



Assessing Taxation Changes In India: Achievements And Dilemmas

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Abstract

This paper explores the transformation of India's tax system since the early 1990s, driven by significant changes in tax policies across various countries. It evaluates the introduction of novel direct and indirect tax structures, examining their impact on revenue and fairness. The analysis also highlights the accomplishments and challenges encountered during their implementation. In conclusion, the paper underscores that, despite eight years of reform efforts, enhancing India's tax system remains a formidable task.

Keywords: tax reform, india taxation, revenue impact

Introduction

Over the past two decades, numerous countries, each with their own economic systems and development levels, have undergone significant changes in their tax systems. These reforms have been motivated by a range of factors, varying from country to country and changing over time based on the prevailing development strategies and philosophies. In many developing nations, the primary impetus for tax reforms has been the urgent need to boost revenues to address impending fiscal crises. As Bird (1993) aptly notes, "Fiscal crises often trigger tax reforms," although these reforms tend to be reactive, aimed at meeting immediate revenue needs, rather than strategically enhancing long-term tax system productivity.

Additionally, recent tax reforms in many developing and transitional economies, including India, have been driven by the shift from centrally planned development strategies to market-based resource allocation. This transition has altered the role of the state in development, moving away from a public-sector-dominated, heavy industry-focused, import-substitution industrialization strategy. Instead, resources are allocated based on market signals, necessitating fundamental changes in the tax system. In export-led open economies, the tax system must not only generate necessary revenues for infrastructure but also minimize distortions to ensure international competitiveness.

In India, like in other countries, systemic tax reforms in the 1990s emerged in response to crisis situations but were executed with detailed analysis. This paper's objective is to analyze the evolution of India's tax system, with a specific focus on systemic reforms in tax structure and operation within the Indian federal framework. Section I provides an overview of tax system reform evolution, different paradigms employed in various countries, and best practices to serve as a framework for examining India's tax reform journey. Section II outlines the Indian tax system and earlier reform initiatives leading up to the comprehensive tax reform of 1991. Section III delves into the key features of comprehensive tax reform since 1991 and its impact on revenues. The final section highlights persisting shortcomings in the tax system and enumerates the challenges faced by the government in developing a coordinated tax system within the Indian federal structure.

Cycles of Tax Reform: Changing Philosophies and Contemporary Approaches

The philosophy behind tax reform has evolved considerably in response to changing perceptions of the state's role. In the past, tax policies focused on generating revenue for a large public sector with little concern for economic impacts. However, recent approaches emphasize minimizing distortions in tax policies to maintain economic competitiveness. This involves reducing both direct and indirect tax rates and narrowing the gap between them. Achieving this goal requires expanding the tax base. The shift has been from vertical equity, characterized by high marginal rates and minimal rate differentiation, to horizontal equity, where taxes are broad-based, straightforward, transparent, and subject to lower and less varied rates. Equity now means improving the living conditions of the poor through expenditure policies and human resource development rather than reducing the incomes of the wealthy, as was the norm in the 1950s and 1960s. Conventional wisdom offers three tax reform models: the optimal tax (OT) model, theoretically sound but impractical; the Harberger tax model (HT), grounded in theory and practical experience, emphasizing administrative capability; and the supply-side tax model (SST), which calls for reducing the state's role by cutting direct tax rates and minimizing exemptions.

Recent reform approaches combine elements of these models, aiming to enhance tax system revenue while minimizing price distortions. These approaches have sought to make tax systems comprehensive, simple, and transparent. Broadening the tax base has been a common theme, as it allows for lower tax rates, which, in turn, reduce disincentives to work, save, and invest. Furthermore, broadening the base promotes horizontal equity, reduces the influence of special interest groups on tax policy, and lowers administrative costs. In the case of indirect taxation, the reform agenda includes the adoption of a broad-based VAT with few exemptions and a limited number of luxury excises. Import duties should replace quantitative restrictions with tariffs, eliminate export taxes, and minimize tariff disparities. Personal income tax should apply to nearly all individuals except those with incomes less than twice the per capita income of the country. While withholding is suitable for most direct taxes, presumptive taxation should apply to hard-to-tax groups. Emphasizing horizontal equity also necessitates strengthening tax administration, enforcement, and information systems, including automation.

India's Tax System Before 1991 Reforms

The trends in tax revenues can be divided into three distinct phases. First, from the 1970s to the mid-1980s, there was a consistent rise in the tax-GDP ratio, driven by a growing economy and the shift from quantitative restrictions to tariffs during economic liberalization in the 1980s. The tax ratio reached 14.6% in 1980-81. The second phase, from the late 1980s until 1992-93, witnessed stagnant revenues due to an economic recession caused by a severe drought. After the economic crisis of 1991 and subsequent tax system reforms, including tariff reductions, the tax ratio declined. It reached a peak of around 17% in 1987-88, but then dropped to 13.9% in 1993-94 before gradually recovering to 14.6% in 1997-98.

In terms of tax revenue composition, the share of direct taxes declined from 21% in 1970-71 to about 14% in 1990-91. After the 1992 tax reforms, revenue from direct taxes grew faster than other taxes and GDP, increasing to 24% by 1997-98. This growth was observed in both corporate and individual income taxes, while taxes on agricultural land and incomes continued to decline, despite the agricultural sector contributing over 30% to GDP.

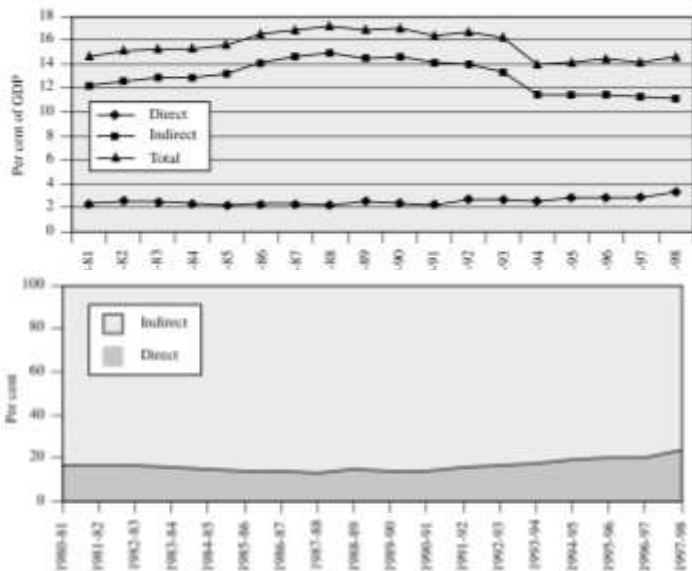
Table 1: Level and composition of taxes in India
(per cent)

Year	1970-71	1980-81	1990-91	1995-96	1996-97	1997-98
Direct Taxes (%)	21.3	16.4	14.0	20.4	20.5	23.6
Corporation Tax (%)	7.8	6.6	6.1	9.4	9.3	9.4
Personal Income Tax (%)	10.0	7.6	6.1	8.9	9.1	12.6
Agricultural Taxes (%)	2.8	1.0	0.9	0.8	0.6	0.6
Others (%)	0.7	1.2	0.9	1.3	1.5	1.0
Indirect Taxes (%)	78.7	83.6	86.0	79.6	79.5	76.4
Customs (%)	11.0	17.2	23.5	20.4	21.4	18.0
Union Excise Duties (%)	37.0	32.8	27.9	22.9	22.5	20.9
Sales Tax (%)	16.6	20.3	20.8	20.4	21.1	21.2
State Excise Duties (%)	4.1	4.2	5.7	4.9	4.5	5.0
Others (%)	10.0	9.1	8.1	10.9	10.0	11.3
Total Tax Revenue (%)	100.0	100.0	100.0	100.0	100.0	100.0
Tax-GDP Percentage (%)	11.0	14.6	16.4	14.4	14.2	14.6

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

The fastest revenue growth occurred in customs duties from 1970 until 1992-93 when import duties were significantly reduced. Some attribute this imbalance in the tax system to constitutional arrangements that allocate revenue from personal income tax and union excise duties to states. Even after the 1992-93 reforms, the decline in revenue share from union excise duties outpaced the decline in import duties share.

Chart 1: Trends in direct and indirect taxes



Both central and state governments have revenue-raising powers in India, with states responsible for about 37% of total revenues.

Chart 2: The shares of direct and indirect taxes

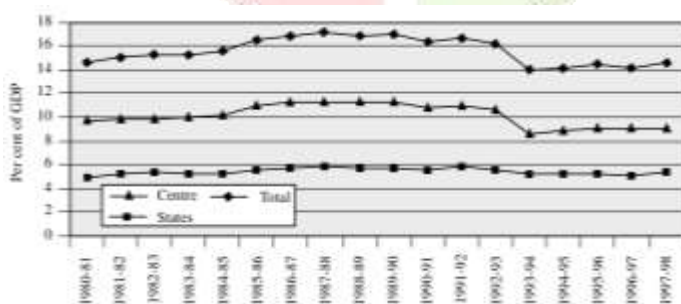
However, revenue trends for both central and state governments followed a similar pattern. Central government tax revenue declined faster due to tariff reductions, while state-level reforms were limited, yet tax ratios declined marginally.

Tax Reform Efforts Until 1990

Since gaining independence, India has made several attempts to reform its tax system primarily to boost revenue for funding ambitious development plans. Although some committees did consider economic efficiency as a goal, their recommendations often aligned with the prevailing philosophies of the time. Even when efficiency-driven measures were suggested, they were typically not implemented if they resulted in revenue loss.

The first comprehensive tax reform effort occurred in 1953 to support the Second Five Year Plan, which aimed to increase savings, transfer resources from private to public sectors, and redistribute wealth. Subsequent attempts focused on various aspects of the tax system.

Chart 3: Trends in tax revenue – centre and states



The expenditure tax, introduced in 1957-58 based on Kaldor Committee recommendations, had to be withdrawn after three years due to inadequate revenue generation. The pursuit of wealth redistribution led to the design of an income tax system with high marginal rates, but these rates were later reduced following the Direct Taxes Enquiry Committee's recommendations in 1971. On the indirect tax side, a major simplification effort was made by the Indirect Taxes Enquiry Committee in 1972. Various states also formed committees to rationalize and simplify their tax systems, primarily to increase revenue for growing public consumption and investment needs. Despite rationalization efforts that reduced marginal tax rates, the prevailing philosophy still supported high rates. In the early 1970s, the marginal tax rate, including surcharges, reached 93.5%. This,

combined with an 8% tax on wealth, created strong incentives for tax evasion and avoidance. Following recommendations by the Direct Taxes Enquiry Committee, the marginal tax rate was lowered to 66% in 1976, along with reductions in wealth tax rates. The most significant indirect tax reform before 1991 was the conversion of union excise duties into a modified value-added tax (MODVAT) in 1986. However, MODVAT initially applied to a limited range of goods and gradually expanded. While attempts were made to simplify and rationalize tax structures, they fell short of being comprehensive reforms.

Impact of Tax Reforms Since 1991: Report Highlights

Tax reform in India, which began after the 1991 economic crisis, aimed to combine economic principles with conventional wisdom. The Tax Reform Committee (TRC) report had three parts. The first part outlined reform principles applied to important taxes such as income, wealth, tariffs, and consumption. The second part addressed the overlooked aspect of administration and enforcement reforms. The third part focused on restructuring tariffs.

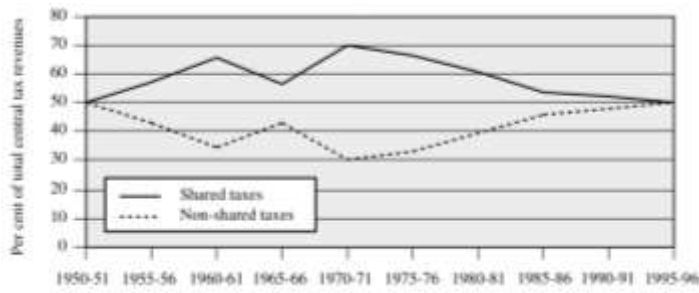
Key TRC recommendations included reducing major tax rates (customs, income, and excise) to reasonable levels without encouraging tax evasion. To broaden the tax base, the TRC proposed minimizing exemptions and simplifying laws and procedures. They emphasized building an information system, computerizing tax returns, and modernizing administrative and enforcement machinery. For domestic production taxes, a full conversion to a value-added tax (VAT) was proposed, extending it to the wholesale level, with extra revenue passed to state governments.

Regarding customs, the TRC suggested tariff rates of 5, 10, 15, 20, 25, 30, and 50 by 1997-98, linked to the commodity processing stage and income elasticity of demand. Critics argued that this approach lacked economic basis and created high differentiation in effective rates, offering excessive protection to non-essential goods. While the TRC couldn't address state-level taxes, it recognized issues with state sales taxes primarily at the manufacturing stage, recommending the extension of central VAT to the wholesale stage with revenue allocation to states.

Implementation of Reforms Since 1991: Key Points

The government accepted and gradually implemented the recommendations of the Tax Reform Committee (TRC), although not all measures to strengthen administration and enforcement were executed. The reforms didn't precisely align with TRC recommendations regarding pace and content. For personal income taxes, significant reductions in tax rates occurred, with three simplified tax brackets and higher exemption limits. Compliance improved with reduced marginal tax rates, and efforts were made to include self-employed individuals in the tax system. A voluntary disclosure scheme offered tax defaulters a one-time amnesty. Corporate income tax rates were lowered for both domestic and foreign companies, but the tax base remained limited due to generous tax incentives for various activities.

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



Minimum Alternative Tax (MAT) was introduced to ensure minimum tax payments. Tariffs saw a substantial reduction in average and peak rates since 1991, with further reductions planned to align with South-East Asian countries. However, the number of tax rates and rate differentiation remained high, offering incentives

for assembly of consumer durables and luxury goods. Union excise duties underwent simplification, with fewer rates and a shift from specific to ad valorem levies. MODVAT credit was extended to a majority of goods. The tax base broadened by removing exemptions, and a simplified tax structure was introduced for the small-scale sector. Selective taxes on services were introduced by the central government, covering various services through its residuary powers. Improvements in tax administration and enforcement, such as simplified assessment procedures and special tax courts, were initiated. Computerization of tax returns and a management information system program were launched with assistance from the Canadian International Development Agency (CIDA).

State Tax Systems: Challenges and Reform Efforts

While significant progress has been made in reforming the central government's tax system, the same cannot be said for state tax systems. Sales taxes, contributing over 60% of state revenues, have stagnated over time. States prefer taxing at the first point of sale, resulting in a narrow tax base. The introduction of 16-20 rate categories for various objectives has made the tax system complex, leading to classification disputes. Taxing inputs and capital goods has caused cascading, where taxes on these inputs result in consumers paying more than what the government collects. Inter-state sales taxes create distortions and favor richer states, leading to inter-state tax exportation. The sales tax system has become complex, opaque, and distorting due to independent and overlapping commodity tax systems at both central and state levels. To address this, a study group recommended moving toward destination-based, consumption-type value-added taxes at the state level and a complete shift to manufacturing stage VAT at the central level. A state Finance Ministers' Committee proposed a gradual transition to VAT. Despite consensus on the need for reform, little action has been taken to rationalize state-level sales tax systems.

Revenue Impact of Reforms

The 1991 economic crisis led to a substantial drop in revenues. While tax reforms aimed for revenue neutrality, lower tax rates naturally meant reduced income for the government. The tax-GDP ratio fell from over 16% in 1990-91 to less than 14% in 1993-94, despite some improvement later. Interestingly, despite significant reductions in individual and corporate income tax rates, revenues increased. Direct taxes' contribution to GDP and total revenue rose notably, from less than 14% in 1990-91 to 24% in 1997-98. The exact reasons behind this boost remain unclear, involving factors like increased public sector wages, better compliance from lower tax rates, and administrative measures. The decline in the tax-GDP ratio since reforms began is mainly attributed to reduced yields from indirect taxes. Customs revenue decreased as high tariffs were reduced, but

excise duties didn't compensate for import duty losses as intended. Thus, the share of excise duties in total revenue dropped significantly. Continued heavy reliance on import duties as a revenue source rather than for protection raises concerns. The central government's incentive to raise revenues from taxes shared with states creates a moral hazard issue. As a result, the government concentrates on non-shared taxes, causing imbalances in revenue growth and negatively impacting economic development.

Shortcomings and Challenges in Tax Reforms

Despite eight years of tax reforms, several issues still persist in India's tax system. Achieving higher tax productivity remains a significant challenge. The tax-to-GDP ratio has not returned to pre-reform levels, and while income tax coverage has improved, reaching harder-to-tax groups remains a task. Simplifying the tax system, particularly for state and local consumption taxes, is necessary. Efforts are needed to establish an effective management information system and automate tax returns. Tax reforms should be continuous, not just sporadic or crisis-driven. In direct taxes, lower tax rates have improved compliance, but revenue potential is untapped. Bringing hard-to-tax groups into the system is essential. Rationalizing savings incentives and expanding tax deduction at source are areas for improvement. Corporate income taxes should broaden their base by reducing tax concessions and preferences. The proliferation of tax incentives has complicated the system, leading to the introduction of the Minimum Alternative Tax (MAT). A complete overhaul of tariff design is necessary. The current system, with seven tax rate categories, leads to wide disparities in effective protection rates. Simplification is required to enhance India's international competitiveness.

The most significant challenge is creating a coordinated consumption tax system. The current separation of taxes between the central government, states, and local governments on the same base results in cascading, distortions, and a non-transparent system. Developing a dual VAT system, a manufacturing-stage VAT by the center and a retail-stage VAT by states, is a solution. However, Joshi, V., & Little, I. M. D. (1996). *India's economic reforms, 1991-2001*. Oxford University Press. progress has been slow. One major obstacle to achieving a retail-stage VAT at the state level is the states' lack of power to tax services. An amendment to the Constitution is needed for proper goods and services tax, with the central government using this as leverage to encourage states to reduce inter-state sales taxes and make destination-based VAT a reality.

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