual 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. In fact, the levy of stamp duties in addition to registration fee, adds to the marginal tax rates, which in any case are very high. Not surprisingly, 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 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 the *Rent Control Act and Urban Land Ceiling Act*. In fact, until recently, the tax rates were as high as 12 to 15 percent 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 initiated reforms to reduce the rates in this direction. In Karnataka for example, the tax rate was reduced from 16 percent in 2001-02 to 8 percent in 2002-03 and thus witnessed 30 percent growth of revenue from stamp duties during the period.

The other important component of state taxes are the taxes on transport comprising of motor vehicles tax and passengers and goods

tax. For administrative convenience, many states have merged the latter with an additional motor vehicles tax. Also the motor vehicles tax on private non-commercial vehicles has been converted into a life time tax by adding up ten years' tax or by adopting a similar formula. The reform in this area has to separate the motor vehicles tax from passengers' and goods tax and the latter should eventually become part of the state VAT rather than a separate tax. Similarly, the taxes on entertainment, electricity duty and luxury tax on hotels and restaurants should also be merged with the VAT.

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 market. 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 is also a source of corruption and rent seeking.

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

In this section, the observed trends in different central and state taxes are 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, whether tax compliance has 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?

Personal Income Tax

The increase in revenue productivity of personal income tax is attributed to the improvement in tax compliance arising from the sharp reduction in marginal tax rates in 1991-92 and 1996-97. This is also the period when the growth of GDP itself had decelerated. This is reflected in the negative correlation between effective tax rates and the ratio of income tax collections to GDP, akin to a Laffer curve.[16] While it is clearly difficult to attribute increase in revenue productivity solely or even mainly to reduction in marginal tax rates, Das-Gupta and Mookherjee (1997) draws a tentative, but important conclusion on the improvement in overall performance 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 reduction in marginal tax rates.

In a more recent analysis Bhalla (2005), estimates the aggregate revenue elasticity at -1.43 percent and concludes that the 1996-97 tax cut was a huge success in increasing revenues. The paper provides an estimate of compliance by comparing the data published by the income tax department, the coverage of which itself is narrow, with those from other sources, particularly the NCAER to establish that the number of people recording incomes within any given bracket for income tax purposes, is significantly lower than the numbers recorded by other surveys. There are problems with this approach – especially for proprietary firms and individual businesses as also association of persons, where the distinction between expenditures of the firm and expenditures of the individual for personal needs can be hard to make.[17] Nevertheless, the paper helps to focus on the need for some informed debate and analysis in this area.

The important point is that it is not appropriate to attribute improvement in revenue productivity of personal income tax since 1996-97 solely or even mainly to reduction in the marginal rate of tax. The information presented in table 4 shows that the main reason for the increase in revenues is the administrative arrangement extending the scope of tax deduction at source. The proportion of tax deducted at source (TDS) to total revenue collections actually declined from 42 percent in 1990-91 to 22 percent in 1994-95. It increased to 50 percent following the expansion in the scope of TDS in 1996-97 and further to 67

percent in 2001-02 before declining marginally to 64 percent in 2003-04. As a proportion of GDP, the ratio of collections from TDS increased by 0.67 percentage points over the period considered. When compared with the increase of 0.56 percentage points increase in ratio of personal income tax collections to GDP, this suggests that the improved compliance is largely if not solely owing to improved coverage or greater effectiveness of TDS as a tool for collecting taxes.

Table 4 : Contribution of TDS to Revenue, Personal Income Tax

	Tax Deduction at Source (%)	Advance Tax (%)	Gross Collections (Rs crore)	Refunds (Rs crore)	TDS/GDP (%)
1990-91	41.75	36.00	6188.37	827.74	0.45
1991-92	48.22	33.29	7523.97	794.79	0.55
1992-93	42.91	33.45	9060.79	1165.44	0.52
1993-94	19.65	51.77	14106.25	4045.96	0.32
1994-95	22.18	56.87	17178.72	3357.76	0.37
1995-96	22.21	50.01	22949.61	6462.48	0.42
1996-97	50.87	27.30	20042.48	1808.49	0.75
1997-98	50.87	24.10	19270.19	2169.60	0.64
1998-99	52.44	23.59	22411.98	2171.83	0.67
1999-00	53.69	24.58	28684.29	3029.79	0.80
2000-01	63.22	20.89	35162.61	3398.63	1.06
2001-02	67.10	19.23	35358.00	3354.00	1.04
2002-03	65.55	20.26	42119.00	5253.00	1.12
2003-04	64.03	20.04	48454.00	7067.00	1.12

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

Interestingly, although it is tempting to attribute this to extension of TDS to interest, dividends, payments to contractors and insurance commission, the increase has come about mainly in TDS in salaries. (Table 5) The TDS in salaries in 1992-93 constituted only 25 percent of total TDS, and it increased to 50 percent in 1999-2000 and thereafter declined to 41 percent, as TDS from payments to non-residents and others and payments to contractors increased substantially. It is also seen that the substantial increase in 1996-97 in TDS and corresponding decline in advance tax is accompanied by a sharp increase in the refunds, as well. However, even after the refunds are adjusted, the share of TDS in total receipts continues to remain high and increasing. This implies that the contribution of TDS to incremental revenue is increasing as well.

Table 5 : Contribution to TDS

(percent)

	1992-93	1997-98	1999-00	2000-01	2001-02	2002-03	2003-04
Salaries	25.15	42.05	50.43	48.99	47.82	44.56	41.23
Interest	40.15	25.25	25.85	19.91	21.39	18.37	16.63
Dividend	5.90	3.41	1.99	1.20	0.81	3.00	2.21
Winnings in lotteries and races	1.02	0.66	0.78	0.29	0.23	0.37	0.41
Payments to contractors	11.85	17.90	19.83	14.92	13.06	13.83	17.56
Insurance Comm.	1.21	0.97	0.93	0.72	1.05	1.05	1.01
Payments to Non-residents & others	14.71	9.77	0.18	13.98	15.64	18.83	20.94
Total	99.99	100.00	100.00	100.00	100.00	100.00	100.00
Total TDS collections (Rs crore)	6,210	13,788	18,546	28,213	30,672	36,568	42,955

Source: Report of the CAG of India, Direct Taxes, various issues.

Thus increase in the tax revenue has more to do with the rapid growth of the organised sector, financialisation of the economy, administrative measures on extending the TDS than improved compliance arising from the reduction in marginal rates of tax. The extension of PAN to cover larger number of potential taxpayers, combined with expanded use of PAN on the one hand and the TIN on the other are expected to advance this cause further, by generating an extensive and reliable database. This however does not make out a case for increasing the marginal tax rates, since such increases would be associated with significant efficiency costs on the economy which are then sought to be corrected/mitigated through exemptions and concessions of various kinds.

There has been a significant increase in the number of non-corporate income tax assesses over the last decade. In fact, during the period 1999-00 to 2003-04 alone, the total number of personal income tax assesses increased from 19.6 million to 28.8 million registering a growth rate of over 10 percent per year (Table 6). Interestingly, the highest growth was seen in the income range of Rs. 0.2-0.5 million (38.4%) followed by those above Rs. 1 million (16%). The important thing to note is that the number of taxpayers in the country is still small

considering the growing “middle class”. Second, although the taxpayers with income above Rs. 1 million are growing, it still constitutes a small number as well as proportion to the total. There were only about 1,00,000 taxpayers in this group constituting about 0.3 percent of the total taxpayers.

Table 6: Income Range-wise Income Tax Assesses

Taxable Income Range (Rs. million)	Number of Taxpayers Million			Percent of Taxpayers in the Range to Total Number of Taxpayers	
	1999-00	2003-04	Growth Rate	1999-00	2003-04
Less than 0. 2	18.75	26.55	9.1	95.8	92.08
0.2 – 0.5	0.49	1.80	38.4	2.50	6.24
0.5 – 1	0.26	0.37	9.2	1.32	1.28
Above 1	0.06	0.01	16.0	0.30	0.36
Search and Seizure Assessments	0.015	0.012	(-) 5.43	0.08	0.04
Total	19.59	28.83	10.2	100	100

Source: Report of the Comptroller and Auditor General for the year ended March 2004, Government of India, 2005.

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 and equity of the tax system. Given that the reform involved sharp reduction in the marginal tax rates, the effective rate declines as the level of income increases. It would be tempting to conclude from the above that progressivity has declined and overall equity in the tax system has worsened over the years. Such a conclusion would be inappropriate for, what this shows is that between income taxpayers, the progressivity has declined. Surely in 2003-04, as many as 29 million people paid income tax as compared to about 3.9 million in 1989-90 and the tax paid by them now has doubled from less than one percent of GDP to almost 2 percent of GDP. The increase in the number of taxpayers indicates improvement in horizontal equity since more people with similar incomes now possibly pay the tax and the fact that larger proportion of incomes are subject to tax now represents improvement in vertical equity as well.

Corporate Income Tax

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 three times from 0.9 percent in 1990-91 to 2.7 percent in 2003-04, despite significant reduction in the rates. The reforms were mainly in terms 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 a considerable extent. In addition, the introduction of MAT has also contributed to the revenues.

Table 7: Sectoral contribution to Corporate Income Tax (CIT) Collections

(percent)

	1994-95	1995-96	1996-97	1997-98	1998-99	1999-00	2000-01	2001-02	2002-03	2003-04
Mining	2.41	5.20	10.55	11.47	12.88	18.66	22.45	18.27	21.97	13.92
Manufactur										
Food products	6.75	3.69	2.96	3.88	4.55	4.77	4.76	3.67	3.43	3.46
Textiles	1.92	0.83	0.81	0.72	0.56	0.55	0.64	0.37	0.47	0.52
Leather	0.04	0.04	0.04	0.04	0.05	0.11	0.07	0.02	0.02	0.03
Paper and wood	1.61	2.29	0.78	0.53	0.44	0.75	0.89	0.94	0.58	0.74
Petro products	11.75	12.21	7.55	5.50	9.42	6.28	4.97	7.46	11.13	12.48
Chemicals	17.21	13.98	8.67	7.58	6.89	5.74	5.41	5.43	6.00	6.46
Rubber and plastics	0.87	0.63	0.70	0.64	0.93	0.80	0.51	0.47	0.61	0.50
Non-metallic minerals	1.20	1.82	0.82	0.53	0.46	0.38	0.57	0.40	0.30	0.48
Basic metals and products	3.84	4.70	4.32	3.08	3.60	4.45	4.22	2.95	2.86	6.09
Machinery	13.34	9.90	8.68	6.40	6.35	5.75	3.51	3.92	3.63	3.88
Transport equipment	8.80	10.84	9.41	6.37	5.65	4.61	2.41	3.06	3.96	5.31
Total: Manufacturing	67.33	60.93	44.74	35.27	38.9	34.19	27.96	28.69	32.99	39.95
Electricity gas and steam	0.34	1.70	1.70	8.80	11.49	7.51	9.09	6.49	5.57	1.91
Construction	2.44	1.73	1.38	1.17	1.38	1.27	1.17	0.97	0.89	1.31
Wholesale and retail trade	3.29	2.27	3.31	3.41	2.23	1.89	3.00	2.94	3.03	2.99
Hotels and restaurants	1.15	1.37	0.97	0.62	0.53	0.35	0.38	0.23	0.21	0.21
Transport services	0.36	2.27	2.12	2.07	1.39	1.42	1.91	1.50	1.49	1.27
Post and telecom	10.07	7.91	6.13	5.95	7.58	4.29	5.72	6.35	2.61	6.50

Table 7: Sectoral contribution to Corporate Income Tax (CIT) Collections

(percent)

	1994-95	1995-96	1996-97	1997-98	1998-99	1999-00	2000-01	2001-02	2002-03	2003-04
Financial intermediation	11.89	15.95	28.34	30.39	22.37	28.54	25.83	32.01	28.67	29.74
Real estate	0.01	0.03	0.03	0.02	0.01	0.02	0.01	0.02	0.02	0.03
Computer, R&D and other Business services	0.67	0.60	0.64	0.72	1.06	1.46	2.19	2.21	2.13	1.79
Social services	0.04	0.05	0.09	0.13	0.19	0.39	0.31	0.32	0.40	0.40
Proportion of Total CIT Collections	50.06	62.16	77.39	80.82	64.54	62.21	61.95	72.62	80.38	65.09

Source: Prowess database.

It would be instructive to analyse the contribution of various sectors to corporation tax. The contribution of manufacturing sector from the prowess database accounts for two-thirds of the corporate tax collections (Table 7). The analysis shows that the manufacturing sector contributed 40 percent of the corporation tax in 2004-05. Within the manufacturing sector, the petroleum sector contributed the highest (12.5%) followed by chemicals (6.5%) and basic metal industry (6.1%). In contrast, the contribution of textiles was just about 0.5 percent. 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.

Another important issue examined here refers to the contribution of the public sector enterprises. Curiously, the contribution by public enterprises has shown significant increase since 1991. In fact, the share fell from 23 percent in 1990-91 to 19 percent in 1994-95, but increased thereafter to constitute about 38 percent in 2002-03. This meant that over 40 percent of the increase in corporation tax was collected from public enterprises (Table 8). This is partly owing to the fact that public enterprises do not undertake elaborate tax planning to minimise the taxes unlike the private sector.

Table 8: Contribution of Public Sector Enterprises to Corporation Tax

Year	Tax provision by public enterprises (Rs. crores)	Total collections (Rs. crores)	Percent of tax by public sector to total
1990-91	1229.3	5335	23.04
1991-92	1674.11	7853	21.32
1992-93	1804.37	8899	20.28
1993-94	2109.93	10060	20.97
1994-95	2581.46	13822	18.68
1995-96	4186.66	16487	25.39
1996-97	5192.51	18567	27.97
1997-98	5634.11	20016	28.15
1998-99	6499.00	24529	26.50
1999-00	7706.25	30692	25.11
2000-01	9313.62	35696	26.09
2001-02	12254.32	36609	33.47
2002-03	17429.95	46172	37.75

Source: Public Enterprises Survey, Government of India (various years).

Union Excise Duties

Declining tax-GDP ratio of union excise duties is truly a matter of concern as this has been a constraint in reducing the import duties further. 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 percent, it is significantly lower than the ratio in 1991-92 (4.1%).

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 — goods transport vehicles being a prime example.

The commodity-wise revenue collections from union excise duty presented in table 9 bring out some interesting features with implications on both efficiency and equity of the tax system. One of the most important features of the union excise duties 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 percent 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 percent of the union excise duty collections, with more than three times increase in share over a 13-year period. This imposes disproportionate 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 consequence of the pattern of excise revenue collections is that an overwhelming proportion of the duties is collected from commodity groups which are in the nature of intermediate products, used in the production of goods or services which are not subject to excise. Besides petroleum products, a significant proportion of which is used in transportation of goods and persons involved in or related to other kinds of 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 one 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.

Table 9: Revenue from Union Excise Duties by Commodity Groups

	1990-91	1995-96	1998-99	1999-00	2000-01	2001-02	2002-03	2003-04
Food products	4.01	3.55	4.80	4.38	4.53	3.67	3.57	3.24
Tobacco products	8.29	8.07	7.95	6.74	6.74	6.57	5.90	5.58
Minerals and ores	8.38	8.68	7.18	6.66	6.24	5.99	5.76	6.24
Petroleum Products	**13.93**	**12.39**	**22.46**	**29.56**	**32.91**	**38.32**	**40.37**	**40.99**
Chemicals	**11.15**	**14.42**	**11.14**	**9.79**	**10.17**	**9.86**	**9.31**	**8.86**
Plastics and articles thereof	2.50	4.04	4.21	3.66	2.28	2.38	2.39	2.52
Rubber products	4.93	4.62	2.90	2.65	2.16	1.96	1.79	1.27
Leather and wood products	0.56	0.43	0.23	0.20	0.20	0.17	0.15	0.15
Textiles and garments	10.78	8.54	6.25	5.20	4.84	4.68	4.62	3.73
Basic Metals	**9.62**	**14.53**	**11.43**	**11.15**	**10.42**	**9.18**	**9.84**	**11.24**
Electrical and electronic goods/tools	**16.11**	**11.88**	**10.47**	**9.47**	**8.81**	**8.18**	**7.77**	**7.82**
Transport vehicles	**8.39**	**7.35**	**8.46**	**8.79**	**8.90**	**7.17**	**6.97**	**6.63**
Miscellaneous	1.35	1.51	2.51	1.76	1.81	1.88	1.57	1.73
Total	100	100	100	100	100	100	100	100

Source: Central Excise Data

A striking feature of the excise duty collections is that akin to the case of the corporation tax, a predominant proportion of collection is paid by the public sector enterprises. The contribution of public sector to total excise collections in 2002-03 was about 42 percent (Table 10). Another important feature of this component of revenue is the wide fluctuation from year to year. It reached the highest share of 53 percent in 1999-2000, and the share was the lowest in 2001-02 at just about 30 percent. 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 varies with international prices as well. In other words, the revenue from excise duties, which constitutes an important source of revenue for the central government, is vulnerable to pricing and output decisions of public enterprises and given the significant dependence on this sector, the ability of the PSUs to forge an independent pricing policy too could be compromised.

Table 10: Contribution of PSEs to Excise Revenues of GOI

	Public enterprises	Total collections	Share of PSEs
1990-91	9655.69	24514	39.39
1991-92	9815.15	28110	34.92
1992-93	12179.9	30832	39.50
1993-94	12527.11	31697	39.52
1994-95	16414.07	37347	43.95
1995-96	17044.41	40187	42.41
1996-97	22192.87	45008	49.31
1997-98	21719.61	47962	45.29
1998-99	23131.67	53246	43.44
1999-00	32941.53	61902	53.22
2000-01	20824.38	68526	30.39
2001-02	31202.78	72555	43.01
2002-03	34610.32	82310	42.05

Source: Public Enterprises Survey various issues, and Budget of GOI, various years

Note: Tax provision relates to the provision made for corporate tax

Customs Duties

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

A major problem from the viewpoint of efficiency is the continuation of differentiated tax rates varying with the stages of production. The rates on raw materials and intermediate goods continue to be lower than those on consumer goods and capital goods. The import tariff reduction has continued to be guided by this "unprincipled principle" (Joshi and Little, 1996), and even the Kelkar Task Force on indirect taxes has suggested that the rate differentiation should be made on the basis of the stage of production. This approach retains the focus on greater protection for "final use industries" as compared to inputs and intermediate goods, a continued reliance on the self sufficiency model of development as against a comparative advantage model.

Table 11 presents the commodity group wise collection of customs from 1990-91 to 2003-04. Interestingly, despite significant external liberalisation, almost 60 percent of the duty is collected from just three commodity groups namely, machinery (26.6%), petroleum products (21%) and chemicals (11%). Furthermore, overwhelming proportion (over 75%) of the duty is collected from either machinery or basic inputs and intermediate goods. Thus, contrary to the fear, liberalisation has not led to massive inflow of consumer goods. This also implies that further reduction in the duties and greater uniformity in the structure of duties would have beneficial effects on the economy. A detailed econometric study of Virmani *et. al* (2004) shows that uniform reduction in tariffs has had favourable effects on production, exports, employment and capital and these gains are different across different sectors.

The commodity group composition of import duties also shows a significant increase in the proportion of import duties collected from machinery from 19.5 percent in 1990-91 to 26.6 percent in 2003-04. This has happened despite providing exemption to the plant and

machinery imported for several project imports. This implies that external liberalisation is leading to adoption of more modern machinery and technology in the production process and this would have favourable effect on the productivity growth. The other item that has shown increase in revenue importance is food products. In contrast, revenue from iron and steel and other basic metals has shown a substantial decline over the years and this may be due to the fact that these items have, over the years have become more competitive and therefore, it is perhaps more attractive to buy them in the domestic market rather than importing them.

6. Towards Further Reforms in the Tax System

In the last few years, there has been considerable focus on the reforms in the tax system at the central level with the tax system being studied by various study groups and task forces. 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, 2004b) have made a comprehensive examination of the tax system and made important recommendations to reform. All these are in conformity with the direction set by the TRC (India, 1991, 1993) of broadening the base, reducing the rates, simplification and minimising rate differentiation in the tax systems. Like the TRC reports, these reports emphasise the need to focus on tax administration as well. While there are differences relating to some of the specific recommendations of the KTF, both on direct and indirect taxes and on the *FRBM Act*, there is broad agreement on the direction and thrust of reforms and on the emphasis placed on the reform of tax administration and information system.

Tax reform is an ongoing process, and in India in particular, with the fiscal imbalance looming large, reforms to improve the long-run revenue productivity will have to continue. The reforms would have to be within the tax systems, involving tax structure, administration, as well as institutions. Besides the general thrust of broadening the tax base, reducing the rates, make the tax system simple and transparent, it is

important to evolve a system which is general and rule based. In a

Table 11: Composition of Revenue from Customs Duties

(percent)

	1990-91	1995-96	1996-97	2000-01	2001-02	2002-03	2003-04
Food items	2.49	2.43	2.25	5.42	10.64	8.76	6.36
Tea/coffee	0.12	0.04	0.04	0.05	0.06	0.09	0.04
Beverages	0.08	0.13	0.07	0.09	0.22	0.16	0.10
Minerals and ores	1.38	0.74	0.52	1.34	1.55	1.80	1.74
Petroleum products	19.39	23.39	28.54	23.16	16.14	19.50	20.93
Chemicals	12.34	11.86	11.19	10.35	11.41	11.19	11.12
Of which:							
Pharmaceutical products	0.06	0.07	0.05	0.21	0.30	0.44	0.29
Plastics	6.36	4.86	4.71	2.99	3.14	3.07	3.10
Rubber	1.38	1.32	1.48	1.39	1.40	1.30	1.33
Paper	1.04	0.65	0.74	0.70	0.71	0.69	0.89
Textiles	2.16	1.26	0.94	0.97	0.85	0.96	1.40
Cement products etc.	0.20	0.19	0.14	0.19	0.21	0.23	0.26
Ceramics	0.58	0.52	0.45	0.69	0.78	0.75	0.98
Iron and steel	10.24	6.63	5.15	3.81	3.78	3.72	4.64
Other basic metals	4.28	4.95	4.38	2.12	2.30	2.17	2.50
Machinery	19.49	20.84	18.81	23.55	24.80	26.36	26.58
Transport equipment	3.29	4.04	4.69	3.94	3.96	3.37	4.14
Others	15.20	16.16	15.90	19.25	18.06	15.87	13.90
Total	100	100	100	100	100	100	100

democratic polity with so many special interest groups influencing policies, it is difficult to move away from the culture of selectivity and discretion, but this has to be achieved over a period of time.

6.1 Reform of Central Taxes

The reforms with regard to personal income tax will involve further simplification of the tax system by withdrawing tax exemptions and concessions on incomes from specified activities. It is also necessary to abolish the surcharge and further simplify the tax initially by reducing the tax brackets to two. In fact, there is considerable virtue in having a single tax rate with an exemption limit as many of the transitional economies have found. In any case, the ability of the income tax system in bringing about significant redistribution through tax policy is limited and if it is taken that equity in fiscal policy should focus on increasing the incomes of the poor rather than reducing the incomes of the rich, the objective is better achieved by allocating and targeting adequate resources to human development rather than creating disincentives to work, save and invest. However, moving towards a single rate of tax may not be politically feasible at this juncture, but it may be possible to reduce the number of tax rates to two, with a small reduction in the marginal tax rate (say 25%).

As regards the corporation tax, base broadening involves getting rid of the tax concessions and 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 depreciation allowance given at present, even after the proposed reduction in 2005-06 is quite generous and there is a case for reducing it to more realistic levels and at the same time reducing the tax rate to align it with the marginal tax rate on personal income tax. Most importantly, it is important to avoid flip flop in tax policy. The history in regard to taxation of dividends, in particular has been full of contradictory policy stance from one year to another. It is important to settle the issue of whether dividends should be taxed in the hands of tax payers or companies. The most satisfactory solution is to have partial integration of the tax with personal income tax. However, for administrative reasons, if it is thought that it is better to collect the tax from the company, then the tax rate applicable on dividends should be determined on the basis of the difference between the marginal tax rate of personal income tax and effective rate of corporation tax.[18]

The other important issue in the context of corporate income tax is the differential between the rates applicable to domestic and foreign companies. Part of the rationale for having some differential rests in the form of the dividend tax, which is payable by domestic companies alone. The rationalisation of these two aspects therefore needs to go together.

With regard to import duties, the reform will have to move in the direction of further reduction and unification of rates. As most non-agricultural tariffs fall between zero and 15 percent, a uniform tariff of 10 percent would considerably simplify and rationalise the systems (Panagariya, 2005; Acharya, 2005). Equally important is the need to get rid of a plethora of exemptions and concessional treatment to various categories including project imports. In fact, a minimum tariff of 5 percent on all exempt goods could be introduced as a first step in rationalising the duty to bring it in line with the above recommendation.

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 have not only eroded the tax base but have inhibited the growth of firms into an economic scale. Similarly, various exemptions given to project imports have significantly eroded the tax base. This has also imparted selectivity and discretion to the tax system. On the rationalisation of the rate structure, it is important to convert the remaining items subject to specific duties to *ad valorem*, and unify the rates towards a single CenVAT rate. The next step is to fully integrate the CenVAT with the taxation of services. This would require the extension of the service tax to all services excluding a small list of exemptions and a small negative list as recommended by the *Expert Group on Service Taxation* (India, 2001) M. Govinda Rao. This would help in assessing the potential from service taxation. At the next stage, the taxes on services could be unified with the CenVAT to evolve a manufacturing stage value added tax on goods and services. Since the Acts already provide for credit of the tax paid on both goods and selective services taxed at present, universal coverage of service tax with tax credit mechanism and its integration with CenVAT will rationalise the tax system considerably. In addition, this tax will have a broader base and not only increase short term revenues, but also improve revenue productivity of the tax system. However, it should be pointed out here, that the restriction of the CenVAT to the manufacturing stage alone, as at the present juncture, brings in the need to have a number of

agents in the system, who do not collect and pay taxes to the department but are entitled to issue VAT invoices. In the Indian context, wholesalers are authorised to issue multiple VAT invoices on their sales against the single invoice of their purchases, in order to facilitate the credit mechanism for small and medium manufacturers, who may not always buy from other manufacturers. This constitutes a weak link in the chain of invoices since these agents would be difficult to monitor and administer. This problem can get further exacerbated with integration of services into the credit mechanism, since a larger number of agents would seek to purchase from agents other than manufacturers. This is a problem that besieges the CenVAT administration today and needs to be addressed. While the solution discussed by the Tax Reforms Committee (India, 1993) of expanding the coverage of CenVAT to the wholesalers with the revenue being assigned to the states, is one option, an administrative alternative could be devised by mandating the filing of informational documents and periodic auditing of these dealers.

6.2 Evolving Co-ordinated 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. This is necessary to ensure fair distribution of the burden of taxation between different sectors and between goods and services, improve the revenue productivity, minimise relative price distortions and above all, ensure a common market in the country without placing any impediments on the movement of factors and products.

The above involves co-ordinated 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, the reform initiated in April, 2005, of introducing the VAT has to be completed. The most important step involved in this is the extension of input tax credit mechanism not only to intra-state trade but also inter-state trade by introducing appropriate zero-rating mechanism. This would require building up a proper information system on inter-state transactions, which has been initiated. This will have to be adopted by all the states and union territories. 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 at a comprehensive VAT. An important problem in this regard is devising a system for

taxation of services with an inter-state coverage, which would depend closely on the mechanism chosen for zero-rating inter-state trade.

An important aspect from the viewpoint of efficiency in resource allocation is the continued cascading of the tax on petroleum products. These are kept outside the CenVAT system. They are also not a part of the VAT system in states. These contribute to over 40 percent of the revenues of both the taxes. Considering the use of these items for intermediate consumption, the extent of cascading and relative price distortion will continue to be high.

In terms of the burden distribution, extending the scope of service tax to all services and then unifying it with CenVAT in a revenue neutral manner would help bring down the CenVAT rate approximately by about three percentage points. This would enable the centre to reduce the VAT rate to about 12 percent and for reasons of equity and revenue, a special excise of an additional 6 percent could be levied on items of luxury consumption (Acharya, 2005). The tax rate of 12 percent at manufacturing stage would be equivalent to 8 percent at retail stage assuming that value added beyond the stage of manufacturing amounts to a third of the retail value of the commodity. KTF on indirect taxes assumed that the overall consumption tax burden should not exceed 20 percent, and in such a case, a 12 percent manufacturing stage VAT would leave a tax room of about 12 percent to the states for the levy of VAT at the retail stage. Along with the levy of VAT at the state level, it is important to integrate many of the existing taxes, such as entertainment tax, electricity duty, passengers and goods tax and luxury tax on hotels. Also there is no case for turnover taxes, surcharges, and additional taxes.

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 alternative source of revenue. 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, a better option is to allow the local bodies to piggyback on the VAT collections in urban local body jurisdictions. This will avoid cascading of the tax and minimise tax spillovers by the urban local bodies to non-residents.

6.3 Reform in Tax Administration

In India, until recently the focus of tax reform attempts was on "what to do" and much less on "how to do". The administrative dimension has been in the periphery rather than the centre of tax reform (Bird, 1989). The TRC did emphasise the need to reform tax administration to some extent but it is the KTF on Direct and Indirect taxes that has brought the administrative dimension to the centre of reform process.

Not surprisingly, the poor state of tax administration has been a major reason for low levels of compliance and high compliance cost. A major aspect of poor tax administration 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. Given the complexity in the tax structure and poor information system, the tax system often, acquired the character of negotiated payments (India, 1993, 2002a, 2002b). The consequence of this has been a 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 percent of personal income tax collections and in the case of corporate tax, between 6 and 15 percent of the tax paid, with the bulk being legal costs of compliance. While these estimates should be taken with a note of caution as the author himself has reservations on the adequacy and quality of the sample analysed, the important point to note is that the compliance cost in Indian income taxes is extremely high.

High compliance cost combined with poor state of computerisation and information system has led to continued interface of taxpayers and tax officials, negotiated payment of taxes, corruption and rent seeking and low levels of tax compliance. An important indication of the poor state of information system is seen by the fact that even as the coverage of TDS was extended over the years, there was virtually no information system to check whether those deducting the tax at source file the returns and pay the tax. As the CAG report for 2003-04 states, of the 626 thousand returns to be filed by TDS assesses, only 499 thousand returns were filed. In other words, more than 20 percent of the TDS assesses did not file the returns. Even this is a vast improvement

from the previous year when almost 80 percent of the TDS assesses did not file the returns.

The fact that tax administration was the soft underbelly of the tax system and is a critical element in improving tax policy and revenue productivity has been underlined for long (Das-Gupta and Mookherjee, 1998). The Chelliah Committee (India, 1993) devoted considerable attention to this issue and the ideas of building a tax information network go back to the recommendation of this committee. The *Kelkar Task Force on Direct and Indirect Taxes* rightly brought these issues to the fore with greater emphasis once again.

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 PAN which in turn has facilitated the compiling of information on all taxpayers. Furthermore, the Tax Information Network has been established by the National Securities Depository Limited (NSDL). The initial phase was focused on ensuring that TDS assesses do in fact file the returns, besides matching and cross-checking the information from banks and financial institutions to ensure that the taxes paid according to the returns are actually credited into government accounts. The Online Tax Accounting System (OLTAS) was operationalised in July, 2004. This has helped to expedite the number of refunds from 2.6 million in 2002-03 to 5.6 million in 2003-04. The PANs issued increased to 36 million by late 2004. Large companies such as Infosys Ltd could now upload one diskette for filing the TDS of their employees instead of filing separate TDS returns for each employee. In short, in the last four years, the direct taxes have shown annual growth rate of over 20 percent per year and the contribution of improved information system in this has not been insignificant.

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 percent of India's international trade. The technical assistance from Canadian International Development Agency (CIDA) has helped the excise department to establish and build capacity in modern audit systems and computerise

risk assessment for detailed audit. This is a step-up in building up expertise in areas requiring significant technical of expertise. Both the direct and indirect tax departments could gain from building up expertise through functional specialisation in such identified areas which require technical and focused expertise.

These initial steps in building computerised information system are the basic requirement for tax administration. The second phase of the TIN has been initiated and when completed, this should help not only in better administration and enforcement of the tax but also in planning the policy changes in regard to the tax system. Computerised information system will help to put together data from a variety of relevant sources, ensure better administration and enforcement of the tax, and thus improve tax compliance. It will also help in significantly reducing the compliance cost as it will avoid the need to interact with tax officials. An important constraint for this is the fact that many of the senior officers are not initiated to computers and there is natural hesitancy and often unwillingness on their part to adapt to new technology. Orientation workshops can go a long way in managing this change well.

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 legally 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 for various assesses. In the second, CBDT and CBEC should exchange information to ensure a measure of consistency between the returns filed by the two departments. In the third, it is necessary to exchange information between central and state taxes. It is only through a well organised and computerised information system of returns, will it be possible to enforce the tax and improve tax compliance.

7. Concluding Remarks

The foregoing analysis shows that there has been significant progress in tax reforms particularly in tax administration in recent years that has helped in the recovery of tax-GDP ratio close to the levels that prevailed prior to significant reduction in customs. This, however, is only the beginning, and considerable distance in reforming the tax system is yet to be covered. In other words, the tax system reform including reform in administration is a continuous exercise for improving the revenue productivity, minimise distortions and improve equity.

It is important to note that the reforms should be undertaken at central, state as well as local levels. A major objective should be to minimise distortions and compliance cost. In fact, the sub-national tax system should be evolved such that the principles of common market are not violated. It is also necessary that domestic trade taxes on goods and services should be calibrated in a coordinated manner in the spirit of cooperative federalism. Coordinated calibration of domestic and external trade taxes to ensure the desired degree of protection to domestic industry and the desired burden of consumption taxes to the community is also necessary.

Broadening the base of both central and state taxes and keeping the tax structures simple — within the administrative capacity of the governments is an important international lesson that has to be taken note of in calibrating further reforms. Phasing out small scale industry exemptions, minimising exemptions and concession to industries in the services sector, minimising 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.

Although the customs duties have been significantly reduced, India is still one of the highly protected economies. Further reduction in tariffs as also further unification and rationalisation is necessary. This would certainly entail loss of revenue and there has to be corresponding improvement in the revenue productivity in all the taxes. The reforms in converting the prevailing sales taxes into a destination based consumption type VAT by the states initiated in April, 2005, will have to be carried out with vigour and completed within the next few years. This

would require complete phasing out of the central sales tax. Finalising the mechanism to relieve taxes on inter-state transactions and building a proper information system for the purpose, is therefore, extremely important, both to improve the revenue productivity and to improve the efficiency of the tax system.

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, and compiling and matching information is most desirable. It is also important to note that there must be a large taxpayer unit which not only compiles information, its collation and matching, but should also assist taxpayers without delay, and thus help them to reduce their compliance costs.

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Endnotes

[1] The important exception to this is the introduction of expenditure tax on Kaldor's advise in the mid 1950s. *See*, India (1956).

[2] 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…".

[3] The Report of the Task Force on the Implementation of Fiscal Responsibility and Budget Management Act, 2003 (India, 2004) for example, states, "Indirect tax policy in India tends to be constantly battered by special interest groups that find it to their interest to have the structure cater to their particular benefit."

[4] 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).

[5] Rajaraman (2004) cites the estimates of the IMF study (Ebrill *et.al.,* 2001) to show that countries with higher per capita GDP tended to gain, but the poorer countries tended to lose by introducing the VAT. Besides the usual problems with cross-country regression estimates which both the papers point out, it must be noted that a properly calibrated VAT with its information on turnovers can improve income tax. In Thailand for example, the introduction of VAT replacing the manufacturers' sales tax in 1991 at a uniform rate of 7% which was actually less than the revenue neutral rate (10%), led to full revenue recovery. What was surprising was that it also increased the income tax by 25 percent. (India, 1995).

[6] According to a report in the Financial Times of April 6, 2005, last year in India, the use of credit card by foreigners increased by 42 percent to USD. 75 million

[7] *See.* Harberger (2003) and Bird and Zolt (2005).

[8] The *88th Amendment* to the Constitution of India assigns the power to levy service tax to the central government, with the proceeds being collected and appropriated by the central and state governments, in accordance with the principles formulated by the Parliament.

[9] For incomes from capital alone, with a wealth tax of 5 percent, the above tax structure meant that there was a ceiling on income at Rs. 250 thousand – this was the desired goal as explicitly recorded in the budget speech of 1971-72.

[10] Indira Gandhi, presenting the 1970-71 budget stated, "Taxation is also a major instrument in all modern societies to achieve greater equality of incomes and wealth. It is, therefore, proposed to make our direct tax

system serve this purpose by increasing income taxation at higher levels as well as by substantially enhancing the present rates of taxation on wealth and gifts."

[11] Arbalaez (2002) for discussion of effects of such a tax in Columbia.

[12] Thereafter only a few commodities remained on specific duties – tea, cement, and cigarettes are notable among these.

[13] 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 has a tradition of appointing a tax reform committee every five years. Sometimes, the studies were repeated after some years. These recommendations continue to be pertinent suggesting that very few have been translated into policy.

[14] There is also a commodity tax at the local level called "octroi". This is a tax on the entry of goods into a local area for consumption, use, or sale. This tax levied by urban local bodies and in application in many states.

[15] The tax ratios however do vary significantly across states, with the southern states of Kerala, Karnataka, and Tamil Nadu on average, recording higher levels than the other states.

[16] Effective tax rates are derived by applying the tax structure to reference income levels. Given the limited sample size, such an exercise would not be empirically sound and hence is not reported.

[17] The *Income Tax Act* provides for some deductions in the case of business and traders. The deductions include expenditure on travel and entertainment. Further, expenses on telecommunications too are a case in point. While any income tax return would show some or all of these expenses as business expenses, in most other consumer surveys, these would figure as personal expenses. Given that the proportion of these expenses in total income is likely to be higher in the "middle", and given the higher possibility of this group of agents being in the "middle", it appears that this definitional issue itself could induce the pattern observed in the paper.

[18] The rationale for a separate taxation of dividends is that the effective rate of corporation tax is lower due to tax preferences and therefore, the difference should be taxed to treat corporations on the same footing as unincorporated businesses which pay the tax at personal income tax rates.