Strategic Imperatives of Tax Reforms in India: Evolution and Challenges

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ABSTRACT

Tax policy has evolved in the country in response to changing development strategy over the years. In the initial years, the tax policy was guided by a large number of demands placed on the government. These demands by taxpayers have been summarized into the need to increase the level of savings and investment in the economy to stimulate growth and the need to ensure a fair distribution of incomes. These meant an effort to raise taxes from those with an "ability to pay", with little regard for the effective measures for the chosen instruments.

Key words: GST,Optimal Tax, Supply Side Tax Model (SST), MAT,VAT,

Introduction

Many western consumer firms operating in India have been successful at adapting to the country's unique market challenges, which range from distinct consumer tastes and preferences to the logistical challenges of reaching a population that is still overwhelmingly rural. Taxation and regulation have often been less pliable obstacles, as demonstrated by the deep resistance to allowing foreign investment in multi-brand retail outlets. However, a key tax reform included in India's 2015 budget is an attempt to improve the business environment, particularly for foreign consumer goods companies and single-brand retailers with a presence in India.

Unlike most third world, which was guided in their tax reforms by various agencies, Indian tax reform attempts have largely borne a domestic brand. They have been calibrated in response to changes in the development strategy over time while keeping in tune with the institutional arrangements in the country. The nature of federal polity, assignment of tax powers and tax sharing arrangements have made impact on the incentives for revenue mobilization and the structure and administration of the taxes in both central and state governments. The overlapping tax systems have made it difficult to have encompassing, comprehensive and co-ordinated tax system reforms.

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

An Analysis of the Indian Tax System

It details the evolution of the tax system and its reform over the years and analyses its efficiency and equity implications. With a view to identifying the best practice approach followed in tax system reforms alternative models of tax system reform are presented. Surely, in a democratic polity, it is difficult to achieve the ideal and yet, the framework helps to keep the focus on further reforms. The evolution of Indian tax system and the impact of historical and institutional factors were also important in shaping Indian tax policy. The trends in tax revenue point towards a relative stagnation and deceleration in tax revenues at both central and state levels.

Philosophy of Tax Reform

Over the years the philosophy of tax reform has undergone a great change in view of the changing perception of the role of the state. With the change in the development strategy in favor of market determined resource allocation, the conventional approach of increasing revenues to finance a large public sector without much regard to economic effects has been given up. The recent approaches to reform lay emphasis on minimizing distortions in tax policy to keep the economy competitive. Minimizing distortions means reducing the marginal rates of both direct and indirect taxes. This also calls for reducing differentiation in tax rates to reduce unintended distortions in relative prices. To achieve this, the approach suggests broadening of the tax bases. Thus, over the years, emphasis has shifted from vertical equity in which both direct and indirect taxes are subject to high marginal rates with subtle differentiation in rates, to horizontal equity in which, the taxes are broad-based, simple and transparent, and subject to low and less differentiated rates. Generally, equity is taken to mean improving the living conditions of the poor. This has to be achieved mainly through expenditure policy and human resource development rather than reducing the incomes of the rich as was envisaged in the 1950s and 1960s.

According to traditional wisdom on tax reforms there are three separate model of tax reform. In terms of its theoretical soundness the Optimal Tax (OT) model is satisfactory but had been found to be impractical in its applications. Apart from the trade-off between efficiency and equity in tax policy, the information and administrative costs of designing an optimal tax model have been found to be prohibitive and, therefore, as a practical guide to tax policy this has not been useful.

Like the OT model, the Harberger Tax Model (HT) is well grounded in theory. It, however, draws much more on practical experience. According to this model, while efficiency (and distribution weights) is clearly desirable in the design of tax policy, administrative capability is equally, if not more, important. According to this approach, the principal concern is not to design a system that will be optimal, but emphasize the system that will minimize tax-induced distortions and at the same time be administratively feasible and politically acceptable. In fact, for Harberger tax reformers should pay less attention to the economic methodology and more to best practice experiences. The basic HT reform package for developing countries that are price takers in the international market consists of, inter alia, a uniform tariff and a broad-based VAT (value-added tax).

Third model is the Supply Side Tax model (SST). This model laid stress on the need to reduce the role of the state. It propounds reduction in the volume of public expenditures which has to be achieved by cutting the tax rates, particularly the direct tax rates to minimize disincentives on work, savings and investment. The proponents of this model lay stress on the need to broaden the base with minimal exemptions and preferences and to have low marginal tax rates. Again emphasis is on minimizing distortions in relative prices and, therefore, the approach emphasizes less rate differentiation. The recent reform approaches combine elements of all these three models. This incorporates both theory and past reform experiences and takes into account administrative, political and information constraints in designing and implementing reforms. The crux of this approach is to increase the revenue productivity of the tax system while minimizing relative price distortions. The best practice approach has made effort to make the tax systems comprehensive, simple and transparent. As has been mentioned earlier, the general pattern of these reforms has been to broaden the base of taxes, reduce the tax rates and lower the rate differentiation both in direct and indirect taxes. A broader base needs lower rates to be levied to generate a given amount of revenues. Lower marginal rates not only reduce disincentives to work, save and invest, but also help to improve tax compliance.

It is imperative to broaden the tax base to ensure horizontal equity. It is desirable from the political economy point of view as it reduces the influence of special interest groups on tax policy, and reduces administrative costs. In the case of indirect taxation, the reform agenda includes the levy of a broad-based VAT with minimal exemptions and supplemented by a few luxury excises. With regards to import duties, quantitative restrictions should be replaced by tariffs, export taxes eliminated, and dispersion in tariffs should be minimized. Personal income tax too is to be levied on all but a small number of persons with income levels less than twice the per capita income of the country.

Much of the direct taxes should be collected by withholding, but for the “hard-to-tax” groups, presumptive taxation is to be applied. Emphasis on horizontal equity also implies emphasis on strengthening administration and enforcement of the tax and the development of proper information systems and automation.

Tax System in India: It's Evolution

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

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

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

Implications of Evolution of Tax Planning:

The basic premise within which tax planning system had been made were public sector heavy industry dominated and import substituting industrialization strategy. The focus of evolution of tax policy has had several implications which are as follows:

- The objective of achieving socialistic pattern of society on the one hand and the large oligopolistic rents generated by the system of licenses, quotas and restrictions on the other, necessitated steeply progressive tax structure in both direct and indirect taxes.
- The quest of various objectives complicated the tax system with adverse consequences on efficiency and horizontal equity. This also opened up large avenues for evasion and avoidance of taxes. The disregard for efficiency considerations was a part of import substituting industrialization strategy.
- Tax policy was directed to raise resources for large and increasing requirements of public consumption and investment irrespective of the efficiency implications.
- All these required not only differentiation in tax rates based on arbitrary criteria but also legitimized selectivity and discretion in tax policy and administration. This gained legitimacy from the plan priorities. Once selectivity and discretion were accepted as legitimate, it mattered little whether these were exercised as intended. This provided enough scope for the special interest groups to influence tax policy and administration.
- 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.
- Poor information system was both the cause of selective application of the tax system as well as its effect.

Tax System in India (before reforms in 1991)

Varied trends in tax revenues present three distinct phases. In the first phase, from 1970s to mid-1980s, there has been a steady increase in the tax-GDP ratio in keeping with the buoyant economic conditions and acceleration in the growth rate of the economy. The tax ratio, which was about 11% in 1970-71, increased steadily to 14.6% in 1980-81.During the early 1980s,the ratio continued to increase steadily. In addition to the economy attaining a higher growth path, the buoyancy in tax revenues was fuelled by the progressive substitution of quantitative restrictions with tariffs following initial attempts at economic liberalization in the 1980s.

The economic recession following the severe drought of 1987 led to stagnation in revenues in the second phase until 1992-93. Following the economic crisis of 1991 and the subsequent reforms in the tax system, especially reduction in tariffs, actually caused a decline in the tax ratio. Overall, it is seen that the tax ratio which reached the peak of about 17 per cent in 1987-88, declined thereafter to 13.9 per cent in 1993-94 and gradually recovered to 14.6 per cent in 1997-98. Overall, the level of tax revenues, although reasonable as compared to the average tax level in developing countries, is clearly inadequate from the viewpoint of resource requirements of the economy.

With regard to composition of tax revenue, there witnessed a steady decline in the share of direct taxes from 21 per cent in 1970-71 to about 14 per cent in 1990-91. Following the introduction of tax reforms in 1992, the revenue from direct taxes has grown faster than revenue from other taxes as well as GDP and consequently, the share of direct taxes increased by almost ten percentage points to 24 per cent on 1997-98. An increase was registered in both corporate income and individual income taxes though, taxes on agricultural land and incomes have continued to decline. In fact, although the agricultural sector contributes over 30 per cent of GDP, its contribution to tax revenues is just about half a per cent.

From 1970 until 1992-93 the fastest growth of revenues was customs, when import duties were significantly reduced. Some observers attribute this lopsided development of the tax system to the perverse incentives arising from the constitutional arrangement of devolving revenue from personal income tax and union excise duties to states.

It is also seen that even after reforms were initiated in 1992-93, although the share of revenue from import duties has declined due to reduction in tariffs, the decline in the share of revenue from union excise duties has been much faster. In the Indian federal from the government, both central and state governments exercise revenue powers and the latter raise about 37 per cent of total revenues. The Seventh Schedule to the Constitution specifies revenue sources of the centre and the states respectively in the union and state lists.

The major tax powers of the central government consist of taxes on non-agricultural income and wealth, corporate profits, excise duties except those on alcohol and customs duties, While the states, on the other hand, can levy taxes on agricultural land, incomes and wealth, excises on alcohol, sales taxes, taxes on motor vehicles and goods and passengers, stamp duties and registration fees. Our 72nd and 73rd Constitutional amendments also specify some tax sources to urban and rural local governments. The two potent taxes assigned to the local bodies are property taxes and taxes on the entry of goods into a local area for consumption, use or sale. Information on local tax collections consolidated for all urban and rural local governments is not available. However, as per the available information local governments enjoy very little and limited revenue raising powers and much of the expenditures of the local governments are met from devolution of revenues from the state governments.

If we analyze the revenue trends in India, both the centre and the states follow a similar pattern. However, decline in the ratio of tax revenue to GDP in the case of the central government has been much faster than that of the states. This is understandable, as the central government had to reduce tariffs as a part of the structural adjustment programme. On the other hand, there have been hardly any worthwhile reforms at the state level and yet, the tax ratio has shown a decline, albeit marginal.

Attempts to Improve Tax System since Independence to 1990

There have been deliberate attempts on the part of our government to improve the tax system since independence. The principal objective of these attempts has been to enhance revenue productivity to finance large development plans. Although the various tax reform committees considered economic efficiency as one of the objectives, the recommendations do not bear much testimony to this aspect. The recommendations were in keeping with the philosophy of the times. Further, even when the committees did recommend certain measures on efficiency considerations, this was not acted upon if it involved loss of revenues.

The first significant attempt at reforming the tax system was initiated by the Tax Reform Committee in 1953.This provided the backdrop for the generation of resources for the Second Five Year Plan (1956-60), and needed to fulfill several of objectives such as raising the level of savings and investment, effecting resource transfer from the private to the public sector and achieving a desired state of redistribution. Since then, there have been several attempts, most of them partial, to remedy varied aspects of the tax system. The expenditure tax levied on the recommendation of the Kaldor Committee in 1957-58 had to be withdrawn after three years as it did not generate the expected revenues. The attempt to achieve the desired state of redistribution caused the policy makers to design the income tax system with confiscatory marginal rates.

The consequent moral hazard problems led to establish Direct Taxes Enquiry Committee in 1971 with view to recommend a significant reduction in marginal tax rates. On the indirect taxes side, a major simplification exercise was attempted by the Indirect Taxes Enquiry Committee in 1972. At the state and local level, there were several tax reform committees in different states that went into the issue of rationalization and simplification of the tax system. The ultimate objective for almost all these committees was to raise more revenues to finance ever-increasing public consumption and investment requirements. Although the effect of the rationalization has been to reduce the marginal tax rates, the prevailing philosophy still dictated keeping the rates very high. It may be noted that in the early 1970s the marginal tax rate including the surcharge was as high as 93.5 per cent. Combined with the highest marginal wealth tax rate of 8 per cent tax on wealth, the tax system produced enormous incentives for evasion and avoidance of the tax. On the recommendation of the Direct Taxes Enquiry Committee, the marginal tax rate was brought down to 77 per cent in 1974-75 and further to 66 per cent in 1976.

Similarly, the highest wealth tax rate was reduced to 2.5 per cent. On the indirect taxes front, the most important reform before 1991 was the conversion of the union excise duties into a modified value added tax (MODVAT) in 1986.The MODVAT was introduced in a limited manner on a few commodities and the coverage was gradually extended over the years. It was an income type VAT applicable only to a few manufactured goods. Also, there was an attempt to substitute ad valorem taxes to specific levies though quite a few commodities are subject to specific tax even today. There were attempts to simplify and rationalize the structures, but these cannot be considered comprehensive.

Demerits and Major Challenges

Despite various attempts to bring reform in tax system, improving the productivity of the tax system continues to be a major challenge in India. The tax ratio is yet to reach the pre-reform levels. Although the coverage under income tax has shown significant improvement, much remains to be done to reach the hard-to-tax groups. The ratio of domestic trade taxes in particular has continued to decline and this has posed a major constraint in reducing tariffs which is necessary to achieve allocative efficiency.

Designing of tariffs itself needs to be re-examined to ensure lower tariffs a well as a low level of dispersion to ensure that effective rates of protection are as intended.

Reforms in excise duties have not reached the stage of achieving a simple and transparent manufacturing stage VAT. Much remains to be done to simplify and rationalize the state and local consumption taxes.

To create a proper management information system and automating tax returns concerted efforts are necessary. Above all, tax reforms should become systemic, a continuous process to keep the economy competitive instead of being sporadic and crisis-driven. In the case of direct taxes, as already mentioned, the revenue ratio has shown an upward trend. Great decline in tax rates appears to have improved tax compliance, though much of the increase seems to have come about due to increases in public sector wages. Yet, the revenues realized are nowhere near the potential and much remains to be done to improve the horizontal equity of the tax system by extending the tax net to hard-to-tax groups. The criteria stipulated for filing tax returns has increased the number of tax returns from less than half a per cent of population to more than 2%. But this has not brought about a corresponding increase in revenues.

Inability to bring in the hard-to-tax groups into the net has continued to exert pressure to increase the standard exemption limit deductions.

There is also scope for rationalizing savings incentives. Perquisites continue to receive favorable tax treatment and the coverage of tax deduction at source requires to be expanded before long.

In the case of corporate income taxes, too, it is necessary to broaden the tax base by minimizing tax concessions and preferences. Rather than minimizing them, the coalition governments of today have gone about proliferating tax incentives to complicate the tax system and to create a wide wedge between the nominal and effective corporate tax rates.

As the companies began using the provisions, for revenue reasons, the government started levying the minimum alternative tax (MAT). Thus one imperfection was sought to be remedied through another. This has complicated the tax system further. As has been above mentioned, complete rethinking is necessary in designing tariffs. The TRC recommendation of having seven tax rate categories, the rates varying according to the stage of production, would create large dispersal in the effective rate of protection. Levying lower rates on necessities and higher rates on consumer durable and luxury items of consumption enormously increases protection to these products. It is essential that the highest tariff rate should be brought down to 15-20% and there should be no more than three rate categories. Unless this is done, it would not be possible for Indian manufacturing to achieve international competitiveness in the medium term.

The greatest challenge in restructuring the tax system in the country is to evolve a co-ordinated consumption tax system. Although tax assignment between different levels of government follows the principle of separation, as these separate taxes levied by the centre (excise duties), states (sales taxes, state excise duties, taxes on motor vehicles, goods and passengers), and local governments (octroi) fall on the same tax base, we end up in a chaotic situation with tax on tax and mark up on the tax.

Apart from cascading and relative price distortions, this resulted in a totally non-transparent tax system. Development of dual VAT– a manufacturing stage VAT by the centre and a consumption type destination based retailed stage VAT by the states is a solution, which needs to be progressively applied. However, neither the centre nor the states have made appreciable progress in this regard. For making it more effective the rates should be rationalized into a maximum of two and tax credit should be provided on a systematic basis. For this, developing a proper information system is imperative. At the state level, transforming the state taxes into VAT has to be calibrated even more carefully. Rate rationalization, systematic provision of tax credit on inputs and those paid on previous stages, removal of competing tax incentives and concessions, zero rating the tax on inter-state sales– all these have to be done in phases.

Tax Reforms and GST

In the present context, Goods and Services Tax, or GST, will be a comprehensive tax levy on the manufacture, sale, and consumption of goods and services. The GST will be “collected on value-added goods and services” at each transactional stage of the supply chain. Firms will be permitted to use the GST paid on the “procurement of goods and services” to offset GST owed on the “supply of goods and services.” Under the current tax regime in India, businesses are subject to various indirect taxes including central and state sales taxes, entry tax, stamp duty, and taxes on the transportation of goods and services. The GST will replace the multi-layer tax scheme and instead will create a unified market with one principal indirect tax.

In the GST system, both Central and State GST will be collected at the point of supply. Thus, under this regime, taxes on different stages of production and distribution can become a pure ‘pass through’ and tax cost would essentially be incurred on final consumption only. As a consequence, revenues will effectively accrue to the State in which consumption will take place.

The GST will bring many advantages, but, for foreign investors, one stands out—the simplified tax structure will increase transparency and decrease corruption. Implementation of the GST will reduce the discretion of government agents to exempt companies from tax or to deviate from rate structures, which is possible for certain taxes under the current regime. The GST also relies heavily on technology to ensure compliance, reducing contact between companies and government agents and thereby decreasing the opportunities for low level corruption.

The GST reform complements other attempts by the government to rationalize what has historically been a confusing and disjointed tax system. As part of the current budget, India has proposed reducing the corporate tax rate from 30% to 25%.Additionally, it has postponed the introduction of General Anti-Avoidance Rules (GAAR), which would allow the Indian government to scrutinize corporate transactions structured to minimize or avoid taxes. This will end the unfavourable tax ruling system like controversial enforcement trends involving the threat of retrospective application of tax laws to corporate transactions. These recent changes in tax reforms are the significant moves to enter into a new era of simplified and taxpayer friendly environment in India. These efforts are certainly leading to remove obstacles for foreign investors and ease their concerns over India's tax policies.

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