

## TAX REFORM IN INDIA: ACHIEVEMENTS AND CHALLENGES

*M. Govinda Rao\**

*There have been major changes in tax systems in several countries over the last two decades for a variety of reasons. The objective of this paper is to analyse the evolution of the tax system in India since the early 1990s. The paper describes and assesses the introduction of new forms of direct and indirect taxes, their revenue and equity implications and the successes achieved in their implementation. The paper concludes that after eight years of reform improving the tax system remains a major challenge in India.*

There have been major changes in tax systems of countries with a wide variety of economic systems and levels of development during the last two decades. The motivation for these reforms has varied from one country to another and the thrust of reforms has differed from time to time depending on the development strategy and philosophy of the times. In many developing countries, the immediate reason for tax reforms, has been the need to enhance revenues to meet impending fiscal crises. As Bird (1993) states, "...fiscal crisis has been proven to be the mother of tax reform". Such reforms, however, are often ad hoc and are done to meet immediate exigencies of revenue. In most cases, such reforms are not in the nature of systemic improvements to enhance the long run productivity of the tax system.

One of the most important reasons for recent tax reforms in many developing and transitional economies has been to evolve a tax system to meet the requirements of international competition (Rao 1992). The transition from a predominantly centrally planned development strategy to market based resource allocation has changed the perspective of the role of the state in development. The transition from a public sector based, heavy industry dominated, import substituting industrialization strategy to one of allocating resources according to market signals has necessitated systemic changes in the tax system. In an export-led open economy, the tax system should not only raise the necessary revenues to provide the social and physical infrastructure but also minimize distortions. Thus, the tax system has to adjust to the requirements of a market economy to ensure international competitiveness.

---

\* Director, Institute for Social and Economic Change, Bangalore, India.

As in other countries, the systemic reforms in the tax system in India in the 1990s were the product of crisis but the reforms were calibrated on the basis of detailed analysis. The objective of this paper is to analyse the evolution of the India tax system with special reference to the systemic reforms in the design and implementation of the structure and operation of the taxes in Indian federal polity. In section I, the evolution of tax system reforms, alternative paradigms employed in reform exercises in different countries and the best practice approaches to reform are described to provide a framework for analysing the Indian tax reform experience. Section II describes the Indian tax system and the reform initiatives undertaken until the comprehensive tax reform exercise was taken up in 1991. The salient features of comprehensive tax reform since 1991 and its impact on revenues are analysed in section III. The last section brings out the major shortcomings still persisting in the tax system and lists the challenges faced by the government in developing a co-ordinated tax system in the Indian federal polity.

### **I. PARADIGMS OF TAX REFORM**

The philosophy of tax reform has undergone significant changes over the years in keeping with the changing perception of the role of the state. With the change in the development strategy in favour of market determined resource allocation, the traditional approach of raising 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 implies 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 minute differentiation in rates, to horizontal equity in which, the taxes are broad-based, simple and transparent, and subject to low and less differentiated rates. Equity in general, 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.

Conventional wisdom on tax reforms provides us with at least three different model of tax reform. The optimal tax (OT) model (Ahmad and Stern 1991) is satisfactory in terms of its theoretical soundness, but has been found to be impractical in its applications. Besides 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.

The Harberger tax model (HT) like the OT model is well grounded in theory. It, however, draws much more on practical experience. According to this, while efficiency (and distribution weights) is clearly desirable in the design of tax policy, administrative capability is equally, if not more, important. The principal concern, according to this approach, is not to design a system that will be optimal, but emphasise the system that will minimize tax-induced distortions and at the same time be administratively feasible and politically acceptable. In fact, Harberger suggests that 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).

The third is the supply-side tax model (SST). This model emphasises the need to reduce the role of the state. Reduction in the volume of public expenditures has to be achieved by cutting the tax rates, particularly the direct tax rates to minimize disincentives on work, saving and investment. The proponents of this model emphasise 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 emphasises less rate differentiation.

The recent reform approaches combine elements of all three models sketched above. This incorporates both theory and past reform experiences and takes into account administrative, political and information constraints in designing and implementing reforms. The thrust of this approach is to enhance the revenue productivity of the tax system while minimizing relative price distortions. The best practice approach has attempted to make the tax systems comprehensive, simple and transparent. As 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 requires 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. More importantly, broadening the tax base helps to ensure horizontal equity, 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. As regards 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.

## II. INDIA'S TAX SYSTEM PRIOR TO COMPREHENSIVE REFORMS 1991

The trends in tax revenues presented in table 1 present three distinct phases. In the first, right from the 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 per cent in 1970-71, increased steadily to 14.6 per cent in 1980-81 (table 1). The ratio continued to increase steadily during the early 1980s (chart 1). 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 resulted in stagnation in revenues in the second phase until 1992-93. Following the economic crisis of 1991 and the subsequent reforms in the tax system, particularly 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.

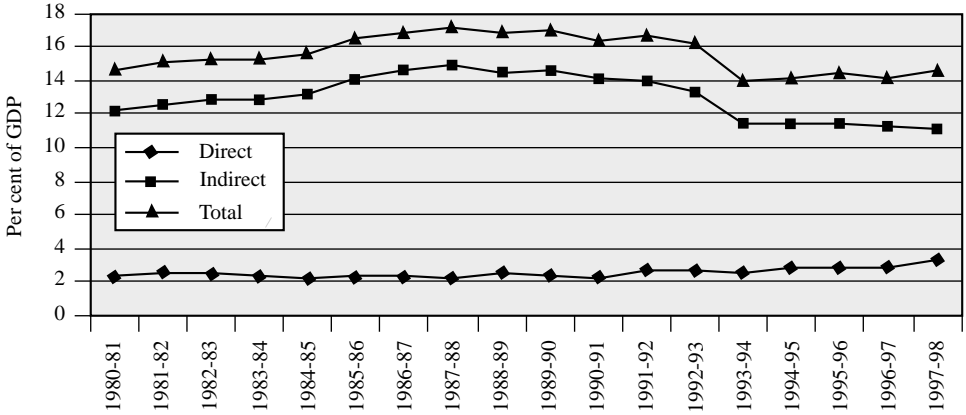
In terms of composition of tax revenue, there has been a steady decline in the share of direct taxes from 21 per cent in 1970-71 to about 14 per cent in 1990-91. After the introduction of tax reforms in 1992, the revenue from direct taxes has

**Table 1. Level and composition of taxes in India  
(per cent)**

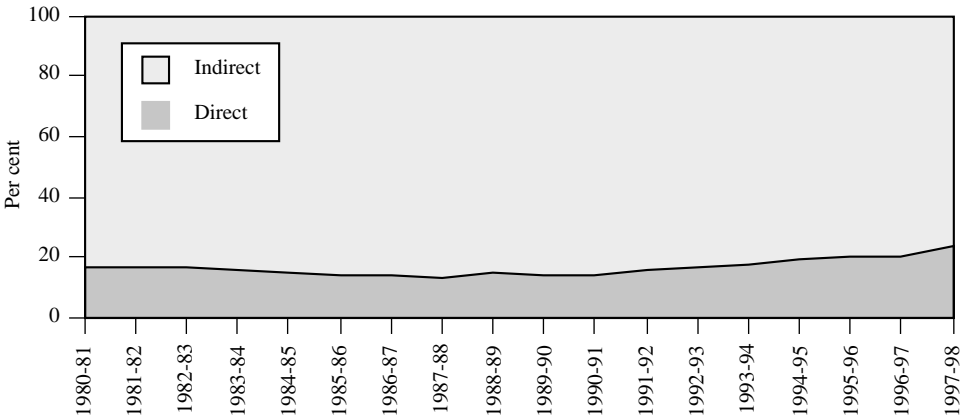
<i>Tax</i>	<i>1970-71</i>	<i>1980-81</i>	<i>1990-91</i>	<i>1995-96</i>	<i>1996-97</i>	<i>1997-98</i>
Direct taxes of which:	21.3	16.4	14.0	20.4	20.5	23.6
Corporation tax	7.8	6.6	6.1	9.4	9.3	9.4
Personal Income tax	10.0	7.6	6.1	8.9	9.1	12.6
Agricultural taxes	2.8	1.0	0.9	0.8	0.6	0.6
Others	0.7	1.2	0.9	1.3	1.5	1.0
Indirect taxes of which:	78.7	83.6	86.0	79.6	79.5	76.4
Customs	11.0	17.2	23.5	20.4	21.4	18.0
Union excise duties	37.0	32.8	27.9	22.9	22.5	20.9
Sales tax	16.6	20.3	20.8	20.4	21.1	21.2
State excise duties	4.1	4.2	5.7	4.9	4.5	5.0
Others	10.0	9.1	8.1	10.9	10.0	11.3
Total tax revenue	100.0	100.0	100.0	100.0	100.0	100.0
Tax-GDP percentage	11.0	14.6	16.4	14.4	14.2	14.6

*Source:* Public Finance Statistics (various issues); Government of India, New Delhi.

**Chart 1. Trends in direct and indirect taxes**



**Chart 2. The shares of direct and indirect taxes**



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 seen 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.

The fastest growth of revenues was in respect of customs during the period from 1970 until 1992-93, 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 (see Burgess and Stern 1993 and Joshi and Little 1996). 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 polity, 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<sup>1</sup>. 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. 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. The 72<sup>nd</sup> and 73<sup>rd</sup> Constitutional amendments also specify some tax sources to urban and rural local governments. The two important 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, available information shows that local governments have very little revenue raising powers and much of the expenditures of the local governments are met from devolution of revenues from the state governments.

Analysis shows that, revenue trends of both the centre and the states follow a similar pattern (chart 3). 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.

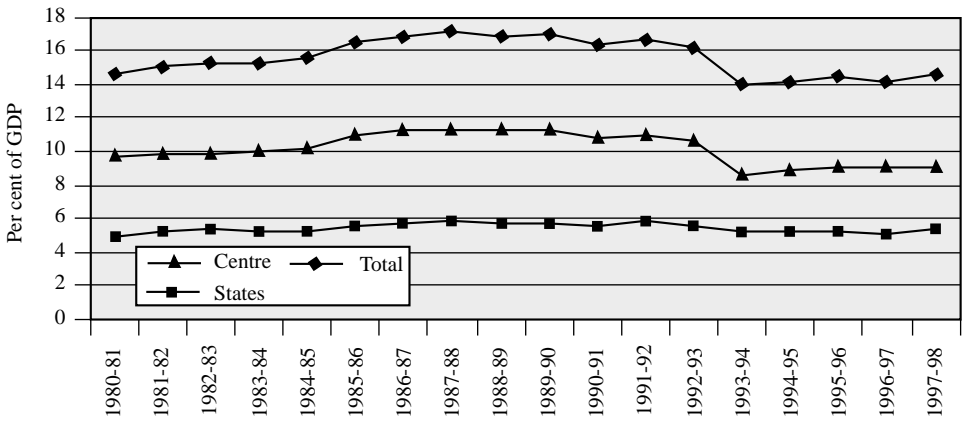
### ***Tax reform attempts until 1990***

There have been a number of attempts at improving 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.

---

<sup>1</sup> There is a concurrent list in the schedule as well. However, the tax powers are not assigned in the concurrent list as the Constitution follows the principle of separation.

**Chart 3. Trends in tax revenue – centre and states**



The first comprehensive attempt at reforming the tax system was 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 was required to fulfil a variety 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 a number of attempts, most of them partial, to remedy various 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 the Direct Taxes Enquiry Committee in 1971 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 a number of tax reform committees in different states that went into the issue of rationalization and simplification of the tax system. The motivation for almost all these committees was to raise more revenues to finance ever-increasing public consumption and investment requirements.

As mentioned earlier, 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.

### III. IMPACT OF TAX REFORMS SINCE 1991

#### *Report of the Tax Reform Committee (TRC)*

Tax reform since 1991 was initiated as a part of the structural reform process, following the economic crisis of 1991. In keeping with the best practice approaches, the TRC adopted an approach of combining economic principles with conventional wisdom in recommending comprehensive tax system reforms (see Bird 1989). There are three parts in the report. In the first interim report, the Committee set out the guiding principles of tax reform and applied them to important taxes namely, taxes on income and wealth, tariffs and taxes on domestic consumption. The first part of the final report was concerned mainly with the much-neglected aspect of reforms in administration and enforcement of both direct and indirect taxes. The second part of the report dealt with restructuring the tariff structure. In keeping with the structural adjustment of the economy, the basic principles taken in the recommendations were to broaden the base, lower marginal tax rates, reduce rate differentiation, and undertake measures to make the administration and enforcement of the tax system more effective. The reforms were to be calibrated to bring about revenue neutrality in the short term and to enhance revenue productivity of the tax system in the medium and long term. The overall thrust of the TRC was to (i) decrease the share of trade taxes in total tax revenue; (ii) increase the share of domestic consumption taxes by transforming the domestic excises into VAT and (iii) increase the relative contribution of direct taxes.

The important proposals put forward by the TRC included reduction in the rates of all major taxes, viz. customs, individual and corporate income taxes and excises to reasonable levels, maintain progressivity but not such as to induce evasion. The TRC recommended a number of measures to broaden the base of all taxes by minimizing exemptions and concessions, drastic simplification of laws and procedures, building a proper information system and computerization of tax returns, and a thorough revamping and modernization of the administrative and enforcement machinery. It also recommended that the taxes on domestic production should be fully converted



into a value added tax, and this should be extended to the wholesale level in agreement with the states, with additional revenues beyond the post-manufacturing stage passed on to the state governments.

In the case of customs, the TRC recommendations were the weakest. The TRC recommended tariff rates of 5, 10, 15, 20, 25, 30 and 50 to be achieved by 1997-98. The tariff rate was to vary directly with the stage of processing of commodities, and among final consumer goods, with the income elasticity of demand (higher rates on luxuries). Excessive rate differentiation (seven rates) and according varying degrees of protection depending on the stage of processing has been severely criticized by Joshi and Little (1996, p. 74) when they state, "...this is a totally unprincipled principle, for it has no foundation in economic principles". In addition to continued complexity, the proposed tariff structure creates very high differences in effective rates and provides a higher degree of protection to inessential commodities.

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

### ***Implementation of reforms since 1991***

The government accepted the recommendations of the TRC and has implemented them in phases. Although it did not entirely follow the recommendations and is yet to implement many of the measures to strengthen the administration and enforcement machinery, most of the recommendations have been implemented. It must also be noted that the pace and content of reforms have not been exactly true to TRC recommendations.

As regards the personal income taxes, the most drastic and visible changes have been seen in the reduction in personal and corporate income tax rates. In the case of personal income taxes, besides exemption, the number of tax rates have been reduced to three and the tax rates were drastically reduced to 10, 20 and 30 per cent. At the same time, the exemption limit was raised in stages to Rs 50,000. Combined with the standard deduction, a salaried taxpayer up to an income of Rs 75,000 need not pay any tax. In addition, saving incentives were given by exempting investment in small savings and provident funds up to a specified limit. Attempts have also been made to bring in the self-employed income earners into the tax net. Every individual living in large cities covered under any of the specified conditions (ownership of house, cars, membership of a club, ownership of credit card, foreign travel) is necessarily required to file a tax return. Empirical evidence shows that this drastic

reduction in the marginal tax rates has improved the compliance index significantly<sup>2</sup>. Thus, revenues from personal and corporate income taxes have shown appreciable increases after the reforms were initiated in spite of the fact that the rates of tax have been reduced significantly. Voluntary disclosure scheme to allow a one time amnesty to tax defaulters by paying the necessary tax was introduced in 1997-98.

In the case of corporate income taxes, the rates were progressively reduced on both domestic and foreign companies to 35 per cent and 48 per cent respectively. The dividend tax at the individual income tax level has been abolished. However, very little has been done in terms of broadening the base of corporation tax. In fact, besides depreciation allowances and exemptions for exporters, generous tax holidays and preferences are given for investment in various activities (housing, medical equipment, tourism, infrastructure, oil refining, free trade zones, software development, telecommunication, sports etc.). Consequently, the tax base has not grown in proportion to the growth of corporate profits. As many corporate entities took generous advantage of all these tax preferences, there were a number of "zero-tax" companies. To ensure minimum tax payments by them, a Minimum Alternative Tax (MAT) was introduced in 1997-98.

In the case of tariffs, there has been a drastic reduction in both the average and peak tariff rates. In 1990-91, the unweighted average nominal tariff was 125 per cent and peak rate was 355 per cent. These were progressively reduced over the years. The peak rate of import duty in 1997-98 was 40 per cent and the average rate of tariff is just about 25 per cent. It is proposed to reduce the tariffs further to the levels prevailing in the South-East Asian countries in the next five years. In terms of rate differentiation, the number of tax rates continues to remain high. While in the initial years, there was an attempt to reduce the rate differentiation, in more recent years, the variations have, in fact, increased. Again, the pattern of tariffs with the rates varying with the stage of processing has resulted in very high incentives given to the assembly of consumer durables and luxury items of consumption.

There has been a considerable simplification and rationalization of union excise duties as well. Besides reduction in the number of rates, the tax has been progressively converted from a specific into *ad valorem* levy in respect of the majority of commodities. The facility of providing credit on input taxes under the MODVAT too has been progressively extended to a larger number of commodities. As of now almost 80 per cent of the goods covered under excise duties are provided with the

---

<sup>2</sup> Compliance index is defined by Dasgupta and Mookherjee (1998, pp. 73-74) as the fraction of taxes that are liable that is actually paid. To get the taxes liable, the authors assume that the tax base is a constant proportion of non-agricultural GDP. This is weighted with the average effective tax rate to take into account exemptions and deductions. The ratio of actual tax revenue collections to this estimated base gives the tax compliance index.

MODVAT facility. The base of the tax was broadened by removing the exemptions and levying excise duty at the lowest rate (8 per cent). There has also been a simplification of the tax on the small-scale sector. As the government realized that there was considerable misuse, availability of MODVAT credit was reduced to 95 per cent instead of 100 per cent.

Another important change that has been brought about since 1991 is the introduction of a selective tax on services. The constitution does not assign this tax base specifically either to the centre or the states. However, the central government by invoking residuary powers has introduced a tax on services since 1994-95. Beginning with three services (telephones, non-life insurance and stock brokerage), the base of the tax has been broadened to cover a large number of services such as transporters, car rentals, air travel agents, architects, interior designers, management consultants, chartered accountants, cost accountants, company secretaries, credit rating agencies, market research agencies, underwriters, private security/detectives, real estate agencies and mechanized slaughter houses.

There have been significant attempts to improve the administration and enforcement of the tax as well, though progress in actual implementation has not been commensurate. Besides amnesties given from time to time, efforts have been made to reduce arrears by introducing simplified assessment procedures. A large number of pending cases in courts have been decided through out of court settlements. There have also been attempts to establish special tax courts to deal exclusively with tax disputes. With the assistance of the Canadian International Development Agency (CIDA), the government has started an ambitious programme of computerising tax returns and building a management information system.

### *State tax systems*

While a good deal of progress has been made in the tax system reform of the central government, progress in the case of state tax systems has not been commensurate. The sales taxes, which account for over 60 per cent of states' revenues, have, over the years, become stagnant. The states prefer to levy the tax at the first point of sale, and this makes the tax base narrow. With as many as 16-20 rate categories introduced to fulfil a variety of objectives, the tax has become complicated. This has given rise to a large number of classification disputes as well. Taxation of inputs and capital goods, in addition, has contributed to cascading. In an imperfect market characterized by mark up pricing, the taxes on inputs and capital goods results in the phenomenon tax-on-tax, and mark up on the tax with consumers paying much more than the revenues collected by the government. In addition, there is a tax on inter-state sales, which not only causes severe distortions but also results in inter-state tax exportation in favour of richer states. All these have combined to make the sales tax system complicated, opaque and distorting. Above all, with independent and

overlapping commodity tax systems at the central and state levels<sup>3</sup>, co-ordinated and harmonized development of domestic trade taxes has become difficult.

The Government of India appointed a study group to recommend measures to harmonise and rationalize the domestic trade tax system in the country (India 1994). The study group made a thorough analysis of the distortions of the prevailing system of taxation and has recommended the gradual moving over to destination based, consumption type value added taxes at the state level. At the central level, the study group recommended complete switching over to the manufacturing stage VAT. At the state level, the existing sales taxes were to be transformed into retail stage destination type VAT.

In order to persuade the states to rationalise their tax systems on the lines recommended by the study group the Government of India appointed a state Finance Ministers' Committee. The Committee has made recommendations to switch over to the VAT in a given time frame through stages. Unfortunately, in spite of the consensus on the need for reforms in the sales tax systems at the state level, there has been very little action in terms of actual rationalization.

### *Revenue implications of reforms*

The economic crisis of 1991 resulted in a significant decline in revenues. Although the tax reforms were intended to be a revenue neutral exercise, the natural consequence of a significant decline in tax rates was to reduce revenues. As there was no commensurate increase in the tax base, the revenue naturally showed a declining trend. Thus, the tax-GDP ratio, which was over 16 per cent in 1990-91, declined sharply to less than 14 per cent in 1993-94. Although thereafter there has been some improvement, it still remains less than 15 per cent and this remains a matter for concern (India 1994). Thus, the reforms in the Indian context have in fact, caused an immediate loss of revenues, though in the next few years, they are likely to reach pre-reform levels.

Interestingly, in spite of significant reductions in the rates of both individual and corporate income taxes, the revenues have shown a significant increase. The share of revenue from direct taxes showed a significant increase as a proportion of GDP as well as total tax revenue. The contribution of revenue from direct taxes, which was less than 14 per cent in 1990-91, increased sharply to 24 per cent in 1997-98. However, it is not clear to what extent the increase in revenue productivity is due to increase in public sector wages following the implementation of pay commission recommendations, how much of this is attributable to better compliance arising from lower marginal tax rates and how much due to administrative measures.

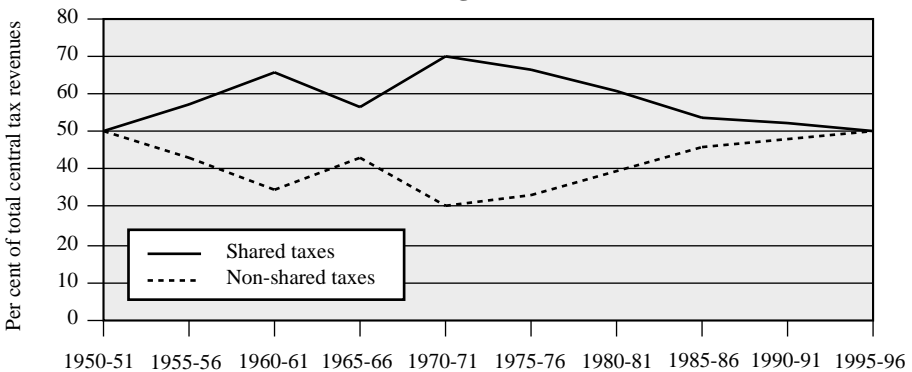
---

<sup>3</sup> There is also a commodity tax at the local level called "octroi". This is a tax on the entry of goods into a local area for consumption, use or sale. This tax is levied by urban local bodies and is levied in many states.

The decline in the tax-GDP ratio since the reforms were initiated has to be attributed to lower yield of indirect taxes. Naturally, some reduction in customs revenue was only to be expected as the prevailing tariffs were extremely high and had to be drastically reduced. For the same reason, the reforms in excise duties were to be calibrated to compensate revenue loss from import duties. This, however, did not happen and in fact, the revenue from union excise duties showed a drastic decline. Analysis shows that the revenue from import duties as a ratio of GDP declined by 1.3 percentage points from 3.9 per cent in 1990-91 to 2.6 per cent in 1997-98. However, decline in the revenue from excise duties was faster, by 1.5 percentage points from 4.6 per cent to 3.1 per cent during the same period. Consequently, the share of excise duties in total revenue declined by about 7 percentage points (from 28 to 21 per cent) as compared to a 6 percentage point decline in the share of customs (from 24 to 18 per cent). Significant improvements in the tax ratio, therefore, have to come from improvement in the revenue productivity of domestic indirect taxes.

The continued heavy reliance on import duties as a source of revenue rather than as an instrument of protection is an issue that merits some discussion. It has been pointed out that the central government does not have the incentive to raise revenues from the taxes that are shared with the states. According to the existing intergovernmental fiscal arrangement, the central government should share 87.5 per cent of the net collections from personal income tax and 47.5 per cent of gross revenues from union excise duties with the states. This is alleged to have created a moral hazard problem and it is stated that the central government concentrates on those taxes which are not shared. Consequently, while the share of revenues from the taxes that are shared with the states have declined, the revenues from the sources that are not shared have shown a steady increase (chart 4). Therefore, Joshi and Little (1996, pp. 93-94) state, "...there is no doubt that this cockeyed growth of the tax system has harmed the development of the whole economy."

**Chart 4. Composition of shared and non-shared tax revenues of central government**



#### IV. SHORTCOMINGS AND CHALLENGES

After eight years of tax reform, as already mentioned, a number of disquieting features in the tax system still remain. 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 as 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 rationalise the state and local consumption taxes. Concerted efforts are necessary to create a proper management information system and automating tax returns. 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. Marked decline in tax rates seems 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 per cent. 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 favourable tax treatment and the coverage of tax deduction at source needs 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 recent coalition governments 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 started 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 already 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 per cent 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 most important 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. Besides cascading and relative price distortions, this results in a totally non-transparent tax system. Development of dual VAT – a manufacturing stage VAT by the centre and a consumption type destination based retail 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. To achieve this, in the case of the centre, the excise duties should be levied entirely as *ad valorem* levies. The rates should be rationalised 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.

A major difficulty in evolving a destination based retail stage VAT at the state level arises from the fact that the states do not have the power to levy tax on services. As mentioned earlier, the states can levy sales taxation of only goods. Taxation of services is not assigned to either the centre or the state, but the former levies taxes on selected services based on power to levy taxes on residual items. Proper levy of goods and services tax would, therefore, require an amendment of the Constitution. The central government can use this as a leverage to persuade the states to reduce and eventually eliminate the taxation on inter-state sales so that a levy of destination based VAT becomes a reality.

---

**REFERENCES**

- Ahmad, Ehtisham and Nicholas Stern, 1991. *The Theory and Practice of Tax Reform in Developing Countries* (Cambridge, University Press).
- Bagchi, A, 1994. "India's tax reform: a progress report", *Economic and Political Weekly*, vol. XXIX, 22 October, pp. 2809-2815.
- Bird, R.M., 1989. "Administrative dimension of tax reform in developing countries", in Malcolm Gillis, ed., *Tax Reform in Developing Countries* (London, Duke University Press).
- \_\_\_\_\_, 1993. "Tax reform in India", *Economic and Political Weekly*, vol. XXVIII, 11 December, pp. 2721-2726.
- Burgess, Robin and Nicholas Stern, 1993. "Tax reform in India", Working Paper No. 45, STICERD, London School of Economics.
- Dasgupta, Arindam and Dilip Mookherjee, 1998. *Incentives and Institutional Reform in Tax Enforcement* (Oxford University Press).
- Harberger, Arnold, 1990. "Principles of taxation applied to developing countries: what have we learned" in Michael Boskin and Charles McLure, Jr., eds., *World Tax Reform: Case Studies of Developed and Developing Countries* (San Francisco, ICS Press) pp. 25-46.
- India, 1994. *Reform of Domestic Trade Taxes in India: Issues and Options, Report of the Study Team* (Chairman: Dr Amaresh Bagchi)
- Joshi, Vijay and I.M.D. Little, 1996. *India's Economic Reforms 1991-2001* (New Delhi, Oxford University Press).