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Trends and Issues in Tax Policy and Reform in India

Tax systems the world over have undergone significant changes during the last twenty years as many countries across the ideological spectrum and with varying levels of development have undertaken reforms. The wave of tax reforms that began in the mid-1980s and accelerated in the 1990s was motivated by a number of factors. In many developing countries, pressing fiscal imbalance was the driving force. Tax policy was employed as a principal instrument to correct severe budgetary pressures.¹ In others, the transition from a planned economy to a market economy necessitated wide-ranging tax reforms. Besides efficiency considerations, these tax reforms had to address the issues of replacing public enterprise profits with taxes as a principal source of revenue and of aligning tax policy to change in the development strategy. Another motivation was the internationalization of economic activities arising from increasing globalization. On the one hand, globalization entailed significant reduction in tariffs, and replacements had to be found for this important and relatively easily administered revenue source. On the other, globalization emphasized the need to minimize both efficiency and compliance costs of the tax system. The supply-side tax reforms of the Thatcher–Reagan era also had their impact on the tax reforms in developing countries.

The evolution of the Indian tax system was driven by similar concerns and yet, in some ways, it is different and even unique. Unlike most developing countries, which were guided in their tax reforms by multilateral agencies

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1. Ahmad and Stern (1991).

such as the International Monetary Fund, Indian tax reforms have largely borne a domestic brand. They have been calibrated to changes in the development strategy over time while staying in step with the institutional arrangements in the country.² Thus, even when the government sought assistance from multilateral financial institutions, the recommendations of these institutions did not directly translate into an agenda for tax reform. Despite this, the tax system reforms were broadly in conformity with international trends and advice proffered by expert groups and was in tune with international best practices.³

Inevitably tax policy in the country has responded to changing development strategy over the years. In the initial years tax policy was guided by a large number of demands placed on the government.⁴ These demands can be summarized as the need to increase the level of savings and investment in the economy and hence the need to stimulate growth and ensure a fair distribution of incomes. That in turn meant an effort to raise taxes from those with an ability to pay, with little regard for the efficiency implications of the chosen instruments for the purpose.

The role of history and institutions was also important in shaping India's tax system. Indeed, the nature of the federal polity, the assignment of tax powers, and tax sharing arrangements have influenced 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 enact and implement comprehensive and coordinated tax reforms. Another legacy of the era of planning is selectivity and discretion both in designing the structure and in implementing the tax system. These contributed to erosion of the tax base, created powerful special interest groups, and introduced the concept of "negotiated settlement" into the tax system.⁵ In a closed economy, inefficiencies did not matter and relative price distortions and disincentives to work, save, and invest did not warrant much consideration.

2. The important exception to this is the introduction of an expenditure tax on Kaldor's advice in the mid-1950s. See Government of India (1956).

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

4. Bagchi and Nayak (1994).

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

Because of the size of the country, its multilevel fiscal framework, the unique reform experience, and difficulties in calibrating reforms posed by institutional constraints, the Indian tax reform experience can provide useful lessons for many countries. The reform, by itself, is an important enough reason for a detailed analysis of the tax system in India. Unfortunately, unlike in many developed countries where major tax reform initiatives were followed by detailed analysis of their impact, no serious studies analyzing the economic impact of tax reforms have been conducted in India.⁶

This paper analyzes the Indian tax system. Alternative models of tax system reform are presented with a view to identifying the best-practice approach followed in tax system reforms. Surely, in a democratic polity, it is difficult to achieve the ideal and yet, the framework helps to keep the focus on further reforms. We then analyze the evolution of the Indian tax system and the impact of historical and institutional factors in shaping Indian tax policy. Trends in tax revenue are presented, and these point toward a relative stagnation and deceleration in tax revenues at both the Union, or central, and state levels. An analysis of the reasons for this stagnation is followed by an exploratory discussion on the possible efficiency and equity implications of the tax system. The final section presents directions for further reforms.

Changing Paradigms of Tax Policy and Reform

In the literature on tax design and reform, the thinking on what constitutes the best tax system and an implementation strategy to achieve it have undergone considerable change over the years, mainly because of the changing role of the state in development and internationalization of economic activities.⁷ Designing tax policy and reforming an existing tax regime can be two distinctly different exercises, not always generating the same set of results. It is possible to argue that the objective of tax reform should be to chart the course for turning a given tax regime into one that has been “optimally” designed. The history of the existing system, however, as well as political and administrative constraints, could place limits on such a transition path. For instance, a comprehensive consumption tax of the value-added

6. In the United States, for example, there have been several studies analyzing the impact of the Tax Reform Act of 1986. For a detailed review of these studies, see Auerbach and Slemrod (1997).

7. Bird and Oldman (1990); Gillis (1989); Boskin and McLure (1990).

tax (VAT) variety might be best implemented at the national level, to avoid issues relating to treatment of interstate taxation. But the assignment of tax powers in India could make that transition difficult if not impossible. Reform therefore might have to explore other alternatives such as a dual VAT system.

One important school of thought, which focuses on the design of a tax system, is known as the optimal taxation school. It recognizes the difficulties of achieving the first-best solution and emphasizes the need to minimize the deadweight losses in exploring the second-best solutions. Here one can distinguish two key approaches. The first approach, based on the assumption that government is all-powerful, fully informed, benevolent, and driven by efficiency considerations, derives the following result: to minimize the excess burden of raising a given amount of revenue, consumption should be taxed and the optimal rate of tax on individual commodities should be related to the direct and cross-price elasticities of demand. In the special case when the compensated cross-price elasticities are zero, the optimal tax rate is inversely proportional to the direct, compensated price elasticity of demand (Ramsey rule). The lower the compensated price elasticity of demand, the smaller the movement away from the undistorted first-best optimum in response to the tax so that it pays to tax the lower-elasticity goods at higher rates. Since tax structures designed on these principles would involve taxing necessities, the need to address distributional concerns becomes paramount.⁸ Incorporating distributional considerations into this paradigm introduces discussions of optimal income tax, applications of which interestingly do not support sharply progressive tax structures.

The second approach recognizes that the government typically lacks the information on elasticities and is subject to lobbying when it is willing to tax different goods at different rates. This approach leans more heavily toward taxing consumption at uniform rates across goods.⁹ According to this approach, while efficiency (and distribution weights) is clearly desirable in the design of tax policy, administrative capacity, attention to local institutions and political realities are equally, if not more, important. The principal concern is not to design a system that will be optimal, but to adopt a system that will minimize tax-induced distortions and at the same time, be administratively feasible and politically acceptable. The basic Harberger reform package for developing countries that are price takers in the international market consists, among other things, of uniform tariffs and a broad-based VAT. Panagariya and Rodrik examine the rationale for uniformity in the

8. Stern (1987).

9. This approach is associated with the names of Harberger (1990) and Hatta (1986).

context of import tariffs and argue that while the case for uniform tariffs is not watertight, uniformity minimizes the pressures for favorable (higher) rates on some goods over others.¹⁰ The commitment to a uniform tax rate introduces a free-rider problem for industries to lobby for lower rates for themselves (since such lower rates are then extended to everyone).

While the literature has focused more on the first approach described above, optimal taxation has played only a limited role in the formulation of actual tax policy. The second approach, combined with administrative cost considerations, is a closer approximation of the approach of tax policy practitioners. The thrust of most tax policy advice within this approach is to enhance the ability of the tax system to raise revenue while minimizing relative price distortions. This involves efforts to broaden the tax base, lower the rates, and reduce rate differentiation of both direct and indirect taxes. Adoption of uniform tax rates has been an important feature of practical approaches to tax reform.¹¹ A broader base requires lower rates to be levied to generate a given amount of revenues. It also helps to ensure horizontal equity, and it is desirable from the political economy viewpoint because elimination of exemptions and concessions reduces administrative costs as well as the influence of special interest groups on tax policy. Lower marginal rates not only reduce disincentives to work, save, and invest, but also help to improve tax compliance. The preference for broad-based and uniform rates of taxation is thus guided by the need to eliminate an arbitrary array of tax differentials determined more by special interest group politics than pursuit of economic efficiency. Further, the limited infrastructure and capacity of tax administrations in developing countries constrain them from effectively administering complicated tax regimes. Broad-based systems of taxation applying uniform rates are a mechanism for providing stability and simplicity to the tax system.

The introduction of a VAT is an important component of recent tax reform packages in many countries, especially in the context of declining emphasis on import tariffs. Keen and Ligthart show that in small open economies, any revenue-neutral tariff cut accompanied by a price-neutral, destination-based VAT will enhance both net revenue and welfare.¹² While this result is contested, especially in the context of developing economies with significant informal sectors, that debate does not extend to cases where a VAT seeks to replace a cascading type of sales tax or broad-based excise duty. In large

10. Panagariya and Rodrik (1991).

11. Rao (1992).

12. Keen and Ligthart (2002).

economies, however, complete replacement of revenue from international trade taxes by a VAT may not be possible since it might be associated with unacceptably high tax rates; even if it were acceptable, the revenue might not accrue to the central government in a federal setup like India where the states have traditionally held the power to levy sales taxes.¹³ There may thus be a need to explore all other alternatives.

In many countries, the reason for levying a VAT has as much, if not more, to do with replacing the cascading-type sales taxes, which are often, confined to the manufacturing stage, than to substitute for import duties as a source of revenue. In many cases the expansion of the tax base accompanying the VAT, caused both by extending the tax to the stages following manufacturing and by the self-enforcing nature of the tax, has led to higher revenue productivity. Often, this expansion of the VAT tax base has strengthened the information base for tax administration, resulting in improved compliance for other taxes and thereby enhancing the overall productivity of the tax system.¹⁴ Thus, although a VAT is not necessarily a “money machine,” the conventional conclusion holds that a properly administered VAT is the best way to make up for the revenue loss from trade liberalization.¹⁵

Some recent theoretical explorations have argued that because the VAT is a tax on the formal sector of the economy and is often combined with weak administration, it helps the informal economy to spread, which is not conducive for development.¹⁶ This argument, however, applies to many other taxes levied in developing countries. In fact, most taxes in developing countries are levied on the formal sector. In the context of tariffs, it has been shown that smuggling—the informal sector counterpart in the case of imports—lowers both revenue and welfare.¹⁷ Moreover, the economic agent has to contend with high transaction costs simply because he is in the informal sector. The extent to which a VAT encourages the informal sector also

13. Rajaraman (2004).

14. Rajaraman (2004) cites the estimates of an IMF study (Ebrill and others 2001) to show that countries with higher per capita GDP tended to gain, but poorer countries tended to lose by introducing the VAT. Besides the usual problems with cross-country regression estimates which both papers point out, it must be noted that a properly calibrated VAT with its information on turnovers can improve the income tax. In Thailand for example, the introduction of a VAT replaced the manufacturers’ sales tax in 1991 at a uniform rate of 7 percent (which was actually less than the revenue neutral rate of 10 percent), and led to full revenue recovery. What was surprising was that the VAT also increased the income tax by 25 percent. See Government of India (1993).

15. This argument is made by Bird (2005).

16. Emran and Stiglitz (2004, 2005); Hines (2004); Gordon and Wei (2005).

17. Bhagwati and Hansen (1973); Martin and Panagariya (1984).

varies from country to country. This argument against the VAT also overlooks the dynamism created by the formal sector as it opens up avenues to expand businesses.¹⁸

Another critique of the appropriateness of the VAT in developing countries is based on market structures. Das-Gupta argues that under imperfect competition, since neither the gains from an input tax credit nor the entire tax burden need to be passed on to the consumer, a turnover tax may produce both more revenue and greater welfare than a VAT.¹⁹ This result, however, is based on a static framework. In a dynamic context, the taxpayers in a turnover-based tax system can integrate vertically, thereby avoiding taxes and potentially undermining production efficiency. Further, such a tax regime would perpetuate tax spillovers both across jurisdictions within the country and across international borders. These would undermine the competitiveness of the domestic industry and violate common market principles.

Thus, as stated by Bird, “One may criticise VAT in both theory and practice, and much more such analysis and criticism is not only to be expected but also welcomed. In the end, VAT almost certainly works better both in theory and practice in most countries than any feasible alternative.” Again, as Bird states, “the most basic lesson. . . from experience to date with implementing VAT in developing and transitional economies. . . is. . . that doing it right is in most respects a matter more of art than of science. . . the behaviour of the informal sector depends. . . largely on the interaction between formal institutions such as the tax administration and the prevalent norms and customs in a country. . . .”²⁰

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

18. According to a report in the *Financial Times* of April 6, 2005, the use of credit cards by foreigners in India increased by 42 percent to \$75 million.

19. A turnover tax is one that is fixed as a percentage of total turnover of the tax paying dealer; see Das-Gupta (2004c).

20. Bird (2005).

immediately after the Second World War.²¹ That high marginal tax rate persisted in the United States until 1963.

Three important factors led to moderation in the pursuit of redistribution through tax policy. First, experience showed that highly progressive tax systems did little to reduce inequality in developing countries as they were neither progressive nor comprehensive.²² Empirical studies in the United States and Chile showed that the income redistribution and reduction in inequality achieved by the tax systems were insignificant.²³ Second, a redistributive tax system can impose additional costs on the economy, including administrative costs, compliance costs, economic efficiency costs, and political costs. Third, the focus of equity in fiscal policy itself has shifted from “reducing the incomes of the rich” to “increasing the incomes of the poor” and in this, the alternative approach of using expenditure programs for poverty alleviation has attracted greater attention.²⁴

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

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

21. Harberger (2003).

22. Harberger (2003); Bird and Zolt (2005).

23. For the United States, see Pechman (1985); for Chile, see Engel, Galetovic, and Raddatz (1999).

24. Harberger (2003); Bird and Zolt (2005).

Probably the most important aspect of the advice for developing countries in designing their tax systems is to keep the administrative dimension at the center rather than the periphery of reform efforts. Poor administrative capacity creates a wedge between the structure of the tax on paper and what actually works in practice. Apart from eroding revenue productivity, poor administration results in the perpetuation and even the spread of the informal economy, significant deadweight losses, and the violation of horizontal equity.

Tax policy, or for that matter any policy, stands on the tripod of architecture, engineering, and management.²⁵ Architecture provides the design of the tax system to be achieved, which is guided by the objectives of tax policy. Engineering provides the mechanics to achieve it, and these are provided by the nature of institutions and systems involved in tax collection. Management provides the implementation strategy and action, which, among other things, depends on the political support and vision and the nature of administrative agencies and the information system. The three legs of the tripod are interdependent. A tax policy is only as good as it is administered; so it is important to design the tax system keeping the administrative capacity in mind. Similarly, the nature of tax institutions and systems will have to be adapted to conform to the design of the tax system and the implementation capacity. Further, administrative capacity should be continuously augmented to keep pace with changing requirements of tax policy. In other words, reform of the tax system involves both its structure and operations, is a continuous process, and has to be calibrated constantly. A complementary action in this regard is the building of proper information system.

Evolution of Indian Tax System

The basic framework for the tax system in independent India was provided in the constitutional assignment of tax powers. The important feature of the tax assignment is the adoption of the principle of separation in tax powers between the central and state governments. The central government has the power to levy the major broad-based and mobile tax bases, which include taxes on nonagricultural incomes and wealth, corporate income taxes, customs duties, and excise duties on manufactured products. Over the years, the last item has evolved into a manufacturers' VAT on goods. The major

25. Bird and Zolt (2005).

tax powers assigned to the states include taxes on agricultural incomes and wealth, sales taxes, excises on alcoholic products, taxes on motor vehicles and on transport of passengers and goods, stamp duties and registration fees on transfers of property, and taxes and duties on electricity. States also have powers to levy taxes on entertainment and on income earned by engaging in a profession, trade or employment; some states have retained these powers for themselves, while others have assigned them to local bodies.²⁶ Although the state list also includes property taxes and taxes on the entry of goods into a local area for consumption, use, or sale, these have been assigned to local bodies. Until 2003 India's constitution did not explicitly recognize and assign to any level of government the power to tax services. However, since all residuary tax powers were assigned to the central government, in 1994, this authority became the basis for levying a tax on selected services. In 2003 an amendment to the constitution specifically assigned the power to tax services to the central government.²⁷

Tax policy in India has evolved as an important component of fiscal policy that played a central role in the planned development strategy. In particular, tax policy was the principal instrument for transferring private savings to public consumption and investment.²⁸ Tax policy was also used to encourage savings and investment, reduce inequalities of income and wealth, foster balanced regional development, encourage small-scale industries on the assumption that they are employment intensive, and influence the volume and direction of economic activities in the country.

The evolution of tax policy within the framework of an industrialization strategy based on the public sector, heavy industry, and import substitution has had several implications. First, tax policy was directed to raise resources for the large and increasing requirements of public consumption and investment irrespective of the efficiency implications it entailed. Second, the objective of achieving a socialistic pattern of society, combined with the large oligopolistic rents generated by the system of licences, quotas, and restrictions, necessitated steeply progressive tax structure in both direct and indirect taxes. Third, the pursuit of a multiplicity of objectives enormously complicated the tax system with adverse consequences on efficiency and horizontal

26. While this tax applies to individuals based on the income earned, it is considered distinct from income tax, since the total tax leviable is limited by a cap spelled out by India's constitution.

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

28. Bagchi and Stern (1994).

equity. It also opened up large avenues for evasion and avoidance of taxes. The disregard for efficiency considerations was a part of the import-substituting industrialization strategy. Fourth, not only did all of this require differentiation in tax rates based on arbitrary criteria, but plan priorities also legitimized selectivity and discretion in tax policy and administration. Once selectivity and discretion were accepted as legitimate, it mattered little whether these were exercised as intended. This provided enough scope for the special interest groups to influence tax policy and administration. Fifth, the influence of special interest groups, changing priorities, and the lack of an information system and scientific analysis led to ad hoc and often inconsistent calibration of policies. Finally, the poor information system was the cause of selective application of the tax system as well as its effect.

This section summarizes the evolution of the major central taxes and provides an overview of the state taxes. For the central government, the major direct taxes are personal income and corporate taxes; the major indirect taxes are excise duties, customs duties, and service tax. At the state level, the major initiative in recent times has been the introduction of the VAT, and the discussion limits itself to this measure.

Reform of Central Taxes

The systematic evolution of the tax system in independent India started with the implementation of the report of the Taxation Enquiry Commission.²⁹ In fact, this was the first comprehensive attempt to review the existing tax system and design a system that would cover central, state, and local taxes. It was intended to fulfill a variety of objectives such as raising the level of savings and investment, transferring resources from the private sector to public sector, and achieving a desired state of redistribution. The commission report was available in 1953–54, but because of the ideological orientation of the Second Five-Year Plan (1956–60), Nicholas Kaldor was invited to produce another report on Indian tax reform. This report, published in 1956, was used (rather incompletely) to raise resources for the Second Five-Year Plan. Kaldor recommended the implementation of an expenditure tax to curb consumption and raise the level of saving, which was abysmally low at about 10 percent of gross domestic product (GDP).³⁰ However, this tax had to be withdrawn in 1957–58 because it did not generate the expected revenues.

29. Government of India (1953).

30. Government of India (1956).

With the adoption of a planned-development strategy in a mixed economy framework, raising more resources and achieving the desired state of redistribution became an obsession, which led policymakers to design the income tax system with confiscatory marginal rates. The consequent disincentives, as well as the high rate of return on tax evasion, low probability of detection, and an ineffective legal system that failed to impose penalties within a reasonable time period, led the Direct Taxes Enquiry Committee in 1971 to recommend a significant reduction in marginal tax rates.³¹

On the indirect taxes side, a major simplification exercise was attempted by the Indirect Taxes Enquiry Committee.³² Implementation of the important recommendations of this committee, however, were not initiated until 1986.

Systematic and comprehensive attempts to reform the tax system at the central level started only after market-based economic reforms were initiated in 1991, when the Tax Reforms Committee (TRC) laid out a framework and a road map for reforming both direct and indirect taxes.³³ Subsequent reports providing the analytical basis for reform in the new millennium were issued in 2002 and 2004.³⁴ In many ways the reforms since 1991, with their emphasis on simplicity and efficiency, are a marked departure from the past. In fact, the 2002 task force reports built on the recommendations of the TRC, which are summarized below.

The tax reforms initiated since 1991 have been a part of the structural reform process that followed the economic crisis of 1991. In keeping with the best-practices approach, the TRC combined economic principles with conventional wisdom in recommending comprehensive tax system reforms. The report is in three parts. 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 outlined in the recommendations are to broaden the tax base, lower marginal tax rates, reduce rate differentiation, simplify the tax structure, 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

31. Government of India (1971).

32. Government of India (1977).

33. Government of India (1991).

34. Government of India (2002a, 2002b, 2004b).

enhance revenue productivity of the tax system in the medium and long term. The overall thrust of the TRC was to decrease the share of trade taxes in total tax revenue; increase the share of domestic consumption taxes by transforming the domestic excises into a VAT, and increase the relative contribution of direct taxes.

The important proposals put forward by the TRC included reducing the rates of all major taxes—customs, individual and corporate income taxes, and excises—to reasonable levels, maintaining progressivity but without inducing evasion. The TRC recommended a number of measures to broaden the tax base by minimizing exemptions and concessions, drastically simplifying laws and procedures, building a proper information system, and computerizing tax returns, and thoroughly modernizing administrative and enforcement machinery.

In the case of customs, the TRC recommended tariff rates of 5, 10, 15, 20, 25, 30, and 50 percent to be achieved by 1997–98. Implementing this recommendation meant a considerable rationalization from the prevailing structure, which had more than 100 rates ranging up to 400 percent. The tariff rate was to vary directly with the stage of processing of commodities, and among final consumer goods, with income elasticity of demand (higher rates on luxuries). In hindsight, it is easy to criticize the excessive rate differentiation (seven rates) as well as the degree of protection depending on the stage of processing. Joshi and Little for example, call this “a totally unprincipled principle, for it has no foundation in economic principles.”³⁵ In addition to continued complexity, the proposed tariff structure created very high differences in effective rates and provided a higher degree of protection to inessential commodities.

The TRC recommendation also fell far short of developing a coordinated domestic trade tax system in the country. This, in a sense, is understandable, as the committee had no mandate to reform state taxes. However, the committee was aware of the serious problems of avoidance and evasion of sales taxes levied by the states predominantly at the manufacturing stage. Therefore, it did recommend the extension of the central government’s VAT to the wholesale stage with the revenues from the extended levy beyond the postmanufacturing stage assigned to the states.

By all accounts, the tax system at the central level was considerably simplified and rationalized by 2005, although these reforms were neither uniform nor consistent and the system was far from perfect.³⁶ Some areas

35. Joshi and Little (1996, p. 74).

36. Acharya (2005).

still need require reforms, and these are discussed later. Although a broad account of the history of tax reform has been given here, it is important to understand the evolution of the tax structure for each of the central government's major taxes: personal income tax, corporation income tax, Union excise duties, and customs.

Reform of Direct Taxes

At the central level, the changes in the income tax structure until the mid-1970s were largely ad hoc, dictated by the exigencies of bringing about a socialistic pattern of society. In 1973–74, the personal income tax had eleven tax brackets with rates monotonically rising from 10 percent to 85 percent. When a surcharge of 15 percent was taken into account, the highest marginal rate for persons with income above Rs. 0.2 million was 97.5 percent.³⁷ In fact, the increase in income tax rates to confiscatory levels was completed immediately after the split in the Congress party in 1969 and appeared to be a part of the effort to give the party a pro-left image.³⁸

The policy was similar in the case of corporate taxation. The classical system of taxation involved taxing the profits in the hands of the company and dividends in the hands of the shareholders. A distinction was made between widely held companies and different types of closely held companies, and the tax rate varied from the base rate of 45–65 percent in the case of some widely held companies. Although nominal rates were high, the effective rates were substantial lower due to generous depreciation and investment allowances. In fact some companies benefited from the preferences so much that they did not pay any corporate tax year after year.

The Direct Taxes Enquiry Committee succinctly described the impact of the confiscatory tax system in 1971. It attributed the large-scale tax evasion to confiscatory tax rates and recommended reducing marginal rates to 70 percent. This change was implemented in 1974–75, when the tax was brought down to 77 percent including a 10 percent surcharge. Simultaneously, however, the wealth tax rates were increased. In 1976–77, the marginal rate was further reduced to 66 percent, and the wealth tax rate was

37. For incomes from capital alone, with a wealth tax of 5 percent, the above tax structure meant that there was a ceiling on income at Rs. 250,000; this was the desired goal as explicitly recorded in the budget speech of 1971–72, by Y. B. Chavan.

38. Indira Gandhi, presenting the 1970–71 budget, stated, "Taxation is also a major instrument in all modern societies to achieve greater equality of incomes and wealth. It is, therefore, proposed to make our direct tax system serve this purpose by increasing income taxation at higher levels as well as by substantially enhancing the present rates of taxation on wealth and gifts."

reduced from 5 percent to 2.5 percent. In 1979–80, the income tax surcharge was increased, and the wealth tax rate returned to a maximum of 5 percent. A major simplification and rationalization initiative, however, came in 1985–86, when the number of tax brackets was reduced from eight to four, the highest marginal tax rate was brought down to 50 percent, and wealth tax rates came down to 2.5 percent.

The last wave of reforms in personal income taxation was initiated on the basis of the recommendations of the TRC. Under the reforms, there were only three tax brackets, of 20, 30, and 40 percent, starting in 1992–93. Financial assets were excluded from the wealth tax, and the maximum marginal rate was reduced to 1 percent. Further reductions came in 1997–98, when the three rates were brought down further to 10, 20, and 30 percent. In subsequent years, the need for revenue has led to a general surcharge and additional surcharge of 2 percent dedicated to primary education, the latter applicable on all taxes.

The basic corporate tax rate was reduced to 50 percent, and rates applicable to different categories of closely held companies were unified at 55 percent. Following the recommendations of the TRC, the distinction between closely held and widely held companies was done away with and the tax rates were unified at 40 percent in 1993–94. In 1997–98, the corporate rate was further reduced, to 35 percent, and the 10 percent tax on dividends was shifted from individuals to companies. Since then the measures adopted have lacked direction. The dividends tax rate was increased to 20 percent in 2000–01, then reduced again to 10 percent in 2001–02 and levied on shareholders rather than the company. The policy was reversed once again in 2003–04, with the dividend tax imposed on the company.

A major problem that has haunted the tax system and reduced the tax base is the generous tax preferences. The Advisory Group on Tax Policy and Tax Administration needed twenty-five pages in its report to list the personal income tax preferences, and the Task Force on Tax Policy and Tax Administration also made a detailed list of these concessions.³⁹ Among the tax preferences are 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. These tax preferences have not only distorted the after-tax rates of return on various types of investments in unintended ways but have also significantly eroded the tax base.

39. Government of India (2001a, pp. 125–50).

The major corporate tax preferences are investment and depreciation allowances. Tax incentives were also provided for businesses locating in underdeveloped areas. As a result, some companies planned their activities to take full advantage of the generous concessions and fully avoid the tax. This form of tax avoidance by “zero-tax” companies was minimized by the introduction of a minimum alternative tax (MAT) in 1996–97. Even as companies can take advantage of the tax preferences, they are required to pay a tax on 30 percent of their book profits. In subsequent years, a provision was incorporated allowing those companies paying a MAT to take a partial credit against income tax liabilities in following years. Since the MAT meant that a lot of the other preferences accorded in the tax statute like accelerated depreciation were not available to business units, the partial credit mechanism sought to dilute the impact of the MAT on business units that were liable for the MAT only sporadically.

While tax reforms were calibrated on the basis of a consistent theoretical framework until the mid 1990s, some of the subsequent changes were ad hoc. The prime example is the decision to introduce the MAT instead of phasing out tax preferences. Setting the tax rate on corporate profits higher than the highest marginal rate on personal income is another example. Similarly, to improve tax compliance and create an audit trail, a securities transactions tax was introduced in April 2004 and tax of 0.1 percent on all cash withdrawals above Rs. 25,000 from current accounts of commercial banks was introduced in April 2005. These measures, however, are retrograde. The former hinders the development of stock market and discriminates against investments in shares. The latter penalizes small and medium-size firms, which have to withdraw large amounts of cash just to pay the salaries of their employees.⁴⁰

Personal income tax rates have remained stable since 1997–98, at 10, 20, and 30 percent, with some changes in the associated tax brackets. A surcharge of 5 percent of the income tax payable was imposed in 2002–03 in the wake of the Kargil war and was discontinued the following year. It was replaced, however, with a separate 10 percent surcharge imposed on all taxpayers with taxable incomes above Rs. 850,000; the level was raised to Rs. 1 million in the 2005–06 budget. Further, all taxes are topped up by a 2 percent education cess—a surcharge dedicated to an education fund from 2004–05 onward. Although the income exemption limit has remained at Rs. 50,000 since 1998–99, the generous standard deduction and the

40. Arbalaez, Burman, and Zuluaga (2002) for discussion of effects of such a tax in Columbia.

exemptions on dividends and interest on government securities up to specified limits have effectively increased the threshold substantially. The 2004–05 budget did not raise the exemption limit but provided that those with incomes under Rs. 100,000 need not pay the tax. The budget still retained the existing tax brackets, however, which gave rise to a peculiar problem—those with taxable incomes above Rs. 100,000 were left with lower after-tax incomes than those with incomes marginally lower than Rs. 100,000, requiring an ad hoc correction. The budget for 2005–06 raised the exemption limit itself to Rs. 100,000, abolished the standard deduction, and made marginal changes in the tax brackets. The exemption limit was increased to Rs. 135,000 for women and to Rs. 185,000 for senior citizens. Savings in a variety of instruments including pension funds up to Rs. 100,000 were made deductible from taxable income.

The Income Tax Act has a provision to assess the value of identifiable perquisites provided by companies to their employees and to include the same in the taxable income of the individual. The budget for 2005–06 goes a step further and classifies a range of other expenses by the company, which provide indirect perquisites to the entire group of employees but are not directly assignable to any single employee. A specified proportion of each of these benefits is to be taxed at a rate of 30 percent through a fringe benefits tax, to be paid by the employer. Benefits covered include entertainment, conferences, employee welfare, sales promotion including publicity, conveyance, tour and travel (including foreign travel expenses), and use of the telephone.

The structure of corporate income taxes has also remained stable since 1997–98, when the rate was reduced to 35 percent. As described earlier, however, there have been frequent changes and inconsistency in taxing dividends. In 2005–06, the corporate income tax was reduced to 30 percent on domestic companies. A surcharge of 10 percent (without any conditions regarding installed capacity increases) is also chargeable. The depreciation rate has been reduced to 15 percent in the case of general plant and machinery, but initial depreciation is set at 20 percent, thereby reducing the overall benefit of lowering corporate income tax rates.

The most important reform in recent years is in tax administration. Expansion of the scope of tax deduction at source is one of the significant measures taken to reach the “hard to tax” groups. Further, every individual living in a large city and covered under any one of the six conditions (ownership of house, ownership of a car, membership in a club, ownership of credit cards, foreign travel, and a subscriber of a telephone connection) is necessarily required to file a tax return. The government is also issuing

permanent account numbers and strengthening the tax information system. Strengthening the information system, along with 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

UNION EXCISE DUTIES. After independence, excise duties were levied on selected goods to raise revenue. Over the years, as the revenue requirement increased, the list of commodities subject to tax was expanded. In the initial years, for reasons of administrative convenience, the taxed commodities tended to be raw materials and intermediate goods rather than final consumer goods.⁴¹ As pressure to raise revenue increased, final consumer goods were included. In 1975–76 the tax was extended to all manufactured goods.

By this time the structure of excise duties was complex and highly distortionary. Some commodities were subject to specific duties and others to ad valorem taxes; on the latter alone there were twenty-four different rates ranging from 2 to 100 percent (tobacco and petroleum products were taxed at even higher rates). The process of converting specific duties to ad valorem rates was more or less completed by 1993–94.⁴² The number of rates did not decrease, however, which led to several classification disputes. In effect, the excise duty became a manufacturers' sales tax administered on the basis of goods cleared from the warehouse. "Cascading" from the tax resulted not merely from its preretail nature but also because it was levied not only on final consumer goods but also on inputs and capital goods. The tax system was complex and opaque, and a detailed analysis showed significant variation in the effective rates.⁴³

Although the Indirect Tax Enquiry Report issued in 1977 provided a detailed analysis of the allocative and distributional consequences of union excise duties, its recommendations were not implemented for almost a decade. The rationalization recommendations included converting specific duties into ad valorem taxes, unifying rates, and introducing an input tax credit to convert the cascading manufacturers' sales tax into a manufacturing-stage value-added tax (MANVAT). The interesting part of the reform was that there was virtually no preparation and the introduction of modified value-added tax (MODVAT) was a process of "learning by doing." This

41. Government of India (1977).

42. Thereafter only a few commodities remained on specific duties; tea, cement, and cigarettes are notable among these.

43. Ahmad and Stern (1983).

was a strange combination of taxation based on physical verification of goods with provision of an input tax credit. The coverage of the credit mechanism also evolved over time. It began with selected items, with credit based on a one-to-one correspondence between inputs and outputs. It was only by 1996–97, that it covered a majority of commodities in the excise tariff and incorporated comprehensive credit. Nowhere else in the world can one find VAT introduction so complicated in its structure, so difficult in its operations, and so incomplete in its coverage. In fact, the revenue from the tax as a ratio of GDP declined after the introduction of MODVAT.

Further reform of the 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, eleven tax rates were merged into three, with a handful of “luxury” items subject to an additional nonrebateable tax (6 and 16 percent). The three rates were merged into a single rate in 2000–01 to be called a central VAT (CenVAT), along with three special additional excises of 8, 16, and 24 percent for a few commodities. Further, the tax base was widened; some exemptions were replaced by a tax at 8 percent. Some simplification of the tax on the small-scale sector was also attempted. Small businesses could either take an exemption or pay tax at a concessional rate of 60 percent of tax due, with access to the tax credit mechanism. This option, however, was withdrawn from the budget of 2005–06.

CUSTOMS DUTIES. Contrary to the general patterns seen in low-income countries, where an overwhelming proportion of revenues is raised from international trade taxes, revenue from this source was not very large in the initial years of independent India, largely because imports were restricted.⁴⁴ In addition, high and differentiated tariffs, with rates varying with the stage of production (lower rates on inputs and higher rates on finished goods) and income elasticity of demand (lower rates on necessities and higher rates on luxury items) not only resulted in high and widely varying effective rates of protection, but provided large premiums for inefficiency and caused unintended distortions in the allocation of resources.

By the mid-1980s, the tariff rates were very high and the structure quite complex. The government’s Long-Term Fiscal Policy (LTFP) presented in the Parliament in 1985–86 emphasized the need to reduce tariffs, apply fewer and more uniform rates, and reduce and eventually eliminate quantitative restrictions on imports. The reforms undertaken, however, were not

44. Chelliah (1986).

comprehensive. Rationalization in the rates was attempted for specific industries such as capital goods, drug intermediates, and electronic goods. In fact, contrary to the LTFP recommendations, the tariffs were raised for revenue reasons, and the weighted average rate increased from 38 percent in 1980–81 to 87 percent in 1989–90.⁴⁵ Thus, by 1990–91, the tariff structure ranged from 0 to 400 percent. More than 10 percent of imports were subject to tariffs of 120 percent or more. Wide-ranging exemptions, reflecting the influence of various special interest groups on tax policy, often granted outside the budgetary process, further complicated the system and made it ad hoc.

The reform of import duties in earnest began in 1991–92 when all duties on nonagricultural goods above 150 percent were reduced to this level. This “peak” rate was lowered over the next four years to 50 percent, and then to 40 percent in 1997–98, 30 percent in 2002–03, 25 percent in 2003–04, and finally to 15 percent in 2005–06. Along with relaxation of quantitative restrictions on imports and exchange rate depreciation, the change in the tariffs constituted a major change in the foreign trade regime in the country.

The number of major duty rates was reduced from twenty-two in 1990–91 to four in 2003–04. Of course, some items are outside these four rates, but 90 percent of the customs is collected from items under the four rates. At the same time, a special additional duty was imposed on goods imported into the country on the rationale that if the commodity was domestically produced and sold interstate, it would have attracted the tax rate of 4 percent. This duty was abolished in January 2004, only to be reintroduced in 2005–06. Thus, the direction of reforms was not always consistent, but overall the thrust has been to reduce the rates and reduce their dispersion. However, tariffs rates still vary with the stage of processing, and this practice has caused very high effective rates of protection on assembly of consumer durables and luxury consumption items.

SERVICE TAX. An interesting aspect of the tax system in India is that except for a few specified services assigned to the states such as the entertainment tax, passengers and goods tax, and the electricity duty, the services were not specifically assigned to either the center or the states. This omission violated the principle of neutrality in consumption as it discriminated against the goods component of consumption. Because services are relatively more income elastic, the tax system is rendered less progressive when these are not taxed. An even more important argument for taxing services is to enable a

45. Government of India (1991).

coordinated calibration of a consumption tax system on goods and services because services enter into goods production and vice versa.

Although there was no specific authority to tax services, the central government levied taxes on three services in 1994–95: insurance other than life insurance, stock brokerages, and telecommunications. The list was expanded in succeeding years and now includes more than eighty services. The initial 5 percent tax rate was increased to 8 percent in 2003–04 and to 10 percent in 2004–05. The Expert Group on Taxation of Services recommended extending the tax to all services, providing an input tax credit for both goods and services, and eventually integrating the services tax with the CenVAT.⁴⁶ With these reforms, the tax system can effectively be called a manufacturing-stage VAT. The exceptions were to be two small lists—one, a list of exempt services, and the other, a negative list of services, where the tax credit mechanism would not cover taxes paid on these services. The recommendation on the levy of general taxation of services has not been implemented, and the tax continues to be levied on selective services. However, the recommendation pertaining to the extension of input tax credit for goods entering into services and vice versa has been implemented.

State-Level Tax Reforms

Tax reforms at the state level were not coordinated with those at the center. While individual state governments tried to appoint committees from time to time and reform their tax structures, no systematic attempt was made 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 revenue needs rather than attempts to modernize the tax system. In some cases, even when systematic studies were done, the recommendations were rarely implemented.⁴⁷ Increasing budget pressures and, in some cases, conditions imposed by multilateral lending agencies or the need to meet targets set by the medium-term fiscal reforms facility instituted by the eleventh Finance Commission helped to accelerate the pace of tax reforms in the states in the latter half of the 1990s. The major landmark in coordinated tax reform at the state level was the simplification and rationalization of the

46. Government of India (2001b).

47. The National Institute of Public Finance and Policy has conducted several studies on the tax systems in various states since 1980, including Assam, Bihar, Kerala, Madhya Pradesh, Punjab, and Tamil Nadu. Uttar Pradesh had a tradition of appointing a tax reform committee every five years. Sometimes, the studies were repeated after some years. These recommendations continue to be pertinent, suggesting that very few have been translated into policy.

sales tax system, beginning in 1999 and the introduction of a VAT in twenty-one states on April 1, 2005, to replace the existing cascading sales tax.

Although good progress has been made in converting the central government's excise duties into a manufacturing-stage VAT, the reform in the states' sales tax systems has lagged behind. These reforms are critical from the viewpoint of efficiency, for they contribute over 60 percent of states' tax revenues. Moreover, to have a coordinated consumption tax system in the country, reforms in the state sales tax systems should be considered along with reforms of the central excise duty regime.

A systematic discussion on evolving a coordinated consumption tax system in the country was initiated in the "Report on Reform of Domestic Trade Taxes in India," prepared by the National Institute of Public Finance and Policy (NIPFP) in 1994. It examined alternative models for a coordinated consumption tax system for India and studied the feasibility of centralizing sales taxes and unifying the levy with excise duties; giving the states the power to levy all domestic indirect taxes with a corresponding reduction in tax devolution; and evolving an independent dual VAT at the central and state levels with no credit for the payment of the central taxes by the states and vice versa. The report favored the last solution as the most practicable in the Indian context because it maintains a balance between subnational fiscal autonomy and the central government's fiscal capacity to undertake any desired interstate redistribution. Burgess and Stern had reached a similar conclusion in 1993, while an analysis by Joshi and Little in 1996 favored either centralization or assigning all indirect taxes either to the center or to the states.

Considerations of fiscal autonomy and demands on the central government to effect sizable interregional resource transfers as well as the political acceptability tilted the decision in favor of the dual VAT scheme as a medium-term goal.⁴⁸ While a centralized tax on goods and services is desirable for creating a harmonized consumption tax system, it can be considered only as a long-term goal. In the medium term, as part of the initiative to introduce a dual VAT, it has been decided to convert the cascading state-level sales taxes into a destination-based VAT.

There are a number of arguments for replacing the prevailing state sales tax with a destination-based VAT, that is, a VAT system where the tax accrues to the state where the good is finally consumed. In most states, sales taxes are levied only at the first point of sale, that is, either sale by a manufacturer

48. NIPFP (1994); Rao (1998).

of a good or by an importer of the good in the state, and this makes the base narrow. The multiplicity of rates makes the tax system complex. The taxation of inputs and capital goods contributes to cascading, vertical integration of firms, and opaqueness. In an imperfect market characterized by markup pricing, the taxes on inputs and capital goods result not only in a tax on tax but also a markup on the tax, with consumers paying much more than the revenues collected by the government. Interstate competition in providing liberal tax incentives, besides distorting resource allocation, involves significant cost to the exchequer in tax expenditures. The tax on interstate sales combined with input and capital goods taxation has caused significant interstate tax exportation from richer to poorer states. In addition, in many states, the urban local bodies impose a tax, known as *octroi*, on the entry of goods into a local area for consumption, use, or sale. Thus the country was divided into several tariff zones, limiting the scope and the gains from a common domestic market. Above all, with independent and overlapping commodity tax systems at the central and state levels, developing coordinated and harmonized domestic trade taxes has become difficult.

As a part of the dual VAT design, therefore, the NIPFP study group recommended that a separate destination-based, consumption-type, retail-stage VAT replace the existing state sales taxes. To persuade the states to rationalize their tax systems along the lines recommended by the study group, the government of India appointed a State Finance Ministers' Committee to make recommendations to phase in the VAT within a given time frame. The committee, which was subsequently transformed into the Empowered Committee of State Finance Ministers, recommended that the states adopt floor rates to minimize the "race to the bottom." The committee's recommendation that the VAT be implemented in 2003 was postponed repeatedly, until April 2005.

Although characterized as adoption of VAT, the reform in April 2005 only extends the sales tax up to the retail stage with credit allowed for taxes paid on intrastate purchases used for all intrastate and interstate sales. The interstate sales tax, that is, the central sales tax, will continue in the same form, although a pending proposal would phase it out over a two-year period. In this sense, the reform is only a transitional measure to achieve the ultimate objective of having a destination-based, retail-stage VAT.

The salient features of the April 2005 reform are summarized here:

—The tax is levied at two rates (except for bullion, specie, and precious metals, which are taxed at 1 percent). Basic necessities (about 75 items)

are exempted. Most items of common consumption, inputs, and capital goods (about 275 items) are taxed at 4 percent, and all other items are taxed at 12.5 percent. Gasoline and diesel fuel (which contribute about 40 percent of the sales tax) are kept outside the VAT regime, and a floor rate of 20 percent is to be levied on them.

—The tax credit facility covers inputs and purchases as well as capital goods for both manufacturers and dealers. Credit for taxes paid on capital goods can be used over three years of sales.

—The tax credit mechanism operates fully only for intrastate sales. In interstate transactions, the exporting state is supposed to give an input tax credit for purchases made locally, against the collection of the central sales tax. The central sales tax credit in the importing state, or other mechanisms of zero-rating of interstate sales, will be introduced in two years, when the central sales tax in its present form will be phased out. In the meantime, an information system on interstate trade will be built up.

—The central government has agreed to compensate the states for any loss of revenue at rates of 100 percent in the first year, 75 percent in the second year, and 50 percent in the third year. The loss will be calculated by estimating the difference between the projected sales tax revenue using 2004–05 as the base and the actual revenue collected. The projected revenues will be estimated by applying the average of the best three years' growth rates during the last five years.

—Tax incentives given to new industries by different states could be continued so long as it does not break the VAT chain. Many states propose to convert tax holidays into deferment of the tax.

—All dealers with annual turnover above Rs. 500,000 are required to register for the VAT. However, the states may levy a simple turnover tax not exceeding 2 percent on those dealers with turnover up to Rs. 5 million. Such dealers, paying the turnover tax, do not have to keep detailed accounts of their transactions. But these small dealers will not be a part of the VAT chain, and no credit will be available for the taxes paid on purchases from these dealers. They may therefore voluntarily register as regular VAT dealers.

Altogether, as of April 2005 eighteen states and five Union Territories have committed themselves to implementing the VAT. Haryana began to implement the VAT in April 2004, but with three main rates (4 percent, 10 percent, and 12 percent). Eight states, including Gujarat, Madhya Pradesh, Tamil Nadu, and Uttar Pradesh, have stayed out of the system. These are

some of the larger states with significant industrial bases. Given the perceived incentives of VAT regime in the form of input tax credit, there are pressures on these states to join in as well.

Issues of Design and Implementation

The introduction of the VAT is a major reform exercise, and it is not surprising that the measure would lead to some confusion and uncertainty. Two sets of issues need to be highlighted. One is the ad hoc manner in which the tax has been introduced, which can be seen in the lack of preparedness on the part of many of the states on the one hand and in the lack of firm decisions on the design and structure of the tax, even a few months after it was introduced, on the other. Education and awareness programs for dealers and the public have been largely inadequate in a number of states. Some states started off the new regime without the rules and forms in place. Even tax officials are not clear about many issues. In other words, this switchover can in no terms be called a planned switchover.

The second issue involves three shortcomings in the design of the tax itself. First, the difference of 8.5 percentage points between the tax rates on inputs and outputs (4 percent and 12.5 percent) tends to reduce tax compliance. In fact, it is inappropriate to specify a lower rate on inputs in a VAT system because full credit is available for taxes paid on inputs used in the production against the tax payable on the final product. No other country in the world operating a VAT system permits concessional treatment of inputs. Many commodities are used as inputs as well as final consumer goods, and the lower rate implies a loss of revenue when goods classified as "inputs" are sold for final use. Further, a manufacturer might prefer to pay the input tax at 4 percent, suppress his sale, and evade the larger tax on the final product. The large tax differential also encourages intense lobbying to shift more items from the higher rate to the lower rate category. From the viewpoint of better tax compliance, it would have been better to choose rates like 4 percent and 10 percent.

Second, it would have been better to stipulate the two tax rates as floor rates rather than uniform rates. The only condition should have been that no state should levy the tax at more than two rates, and the items under the two categories could have been specified. This approach would have provided a degree of autonomy to the states and potentially reduced the need for compensation.

The third important issue is the decision to apply the VAT on the maximum retail price (MRP) at the first point on pharmaceuticals and drugs in

West Bengal and Maharashtra. This was possibly done to accommodate the existing trade practices organized through commissions; once MRP is taken as the base, there cannot be more value added at later stages. This goes against the principle of VAT—of collecting the tax at different stages of value added with credit given for the tax paid at the previous stage. Further, this special treatment for pharmaceuticals puts two different mechanisms in place for taxation within the same state and for certain dealers, a complication both for administration and compliance.

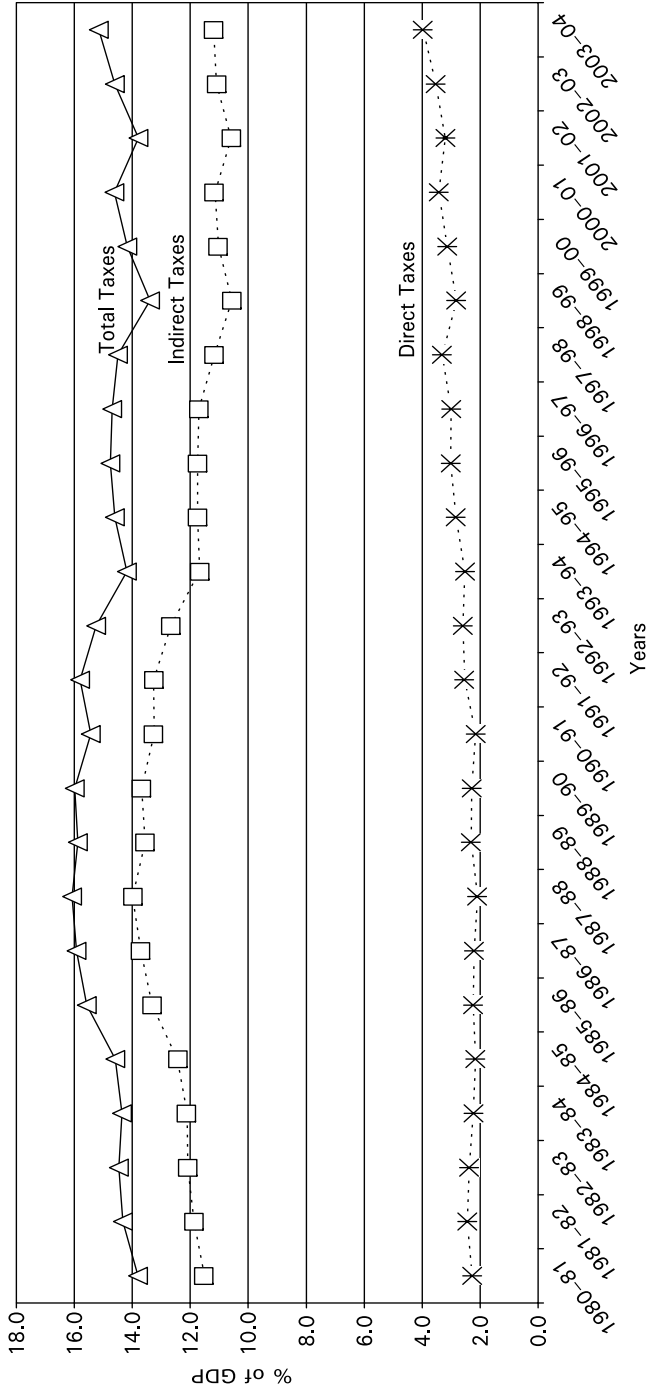
Trends in Indian Tax Revenues

This section analyzes the trends in tax revenue in India, focusing 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 systematic reforms, the revenue productivity of the tax system has not shown any appreciable increase—a reduction in customs duties has not been offset by any internal indirect taxes.

The aggregate trends in tax revenue in India show four distinct phases (table 1; figures 1 and 2). In the first phase, the ratio of tax revenue to GDP steadily increased, from 6.3 percent in 1950–51 to 16.1 percent in 1987–88. In the initial years of planning, an increase in this ratio was needed to finance large public sector plans, and an increase was relatively easy because it started from a low base. In addition, rising imports and the extension of manufacturing excises to raw materials and intermediate goods, and later to all manufactured goods, increased the buoyancy. That buoyancy was maintained in the later years in this phase as the economy attained a higher growth path and quantitative restrictions on imports were replaced by protective tariffs following initial attempts at liberalization in the late 1980s.

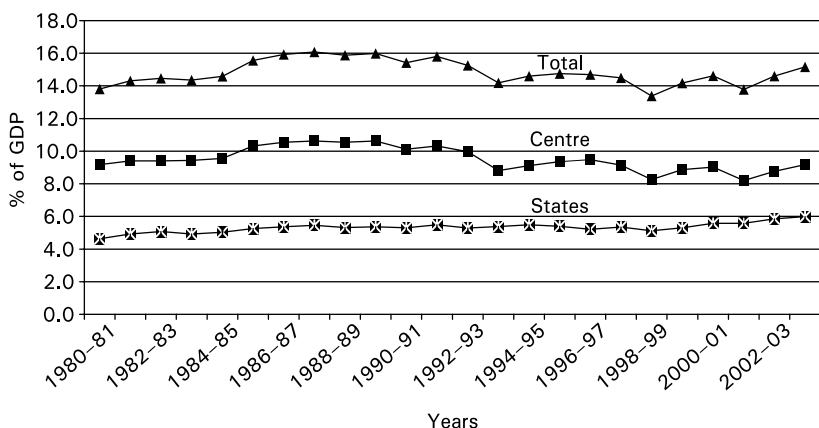
The second phase started with a recession caused by the severe drought of 1987 and was marked by stagnation in revenues. This was followed by a decline in the tax ratio following the economic crisis of 1991 and the subsequent reforms in the tax system, including a reduction in tariffs. Thus, in the third phase, the tax ratio declined from 15.8 percent in 1991–92 to its lowest level of 13.4 percent in 1997–98 and fluctuated around 14 percent until 2001–02. Although the tax ratio has trended upward since then, it has yet to reach the levels that prevailed before systematic tax reforms were initiated in 1991.

FIGURE 1. Trends in Direct and Indirect Taxes



Source: Government of India (2004a) and authors' calculations.

FIGURE 2. Trends in Tax Revenue—Centre and States



Source: Government of India (2004a) and authors' calculations.

TABLE 1. Trends in Tax Revenue in India

Percent of GDP

Year	Central government			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
1997-98	3.2	6.0	9.1	0.1	5.2	5.3	3.3	11.2	14.5
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 ^a	3.8	5.4	9.2	0.2	5.8	6.0	4.0	11.2	15.2
2004-05 ^b	4.3	5.6	9.9	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.

Source: Government of India (2004a).

n.a. Not available.

a. Actual for the central government and revised estimates for the states.

b. Revised estimates for the central government.

Interestingly, the trends in tax ratios of direct and indirect taxes follow different paths. The tax ratio for direct taxes remained virtually stagnant throughout the forty-year period from 1950 to 1990 at a little over 2 per cent of GDP. Thereafter, coinciding with the reforms marked by significant

reduction in the tax rates and simplification of the tax structure, direct taxes increased sharply to over 4 percent of GDP in 2003–04 and were expected to be about 4.5 percent in 2004–05. In contrast, much of the increase in the tax ratio during the first forty years of planned development in India came from indirect taxes, which more than tripled, from 4 percent of GDP in 1950–51 to 13.5 percent in 1991–92. Since then, however, revenue from indirect taxes has fallen back to around 11 percent of GDP.

The decline in the total tax ratio observed since 1987–88 has occurred mainly at the central level, since center accounts for about 60 percent of the total. Notably, tax ratios of both central and state governments increased sharply between 1950–51 and 1985–86. Thereafter, the tax ratio at the state level was virtually stagnant at about 5.5 percent until 2001–02, when it increased modestly. In contrast, the central tax ratio increased to its peak in 1987–88, and remained at that level until the fiscal crisis of 1991–92, when it declined sharply until 2001–02; by 2004–05, it had nearly recovered its pre-1991 level. Within the central level, the share of direct taxes has shown a steady increase from less than 20 percent in 1990–91 to more than 43 percent in 2004–05.

Analysis of Central Taxes

Interestingly, the comprehensive tax reform at the central level was the direct consequence of economic crisis. As Bird stated after observing tax reforms in many countries, “fiscal crisis has been proven to be the mother of tax reform.”⁴⁹ Unlike most ad hoc reforms undertaken in response to economic crises, the tax reforms in India were made systematically after a detailed analysis; since the reform package was introduced in 1991, the direction of reforms has continued. Thus the decline in central tax revenues as a share of GDP—from 10.1 percent in 1990–91 to 8.2 percent in 2001–02, before recovering to about 10 percent in 2004–05—came as a surprise and prompted many to ask whether the tax reform itself was responsible. The contrary view is that the ratio declined despite the reforms.

The disaggregated analysis of the trends in central tax revenue presented in table 2 and figure 3 shows that the sharpest decline in the tax–GDP ratio was in indirect taxes—both customs duties and central excise duties. The former declined by about half, from 3.6 percent in 1991–92 to 1.8 percent in 2004–05. Revenues from excise duties fell by 1 percentage point, from 4.3 percent to 3.3 percent during the period. The tax ratio for both taxes has been stable since 2001–02. Indicators suggest that while tax ratio for customs

49. Bird (1993).

duties may continue to decline as tariff levels are further reduced, the tax ratio for internal indirect taxes is likely to increase if reforms to expand the coverage of the services tax and integrate it with CenVAT are undertaken and significant improvement is achieved in tax administration.

TABLE 2. Level and Composition of Central Tax Revenue

	<i>Personal income tax</i>	<i>Corporate income tax</i>	<i>Direct tax</i>	<i>Customs</i>	<i>Excise</i>	<i>Indirect tax</i>	<i>Total</i>
As a percent 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	1.6	2.7	4.3	1.8	3.3	5.6	9.9
2005-06	1.9	3.1	5.0	1.5	3.5	5.5	10.5
As a percent of total tax revenue							
1985-86	9.2	10.1	19.3	33.0	45.0	80.7	
1990-91	9.3	9.3	19.2	35.9	42.6	80.8	
1995-96	14.0	14.8	30.2	32.1	36.1	69.8	
2000-01	16.8	18.9	36.2	25.2	36.3	63.8	
2001-02	17.1	19.6	37.0	21.5	38.8	63.0	
2002-03	17.0	21.3	38.4	20.7	38.1	64.5	
2003-04	16.3	25.0	41.3	19.1	35.7	61.3	
2004-05 ^a	16.6	27.1	43.9	18.4	32.9	56.1	
2005-06 ^b	17.9	29.9	47.9	14.4	32.8	52.1	

Source: *Receipts Budget, Union Budget* (various years).

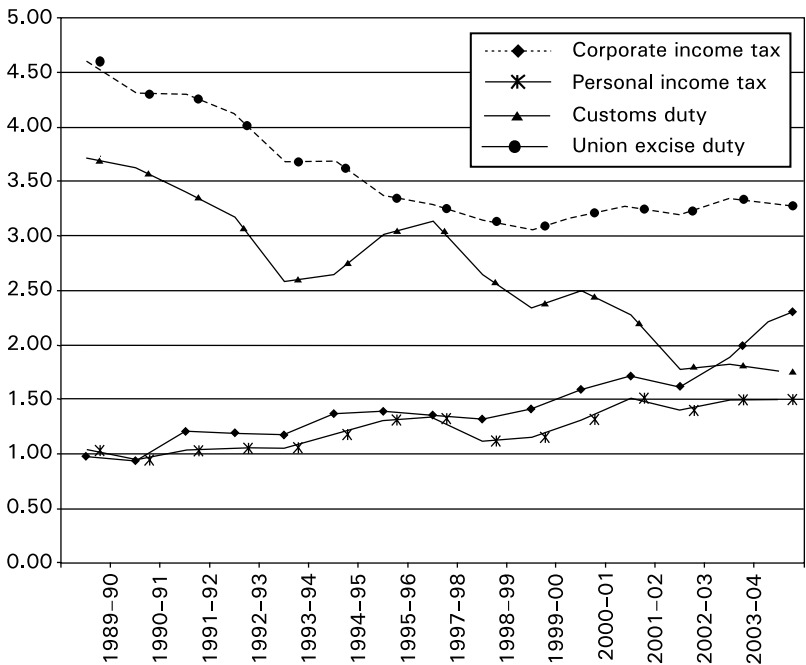
a. Revised estimates.

b. Budget estimates.

In contrast to the indirect taxes, revenue from centrally imposed direct taxes has increased significantly. Both personal and corporate income taxes have more than doubled as a ratio of GDP (see table 2). The major reason given for the increase is improved tax compliance arising from reduction in marginal tax rates.⁵⁰

That increase also increased the importance of direct taxes in the total revenue picture. In 1991-92, direct taxes constituted less than one-fifth of the total tax revenue of the central government. In 2004-05, direct taxes accounted for 44 percent of the total and were estimated at 48 percent

50. Of course, there is some independent evidence on the improvement in tax compliance since 1991; see Das-Gupta and Mookherjee (1997) and Das-Gupta (2002).

FIGURE 3. Ratio of Central Taxes to GDP (as percent of GDP)

Source: Government of India (2004a) and authors' calculations.

for 2005–06. There has been a commensurate decline in the share of indirect taxes in total revenue, from 80 percent in 1991–92 to 56 percent in 2004–05 (see table 2).

The decline in the share of customs revenue might have been even greater but for the hesitancy on the part of the Finance Ministry in the face of demands from the domestic industry for protection against imports. The declining trend in customs revenue is likely to continue. Although imports have grown significantly since liberalization, it has not been enough to balance the lost customs revenues.⁵¹ One reason for this could be the large-scale exemptions. Although the coverage of exemptions has not been expanded in a major way, the expansion in the base that should have accompanied a reduction in the rates of tax was not accomplished.

One explanation for the declining trend in excise duties throughout the 1980s is that the rate structure assumed was not revenue neutral when the input tax credit was allowed. Continued exemption of the small business

51. Panagariya (2005).

sector, expansion of its definition to include businesses with annual turnover of Rs. 10 million, and widespread use of area-based exemptions are other important reasons for the decline in excise duty revenues. Perhaps even more important were excessive claims for the input tax credit, made possible by the poor information system. Furthermore, since 1997-98 more than 75 percent of the increase in the GDP is attributable to the growth of the service sector. The manufacturing sector has been relatively stagnant, implying an automatic reduction in the ratio of taxes on the manufacturing base as a percentage of total GDP.

Level, Composition, and Trends in State Taxes

Table 3 presents the trends in state tax revenues. It shows that the revenue from state taxes as a ratio of GDP was virtually stagnant throughout the 1990s at around 5.5 percent. There was some decline from 1994-95 and the low point of 5.1 percent was reached in 1998-99, the year in which the states had to revise their pay scales, which exacerbated their fiscal problems. Since then the tax ratio has steadily improved, reaching 6.0 percent in 2003-04.⁵²

TABLE 3. Trends in State Level Taxes in India
Percent of GDP

<i>Year</i>	<i>Direct taxes</i>	<i>Sales tax</i>	<i>State excise duty</i>	<i>Stamps and registration</i>	<i>Taxes on transport</i>	<i>Other indirect taxes</i>	<i>Total indirect taxes</i>	<i>Total taxes</i>
1985-86	0.2	3.1	0.7	0.4	0.5	0.3	5.0	5.2
1990-91	0.2	3.2	0.9	0.4	0.5	0.3	5.1	5.5
1991-92	0.2	3.4	0.9	0.4	0.5	0.4	5.4	5.7
1992-93	0.2	3.2	0.9	0.4	0.5	0.3	5.1	5.5
1993-94	0.2	3.3	0.9	0.4	0.5	0.3	5.2	5.5
1994-95	0.2	3.3	0.8	0.5	0.5	0.3	5.3	5.5
1995-96	0.2	3.0	0.7	0.5	0.4	0.5	5.2	5.4
1996-97	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: Government of India (2004a).

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

The sales tax is the predominant state tax, constituting about 60 percent of total state tax revenues. Not surprisingly then, the overall trend in states' tax ratio follows closely the trends in sales tax revenue. After reaching a low of 3.1 percent in 1998-99, the sales tax ratio increased marginally to 3.5 percent in 2000-01 and has remained at that level. Any attempt to improve the revenue productivity of states' tax system, therefore, is inextricably intertwined with the reform of the sales tax system; in this respect, the recent move toward a destination-based VAT is extremely important.

The state excise duty is a sumptuary tax on alcoholic products. In addition to the state excise duty, some states levy a sales tax on alcoholic products, which accounts for a good proportion of the state tax revenue. In regard to this excise duty, there has always been a problem of balancing regulatory and revenue considerations. The major components of the tax come from arrack and country liquor on the one hand, and "India Made Foreign Liquor" (IMFL), including beer, on the other. The duty is collected through a licence fee for licenses to sellers or through the auction of selling vends, and through taxes on the consumption of liquor. The problem with country liquor has been the brewing and consumption of illicit liquor, which not only has caused loss of revenue but has been an important health hazard. The problem with IMFL has been tax evasion. The Karnataka Tax Reforms Committee estimated that the amount of evaded tax may be as high as three times the actual revenue collected.⁵³ The way to deal with this problem has more to do with strengthening the tax administration and information system and less to do with the structure of the tax.

The principal source of stamp duties and registration fees is from the sale of immovable property, such as land and buildings. The levy of stamp duties in addition to registration fees, adds to the marginal tax rates, which are already very high. Not surprisingly, the most important problem with this tax is undervaluation of the property sold. Undervaluation of immovable property is aided by the lack of an organized market. Development of organized market for urban immovable property transactions is hindered by the high rate of stamp duties and registration fees and other policies such as the rent control act and the urban land ceiling act.⁵⁴ Until recently, the tax rates were as high as 12-15 percent on the value of transactions.⁵⁵

53. Government of Karnataka (2001).

54. The Urban Land Ceiling Act was introduced to prevent hoarding of land in private hands. It is currently being repealed in most states.

55. NIPFP (1996).

Many of the states that reduced the rates have found the typical working of the “Laffer curve” phenomenon. In Karnataka, for example, the tax rate was reduced from 16 percent in 2001–02 to 8 percent in 2002–03, and revenue from stamp duties grew 30 percent.

The other important component of state taxes are the taxes on transport, consisting of a motor vehicles tax and a tax on transport of passengers and goods. For administrative convenience, many states have merged the latter with an additional motor vehicles tax. Also the motor vehicles tax on private noncommercial vehicles has been converted into a lifetime tax by adding up ten years’ tax or by adopting a similar formula. The reform in this area should separate the motor vehicles tax from the passengers’ and goods tax, and the latter should eventually become a part of the state VAT rather than a separate tax. Similarly, the entertainment tax, electricity duty, and luxury tax on hotels and restaurants should also be merged with the VAT.

At the local level there are two taxes of some significance. These are the taxes on property and in some states, *octroi*, the checkpost-based tax levied by urban local bodies. The major problem with urban property taxes, as in the case of registration fees, is undervaluation. Alternative models of reform, such as 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 value as determined in some independent manner. For instance, one city has divided the entire city into different categories of localities, and fixed a rate per square foot of built-up area. This process dispensed with the need to undertake acceptable property valuation. For its part, *octroi* not only impedes internal trade and violates the principle of common market, but also is a source of corruption and rent seeking.

Analysis of the Trends and Economic Impact of the Tax System

In this section, the observed trends in different central and state taxes are explained in greater detail and the possible efficiency and equity implications of different taxes are analyzed. Specifically, the analysis seeks to answer a number of questions. Has tax compliance improved over the years in response to reductions 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 the personal income tax is attributed to the improvement in tax compliance arising from the sharp reduction in marginal tax rates in 1991–92 and 1996–97. This is also the period when the growth of GDP itself had decelerated. The apparent stimulus of declining marginal tax rates is reflected in the negative correlation between effective tax rates and the ratio of income tax collections to GDP, akin to a Laffer curve.⁵⁶ While it is clearly difficult to attribute the increase in revenue productivity solely or even mainly to reduction in marginal tax rates, Das-Gupta and Mookherjee draw a tentative but important conclusion capturing improvement in overall performance of the tax system.⁵⁷ Similarly, Das-Gupta analyzes sixteen different structural, administrative, and institutional indicators, and concludes that the performance of the tax system has shown improvement: tax compliance indeed improved with the reduction in marginal tax rates.⁵⁸

In a more recent analysis, Bhalla estimates the aggregate revenue elasticity at -1.43 percent and concludes that the 1996–97 tax cut was a huge success in increasing revenues.⁵⁹ Bhalla provides an estimate of compliance by comparing the data published by the income tax department, the coverage of which itself is narrow, with those from other sources, particularly the National Council of Applied Economic Research to establish that the number of people recording incomes within any given bracket for income tax purposes, is significantly lower than the numbers recorded by other surveys. This approach has problems, however, especially for proprietary firms and individual businesses where it can be hard to distinguish between expenditures of the firm and expenditures of the individual for personal needs.⁶⁰ Nevertheless, the paper helps to focus on the need for some informed debate and analysis in this area.

56. 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.

57. Das-Gupta and Mookherjee (1997).

58. Das-Gupta (2002).

59. Bhalla (2005).

60. The income tax act provides for some deductions in the case of business and traders. The deductions include expenditure on travel and entertainment. Expenses on telecommunications too are a case in point. While any income tax return would show some or all of these expenses as business expenses, in most other consumer surveys, these would figure as personal expenses. Given that the proportion of these expenses in total income is likely to

The important point is that improvement in revenue productivity of the personal income tax since 1996–97 cannot be attributed solely or even mainly to reduction in the marginal rate of tax. The information presented in table 4 shows that the main reason for the increase in revenues is the administrative arrangement extending the scope of tax deductions at source—an arrangement whereby the employer withholds the tax due on the income paid to the employees and directly remits the same to the government exchequer. The proportion of tax deducted at source (TDS) to total revenue collections actually declined from 42 percent in 1990–91 to 22 percent in 1994–95. It increased to 50 percent following the expansion in the scope of TDS in 1996–97 and to 67 percent in 2001–02 before declining marginally to 64 percent in 2003–04. As a proportion of GDP, the ratio of collections from TDS increased by 0.67 percentage points over the period considered. When compared with the increase of 0.56 percentage points in the ratio of personal income tax collections to GDP, the improved compliance appears to result largely if not solely from improved coverage or greater effectiveness of TDS as a tool for collecting taxes.

TABLE 4. Contribution of TDS to Personal Income Tax Revenue

<i>Year</i>	<i>Tax deduction at source (percent)</i>	<i>Advance tax (percent)</i>	<i>Gross collections (Rs. crore)</i>	<i>Refunds (Rs. crore)</i>	<i>TDS as a percentage of GDP</i>
1990–91	41.75	36.00	6,188.37	827.74	0.45
1991–92	48.22	33.29	7,523.97	794.79	0.55
1992–93	42.91	33.45	9,060.79	1,165.44	0.52
1993–94	19.65	51.77	14,106.25	4,045.96	0.32
1994–95	22.18	56.87	17,178.72	3,357.76	0.37
1995–96	22.21	50.01	22,949.61	6,462.48	0.42
1996–97	50.87	27.30	20,042.48	1,808.49	0.75
1997–98	50.87	24.10	19,270.19	2,169.60	0.64
1998–99	52.44	23.59	22,411.98	2,171.83	0.67
1999–00	53.69	24.58	28,684.29	3,029.79	0.80
2000–01	63.22	20.89	35,162.61	3,398.63	1.06
2001–02	67.10	19.23	35,358.00	3,354.00	1.04
2002–03	65.55	20.26	42,119.00	5,253.00	1.12
2003–04	64.03	20.04	48,454.00	7,067.00	1.12

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

be higher in the “middle,” and given the higher possibility of this group of agents being in the “middle,” it appears that this definitional issue itself could induce the pattern observed in the paper. Other categories of taxpayers are also affected, including association of persons, which are formed voluntarily to earn incomes.

Interestingly, although it is tempting to attribute this observed trend to extension of TDS to interest, dividends, payments to contractors, and insurance commissions, the increase has come about mainly in TDS in salaries (table 5). The TDS in salaries in 1992–93 constituted only 25 percent of total TDS, increased to 50 percent in 1999–2000 and thereafter declined to 41 percent, as TDS from payments to nonresidents and others and payments to contractors increased substantially. Even after the refunds are adjusted, the share of TDS in total receipts continues to remain high and increasing. This implies that the contribution of TDS to incremental revenue is increasing as well.

TABLE 5. Contribution to TDS

Percent

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

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

The increase in the tax revenue thus has more to do with the rapid growth of the organized sector, expansion in the interaction of the financial sector with the rest of the economy, and administrative measures extending the TDS than with improved compliance arising from the reduction in marginal rates of tax. The extension of permanent account numbers to cover a larger number of potential taxpayers and the expansion of the tax information system (TIN) are expected to advance this cause further, by generating an extensive and reliable database. This finding, however, does not make a case for increasing the marginal tax rates, since such increases would be associated with significant efficiency costs for the economy, which would

likely be corrected or mitigated through exemptions and concessions of various kinds.

The number of personal income tax assessees has increased significantly over the last decade. From 1999–2000 to 2003–04 alone, the number increased from 19.6 million to 28.8 million—a growth rate of more than 10 percent a year (table 6). Interestingly, the highest growth was seen in the income range of Rs. 200,000–500,000 (38.4 percent) followed by those above Rs. 1 million (16 percent). The important thing to note is that the number of taxpayers is still small considering the growing middle class. Although the number of taxpayers with income above Rs. 1 million is growing, it still constitutes a small number as well as a small proportion of the total. There were only about 100,000 taxpayers in this group, constituting about 0.3 percent of the total number of taxpayers.

TABLE 6. Income Tax Assessees by Income Range

<i>Taxable income range (Rs. million)</i>	<i>Number of taxpayers (million)</i>			<i>Ratio of taxpayers in the range to total number of taxpayers</i>	
	<i>1999–2000</i>	<i>2003–04</i>	<i>Growth rate (percent)</i>	<i>1999–2000</i>	<i>2003–04</i>
Less than 0.2	18.75	26.55	9.1	95.80	92.08
0.2–0.5	0.49	1.80	38.4	2.50	6.24
0.5–1	0.26	0.37	9.2	1.32	1.28
Above 1	0.06	0.01	16.0	0.30	0.36
Search and seizure assessments	0.015	0.012	(–)5.43	0.08	0.04
Total	19.59	28.83	10.2	100	100

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

It is important to understand the impact of reductions in the marginal tax rate and in the number of rate categories since 1991–92 on the overall progressivity and equity of the tax system. Given that the reform involved sharp reduction in the marginal tax rates, the effective rate declines as the level of income increases. It would be tempting to conclude that progressivity has therefore declined and overall equity in the tax system has worsened over the years. Such a conclusion would be inappropriate, for it pertains only to progressivity among the taxpayers; with a sharp increase in the total number of people paying tax, the overall progressivity would have improved. In 2003–04, as many as 29 million people paid income tax, compared with about 3.9 million in 1989–90, and the tax paid doubled from less than 1 percent of GDP to almost 2 percent of GDP. The increase in the number of taxpayers indicates improvement in horizontal equity since more people

with similar incomes now possibly pay the tax, and the fact that a larger proportion of incomes are now subject to tax represents improvement in vertical equity as well.

Corporate Income Tax

Of the four major taxes considered, the revenue from the corporate income tax grew at the fastest rate during the 1990s, tripling as a percentage of GDP, from 0.9 percent in 1990–91 to 2.7 percent in 2003–04, despite significant reduction in the rates. The main reforms eliminated the distinction between closely held and widely held companies, reduced the marginal tax rate to align it with the top marginal tax rate of personal income tax, and rationalized tax preferences, namely, investment and depreciation allowances, to a considerable extent. In addition, the introduction of the minimum alternative tax has also contributed to revenues.

It would be instructive to analyze the contribution of different sectors to the corporate tax. According to the Prowess database, the manufacturing sector accounted for two-thirds of the corporate tax collections in 1994–95, but that amount declined to just 40 percent by 2004–05 (table 7). Within the manufacturing sector, the petroleum sector contributed the most (12.5 percent), followed by chemicals (6.5 percent) and the basic metals industry (6.1 percent). In contrast, textiles contributed only about 0.5 percent.

In contrast, public sector enterprises account for a growing share of collections, increasing from 19 percent in 1994–95 to about 38 percent in 2002–03. That means that over 40 percent of the increase in corporate tax revenues was collected from public enterprises (table 8). This increase is attributable in part to the fact that, unlike the private sector, public enterprises do not undertake elaborate tax planning to minimize their taxes.

Union Excise Duties

The declining ratio of Union excise duties to GDP since reforms were introduced is truly a matter of concern as the loss of revenue has been a constraint in further reducing import duties. Although the ratio has been stagnant at 3.3 percent for several years, that is significantly lower than the ratio in 1991–92 (4.1 percent).

Not only has the revenue productivity of Union excise duties declined, but the revenue shows an increased concentration in commodities that would be used in further production. Independent operation of excise and sales tax systems and confining the tax to goods and to the manufacturing stage

TABLE 7. Sectoral Contribution to Corporate Income Tax Collections

Percent	1994-95	1995-96	1996-97	1997-98	1998-99	1999-2000	2000-01	2001-02	2002-03	2003-04
<i>Sector</i>										
Mining	2.41	5.20	10.55	11.47	12.88	18.66	22.45	18.27	21.97	13.92
Manufacturing	67.33	60.93	44.74	35.27	38.90	34.29	27.96	28.69	32.99	39.95
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
Petroleum 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
Nonmetallic 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
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 corporate income tax collections	50.06	62.16	77.39	80.82	64.54	62.21	61.95	72.62	80.38	65.09

Source: PROWESS database.

TABLE 8. Contribution of Public Sector Enterprises to Corporation Tax

<i>Year</i>	<i>Corporate tax paid by public enterprises (Rs. crore)</i>	<i>Total corporate tax paid (Rs. crore)</i>	<i>Ratio of public sector tax to total (percent)</i>
1990-91	1,229	5,335	23.0
1991-92	1,674	7,853	21.3
1992-93	1,804	8,899	20.3
1993-94	2,110	10,060	21.0
1994-95	2,581	13,822	18.7
1995-96	4,187	16,487	25.4
1996-97	5,193	18,567	28.0
1997-98	5,634	20,016	28.1
1998-99	6,499	24,529	26.5
1999-00	7,706	30,692	25.1
2000-01	9,314	35,696	26.1
2001-02	12,254	36,609	33.5
2002-03	17,430	46,172	37.8

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

alone does not remove cascading, and final products in the manufacturing stage are not necessarily final consumer goods—goods transport vehicles being a prime example.

Table 9, which shows Union excise duty collections by commodity, highlights some interesting features with implications for both efficiency and equity of the tax system. One of the most important features is the commodity concentration. Three-fourths of all Union excise duties are paid by just five groups of commodities—petroleum products, chemicals, basic metals, transport vehicles, and electrical and electronic goods. One would normally expect this concentration to decrease as manufacturing diversified. This increased concentration imposes a disproportionate tax burden on different sectors of the economy. Moreover, this type of commodity concentration does not allow objective calibration of policies regarding excise duties as the Finance Ministry would not like to lose revenue from this lucrative source.

Another important feature of the pattern of excise revenue collections is that the overwhelming proportion is paid by commodity groups that are in the nature of intermediate products used in the production of goods or services that are not subject to excise. Besides petroleum products, a significant proportion of which is used in other manufacturing, the duties on all goods used as inputs to service providers, especially of services used in manufacturing activities, contribute to cascading and add to production costs. Transport vehicles and related industries are one such industry. These are a source of

TABLE 9 . Revenue from Union Excise Duties by Commodity Groups

Commodity group	1990-91	1995-96	1998-99	1999-2000	2000-01	2001-02	2002-03	2003-04
Food products	4.0	3.5	4.8	4.4	4.5	3.7	3.6	3.2
Tobacco products	8.3	8.1	7.9	6.7	6.7	6.6	5.9	5.6
Minerals and ores	8.4	8.7	7.2	6.7	6.2	6.0	5.8	6.2
Petroleum products	13.9	12.4	22.5	29.6	32.9	38.3	40.4	41.0
Chemicals	11.1	14.4	11.1	9.8	10.2	9.9	9.3	8.9
Plastics and articles thereof	2.5	4.0	4.2	3.7	2.3	2.4	2.4	2.5
Rubber products	4.9	4.6	2.9	2.6	2.2	2.0	1.8	1.3
Leather and wood products	0.6	0.4	0.2	0.2	0.2	0.2	0.1	0.1
Textiles and garments	10.8	8.5	6.2	5.2	4.8	4.7	4.6	3.7
Basic metals	9.6	14.5	11.4	11.1	10.4	9.2	9.8	11.2
Electrical and electronic goods/tools	16.1	11.9	10.5	9.5	8.8	8.2	7.8	7.8
Transport vehicles	8.4	7.3	8.5	8.8	8.9	7.2	7.0	6.6
Miscellaneous	1.3	1.5	2.5	1.8	1.8	1.9	1.6	1.7

Source: Central excise data.

significant inefficiency in the system. This inefficiency also makes it difficult to speculate on the effect of the tax on different manufacturing enterprises and its effects on employment and incomes and thus to make judgments on the distribution of the tax burden.

A striking feature of excise duty collections is that, as in the case of corporate incomes taxes, a predominant proportion is paid by public sector enterprises (table 10). Another striking feature is the wide fluctuation in collections from public sector enterprises from year to year, ranging from a high of 53 percent in 1999–2000 to a low of 30 percent just two years later. The fluctuations are attributable to fluctuations in administered prices on items such as steel, coal, minerals and ores, and petroleum products. Prices for petroleum products also vary with international prices. In other words, the revenue from excise duties, which constitutes an important source of revenue for the central government, is vulnerable to pricing and output decisions of public enterprises. Given the government's significant dependence on this sector, the ability of public enterprises to forge an independent pricing policy too could be compromised.

TABLE 10. Contribution of Public Enterprises to the Central Government's Excise Revenues

<i>Year</i>	<i>Public enterprises (Rs. crore)</i>	<i>Total collections (Rs. 10 crore)</i>	<i>Public enterprises as percentage of total</i>
1990–91	9,656	24,514	39.4
1991–92	9,815	28,110	34.9
1992–93	12,180	30,832	39.5
1993–94	12,527	31,697	39.5
1994–95	16,414	37,347	44.0
1995–96	17,044	40,187	42.4
1996–97	22,193	45,008	49.3
1997–98	21,720	47,962	45.3
1998–99	23,132	53,246	43.4
1999–00	32,942	61,902	53.2
2000–01	20,824	68,526	30.3
2001–02	31,203	72,555	43.0
2002–03	34,610	82,310	42.1

Sources: Government of India, *Public Enterprises Survey* (various issues), and *Union Budget* (various years).

Customs Duties

The most important and in many ways most far-reaching reforms involved 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 currently. The peak import rate has been lowered from more than 150 percent in 1991 to less than 20 percent.⁶¹

A major problem from the viewpoint of efficiency is the continuation of differentiated rates of duty varying with the stage of production. The rates on raw materials and intermediate goods continue to be lower than those on consumer and capital goods. The import tariff reduction has continued to be guided by this “unprincipled principle”: even the Kelkar Task Force on indirect taxes suggested that the rate differentiation should continue to be made on the basis of the stage of production.⁶² Because it focuses on greater protection for “final use industries” compared with inputs and intermediate goods, this approach continues reliance on the self-sufficiency model of development as opposed to a comparative advantage model.

Table 11 presents the collection of customs by commodity from 1990–91 to 2003–04. Despite significant external liberalization, almost 60 percent of the duty is collected from just three commodity groups—machinery, petroleum products, and chemicals. Furthermore, the overwhelming proportion (over 75 percent) of the duties are collected from either machinery or basic inputs and intermediate goods. Thus, contrary to the fear, liberalization has not led to massive inflow of consumer goods. These data also imply that further reduction in the duties and greater uniformity in the structure of duties would have beneficial effects on the economy. A detailed econometric study shows that uniform reduction in tariffs has had favorable effects on production, exports, employment, and capital and that these gains are different across different sectors.⁶³

The proportion of duties collected from machinery has increased significantly, from 19.5 percent in 1990–91 to 26.6 percent in 2003–04. This increase has occurred despite exemptions provided for import of machinery for several infrastructure projects. The conclusion is that external liberalization is leading to adoption of more modern machinery and technology in the production process, which would have a favorable effect on the productivity growth. Customs collections have also increased for food products. In contrast, revenue from iron and steel and other basic metals has shown a substantial decline over the years; these items have become more competitive in recent years, and therefore may be more attractive to buy in the domestic market rather than from foreign markets.

61. Virmani and others (2004).

62. The quotation is from Joshi and Little (1996).

63. Virmani and others (2004).

TABLE 11. Composition of Revenue from Customs Duties, by Commodity Group Percent

	1990-91	1995-96	1996-97	2000-01	2001-02	2002-03	2003-04
Food items	2.5	2.4	2.3	5.4	10.6	8.8	6.4
Tea and coffee	0.1	0.0	0.0	0.1	0.1	0.1	0.0
Beverages	0.1	0.1	0.1	0.1	0.2	0.2	0.1
Minerals and ores	1.4	0.7	0.5	1.3	1.6	1.8	1.7
Petroleum products	19.4	23.4	28.5	23.2	16.1	19.5	20.9
Chemicals	12.3	11.9	11.2	10.4	11.4	11.2	11.1
<i>Of which:</i>							
Pharmaceutical products	0.1	0.1	0.1	0.2	0.3	0.4	0.3
Plastics	6.4	4.9	4.7	3.0	3.1	3.1	3.1
Rubber	1.4	1.3	1.5	1.4	1.4	1.3	1.3
Paper	1.0	0.7	0.7	0.7	0.7	0.7	0.9
Textiles	2.2	1.3	0.9	1.0	0.9	1.0	1.4
Cement products	0.2	0.2	0.1	0.2	0.2	0.2	0.3
Ceramics	0.6	0.5	0.5	0.7	0.8	0.8	1.0
Iron and steel	10.2	6.6	5.2	3.8	3.8	3.7	4.6
Other basic metals	4.3	5.0	4.4	2.1	2.3	2.2	2.5
Machinery	19.5	20.8	18.8	23.6	24.8	26.4	26.6
Transport equipment	3.3	4.0	4.7	3.9	4.0	3.4	4.1
Others	15.2	16.2	15.9	19.3	18.1	15.9	13.9

Source: Customs department data.

Toward Further Reforms in the Tax System

In the last few years, various study groups and task forces have focused on the reforms in the tax system at the central level. The Advisory Group on Tax Policy and Administration for the Tenth Plan and the Kelkar Task Force (KTF) reports on direct and indirect taxes and more recently the KTF on the implementation of the Fiscal Responsibility and Budget Management Act have comprehensively examined the tax system and made important recommendations for reform.⁶⁴ All these are in conformity with the direction set by the TRC in 1991 and 1993, which called for broadening the tax base, reducing the rates, minimizing rate differentiation, and simplifying the tax systems. While there are differences on specific recommendations, these newer task force reports share broad agreement on the direction and thrust of reforms and on the need to reform tax administration and the tax information system.

64. Government of India (2001a, 2002a, 2002b, 2004b).

Tax reform is an ongoing process, and with the fiscal imbalance in India looming large, reforms to improve long-run revenue productivity will have to continue. The reforms will have to involve all aspects to the tax system, including the tax structure, administration, and institutions, and any reforms should move the system toward one that is general and rule based. In a democratic polity with so many special interest groups influencing policies, moving away from a culture of selectivity and discretion is difficult but can be achieved over a period of time.

Reform of Central Taxes

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

On the corporation tax, base broadening involves getting rid of the tax concessions and preferences. In particular, the exemption for profits from exports, free trade zones, and technology parks, as well as exemptions for area-based development and for infrastructure should be phased out. Similarly, the current depreciation allowance, even after the proposed reduction in 2005-06 is quite generous, and there is a case for reducing it to more realistic levels while at the same time reducing the tax rate to align it with the marginal tax rate on personal income tax. It is most important, however, to avoid flip-flop in tax policy. The history of dividend taxation, in particular, has been full of contradictory policy stances from one year to another. The issue of whether companies or individual shareholders should pay the dividend tax must be settled. The most satisfactory solution is to have partial integration of the tax with personal income tax. However, if for administrative reasons, it is thought to be better to collect the tax from the company, then the tax rate applicable on dividends should be determined

on the basis of the difference between the marginal tax rate of personal income tax and the effective rate of the corporate tax.⁶⁵

The other important issue involving the corporate income tax is the differential between the rates applicable to domestic and foreign companies. Part of the rationale for a differential involves the dividend tax, which is payable by domestic companies alone. The rationalization of these two aspects therefore needs to go together.

With regard to import duties, reform should move in the direction of further reduction and unification of the rates. As most nonagricultural tariffs fall between 0 and 15 percent, a uniform tariff of 10 percent would considerably simplify and rationalize the system.⁶⁶ Equally important is the need to get rid of a plethora of exemptions and concessional treatment for various categories including imports for special projects. A minimum tariff of 5 percent on all currently exempt goods could be introduced as a first step in rationalizing the duty to bring it in line with the above recommendation.

Wide-ranging exemptions are also a problem with excise duties. Therefore, one of the most important base-broadening measures should be to reduce the exemptions. In particular, the exemptions given to small-scale industry have not only eroded the tax base but have inhibited the growth of firms into an economically efficient size. Similarly, various exemptions given to project imports have significantly eroded the tax base. This has also infused the tax system with selectivity and discretion. The rate structure should be rationalized by converting the remaining items subject to specific duties to ad valorem and by unifying the rates toward a single CenVAT rate.

The next step is to fully integrate the taxation of services with the CenVAT. This would require extending the service tax to all services excluding a small list of exemptions and a small negative list, as recommended by the Expert Group on Service Taxation.⁶⁷ This step would help in assessing the potential from service taxation. At the next stage, the taxes on services could be unified with the CenVAT to evolve a manufacturing-stage VAT on goods and services. Since credit for the tax paid on both goods and specific services is already provided, universal tax coverage of services, together with a tax credit mechanism and its integration with CenVAT, would

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

66. Panagariya (2005); Acharya (2005).

67. Government of India (2001b). This expert group was headed by M. Govinda Rao, one of the authors of the current paper.

rationalize the tax system considerably. Not only would this tax have a broader base and increase revenues in the short term, but overall revenue productivity would be improved.

It should be noted, however, that restricting the CenVAT to the manufacturing stage alone, as the system currently does, creates a need to have a number of agents in the system that do not collect and pay taxes but that are entitled to issue VAT invoices. Wholesalers are authorized to issue multiple VAT invoices on their sales against the single invoice of their purchases, in order to facilitate the credit mechanism for small and medium manufacturers, who may not always buy from other manufacturers. This constitutes a weak link in the chain of invoices since these agents are difficult to monitor and administer. Integrating services into the credit mechanism could further exacerbate this problem, since a larger number of agents would seek to purchase from agents other than manufacturers. This is a problem that needs to be addressed. The solution discussed by the TRC of expanding the coverage of CenVAT to wholesalers, with the revenue being assigned to the states, is one option. An administrative alternative could be devised by mandating the filing of informational documents and periodic auditing of these dealers.

Evolving a Coordinated Consumption Tax System

One of the most important reforms needed in the indirect tax system is a coordinated consumption tax system for the country. Such a system is necessary to ensure fair distribution of the tax burden among different sectors and between goods and services, to improve revenue productivity, to minimize relative price distortions, and above all, to ensure a common market in the country without placing impediments on the movement of factors and products.

Such a system would require coordinated reforms at the 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, introduction of the VAT, initiated in April 2005, has to be completed. The most important step here involves extending the input tax credit mechanism not only to intrastate trade but also to interstate trade by introducing an appropriate zero-rating mechanism. This effort requires building an accurate information system on interstate transactions, a step that has been initiated. All the states and Union territories will have to adopt this information system. In addition, appropriate mechanisms will have to be found for enabling the states to levy the tax on services and integrating it with the VAT on goods,

so as to arrive at a comprehensive VAT. An important problem that needs to be solved is devising a system for taxation of services with an interstate coverage, which would depend closely on the mechanism chosen for zero-rating interstate trade.

An important aspect from the viewpoint of efficiency in resource allocation is the continued cascading of the tax on petroleum products, which are kept outside the CenVAT system and are not part of the VAT system in states; although these commodities are subject to the levy, subsequent users cannot take credit for this tax. Petroleum products contribute over 40 percent of the revenues raised by both of both the taxes. Considering the use of these items for intermediate consumption, the extent of cascading and relative price distortion will continue to be high.

Extending the service tax to all services and then unifying it with CenVAT in a revenue-neutral manner would help bring down the CenVAT rate by about 3 percentage points and would thus reduce the overall tax burden. The CenVAT rate could be lowered to about 12 percent, with a special excise of 6 percent levied on luxury items for reasons of equity and revenue.⁶⁸ A 12 percent tax rate at the manufacturing stage would be equivalent to 8 percent at the retail stage, assuming that value added beyond the stage of manufacturing amounts to a third of the retail value of the commodity. The KTF on indirect taxes assumed that the overall consumption tax burden should not exceed 20 percent; thus, a 12 percent manufacturing-stage CenVAT would leave the states room for levying a VAT of about 12 percent at the retail stage. Along with the state-level VAT, it is important to integrate many specific taxes such as the entertainment tax, electricity duties, passengers and goods taxes, and the luxury tax on hotels. Turnover taxes, surcharges, and additional taxes should be eliminated as there should be no need for them.

The major indirect tax reform at the local level relates to the abolition of *octroi*. There is no place for *octroi* in any modern tax system. The problem, however, is one of finding an alternative source of revenue. In many other countries, a property tax is a mainstay of local finances, and reform in this area should help in raising revenue productivity. Yet, a property tax alone may not suffice. A better option may be to allow urban local bodies to piggyback on the VAT collections within their jurisdictions. This approach should avoid tax cascades and minimize tax spillovers from the urban jurisdictions to nonresidents.

68. Acharya (2005).

Reform in Tax Administration

Until recently, the focus of tax reform in India was on “what to do,” rather “how to do.” The administrative dimension has been on the periphery rather than at the center of tax reform.⁶⁹ The TRC and other study groups emphasized the need for tax administration reform to some extent, but it is the KTF that has brought administrative reform front and center.

Not surprisingly, poor tax administration has led to low levels of compliance and high compliance costs. The virtual absence of data on both direct and indirect taxes even at the central level has made it difficult not only to enforce the tax laws but to gather the analytical data necessary to make appropriate changes in the tax structure. The complexity of the tax structure and the poor information system meant that the tax system often acquired the character of negotiated payments—a situation that encouraged corruption and rent seeking.⁷⁰

The only estimate of compliance cost is by Das-Gupta, who has estimated that the cost of compliance is as high as 49 percent of personal income tax collections and between 6 and 15 percent of corporate tax collections.⁷¹ Das-Gupta found that the bulk of these costs were the legal costs incurred to meet the requirements of the Income Tax Act. While these estimates should be taken with a note of caution as the author himself has reservations on the adequacy and quality of the sample analyzed, the important point is that the compliance cost in Indian income taxes is extremely high.

Another example of the poor state of the tax information system is that even as the coverage of TDS was extended, there was virtually no way to check whether those deducting the tax at source filed the returns and actually paid the tax. According to the report of the Comptroller and Auditor General, in 2003–04, only 499,000 returns were filed although there were 626,000 TDS assessees. In other words, more than 20 percent of the TDS assessees did not file returns. Even this is a vast improvement from the previous year when almost 80 percent of the TDS assessees did not file returns.

Recent initiatives on building the computerized information system for direct taxes grew out of the recommendations of the KTF. The Central Board of Direct Taxes outsourced the function of issuing permanent account numbers, which now number more than 36 million; this process has facilitated the compiling of information on all taxpayers. The Tax Information

69. Bird (1989).

70. Government of India (1993, 2002a, 2002b).

71. Das-Gupta (2004a, 2004b).

Network, established by the National Securities Depository Limited, has focused initially on ensuring that TDS assesseees do in fact file returns, and matching and cross-checking the information from banking and financial institutions to ensure that the taxes paid according to the returns are in fact credited into government accounts in the banks. The Online Tax Accounting System, implemented in July 2004, has helped expedite the number of refunds processed, from 2.6 million in 2002–03 to 5.6 million in 2003–04. Large companies such as Infosys Ltd can now upload one disk for filing the TDSs of their employees instead of filing large number of separate TDS returns. In short, in the last four years, collections of direct taxes have shown annual growth of over 20 percent a year, and the contribution of the improved information system in this growth has not been insignificant.

Similar initiatives have been taken in regard to indirect taxes. The customs e-commerce gateway (ICEGATE) and the Customs Electronic Data Interchange System (ICES) have helped to improve the information system and speed up clearance processes. In 2003–04, ICES handled about 4 million declarations in automated customs locations, which constituted about 75 percent of India's international trade. The technical assistance from the Canadian International Development Agency has helped the excise department to establish and build capacity in modern audit systems and computerized risk assessments for detailed audits. This is a step toward building expertise in areas requiring significant technical knowledge. Both the direct and indirect tax departments could gain from building expertise through functional specialization in such identified areas requiring technical and focused knowledge.

A computerized information system would help to put together data from a variety of relevant sources and lead to better administration and enforcement of the tax laws, improve the tax compliance, and reduce compliance costs particularly as it would reduce the need for tax officials to deal directly with taxpayers. An important constraint on how quickly a computerized system can be put in place is the fact that many of the senior officers are not familiar with computers and display a natural hesitancy, and often unwillingness, to adapt to new technology. There have to be several orientation workshops to manage this change well.

Another critical element in tax administration is the networking of the information from various sources. As mentioned earlier, systems have to be evolved to put together information received from various sources to quantify the possible tax implications from them in a legally acceptable manner to improve tax enforcement. The first step is to collect the information; the

second is for the relevant tax agencies at both the central and state levels to exchange information to ensure a measure of consistency among the returns filed. It is only through a properly organized and computerized information system and returns that it will be possible to enforce the tax and improve the tax compliance.

Concluding Remarks

The foregoing analysis shows that India has made significant progress in tax reforms, particularly in tax administration, which has helped raise the ratio of tax revenues to GDP close to the levels that prevailed before significant reductions were made in customs duties. These reforms are only the beginning; considerable distance must still be covered in reforming the tax system. In other words, tax reform, including administrative reforms, is a continuous exercise for improving revenue productivity, minimizing distortions, and improving equity.

Coordinated reforms should be undertaken at the central, state, and local levels. A major objective should be minimization of distortions and compliance costs. In fact, the subnational tax system should be revised so that the principles of a common market are not violated. Taxes on domestically traded goods and services should be coordinated in the spirit of cooperative federalism. Domestic and external trade taxes should also be coordinated to ensure the desired degree of protection to domestic industry and the desired burden of consumption taxes on the community are achieved.

Broadening the base of both central and state taxes and keeping the tax structures simple—within the administrative capacity of the governments—is an important international lesson that should be incorporated in further reforms. Phasing out exemptions for small-scale industry, minimizing exemptions and concessions to industries in the services sector, and minimizing discretion and selectivity in tax policy and administration are all important not only for the soundness of the tax system but to enhance its acceptability and credibility.

Although the customs duties have been significantly reduced, India's economy is still highly protected. Further reduction in tariffs, as well as further unification and rationalization, is necessary. Because these reductions will certainly entail loss of revenue, a corresponding improvement must be made in the revenue productivity of all taxes. The conversion of the prevailing sales taxes into a destination-based, consumption-type VAT by the states

must be carried out with vigor and completed within the next few years. This will require a complete phaseout of the central sales tax. Finalizing the mechanism to relieve taxes on interstate transactions, and building a proper information system for the purpose, is crucial to improving both revenue productivity and the efficiency of the tax system.

The most important reform is in tax administration. It is important to remember that “tax administration is tax policy.”⁷² Making the transition to information-based tax administration, online filing of tax returns, and compiling and matching information are key to administrative reform. Tax administrators should also assist taxpayers in a timely fashion and help them to reduce their compliance costs.

72. Casanegra (1990).

Comments and Discussion

Shankar Acharya: I enjoyed very much the paper by Govinda Rao and Kavita Rao (henceforth Raos), partly because I have recently published a survey of Indian tax reform.¹ So, I was interested to see in what way the Raos' perspectives were different from mine. I was glad to find that there were some differences, which give me an opportunity to comment. However, I must emphasize that there is an enormous amount of commonality between what they say and what I have written. So, although I dwell on the differences in these brief comments, the much broader areas of agreement have to be taken as understood.

To begin with, I liked the section of the paper on evolving paradigms of tax reform. I share the Raos' puzzlement as to why the vast literature on optimal taxation has had relatively limited impact on actual tax policy, not just in India but the world over. However, I was a little disappointed with the apparent lack of application of this useful taxonomic section to the description of Indian tax reform in subsequent parts of the paper. More broadly, I was disappointed by the absence of an analysis of the *economic impact* of tax reforms in India, other than in terms of the usual trends in revenue from different kinds of taxes. Of course, such an assessment of economic impact is very difficult to do, especially given the paucity of extant research studies in India on this theme. But then the heading referring to analysis of the economic impact is misleadingly ambitious.

Turning to the evolution of the Indian tax system, I broadly agree with the Raos' treatment, except for one very important judgment. They claim, "Systematic and comprehensive attempts to reform the tax system at the central level started only after market-based economic reforms were initiated in 1991." That is simply wrong. As I have detailed elsewhere, modern tax reform was really launched in India during V. P. Singh's two year stewardship of the finance ministry (1985–87) in Rajiv Gandhi's Congress government.² In his budget for 1985–86, Singh undertook the most comprehensive reform of direct taxes to date: the top marginal income tax rate was cut from 62 to 50 percent; the number of income tax slabs were halved from eight to four;

1. Acharya (2005).

2. Acharya (1988, 2005).

estate duty was abolished; the top wealth tax rate was reduced from 5 to 2 percent; and the basic rate of company tax was lowered to 50 percent.

Second, in his budget for 1986–87, V. P. Singh introduced MODVAT in thirty-seven chapters of the Central Excise Tariff and made a clear commitment to extend VAT principles to the remainder of the manufacturing sector. This was a huge stride forward in the reform of India's indirect taxes. Third, these reforms of direct and indirect taxes were coordinated and stressed the importance of simplicity, stability, and predictability in tax policy. Fourth, and perhaps most interesting, these tax reforms were embedded explicitly in a medium-term fiscal policy paper, entitled *The Long-Term Fiscal Policy* (LTFP), which was presented to Parliament in 1985.³ It was the first (and until 2004, the only) time that a coherent program of tax reform intentions was articulated in India within a macroeconomic fiscal framework. Against this background, the Raos are clearly incorrect in asserting that comprehensive tax reform in India started after 1991. Of course, the later reports of the Tax Reforms Committee (1991–93) did a far more systematic job of analyzing and presenting a tax reform program for the 1990s, but that program and its subsequent implementation was greatly facilitated by the earlier V. P. Singh reforms.

Where the Raos are right is in their characterization of some of the post-1990s tax policy as “ad hoc” and lacking a “consistent theoretical framework.” In this context, they mention the minimum alternate tax, the securities transaction tax of 2004, the cash withdrawal tax of 2005, and the “frequent changes and the lack of direction” in the taxation of dividends. The benign influence of the V. P. Singh–LTFP reforms and the Tax Reforms Committee–Manmohan Singh reforms had clearly waned by the turn of the millennium. Rather curiously, the Raos are neutral in their description of the 2005 fringe benefit tax, which has come in for a great deal of criticism from both industry and fiscal experts.⁴

The final section of the Raos' paper on future tax reforms has several good ideas but also suffers from some weaknesses. First, the paper is oddly noncommittal on possibly the most important recent tax policy proposal, namely the integrated goods and services tax (GST) proposed by the Kelkar Task Force on implementation of fiscal responsibility legislation.⁵ Its most far-reaching recommendation was to implement a nationwide GST, basically a value added tax with a unified base and explicit sharing by states and

3. Government of India (1985).

4. See, for example, Acharya (2006).

5. Government of India (2004b).

central government of what is essentially a single, integrated, destination-based, value added tax. This important proposal has received considerable support, despite some questions about its constitutional validity. It would have been helpful if the Raos had articulated a considered view of this very important proposal.

Second, their paper has quite rightly bemoaned the presence of a large number of tax preferences and exemptions in all the major taxes. It would have been useful if the authors had delineated some sort of a road map for phasing out some of the more serious schemes of exemptions. This is particularly important in a climate where the political appetite for such exemptions continues unabated, as evidenced by the widening domain of area-based exemptions, including the recently notified income tax exemptions for special economic zones. Third, on tax administration, it might have been desirable for the paper to outline the priority steps that need to be taken in this critically important area. This is especially so given the provenance of the authors from the National Institute of Public Finance and Policy, perhaps the foremost nongovernmental institution with detailed knowledge of administrative practices and lacunae in regard to the major taxes.

Fourth, I come to the reform of capital taxation, particularly the issue of taxing equity capital gains. The fact is that taxation of equity capital gains (or rather its exemption!) today is very concessional compared with taxation of other kinds of capital gains and other kinds of capital income. More broadly, there is surely a serious problem of fairness when long-term equity capital gains are exempt and there is no taxation of dividends in the hands of the recipient, while all forms of labor income fall into the tax net at a fairly modest level. The Raos do not accord adequate attention to this issue.

Finally, let me mention a big problem with India's long-run record of tax reform. While the ridiculously high customs duties of 1990 (and earlier) have been rightly reduced in a phased way, the replacement of declining customs revenue by a moderately high-yielding domestic trade tax, namely Excise/MODVAT, has been a serious failure. This issue, its causes, and its resolution required greater attention by Raos.

Perhaps they will take on the challenge posed by the lacunae pointed out above in a follow-up paper. I certainly hope so.

T. N. Srinivasan: I too enjoyed reading this "double Rao" or "Rao squared" paper. It presents a comprehensive description, historical antecedents and the evolution of Indian tax policy, quantitative implications thereof, and

also what is best described as a glacial pace of tax reform, although after 1985 or 1987 it shifted from being glacial to gradual.

Much of the paper is about the central government's policy, although it does cover state-level developments in the aggregate, rather than state by state. The authors rightly point out that state-level reforms, such as they were, did not coincide with those at the center. There was no systematic attempt to streamline the reform process even after 1991, and most reform attempts were ad hoc and guided more by revenue exigencies than by any general principles.

Let me begin by asking how one might try to evaluate tax policy and its reform in federal India. There is an enormous and growing diversity among and within large states. Also the domestic and global economic and political context for policymaking has changed dramatically. First, does it make sense to talk about tax policy in isolation from fiscal policy narrowly and from other government interventions in the economy more generally? After all, in India state control over the economy was intrusive and extensive, and the state articulated and tried to implement a development strategy in which private sector participation was heavily circumscribed. In such a context, tax policy is just *one* instrument among many that the state uses or could use in steering the development of the economy. For example, public sector production that makes profits is an alternative to leaving that production activity in the private sector and taxing the profits of the private sector. In general, there are many instruments of public policy that are alternatives to narrowly defined tax policy. This means that one cannot think in terms of reform just of one segment of public policy without at the same time considering the whole panoply of state intervention in the economy.

The political economy in India, or in the states of India, is not the same as that of Brazil or that of Brazilian states. To believe that positive findings or normative pronouncements on fiscal policy are valid for all countries and all the time is just daydreaming. I am saying this only to caution that drawing policy inferences from a crude cross-country (or cross-states) regression is unlikely to be informative or meaningful. Fortunately the authors themselves report only one such regression. I am not convinced even that is particularly informative.

The authors say that in the initial years the tax policy was guided by the need to increase the level of savings and investment in the economy. However, they provide absolutely no empirical evidence that it in fact did. As we all know, in India, the largest component of savings is household savings, and a large proportion of household savings is direct savings in the form of physical assets. In what ways do the tax policy instruments influence the

direct savings? All that policy seems to have done is to shift the composition of *financial* savings. Whether you hold your savings in the form of an insurance policy or bank deposit or equity is certainly influenced by the structure of incentives on different forms in which savings are held. However, it is hard to demonstrate empirically that aggregate savings have been influenced by differentials in incentives. The authors are right, of course, in saying that the nationalization of banks and insurance was primarily intended for transferring private resources into public hands for good or bad use. In my view, quite a bit of it was bad use. The basic point is that there is no empirical analysis that has carefully analyzed the impact of tax policies at the central and state level on household savings and their composition or on private investment and its sectoral composition.

The authors say that redistributive considerations heavily influenced tax policy. Again, they do not provide any empirical evidence for this assertion. As they themselves point out, the effective redistribution achieved through tax policy was in fact negligible. This fact was widely known early on. And the worthies who constituted the various tax reform commissions have also pointed this out. Yet only very late in the history of the last sixty years, have marginal rates been brought down.

More generally, if one were to focus on redistributive aspects of tax policy, one has to take an integrated view of all direct taxes, such as the personal income tax, the corporate tax, and the wealth tax, including what used to be taxes on particular forms of wealth in the old days. Unless one takes an integrated view of taxes and expenditures, it is very difficult to say anything meaningful about the redistributive effect of the whole tax expenditure system. In fact, the paper makes absolutely no mention of tax integration or of the debates that have gone on elsewhere in the world on integration of corporate tax or on personal income tax, for example.

I doubt whether my dear friend Al Harberger ever said, as the authors claim he said, that the tax reformers should pay less attention to economic theory and more to best-practice experience. If he did, perhaps, he was referring to the virtually useless optimal tax theory of the first best. But even if one were to confine oneself to positive analysis, it has to be recognized that interventions that do not distort private decisions, like lump-sum taxes and subsidies, are not available in any economy. Tax, subsidy, expenditure, and public production policies are likely to be distortionary. But they influence private decisions to consume, invest, export, and import in various ways. Any positive analysis has to address the complex interaction of all the effects of policy.

What about normative analysis? One could take the simplistic first-best optimal tax theory perspective: the policymaker is a Stackleberg leader who is omniscient—that is, who has all the necessary information—and omnipotent, that is, who has no constraints on his choice of policy instruments. The private sector responds to his policy announcement as a follower. Of course, being omniscient, he knows how the private sector would respond and uses this information in choosing and announcing the optimal tax policy. This is a never-never land. It seems to me this is the theory that AI probably had in mind when he said to forget it. The theory or model we would want to use, if we want to analyze the tax policy in India, would allow for information asymmetries, both among levels of government and between governments and the private sector, and also for constraints on policy choices.

The authors' cryptic remark on welfare effects of external tariff reduction, as opposed to its elimination, is unclear. It is possible that they have in mind some nonlinear welfare response to a tariff change, or some kind of a second-best situation, in which, because other distortions remain, welfare does not change in the expected direction as tariff is reduced. In any case, they rightly point out that no economic logic lies behind the recommendation of the Tax Reforms Committee in favor of multiple tariff levels. I may add such economic illiteracy continues even today, with respect to privatization, for example.

Let me conclude with my approach to tax reform. I will start with what I think is the most essential; namely, the assignment of tax bases and expenditure responsibilities between the center and the states laid out in our constitution, enacted in 1950. The constitution also mandated the appointment of a finance commission every five years or so. We created in the same year an extraconstitutional body, the planning commission, which also makes transfers to states. However today's economy is not that of the 1950s. If the rituals of five-year plans, annual plans, and the "approval" of state plans by the planning commission (let alone the bureaucracy of state planning commissions and planning boards) are no longer relevant, any reform of the planning process will also involve, among other things, reform of the process of transfers from the central planning commission.

Second, we have yet another means of transfers to states, namely, through assistance for the centrally sponsored schemes. These are meant to address interstate externalities and spillovers. Unfortunately externality is often the last resort for the scoundrels among economists—if they can find no other way of justifying a transfer scheme, they invent externalities! Anyway, whether the transfers through these schemes are mere distortions or address genuine externalities, they have to be thought through.

Third, we do not have the analogue of the interstate commerce clause of the U.S. Constitution in our constitution. As Ajay Shah rightly pointed out, India is not a common market. To conclude, one has to think through what the fundamental economic structure of the economy currently is and the roles which the governments at various levels are playing in it, if we want to make progress in tax reform.

General Discussion

Ajay Shah said it was useful to analyze where the tax system was going wrong. Several measures currently in place had adverse efficiency effects, Shah said, including the 2 percent cess, or surcharge, on all taxes that is earmarked for education. Similarly, the subsidy to promote the universal service objective in telecommunications was funded by taxes on telephone usage and interconnections between fixed and cell phones. These specialized taxes were in place, Shah said, even though we know that it is more efficient to fund education and universal service obligations out of general tax revenue. Shah added that because of its bad design and implementation, the value added tax also failed to yield the desired efficiency results. The transactions tax, which started with a security transactions tax, is yet another example of inefficient taxation. The recent plans by the Maharashtra government to introduce very high stamp duties on Mumbai-based financial transactions were likely to be even more damaging, he said.

Shah then pointed out that the revenue implications of eliminating the remaining tariffs were not as dire as they might seem. The standard Indian data for customs revenue included not just the custom duty but also the countervailing duty. Therefore, the fiscal cost and the fiscal challenge of further customs reform were smaller than they appeared: even if the tariff moved to zero, the countervailing duty would still be collected. If the exemptions on the countervailing duty were eliminated carefully, Shah said, it would not be difficult for India to go to zero customs duty on everything very quickly.

Shah also commented on the implications of the developments in information technology. The tax information network set up in India was nothing short of revolutionary compared with what seemed feasible even five years earlier. Firms from all across the country file electronically, feeding directly into a single database and matching up with the tax deduction at source.

Shah concluded with the comment that research economists should be tilting at the windmills of fundamental tax reform. For example, they should

question the idea that states are independent taxing authorities. A unified value-added tax required vesting this power entirely in the central government, he said.

Calling the paper very interesting, Partho Shome said it showed, for example, that progressivity in the tax structure in personal income tax had decreased only among a class of taxpayers but not overall. The paper also showed how the collection of the corporate income taxes, excise taxes, and custom duties was concentrated in a few sectors such as petroleum, chemicals, and metal industries and at the very low end from textiles. The paper also put great emphasis on the need to reform tax administration.

Shome went on to note that India's tax policy was moving "briskly" from (distortionary) indirect taxes to direct taxes. For the first time, this year the government budgeted more than 5 percent of GDP from direct taxes. Also, for the first time, revenue from direct taxes would be higher than the revenue from production taxes and import taxes. Shome also reminded the audience that countervailing duties do not cover state sales tax.

Shome then observed that even though one would like to make rules-based policies at the economywide level, such as a single custom duty rate, the actual policy choice was tempered by a variety of forces working at the sectoral level. For example, Indian tax policy was influenced by what competitor countries are doing in the specific sectors. India's excise and custom duties in the textiles sector, for example, were influenced by what China, Pakistan, Bangladesh, and Vietnam did in that sector.

Shome said that at the same time, the system was extremely sensitive to the needs of domestic industries. The expression policymakers used here was "Is there a domestic angle?" One had to be very careful about employment effects and capital effects. The practice of consulting with representatives of both big corporations and small enterprises was bound to influence the eventual choice of policy.

Shome stated that the export objectives were yet another determinant of that policy. Such policies led to the establishment of export-oriented units and special economic zones, which immediately protected all enterprises with a cut in various taxes and provision of infrastructure. The country's export strategy also led to policies that ensure that exports have "free-trade" status. That in turn led to numerous schemes to free the exports from custom duties on the imported input. Thus there were advance licenses that allowed inputs to be imported free of duty. There were duty drawbacks whereby the company paid the duty but later received drawbacks against it. Then there was the passbook scheme organized by the Ministry of Commerce, where companies had accounts from which they could automatically deduct

the customs duties they paid. In addition, there was a target zero tax scheme, linked to how much exports increase each year. Under yet another scheme, a company that exported a certain amount could import capital goods without paying duty. These were not all, Shome said. They were so numerous and so complex, he added, that he could not hold them in his memory.

Shome pointed to regional balance and development and social infrastructure as yet additional factors that influence policy. Special needs of regions such as Jammu and Kashmir, Special Category States that have been newly formed, and the northeastern states must be taken into account. Charities and trusts have to be considered, as stipulated in the Income Tax Act. As a result, Shome said, the efficiency of implementation was quite low, to put it mildly.

Regarding the fringe benefit tax, Shome noted that before it was enacted, there was a perquisites tax in the personal income tax, similar to the one that existed in most developed countries in Europe and in the United States and Canada. The government felt that the self-assessment and self-declaration of perquisites did not work. The alternative was to fix the problem through the corporate route. The government could identify a positive list of fringe benefits and tax them at the corporate level, although the incidence should be on the individuals who received the benefits. In fact, what is being shown from industry information is that quite a few of the fringe benefits are being rewritten in the salary structure, because the corporations cannot take these deductions any more, Shome said.

Turning to tax administration, Shome said while many initiatives were under way in this area, he would limit himself to the VAT. One thing that is often mentioned is the removal of the central sales tax, which was imposed on interstate trade. But it can be removed only with the full development of the information exchange system, which was being done. Shome concluded with a remark about the unified goods and services tax. One should remember, he said, that under the GST, services and goods would have to become creditable against each other at both central and state levels. That would require a major constitutional amendment, almost like a constitutional convention. So, as a first goal, it may be better to discuss a kind of national VAT with two parallel VATs at the central and state level. Even that would require constitutional amendment.

Reacting to one of Shome's points, Surjit Bhalla argued that economists should resist the political economy pressures that push toward bad policies. If the only way to make textiles competitive with China is to have a special tax rate, Bhalla said, then economists should oppose the special tax. T. N. Srinivasan responded that when recommending policies,

economists could not entirely ignore the presence of political-economy pressures. There was someplace in between presuming to describe the political economy, on which you have no competence, and at the other end, ignoring it completely, when it is staring you in the eye, Srinivasan said.

Rajnish Mehra raised a question on the relationship of the tax system to the Indian stock market valuation. Suppose, he said, one wants to assess whether the Indian market is overvalued. One of the parameters needed is the tax rate on dividend distribution. This rate was 56 percent in 1990 and went down to 10 percent in 1997–98. A permanent cut in dividend tax rates would hugely increase asset valuation. Perhaps, if the market views this tax drop to 10 percent as a permanent tax cut, that might explain some of the valuations that we are seeing. In response, Shankar Acharya stated that perhaps one of the reasons why there was so much variation in the dividend payment was that the taxation on dividends had changed about six times in the last twenty years in India. But he acknowledged that there were a lot of other factors as well.

Bhalla asked Shome what the rationale for the fringe benefit tax was, how effective it had been, and how much revenue had the government been able to raise from it in absolute terms and as a percentage of the total revenue?

Arvind Panagariya asked Shome whether he was asserting that under the current government the country would move substantially to direct taxes as the source of revenue and deemphasize indirect taxes? And if so, would Shome also say that if he were designing the tax system from scratch, he would actually not even bother to have indirect taxes?

Kavita Rao took issue with the suggestion by Shah that India should now think about taking the power to tax final consumption away from the states and vesting it entirely in the center to achieve a unified goods and services tax. There was surely some gain in harmonizing the tax structure, laws, procedures and rules, and even tax administration, Rao said, but do we want a single nationwide tax system that guides the allocation of resources across all states? Rao added that this was not a politically feasible solution. If we wish to let the states choose their own levels of services according to local preferences, it is not feasible to have a national, homogenous, and uniform centralized tax system, Rao said.

Govinda Rao joined Kavita Rao in responding to the discussants' comments. He began by stating that Acharya had raised a very important question about when the tax reform began. In his view, the fundamental tax reform started in 1991. He did not deny that there had been significant simplification of direct taxes before to 1991. The government had actually introduced the MODVAT before then he said, and this had been accompanied by analysis

and discussions within the Finance Ministry. But that was not enough. In 1991, there were something like fifteen income tax rates and twenty excise tax rates. A large number of commodities were still subject to specific rates. There was a plethora of rates in customs duty. Therefore, fundamentally speaking, there had not been any tax reform prior to 1991. In contrast, the reform during the 1990s proceeded according to a clearly laid out roadmap and with appropriate preparations made at various levels.

Shome had the final word. He made three points. First, regarding Bhalla's question on the fringe benefits tax, the rationale had been explained in the Finance Act itself. As Shome had indicated earlier, the perquisites tax had not been working well. It yielded no revenue from loss-declaring firms. So, to improve equity within the corporate sector, the government introduced the fringe benefit tax. As far as the revenue was concerned, the tax was still in an experimental stage and he would not venture to hazard a guess as to how much revenue might be collected.

Second, Shome stated that at the moment the government was indeed moving toward greater reliance on direct taxes. But if it could do something like the goods and services tax and implement a broad-based consumption tax at the national level, which would necessitate a constitutional amendment, Shome said the government would probably return to the broad-based consumption tax. If the central and state taxes were consolidated and one looks at what the center is collecting from excise up to manufacturing and what the states are collecting from the sales tax, then the indirect tax revenues are quite high—higher than the direct tax component.

Finally, Shome commented on the controversy between Acharya and Govinda Rao on the timing of the tax reform. He said the controversy had reminded him of a parallel controversy on when and which country first implemented the VAT. The French started it in the early 1960s on certain items. Then, a couple of years later, Brazil introduced a very comprehensive VAT at the level of the states, addressing even the issue of how to tax the interstate trade. Shome noted that in his view, although France was the first to adopt the VAT technically speaking, Brazil was the one to first adopt it meaningfully.

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