Initiative for Policy Dialogue Working Paper Series

October 2009

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Tax

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Tax System Reform in India

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Many developing countries have embarked on tax reforms in recent years. Such reforms were motivated both by local factors as well as by rapid internationalization of economic activities. The need to correct fiscal imbalances and the transition from a centralized plan to a market economy were the important local factors hastening tax reforms. Difficulties in compressing expenditures necessitated that tax system reform take an important role in fiscal adjustment strategy. The transition from plan to market required the substitution of administered prices with market determined prices, the replacement of physical controls with financial controls, and the substitution of public enterprise profits with tax revenues. Likewise, tax reforms become imperative in a globalizing environment. Enhancing competitiveness and attracting foreign investment require minimizing both efficiency and compliance costs of the tax system. Globalization also involves loss of revenue from customs, which needs to be replaced with domestic taxes.

The Indian tax system too had to be reformed in response to changes in development strategy. In the initial years, tax policy was used as an instrument to achieve a variety of diverse goals which included increasing the level of saving and correcting for inequalities arising from an oligopolistic market structure created by a centralized planning regime, including a licensing system, exchange control, and administered prices (Bagchi and Nayak 1994). While the history of taxation in India is peppered with efforts

for tax reform, especially in the form of various expert committees, the fiscal crisis of 1991 provided the first major window of opportunity for a serious rethink, followed by action.

This paper analyzes both the structure and the operations of the Indian tax system. The first section discusses the evolution of the Indian tax system and tax collections and the impact of historical and institutional factors in shaping Indian tax policy. Next, we provide a critical analysis of some key features of the tax regime and its reform options. An analysis of the observed trends in tax revenue is presented in the following section, highlighting the possible efficiency and equity implications of the tax system. The final section pulls together the various suggestions for consolidation of tax reforms in India.

Evolution of Indian Tax System

The Assignment System

The assignment of tax powers in the constitution provides the framework for the evolution of the tax system in India. It assigns most of the broad-based and mobile tax bases to the center. These are taxes on non-agricultural incomes and wealth, corporation tax, customs duties, and excise duties on manufactured goods. States' tax powers include taxes on agricultural incomes and wealth, sales taxes, excises on alcohol, taxes on motor vehicles, passengers and goods, stamp duties, registration fees on transfer of property, and taxes and duties on electricity. Of these, sales tax is the most important and contributes 60 percent of states' tax revenue.

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

Recent Trends in Indian Tax Reforms

While India has had a history of periodically assessing the tax structure, through the constitution of tax reform committees (India 1971, 1977), actual reform attempts were largely ad hoc; it required a crisis of some severity before systematic tax reforms were implemented. Fiscal and balance of payments crises of 1991 warranted systematic reform not only to improve the revenue productivity of the tax system to phase out fiscal imbalance, but also to reorient the tax system to the requirements of a market economy. Tax reforms were an integral part of this larger reform initiative.

The Tax Reforms Committee (India 1991) laid out a framework and a roadmap for the reform of direct and indirect taxes as a part of the structural reform process. The paradigm shift in tax reforms adopted by the TRC was in keeping with the best practice approach of broadening the base, lowering marginal tax rates, reducing rate differentiation, simplifying the tax structure, and adopting measures to make the administration and enforcement more effective.

The important proposals put forward by the TRC included reduction in the rates of all major taxes, i.e., customs, individual, and corporate income and excise taxes 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 minimizing exemptions and concessions, drastic simplification of laws and procedures, building a proper information system and computerization of tax returns, and revamping and modernization of administrative and enforcement machinery. It also recommended that the taxes on domestic production should be fully converted into a value added tax, and it should be extended to the wholesale level, in agreement with the States, with additional revenues beyond post-manufacturing stage passed on to the State governments. The tax reforms witnessed thereafter sought to follow the directions spelt out in this report.

While the TRC laid down the analytical foundations for the reform of the tax system in a liberalized environment, subsequent reports extended the roadmap for reforms to meet the demands of the emerging economic environment in the new millennium. These include the task force reports on the reform of direct and indirect taxes (India 2002) and the report of the task force on the implementation of the Fiscal Responsibility of Budget Management Act, 2003 (India 2004).

Reform of Direct Taxes

At the central level, the income tax evolved as a principal instrument to bring about redistribution until mid 1970s. Thus, in 1973-74, the personal income tax had eleven tax brackets 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. 200,000 income was 97.5 percent. Combined with the highest wealth tax rate of 5 percent, the budget speech for 1971-72 argued that this tax rate would ensure a ceiling on income at Rs. 250,000, for purely income from capital alone.

In the case of company taxation, the classical system of taxation involved the taxation of the profits in the hands of the company and the dividends in the hands of the shareholders. The distinction was made for widely held companies and different types of closely held companies. 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 substantially lower due to generous tax preferences such as depreciation and investment allowance.[2]

Tax reforms initiated after 1991-92 attempted to simplify tax rates considerably. The number of brackets was reduced to three for personal income tax. In 1992-93, the prescribed rates were 20 percent, 30 percent, and 40 percent. Financial assets were excluded from wealth tax and the maximum marginal rate was reduced to one percent. Further simplification was achieved in 1997-98 when the three bracket rates were reduced to 10-20-30 percent and have remained steady thereafter, with some changes in the associated income

brackets. The budget for 2005-06 made some major changes in structure by raised the exemption limit to Rs. 100,000 and abolishing the provision for standard deduction.[3] The exemption limit for women and senior citizens was higher respectively at Rs. 135,000 and Rs. 185,000. The other major change relates to the amalgamation of provisions under various incentive schemes into a blanket cap of Rs. 100,000, made deductible from income. This was proposed as a step towards the introduction of an Exempt-Exempt-Tax (EET) based system of taxation of savings, investment and income earned.[4] Exigencies of revenue have led to an additional surcharge of 10 percent of the tax paid and a two percent earmarked charge for primary education on all taxes.

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. 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 rates were reduced, the company rate was brought down to 35 percent. The budget of 2005-06 finally achieved a much needed alignment of the highest marginal tax rate in personal income tax with the tax applicable on corporate income tax, thereby reducing the corporate income tax rate to 30 percent**.** This is topped over by a 10 percent surcharge, as applicable to personal income tax for income beyond Rs. 1,000,000. On dividend tax, there has been a distinct lack of direction. The levy of 10 percent tax on dividends was shifted from individuals to companies in 1997-98. The rate of tax was increased to 20 percent in 2000-01, reduced again to 10 percent in 2001-02; in 2002-03, the levy once again reverted to the shareholders.[5] This policy was reversed yet again in 2003-04

with the levy of the tax on the company, ostensibly to encourage the debt and equity markets.

The system evolved from a high marginal tax rates regime to one of lower rates. Generous depreciation provisions and large number of tax preferences in the tax statutes sought to cushion the impact of the former regime on taxpayers. The transition to a regime with more moderate tax rates has been witness to a scaling down of the investment allowance and depreciation provisions. The same cannot, however, be said about the tax incentives and preferences. In the case of personal income tax, the Advisory Group on Tax Policy and Tax Administration lists the incentives in twenty-five pages of its report (India 2001a: 125-150). These include incentives and concessions for savings, housing, retirement benefits, investment in and returns from certain types of financial assets, investments in retirement schemes, and income of charitable trusts. There are a variety of tax preferences that have not only distorted the after-tax rates of return on various types of investments in unintended ways, but also have significantly eroded the tax base. The major tax preferences in the case of corporate tax were investment allowance, accelerated depreciation allowance and tax incentives for investment in infrastructure (section 80IA of Income Tax Act), housing development(section 80 HHBA of Income Tax Act), for investment in backward areas (section 80IC of the Income Tax Act), on export incomes (sections 10A, 10B, 10BA and 80HHC of Income Tax Act), for small units (section 80 HHA of the Income Tax Act), for some sunrise industries (Section 10A of the Income Tax Act) and for special economic zones (section 80IAB of the Income Tax Act). The budget of 2005-06 seeks to tone down the incentives embedded in the depreciation provisions by reducing the rate on general plant and machinery to 15 percent from the existing 25 percent cushioned by an increased

investment allowance, i.e., initial depreciation allowance to 20 percent without conditionalities regarding installed capacity increases.

The wide ranging tax preferences have led to large scale avoidance of the tax by companies resulting in several "zero tax" companies. In order to correct this, Minimum Alternate Tax (MAT) was imposed since 1997-98, at regular rates of tax on 30 percent of book profits. Presently, the liability arises when the tax payable on taxable income computed as per the Income Tax Act is less than 7.5 percent of the "book profit" of the company. Such a company is subject to a MAT of 7.5 percent of "book profit," as defined in the Income Tax Act. Like regular income tax, this tax is also topped up by a surcharge of 2.5 percent and a cess (an additional earmarked charge) of 2 percent. The budget for 2006-07 has raised the MAT rate to 10 percent with provision to provide partial tax credit against corporate income tax in subsequent years.[6]

The budgets of 2004-05 and 2005-06 saw the introduction of a few more stand alone levies ostensibly to plug a few loopholes and garner resources at the same time. The Fringe Benefits Tax was introduced as a levy on companies having Indian employees. The tax is payable by the company on a part of its expenditures on certain identified items of fringe benefits – seventeen such items have been identified, each associated with a number defining the extent of tax liability. Interestingly, this tax is over and above the provision for taxation of perquisites in the hands of the employee, as a part of the personal income tax regime. The second stand-alone levy introduced was a Banking Cash Transactions Tax, which was applicable on "large" cash withdrawals from current accounts operated in banks. This tax was rationalized on the grounds that it would help track 'black economy' transactions, by creating a trail. A third such levy is a securities transaction tax, applicable

on the sale of financial securities on the stock exchanges. This levy was introduced to capture a tax on financial transactions and effectively replace an evasion-prone provision for capital gains taxation. In the neighborhood of each of these activities, it may appear that the solution proposed is an effective one. This, however, results in a proliferation of taxes with unknown effects on equity and efficiency. Further, it leaves unanswered the question, whether the underlying problems should be addressed head on or whether a local solution should be found for every such loophole in the law.

The most important ongoing reform in recent years is in tax administration. Expansion 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 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 the tax return.[7] The Budget for 2004-05 stipulated mandatory reporting by third parties on several high-value transactions which can help to strengthen the information on large taxpayers. 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, processing and matching the information from various sources on a selective basis is an important initiative that is likely to improve tax compliance.

Reform of Indirect Taxes

The structure of excise duties by the middle of the 1970s was complex and highly distortionary. The tax structure was a mix of specific and 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 report of Indirect Tax Enquiry Committee (India, 1977) recommended the conversion of specific duties into ad valorem, unification of tax rates and introduction of input tax credit to convert the tax into a manufacturing stage value added tax (MANVAT), but it was not implemented until 1986-87. Not surprisingly, this piecemeal and gradualist approach led to a decline in the tax-GDP ratio after reforms.

Further reform impetus on excise duties came with the implementation of the recommendations of the TRC. The measures included gradual unification of rates and greater reliance on account based administration. In 1999-2000, almost eleven tax rates were merged into three with a handful of "luxury" items subject to two non-VAT additional rates (6 and 16 percent). However, specific rates in respect of some commodities continued. These were further merged into a single rate in 2000-01 to be called a Central VAT (CenVAT), along with three special additional excises (8 percent, 16 percent, and 24 percent) for a few commodities. Subsequent years have seen stabilization of the primary rate of 16 percent, but there continues a proliferation of multiple rates especially below 16 percent. It should be noted that apart from those that might be built into variations in rates, there are no explicit conventional "excises" levied by the central government in the present era.

Customs Duties

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

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 TRC recommended reduction in the number and level of tariffs to 5, 10, 15, 20, 25, 30, and 50 percent to be achieved by 1997-98. The reform that followed resulted in the reduction in the peak rate from over 400 percent to 40 percent by 1997-98 and further on to reach 12.5 percent in the budget for 2006-07. However, the pattern of tariffs with the rates varying with the stage of processing has continued and this has caused very high effective rates on assembling of consumer durable and luxury items of consumption. 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.

Service Tax

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

The introduction of tax on services at the central level began in 1994-95 with three services – namely, non-life insurance, stock brokerage, and telecommunications. The list was expanded in succeeding years to include over eighty services at present.[8] Although initially taxed at 7 percent, the rate was increased to 10 percent in 2002-03 and further to 12 percent in the budget of 2006-07, with a case for convergence between the goods and services tax, where the former is taxed at 16 percent. The Expert Group on Taxation of Services (India, 2001b) recommended the extension of the tax to all services along with the provision of input tax credit for both goods and services and subsequently, integration with the central VAT (CENVAT) on goods. However, while the government has yet to implement general taxation of services, input tax credit for goods entering into services and vice versa has been extended. Further, the budget for 2006-07 announces an intention to introduce a generalized goods and services tax by 2010.

State-Level Tax Reforms

Tax reforms at the state level have not coincided with those at the center. 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 by attempts to modernize the tax system. Indeed, systematic studies were commissioned to show their reform orientation, but the recommendations were hardly implemented. The pace of tax reforms in the states accelerated in the latter half of the 1990s, with increasing pressures on their budgets and, in some cases, due to the conditionalities imposed by multilateral lending agencies or to meet the targets set by the medium-term fiscal reforms facility. The major landmark in tax reform at the state level was the simplification and rationalization of the sales tax system by introducing a value-added tax in twenty-one states from April 1, 2005. Subsequently, all other states too have switched to this new regime.[9]

The VAT reform adopted in April 2005 levies the tax at two rates, namely 4 percent and 12.5 percent. Basic necessities are exempted. Petrol and diesel (which contribute about 40 percent of sales tax) are kept outside the VAT regime and a floor rate on them is fixed at 20 percent. All dealers up to Rs. 500,000 are exempted. Those with turnover above Rs. 500,000 but below Rs. 5 million may pay a turnover based tax and remain outside the VAT chain unless they voluntarily register and pay the tax at the prescribed rates. All importers and manufacturers as well as other dealers with turnover above Rs. 5 million are required to pay the VAT at prescribed rates and constitute the chain.

There are two major limitations of this design: one, it applies only to intra-state transactions, and two, it applies only to goods. For the taxation of interstate trade, the earlier origin-based system continues to apply. However, there is a provision for input tax credit, so as to ensure that the effective rate of tax on interstate transactions does not exceed the prescribed 4 percent. While the budget for 2006-07 announced the transition to a generalized goods and services tax by 2010, there are a lot of details that need to be worked out before such a transition can be implemented. The road map for the transition is expected to be announced within the next few months.

Trends in Indian Tax Revenues

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

The trends in tax revenue in India show four distinct phases (Rao 2000) (Table 3.1). 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, an increase in tax ratio was necessitated by the need to finance large public sector plans. Thus, the tax ratio increased from a mere 6.3 percent in 1950-51 to 10.4 percent in 1970-71 and further to 13.8 percent in 1980-81. The increase continued until it peaked at 16.1 percent in 1987-88. The buoyancy of the tax

in later years of the phase was fuelled by the economy attaining a higher growth path and progressive substitution of quantitative restrictions with tariffs following initial attempts at liberalization in the late 1980s.

Table 3.1. Fiscal Trends in India
(As a percentage of GDP)

Year	Revenue Deficit[1] (Center)	Fiscal Deficit[1] (Center)	Primary Deficit	Debt stock	Tax Ratio (Center)	Tax Ratio (States)	Tax Ratio (Total)	Transfer to States
1981-82	(0.60)	6.4	4.1	46.4	9.4	4.9	14.3	n/a
1985-86	1.8	8.8	5.7	51.9	10.6	5.3	15.6	n/a
1990-91	4.2	9.3	4.9	61.4	10.1	5.3	15.4	4.9
1995-96	3.2	6.5	1.6	60.1	9.4	5.4	14.8	4.3
1996-97	3.6	6.3	1.1	58.0	9.5	5.2	14.7	4.3
1997-98	4.2	7.2	2.0	56.5	9.1	5.3	14.5	4.9
1998-99	6.4	9.0	3.6	58.6	8.3	5.1	13.4	3.7
1999-00	6.3	9.5	3.8	58.9	8.9	5.3	14.2	3.8
2000-01	6.5	9.2	3.3	61.5	9.0	5.6	14.6	3.9
2001-02	6.9	9.6	3.4	63.2	8.2	5.6	13.8	3.8
2002-03	6.7	9.9	3.4	69.5	8.8	5.9	14.6	3.8
2003-04	5.8	9.2	2.9	72.4	9.2	6.0	15.2	n/a

Source: Public Finance Statistics, Ministry of Finance, Government of India; Annual Report, Reserve Bank of India, 2002-03.
[1]Revised estimates.

The second phase started with the economic recession following the severe drought of 1987 and was marked by stagnancy in revenues until 1992-93. However, triggered by the pay revision of government employees, the expenditure-GDP ratio increased significantly after 1988-89. This caused serious fiscal imbalances (Table 3.2), which led to an unprecedented economic crisis in 1991. The subsequent economic reform program led to sharp reduction in import duties. 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 gradual increase in the tax ratio. Thus, the tax-GDP ratio increased by over one percentage point to 15.2 percent in 2003-04 (revised estimates for the center 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 period from 1950 to 1990 at about 2 percent of GDP. Thereafter, thanks to the reforms marked by significant reduction in the tax rates and simplification of the structure, revenue from direct taxes increased sharply to over 4 percent in 2003-04 and is expected to be about 4.5 percent in 2004-05. This is in sharp contrast to the steady increase in indirect taxes seen during the first forty years of planned development, which, as a ratio of GDP increased from 4 percent in 1950-51 to 13.5 percent in 1991-92 and declined thereafter to about 11 percent.

Fluctuations in the tax ratio are seen mainly at the central level. Central revenues constitute about 60 percent of the total and therefore, fluctuations in central tax ratio impacts significantly the aggregate tax ratio. During the first thirty-five years of planned development (1951 to 1986), the tax ratios at both central and state levels increased sharply. Thereafter, the ratio was stagnant at 5.5 percent at the state level until 2001-02 and then increased marginally to 6 percent in 2003-04. In contrast, the central tax ratio which peaked in 1987 remained at that level until 1991-92. In subsequent years, it declined until 2001-02, but recovered to the pre-1991 level in 2004-05 (revised

estimates). At the central level, the share of direct taxes increased from 20 percent in 1990-91 to over 43 percent in 2004-05.

Table 3.2. Trends in Tax Revenue in India
(As a percentage of GDP)

	Center			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[1]	3.8	5.4	9.2	0.2	5.8	6.0	4.0	11.2	15.2
2004-05[2]	4.3	5.6	9.9	n/a	n/a	n/a	n/a	n/a	n/a

Source: Public Finance Statistics, 2003-04. Ministry of Finance, Government of India.
[1]Actual for the center and revised estimate for States.
[2]Revised estimates for Center.

Analysis of Central Taxes

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

Bird (1993), after observing tax reforms in many countries, states that the "fiscal crisis has been proven to be the mother of tax reform," and Indian experience fits into this. However, unlike crises-driven reforms, which are often ad hoc and address immediate exigencies of revenue, tax reform in India was undertaken after a detailed analysis. Interestingly, contrary to expectations, the period after the introduction of reforms has seen 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 disaggregated analysis of the trends in central tax revenue presented in Table 3.3 shows that the 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 during the period was by one percentage point from 4.3 percent to 3.3 percent. Interestingly, the tax ratio from both the taxes declined up to 2001-02 and has stabilized at that level. This indicates 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.

Table 3.3. Level and Composition of Central Tax Revenue

	PIT	CIT	Direct Tax	Customs	Excise	Indirect	Total
As a percentage of GDP							
1985-86	1.0	1.1	2.1	3.6	4.9	8.8	10.9
1990-91	0.9	0.9	2.0	3.6	4.3	8.2	10.1
1995-96	1.3	1.4	2.8	3.0	3.4	6.5	9.4
2000-01	1.5	1.7	3.3	2.3	3.3	5.8	9.0
2001-02	1.4	1.6	3.0	1.8	3.2	5.2	8.2
2002-03	1.5	1.9	3.4	1.8	3.3	5.4	8.8
2003-04	1.5	2.3	3.8	1.8	3.3	5.4	9.2
2004-05[1]	1.6	2.7	4.3	1.8	3.3	5.6	9.9
2005-06[2]	1.9	3.1	5.0	1.5	3.5	5.5	10.5
As a percentage 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[1]	16.6	27.1	43.9	18.4	32.9	56.1	100
2005-06[2]	17.9	29.9	47.9	14.4	32.8	52.1	100

Source: Estimate of Revenues, Central Budget (various years).
[1] Revised estimates.
[2] Budget estimates.

In contrast to indirect taxes, there has been a significant increase in the revenue from direct taxes. In fact, since the reforms were introduced, the direct tax-GDP ratio more than doubled from about 2 percent in 1991-92 to 4.3 percent in 2004-05. The increase was seen both in personal income and corporate income taxes, with 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 decline in the share of customs revenue is certainly to be expected when the tariff rates are significantly brought down in the wake of external liberalization. In fact, the decline could have been even faster but for the hesitancy on the part of the Finance Ministry to reduce the tariffs even more, mainly due to the demands of the domestic industry. To some extent, it was expected that increasing imports due to liberalization will offset the effect of rate reduction. However, an increase in imports after liberalization was not enough to balance the revenues.

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

In contrast to indirect taxes, the revenues from both personal income tax and corporate income tax have steadily increased over the years since 1991. The major reason attributed to the increase is improved tax compliance arising from a reduction in marginal tax rates (Das-Gupta and Mookherjee 1997; Das-Gupta 2002).

Level, Composition and Trends in State Taxes

Table 3.4 presents the trends in states' tax revenues. It can be seen from the table that revenue from state taxes as a ratio of GDP was virtually stagnant throughout the 1990s, fluctuating at around 5 to 5.7 percent. In fact, from 1994-95, the tax ratio declined 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.

Table 3.4. Trends in State Level Taxes
(As a percentage of GDP)

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

Source: Public Finance Statistics, Ministry of Finance (relevant years).

Of the different state taxes, the 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 has to deal with the reform of sales taxes. Therefore, the recent move towards destination-based VAT is extremely important.

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

The principal source of stamp duties and registration fees is the sale of immovable property transactions. The most important problem afflicting this tax is undervaluation of the value of the property transacted. This is partially due to the high rates of tax. 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 started reforms to reduce the rates in this direction. Undervaluation of immovable property is aided by the lack of an organized market.

At the local level, there are two taxes of some significance. These are the taxes on property, and in some states, Octroi – the tax on the entry of goods into a local area for

consumption, use or sale – 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, using the capital value or rental value for valuing the property, have been suggested. The ultimate reform depends on the development of an organized 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 not only impedes internal trade and violates the principle of common market, but also is a source of corruption and rent seeking. Most states have eliminated this levy in recent times.

Tax Policy: A Critical Review

Direct Taxes

Over the last decade and a half, thanks to simplifying reforms, the irritants in the tax system have been reduced significantly. The structure has been rationalized, both in terms of tax rates and associated brackets. Remaining issues relate to the plethora of tax preferences built into the tax regime. These preferences took the form of deductions from taxable income in some cases – for instance, reimbursement of medical expenses and contributions to pension funds – and rebate in tax payable in others.[10] The latter included a wide range of investment options. Each of these provisions was associated with a separate ceiling, suggesting significant scope and the need for tax planning in order to benefit from the variety of provisions. One sector which receives a significant degree of

incentives within personal income tax is the housing sector. For debt-financed investment in a residential accommodation by tax paying individuals, the tax statutes provided for incentives both on interest payment and repayment of the principle. As a part of a major exercise to consolidate the tax structure, the budget of 2005-06, consolidated a number of these preferences into a single broad provision of deduction from taxable income, with no individual ceilings prescribed. This was proposed as a part of an initiative to make a transition from a regime of exempt – exempt – exempt mode[11] of treatment of savings and investment to one of exempt – exempt – tax mode. In the former regime, investments in designated savings instruments were exempt. The returns from these investments were also exempt, and even when the savings were liquidated after the lock in period, tax was not payable. In the new regime, the tax will be paid when the savings instruments are liquidated. Another major change introduced was the elimination of the standard deduction provision. Alongside, there was an increase in the exemption threshold to compensate for the change in the structure. There is some debate regarding the equity implications of such a change. While the change does reduce the complexity of the regime, it does imply a change in the balance of the tax regime in favour of self-employed as against salaried individuals.

A few issues remain, however. The transition to the EET regime is not yet complete. There is no time path specified. Given the multiplicity of instruments for savings, there is a lack of clarity on whether investment in all forms would be subject to EET or whether the treatment would be limited to some specified instruments. The latter approach would require a mechanism for delineation of future streams of incomes, as

well for taxation purposes, thereby introducing a degree of complexity into the tax regime.

Within corporate income taxation, there are two sets of issues: one relating to the rationale for a minimum alternate tax, and the other relating to the increasing number of stand-alone taxes incorporated into the tax regime, so as to plug existing loopholes in the tax structure. Some of these are discussed below.

Minimum Alternate Tax

As mentioned in the earlier section, whenever the tax payable on taxable income computed as per the Income Tax Act is less than 7.5 percent of the book profit of the company, then this company is subject to a minimum alternate tax of 10 percent of the book profit, as defined, in the Income Tax Act. Like regular income tax, this tax is also topped by a surcharge of 2.5 percent and an additional education charge of 2 percent. Certain incomes are exempt from this tax. These are income from certain infrastructure industries, income from units in specified backward areas, income of certain loss-making companies, and export profits. The primary implication of this tax is to place a ceiling on the incentive provided to companies by way of accelerated depreciation or incentives other than those mentioned above.[12]

The tax preferences available can broadly be divided into two categories:

a. Provisions relating to depreciation, insofar as they are at variance with the prescriptions of the Companies Act. The depreciation provisions in the Income Tax Act until March 2005 provided for a higher rate of depreciation of 20 percent

on plant and machinery, a historical legacy from the times of significantly higher tax rates. While major corrections have been incorporated from the budget of 2005-06, some differences persist.

b. Exemptions and concessions provided to address concerns of geographical equity or to encourage certain sectors of the economy.

The expert opinion is that the underlying causes for divergence between income as defined in the Income Tax Act and Companies Act should be corrected, so as to ensure a convergence between these two definitions of income, both for reasons of rational tax policy and transparency and good corporate governance.

In terms of depreciation, it is not clear what the rationale for continued differences between the Income Tax Act and the Companies Act is. The Companies Act attempts to be faithful to the concept of depreciation – wear and tear in the course of use of a machine or any other good. Given that this gets intimately related to the expected life of the machine and the number of hours per day the machine is expected to run, the depreciation provisions in this Act vary the rate by the type of machine and the number of shifts it runs in a day. However, given that the resources so allocated is a notional entry in the books of account, and the fact that depreciation has to attend to obsolescence of technology/equipment as well, it is desirable to explore a less information/monitoring intensive formula for depreciation. In this sense, the provisions as per the Income Tax Act require less detail for application, especially in the case of machinery and plants.

Turning to the second category of tax preferences, there are broadly five categories of exemptions and tax preferences available in the tax statutes, apart from the preferential treatment of agricultural income and income of charitable institutions: area-

based exemptions for investment in backward areas, exemptions for exports and special economic zones (SEZs), exemptions for investment in power generation and other infrastructure sectors, investments in real estate development (especially for housing projects), and investments in the food-processing sector.

The effects of these incentives have been mixed. There is considerable distortion in economic decision making due to these incentive options. In the case of backward-area incentives, for instance, investments are found to occur in industries with low investment requirements, low value added, and hence, low employment potential. (TECS, 2004) This also suggests the possibility that at the end of the incentive period, most of these industries may move out and return to the original location. On the one hand, this distorts resource allocation in the economy. On the other hand, this does not generate conditions for the sustainable growth of backward regions. Similarly, in the case of incentives for exports, there appears to be little ground for extending such benefits when India has the unenviable status of being the country against whose goods the countervailing duty provisions have been invoked the most over the last five years (Bagchi et al. 2005).

Fringe-Benefits Tax

The fringe-benefits tax, as discussed above, is payable by the companies but is supposed to be a tax on the employees.[13] Further, this tax is payable even if the company is otherwise not liable to pay corporate income tax. There are a number of problems with this approach. First, through this provision, the government has introduced multiple measures for taxation of perquisites and fringe benefits provided by the employer to the

employees. This provision is over and above the existing provision of taxation of perquisites as part of personal income tax. Second, this tax is introduced through an additional Act with its own rules and procedures and a separate return and assessments, making compliance tedious and costly. A simpler approach might be one involving expansion in the scope of taxation of perquisites where benefits can be assigned to identifiable beneficiaries within the income tax, alongside disallowing part or all of the expenditure deduction of other non-assignable items to capture the tax on such fringe benefits. Since, for most companies liable to this tax, personal income tax payable on the wages and salaries to employees would be deductible at source, there would be no additional compliance costs with this approach. Further, this would not require a separate Act with its own rules and procedures, thereby easing the compliance requirements. The only situation where the liability might be reduced is in the case of loss-making companies, since the disallowed expenditure would only contribute to higher losses and hence no taxes; this situation alone cannot merit a separate enactment.

Banking Cash Transactions Tax

This tax is introduced as a means of curtailing cash transactions – a means by which a number of taxes including income tax are evaded. The tax, levied at 0.1 percent, is applicable on cash withdrawals from non-saving accounts held with banks, provided the amount of cash withdrawn is more than Rs. 25,000 in the case of individuals and Rs. 100,000 in the case of firms. While the rationale for the tax is fairly appealing, there is a need to step back and analyze the factors that encourage cash transactions. For instance, it

would be useful to determine the extent of overlap between the formal-sector banking institutions and the black economy. To the extent that income which becomes black or unaccounted remains outside the network, this tax can only address the additions to the stock and not the stock itself. Without addressing the root cause, there is a good likelihood that alternative informal sector institutions evolve to address the needs in this changed environment. For instance, since this tax is applicable only to transactions through scheduled commercial banks and not to cooperative sector banks, this may provide one of the many escape routes.

Securities Transactions Tax

The tax on transactions in securities in a recognized stock exchange in India was introduced in 2004-05 at 0.15 percent. This tax is expected to reduce speculative trading in the stock markets and volatility in prices since this tax would be applicable to each such transaction. The rationale for this tax seems to stem from a perceived inability to appropriately tax the financial economy. One loophole which finds frequent mention in this context is the Double Taxation Avoidance Agreement of India with Mauritius. Under this treaty, corporate bodies registered in Mauritius would be taxed under Mauritian law rather than Indian law. Since Mauritius does not tax capital gains and dividends, it provides a viable routing option for avoiding taxes in India. Interestingly, this treatment has now been extended to the DTAA with Singapore as well. Further, given the impact of these agreements, the tax law was amended to eliminate taxation of long term capital gains and reduce the taxation of short term capital gains to 10 percent along with an STT

of 0.15 percent. Though the solution appears appropriate in the limited context, it is not clear how a re-negotiation of the DTAAs is not a better, more rational solution.

Indirect Taxes

The major issues related to indirect taxes can be classified into two categories: those relating to exemptions and tax preferences and those relating to the development of a coordinated system of domestic trade taxes.

Tax Preferences

Tax preferences within indirect taxes include, in addition to a list of exempt commodities both in excise and customs duties, exemptions for investment in backward areas and for small-scale units in the case of excise duty and a variety of duty-drawback schemes for exports in the case of customs duties.[14] Given the stated intent of reform to consolidate the taxes and reduce the number of rate brackets, there is an emergent need to reexamine the need for commodity-wise exemptions. This holds for both excise duty and customs duty. Similarly, in the case of the Service Tax, the tax continues to be structured as a levy on specified services. Implicit in this definition is a notion of exemption for all uncovered services. While the list of taxable services is being expanded in every budget, it still remains selective. The limitations of such an arrangement are taken up in the discussion on a coordinated system of consumption taxes.

As mentioned in the discussion on direct taxes, tax exemptions and preferences tend to distort economic decision making. The excise exemptions provided, along with income tax holidays for investment in backward areas, do not induce sustainable economic activities. Given the substantial differential induced by these exemptions, activities which are subject to high rates of tax tend to gravitate to these areas. Further, anecdotal evidence suggests that such incentives are prone to evasion through appropriate accounting and billing, without inducing the corresponding scale of economic activity even in the short run. Thus, such incentives do not provide gains which are sustainable in the long run and need to be reconsidered. Similarly, the incentives for small-scale units encourage artificial truncation of economic activities at the defining threshold. Further, these units evolve into a strong interest group which then lobbies for an enhancement of the qualifying threshold thereby expanding the scope of the provision. While the intent is to incentivize only small units, which subsequently grow and move out of the incentive regime, the net impact at the margin at the time of transition is large enough to invoke significant resistance.

Coordinated System of Consumption Taxes

The Constitution of India assigns the power to tax domestic trade in the following manner:

a. The central government is assigned the power to levy excise duty on manufactured goods.

b. The state governments are assigned the power to tax sale of goods within a state's geographical boundaries.
c. The center is empowered to tax the sale of goods when the event spans two states.
d. Following a recent constitutional amendment, the center is empowered to tax all services, except those explicitly assigned to the states such as railways, entertainment, and transportation by road.

This assignment clearly works against the evolution of coordinated and comprehensive system of taxation of consumption in the country. The state sales taxes have made a transition from predominantly cascading type first-point taxes to that of instrastate value added taxes on goods – a transition that could be made while remaining within their constitutional assignment. On the other hand, the center made a transition from a manufacturing excise duty to a manufacturer's value added tax, and subsequently attempted a limited integration of the tax on services with the tax on goods through the tax credit mechanism. The Union budget of 2006-07 has announced that the country would make a transition from the present structure to a generalized goods and services tax by 2010. There is a huge distance to be covered before such a transition can be completed. Some of the key issues that need to be resolved are as follows:

a. Will this be a single tax governing all taxes on goods and services? In other words, would it encompass both central and state-level taxes?
b. Should the country plan the transition directly to this prescribed state or is a transition path necessary?

A single goods and services tax would certainly be a harmonized domestic trade tax and would be desirable from the viewpoint of economic efficiency. This, however,

would call for the states to surrender their fiscal autonomy. This part of the bargain would not be easy to achieve. Kelkar Task Force Report (India 2004) suggests a "Grand Bargain" between the center and states to achieve this. Further, even if such a bargain is effectively struck, there is a need for an institutional mechanism to enforce the new regime, unless it can take the form of a constitutional amendment. Once the bargain is struck, the next big question would be regarding administration of the new tax. With a single tax structure, it is not a big argument to make a case for a single agency administering the tax. However, which level of government will administer the tax and how the tax administrators at the non-administering level will be redeployed will have to be resolved. At a time when both center and states have embarked on fiscal adjustment, it is not going to be easy to resolve this issue. This is further complicated by the coalition governments, where multiple parties have pivotal status.

The second set of issues relates to the transition from the present state to the proposed GST. The state-level VAT regimes are themselves considered to be a transition measure. Extending the prevailing instrastate VAT into an interstate VAT is necessary to make the tax system destination-based. For this transition to be complete, at least so far as the goods segment of the economy is concerned, the Central Sales Tax (CST) – the tax levied by the Union government on interstate sale of goods – will have to be phased out. Given that intrastate sales will be taxed at regular rates and interstate transactions will potentially suffer no tax burden, there is a need for an appropriate mechanism for monitoring interstate trade before the tax can be eliminated. Of the many alternatives available, especially ones that do not require an overarching presence of the union

government, the one that appears most suitable and least risky is zero-rating with pre-payment as described below.

This model works on the principle of zero-rating with the difference that the exporter in the exporting state will get the benefit of zero-rating his transaction provided the importer in the importing state has accounted for the transaction and paid the tax on the same. This could either mean that the transaction is accounted for in the next tax period and the tax due is paid or that the importer agrees to pay the tax on every individual transaction at the time of placing the order and/or receipt of the goods. For instance, for an export transaction of Rs 1000 from state A to state B, the exporter in state A, verifies the registration number of the buyer from state B and claims zero-rating for this transaction as a part of his tax return. In state B, if the rate of tax is 10 percent, the buyer declares the purchase of Rs 1000 and pays Rs 100 as the tax due on the transaction, as a part of his tax return. There would be verification of this information across the states and any mismatch would invoke a reversal of the taxes refunded to the exporter. [15]

While this mechanism safeguards revenues of the exporting and the importing state, the cost of such a security is borne by either the exporter or the importer in the form of higher interest burden, and of verifying the credentials of the buyer. The difference between this system and the system of simply zero-rating is that in the present one the importer pays the tax at the time of the receipt of goods whereas, in the case of zero-rating, the tax has to be paid at the time of sale of goods. Since local purchases would suffer tax upfront, there is a level playing field between local purchases and interstate purchases in a pre-payment system. (See Rao (2005) for a discussion of the alternatives).

Once these reforms are made, the only other major problem remaining will be the treatment of services within the state VAT regime. If services continue to be outside the state VAT base, there are a few immediately apparent services that can add severely to the cost of manufacturing and trade – transportation and electricity. These are inputs into most manufacturing activities, use goods for the supply of services and could suffer significant cascading. This is especially important, since petrol and diesel are being kept out of the VAT net, thereby perpetuating tax cascading in some form or the other.

In the context of the announced transition to a generalized GST, it is not clear how expansion of the scope of state VAT to include services can be worked out. Inclusion of selective localized services, as the above example illustrates, would not address the basic issue of cascading within the tax system. The discussion of a comprehensive power to tax services, however, needs a definition of treatment of services of an interstate nature. Here, options available differ depending on whether or not there is an overarching central tax. Given the context of GST, therefore, it is difficult to discuss reform of state VAT without reference to this context.

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 some detail, and the possible efficiency and equity implications of different taxes is analyzed. Specifically, the analysis seeks to raise a number of questions. These include, has tax compliance improved over the years in response to a 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 reflected in the negative correlation between effective tax rates and the ratio of income tax collections to GDP, akin to a Laffer curve.[16] Das-Gupta and Mookherjee (1997) attribute improvement in the overall performance of the tax system to the reduction in the marginal tax rates. In a more recent analysis based on sixteen different structural, administrative, and institutional indicators, Das-Gupta (2002) concludes that the performance of the tax system has shown improvement and tax compliance has indeed improved after a reduction in marginal tax rates. 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.

Table 3.5. Contribution of TDS to Revenue, Personal Income Tax

	Tax Deduction at Source (%)	Advance Tax (%)	Gross Collections (Rs. crore)	Refunds (Rs. crore)	TDS/GDP (%)
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	5253	1.12
2003-04	64.03	20.04	48454	7067	1.12

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

Can we attribute improved revenue performance of direct taxes only to a reduction in marginal tax rates? A close scrutiny of the revenue generated by personal income tax shows that an increase in the scope of Tax Deduction at Source (TDS) is the main contributor to the revenue increase (Table 3.5). The proportion of TDS to total revenue collections increased from 22 percent in 1994-95 to 50 percent 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. This suggests that improved compliance is largely, if not solely, due to improved coverage or greater effectiveness of TDS as a tool for collecting taxes. This observation however runs contrary to the results quoted above.

Interestingly, although it is tempting to attribute this to an increase in the scope of TDS on interest, dividends, payments to contractors, and insurance commissions, much of the increase has come about in TDS in salaries. Thus, an increase in tax revenue has

possibly more to do with the expansion of the organized sector, financialization of the economy, and administrative measures on extending the TDS, rather than improved compliance due to a reduction in marginal rates of tax. During the period from 1999-00 to 2003-04, the total number of personal income tax assesses increased from 19.6 million to 28.8 million. Broader coverage of PAN and expanded use of PAN and the TIN have helped to create an extensive and reliable database to improve tax compliance. The above evidence, however, cannot be interpreted as presenting a case for increasing the marginal tax rates, since such increases would be associated with significant efficiency costs.

It is important to understand the impact of a reduction in the marginal tax rate and a reduction in the number of rate categories since 1991-92 on the overall progressivity and equity of the tax system. With the reduction in the marginal tax rates, the effective rate declines as the level of income increases. From this, it would be tempting to conclude that progressivity has declined and overall equity has worsened over the years. Such a conclusion would be inappropriate – what this shows is that among income taxpayers, the progressivity has declined. But this is also a period where there is a substantial increase in the coverage of income tax - in 2003-04, as many as 29 million people paid income tax as compared to 3.9 million in 1989-90. The tax-GDP ratio has doubled to more than 2 percent of GDP. This expansion in coverage would suggest that by bringing in a larger proportion of people into the tax net, there would be some improvement in horizontal equity – people with similar incomes remaining outside the tax net are possibly now paying taxes.

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 by three times from 0.9 percent in 1990-91 to 2.7 percent in 2003-04, despite significant reduction in the rates. The reforms focused mainly on doing away with the distinction between closely held and widely held companies, reducing the marginal tax rates to align them with the top marginal tax rate of personal income tax, and rationalizing tax preferences – investment allowance and depreciation allowance – to a considerable extent.

It would be instructive to analyze the contribution of different sectors to the corporation tax. The contribution of manufacturing sector according to the prowess database, accounts for two-thirds of corporate tax collections (Table 3.6). The analysis shows that the manufacturing sector contributed 40 percent of the corporation tax in 2003-04. Within the manufacturing sector, the petroleum sector contributed the highest (12.5 percent), followed by chemicals (6.5 percent), and basic metal industry (6.1 percent). In contrast, the contribution of textiles was just about 0.5 percent. In fact, in 1994-95, industries such as chemicals, machinery, and transport equipment contributed overwhelming proportion of the corporation tax, but their share declined sharply over the years. While part of the decline can be attributed to changes in the shares of these industries in total profits, this does not seem to be the only factor. For financial intermediation for instance, while the share in total profits increased from 18 percent to 28 percent between 1994-95 and 2003-04, its share in total corporate tax collections

changed from 12 percent to 30 percent during the same period. On the other hand, while share of manufacturing declined from 67 percent to 40 per cent in profits, its share in tax revenue changed only from 52 percent to 36 percent.

Table 6. Sectoral Composition of Corporate Income Tax (CIT) Collections
(as percent of total CIT collections)

	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
Manufacturing										
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
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.

Another important issue examined here refers to the contribution of the public sector enterprises. Curiously, the contribution by public enterprises has shown a 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 3.7). This is partly due to the fact that public enterprises do not undertake elaborate tax planning to minimize the taxes, unlike the private sector.

Thirdly, given that MAT was introduced to reduce the gap between the effective tax rates that companies face, it would be instructive to examine the variation in the tax rates as they exist today. Table 3.8 below provides a classification of fifty major business houses in India, in terms of their average effective tax rate.[17] The table clearly illustrates the wide spread in tax rates across difference business houses. Interestingly, given that depreciation allowances were one important contributor to the divergence between book profit and income as per the Income Tax Act, even after correcting for depreciation, the variance continues to persist, reflecting the large impact of other tax preferences. A similar exercise for a sectoral decomposition of economic activity brings to light a range of 4 percent to 38 percent. Given that these numbers pertain to a year where the MAT too, was applicable, clearly, the provision was not enough to ensure a narrow range. The budgetary process seeks to correct this observed feature through an increase in the rate for MAT in budget for 2006-07, to 10 percent. This solution to the perceived problem of leakages from the general tax regime and the resultant sustenance of zero-tax companies, appears to be a perverse solution. The tax statutes seek to provide incentives on one hand and neutralize or tone down the benefits of the same through the provisions of MAT. A

simpler and more transparent alternative would be to reduce or eliminate incentives and eliminate the need for an additional levy.

Table 3.7. Contribution of Public Sector Enterprises to Corporation Tax

Year	Tax provision by public enterprises (Rs. Crore)	Total Collections (Rs. Crore)	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

The declining tax-GDP ratio of union excise duties is a matter of concern, adding to the reduction in import duties. The reforms in union excise duties, transforming it into ModVAT and then CenVAT, instead of improving the revenue productivity, have led to its decline over the years. The revenue from the tax as a ratio of GDP at 3.3 percent in 2004-05 is significantly lower than the ratio in 1991-92 (4.1 percent). A similar trend is witnessed, even if one considers the ratio of excise to GDP from manufacturing sector.

That this is a cause for concern is apparent, given the overall context of declining reliance on custom duties as a source of revenue and an incomplete compensation by way of increases in the direct tax collections. The declining contribution from CenVAT on manufactured products is all the more intriguing in the wake of a fast-increasing corporation tax. Examination of the sectoral composition of corporate income tax indicates that services-sector, power-generation, and primary-sector-based companies have recorded relatively faster growth, especially when compared with manufacturing units and in the event, the share of the manufacturing sector in corporate tax revenues declined from 60 percent to 39 percent. This, however, does not provide the entire answer. Even if one considers only the manufacturing sector, the ratio of CenVAT collections to payments of corporate income tax has not been stable. It is seen that the ratio increased steadily until 2000-01 and declined thereafter. This trend behavior is driven largely by the performance of corporate tax payments as a ratio of sales, which declined consistently till 2000-01 and then recorded a reversal. One explanation for this decline could be found in the decline in interest rates and the corresponding increase in profits relative to sales from 2000-01.

Table 3.8. Distribution of Corporate Houses by Effective Tax Rate

Range	Corporate Tax Paid	Inclusive of Deferred Tax
0-3	J.K. Singhania Group, Essar (Ruia) Group, Williamson Magor Group, Arvind Mafatlal Group, Usha Rectifier Group	Usha Rectifier Group
3-6	Lalbhai Group, Gulabchand Doshi Group, HCL Group	
6-9	Videocon Group, Raunaq Singh Group, LNJ Bhilwara Group, Vardhman Group, Reliance Group	Lalbhai Group, Essar (Ruia) Group, Williamson Magor Group, Arvind Mafatlal Group

	[Ambani], Godrej Group, WIPRO Group, Dalmia Group	
9-12	Goenka G.P. (Duncans) Group, Modi Bhupendra Kumar, Rasesh Mafatlal Group, Chidambaram M.A. Group, Hari Shankar Singhania Group, RPG Enterprises Group, Bangur B.D. Group, Om Prakash Jindal Group	WIPRO Group, Godrej Group, Rasesh Mafatlal Group, HCL Group, J.K. Singhania Group, Chidambaram M.A. Group, Modi Bhupendra Kumar
12-15	Vinod Doshi Group, Kirloskar Group, Ruchi Group	LNJ Bhilwara Group, Vinod Doshi Group, Kirloskar Group, Hari Shankar Singhania Group
15-18	Piramal Ajay Group, DCM Group	Reliance Group [Ambani], Gulabchand Doshi Group
18-21	Shriram Industrial Enterprises Group, Ranbaxy Group, Nagarjuna Group, Mahindra & Mahindra Group, Vijaypat Singhania Group, Tata Group	Vardhman Group, DCM Group, Raunaq Singh Group, Bangur B.D. Group
21-24	Lakshmi Group [Naidu G.V.], Larsen & Toubro Group	Vijaypat Singhania Group, Ranbaxy Group, Tata Group, RPG Enterprises Group, Piramal Ajay Group, Shriram Industrial Enterprises Group
24-27	Escorts Group, Bajaj Group, Murugappa Chettiar Group, T.V.S. Iyengar Group, Birla Group	Larsen & Toubro Group, Mahindra & Mahindra Group, Goenka G.P. (Duncans) Group, Bajaj Group
27-30	T.V.S. Iyengar Group, Birla Aditya Group, Kalyani Group, Firodia Group, MRF Group, Amalgamation Group, Finolex Group	Murugappa Chettiar Group, Dalmia Group
30-33	UB Group, Wadia (Bombay Dyeing) Group, Hero (Munjals) Group,	Finolex (Chhabria P.P.) Group, Birla Aditya Group, Ruchi Group, T.V.S. Iyengar Group, Kalyani (Bharat Forge) Group
33-36		MRF Group, Hero (Munjals) Group, Om Prakash Jindal Group, Wadia (Bombay Dyeing) Group, Amalgamation Group
36-39		Lakshmi Group [Naidu G.V.], Firodia Group, Escorts Group, UB Group, Nagarjuna Group, Videocon Group

Source: Derived from the Prowess Database.

Note: Effective tax rate is the ratio of total corporate tax paid to book profits (profits before tax reported in the profit and loss account). Revised accounting standards from 2001 require companies to set aside resources to meet "deferred tax liabilities." Important among these liabilities is liability on account of accelerated depreciation provisions of the Income Tax Act. the last column measures effective tax rate inclusive of deferred tax liabilities.

Another interesting feature of trends in CenVAT collections, as derived from the corporate sector database, is the general decline in the ratio of excise collections to sales. This ratio is computed alternatively for all manufacturing companies with positive profit and for companies with positive excise tax payments. In the former case, the average rate of tax is lower and the rate of decline slower than that for the latter case. This is a reflection of an increase in the extent of preferential treatments within the tax statutes. An expansion in the coverage or utilization of the preferential treatment would result in an expansion in sales without corresponding expansion in the tax payments. While this could also be the result of an increase in share of exports in total value of output, correcting for this factor does not change the observed trends. The other set of factors that could induce such a result are the various categories of exemptions, like those for investment in backward areas and for small scale units.

Not only has the revenue productivity of CenVAT declined over the years, but even the composition shows an increase in revenue concentration, particularly towards commodities which serve as inputs into 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. Also, final products in the manufacturing stage are not necessarily final consumer goods – goods transport vehicles being a prime example.

Decomposition of CenVAT collections, presented in Table 3.9, brings out some interesting features with implications for both efficiency and equity of the tax system. One of the most important features is the commodity concentration. Just five groups of commodities – namely, petroleum products, chemicals, basic metals, transport vehicles, and electrical and electronic goods – together contribute to 75 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 collections, with a more than three times increase in share over a thirteen-year period, while the value added by this industry group has increased only marginally from 12 to 14 percent of GDP from registered manufacturing sector. This imposes a disproportionate tax burden on different sectors of the economy. Besides, this type of commodity concentration does not allow for 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 this pattern of revenue collections is that an overwhelming proportion of the duties are collected from intermediate products, which are used in the production of goods or services which are not subject to excise. Besides petroleum products, which are used mainly in transportation of goods and persons involved in or related to other manufacturing, the taxes on all goods serving as inputs to service providers, especially of services used as inputs to manufacturing activities, contribute to cascading and add to the production cost. Transport vehicles and related industries are one such industry. These are a significant source of 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 3.9. 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 Board of Excise and Customs, Ministry of Finance, Government of India.

A striking feature of CenVAT collections is that, like in the case of corporation tax, a predominant proportion is paid by public-sector enterprises. The contribution of the public sector to total excise collections in 2002-03 was about 42 percent (Table 3.10). It is also seen that there are wide fluctuations in the share from year to year. The fluctuations are mainly due to the fluctuations in administered prices on items such as steel, coal, and petroleum products. In other words, the revenue from CenVAT is vulnerable to pricing and output decisions.

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 stage 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, and a continued reliance on the self-sufficiency model of development as against a comparative advantage model.

Table 3.10. 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

Sources: Public Enterprises Survey Various Issues, and Budget of GOI, various years.
Notes: Tax Provision relates to the provision made for Corporate Tax.

Table 3.11 presents customs collections by commodity group 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 percent), petroleum products (21 percent), and chemicals (11 percent). Furthermore, the overwhelming proportion (over 75 percent) of the duty is collected from either machinery or basic inputs and intermediate goods. Thus, contrary to some fears, liberalization has not led to a massive inflow of consumer goods. This also implies that further reduction in 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 a uniform reduction in tariffs has had favorable effects on production, exports, employment, and capital, and that 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 liberalization is leading to adoption of more modern machinery and technology in the production process, which would have a favorable effect on productivity growth. The

other item that has shown an 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. This may be due to the fact that these items have become more competitive and, therefore, it is perhaps more attractive to buy them in the domestic market rather than to import them.

Table 3.11. 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**

Source: Central Board of Excise and Customs, Ministry of Finance, Government of India.

Towards Further Reforms in the Tax System

In the last few years, reforming the central tax system has received considerable attention. Several reports have comprehensively examined the tax system and made important recommendations for reform (India 2001a, 2002, 2004). While there are differences related to some of the specific recommendations as compared to the TRC, there is broad agreement on the direction and thrust of reforms and on the emphasis placed on the reform of tax administration.

Reform of Central Taxes

The reforms with regard to personal income tax will involve further simplification of the tax system. This includes withdrawal of tax exemptions and concessions given for specified activities, abolition of surcharge and further simplification of the tax. In fact, there is considerable virtue in having a single tax rate with an exemption limit, as many transitional economies have found. The ability of an income tax system to bring about significant redistribution is limited, and it is increasingly being realized that equity should focus on increasing the incomes of the poor rather than on reducing the incomes of the rich. This objective is better achieved by expenditures on human development and not through the tax system (Bird and Zolt, 2005). Yet, moving towards a single rate of tax may not be politically feasible at this juncture.

On the corporation tax, base broadening involves getting rid of tax preferences. In particular, the exemption for profits from exports, special economic and free trade zones,

technology parks, area-based exemptions for backward area development and for infrastructure should be phased out. Similarly, the present rate of depreciation allowance, even after the reduction in 2005-06, is quite generous and needs to be reduced to more realistic levels. There has been a great deal of flip-flop in regard to the taxation of dividends from one year to another. The most satisfactory solution in this regard is to partially integrate the tax with the personal income tax.

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

Wide-ranging exemptions are also a problem with excise duties. 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. Another important reform area is to integrate fully the CENVAT with the taxation of services (India 2001b).

Evolving a Coordinated Consumption Tax System

One of the most important reforms needed in an indirect tax system is the development of a coordinated consumption tax system for the country (Rao 1998). This is necessary to

ensure that the tax burden is distributed fairly between different sectors and between goods and services. The reform should also improve the revenue productivity, minimize relative price distortions and above all, ensure a common market in the country.

This involves coordinated calibration of reforms at central, state and local levels. At the center, as mentioned above, the first step is to evolve a manufacturing stage VAT on goods and services. At the state level, converting the sales tax into VAT should be completed by allowing input tax credit not only for intrastate sales and purchases but also for interstate transactions. Also, appropriate mechanisms must be found in order to enable the states to levy the tax on services and to integrate 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 interstate coverage.

The local level indirect tax reform relates to finding a suitable substitute for octroi. While most states in India have abolished octroi, this process has made the local bodies dependent on the state government for revenues. In every country, property tax is a mainstay of local body finances; reform in this area should help in raising revenue productivity. Yet, this may not suffice. In this situation, the better option is to allow local bodies to piggyback on the VAT collections in urban local body jurisdictions. This will avoid cascading of the tax and minimize exportation of the tax burden by urban local bodies to non-residents.

Reform in Tax Administration

In India, the poor state of tax administration has been a major reason for low levels of compliance and high compliance costs. This is due in part to the virtual absence of data on both direct and indirect taxes even at the central level. Not only does this hinder proper analysis of taxes needed to provide an adequate, analytical background to calibrate changes in the tax structure, but it also makes proper enforcement of the tax difficult. Thus the changes in the tax structure had to be made in an ad hoc manner.

The consequence of this ad hoc manner has been high compliance costs. The only estimate of compliance costs by Das-Gupta (2004a, 2004b) shows that in the case of personal income tax, it is as high as 49 percent of the collections from the tax. In the case of corporate tax, it is between 6 and 15 percent of the tax paid; much of these costs arise from legal costs of compliance. While these estimates should be taken with a note of caution, it is important to note that the compliance cost of taxes in India is extremely high.

High compliance costs combined with poor state information system has led to continued interface of taxpayers with officials, negotiated payment of taxes, corruption and rent seeking, and low levels of tax compliance. An important indication of the poor information system is that even as the coverage of TDS was extended over the years, information was not assembled even to check whether those deducting the tax at source actually filed the returns. As the CAG report for 2003-04 states, of the 0.63 million returns to be filed by TDS assessees, only 0.50 million were filed. Thus, more than 40

percent of the TDS assessees did not file the returns. Even this is a vast improvement over the previous year when 80 percent of the TDS assessees did not file the returns.

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

Similar initiatives have been taken in regard to indirect taxes as well. The customs e-commerce gateway (ICEGATE) and 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. Progress has been made in building capacity in modern audit systems and computerized risk assessment with assistance from the Canadian International Development Agency (CIDA).

Another critical element in tax administration is the networking of the information from various sources. As mentioned earlier, to improve tax enforcement, systems must be

developed in order to put together information received from various sources to quantify the possible tax implications in a judicially acceptable manner. In the first instance, the information networking should obtain data from various sources such as banks and financial institutions on various assessees. In the second, there must be meaningful exchange of information between the direct and indirect tax administrations. In the third, it is necessary to exchange information between central and state taxes. Building computerized information system will help to improve enforcement of taxes.

Notes

[1] We would like to thank Professor Roger Gordon for detailed comments on the draft of the paper.

[2] Section 32A and 32AB of the Income Tax Act include the provisions for investment allowances while section 32 provides the accelerated depreciation provisions.

[3] The standard deduction was a provision maintained to neutralize the tax disadvantage that a salaried taxpayer faced. While a self-employed taxpayer is entitled to deduct all his expenses towards earning the income as costs, there is no such provision for the salaried. The standard deduction was meant to address this concern.

[4] Under this, a contribution to the saving plan is deductible from gross taxable income and the income from a savings plan is also exempt from the tax. However, the withdrawal of savings and the benefits from it in the form of interest and dividends are subject to tax. This is also known as consumption taxation of savings.

[5] The change in 1997-98 was introduced with the objective for the stated purpose of encouraging plough back of profits by companies in place of distribution of dividends. However since a 10 percent tax on dividends and higher taxes in interest income was perceived to be an anomaly, the rate was increased to 20 percent in 2001-02. In 2002-03, the income was to be taxed in the hands of the recipients, so that the inequities built into a uniform tax are reduced. There was withholding provisions of 10 percent – recipients in higher tax brackets could claim credit for this amount. It should be mentioned that some withholding provisions were always in place whenever the tax was payable by the recipient. However, these were at the rates equivalent to the lowest income tax slab prevalent at the time.

[6] The tax credit in subsequent years is available for amounts over and above the MAT payable in that year. In other words, in every financial year, any given firm is expected to pay at least the minimum alternate tax.

[7] This was discontinued in the 2006-07 budget.

[8] The budget for 2006-07 expands the scope further to include an additional fifteen categories of services.

[9] It may be mentioned that there are two separate levies on sale of goods – a CenVAT levied and collected by the central government and a state VAT levied and collected by the state governments. As discussed above, the former applies only on manufacture of goods and allows for tax credit to flow between this tax and service tax. In the states, the levy applies on sale of goods alone.

[10] Whether reimbursement of medical expenses or contributions to pension funds should be considered “preferences” is a debatable issue. In the context of India, the extent of deductions on these counts are limited and prescribed by the Income Tax Act. For instance, all reimbursements of medical expenses upto Rs 15000 per annum per employee are deductible from taxable income, but for expenses beyond this limit, the rest is considered a part of taxable income. This therefore does not provide a rational basis for treatment of medical expenses. Further, this option is available only to salaried employees not to self employed individuals. In the case of contributions to pension funds too, the limit is Rs 10,000. Contributions beyond this level are from tax paid incomes.

[11] "Exempt-exempt-exempt" refers to a form of treatment where the incomes if saved are not subject to a tax, the income on these savings, i.e., interest or dividend, when it accrues is not taxes, nor is it taxed when it is withdrawn from savings and consumed.

[12] Since the MAT meant that a lot of the other preferences accorded in the tax statute like accelerated depreciation.

[13] The Act defines ‘fringe benefits’ to mean any privilege, service, facility, or amenity, directly or indirectly, provided by an employer to an employee by reason of his employment, or any reimbursement made by an employer directly or indirectly for any purpose, or any free or concessional travel ticket for private journeys, or any contribution by an employer towards an approved superannuation fund.

[14] While in principle, duty drawback for exports would not be considered an incentive, when the form of the scheme does not maintain a clear link between the extent of duty suffered by the exported good and the duty drawback offered, the scheme takes on the

form of a tax preference. In India, the drawback rates are specified by law on the basis of industry averages of inputs used and not on the basis of invoices for taxes paid.

[15] A similar system is already in place in India for supporting the tracking of inter-state sales for taxation under the central sales tax Act. This system requires the importer to provide documentary evidence of being a taxpayer in the importing state in order to avail the lower rate of tax. An alternative mechanism could be one where the importer declares upfront to the tax department, the details of the consignment intended for import from another state and this information is used by the exporting state to provide the exporting dealer with zero-rating.

[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] A business house has been used in Prowess to include all companies where one entity has a majority share in equity holding.

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