Tax reforms in india since 1991

Tax Reforms in India Since 1991 BY shahtn565 There have been major changes in tax systems of countries with a wide variety of economic systems and levels of development during the last two decades. The motivation for these reforms has varied from one country to another and the thrust of reforms has differed from time to time depending on the development strategy and philosophy of the times. In many developing countries, the immediate reason for tax reforms has been the need to enhance revenues to meet impending fiscal crises.

One of the most important reasons for recent tax reforms in many developing and ransitional economies has been to evolve a tax system to meet the requirements of international competition.

Indian Criteria There have been a number of attempts at improving the tax system since independence. The principal objective of these attempts has been to enhance revenue productivity to finance large development plans. Although the various tax reform committees considered economic efficiency as one of the objectives, the recommendations do not bear much testimony to this aspect.

The recommendations were in keeping with the philosophy of the times.

Further, even when the committees id recommend certain measures on efficiency considerations, this was not acted upon if it involved loss of revenues. IMPACT OF TAX REFORMS SINCE 1991 As in other countries, the systemic reforms in the tax system in India in the 1990s were the product of crisis but the reforms were calibrated on the basis of detailed analysis. Tax

reform since 1991 was initiated as a part of the structural reform process, following the economic crisis of 1991.

In keeping with the best practice approaches, the Tax Reform Committee (TRC) adopted an approach of combining economic principles with conventional wisdom in recommending comprehensive tax ystem reforms. There are three parts to it.

In the first part, 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 dealt with restructuring the tariff structure. In keeping with the structural adjustment of the economy, the basic principles taken in the recommendations were to broaden he base, lower marginal tax rates, reduce rate differentiation, and undertake measures to make the administration and enforcement of the tax system more effective. The reforms were to be calibrated to bring about revenue neutrality in the short term and to enhance revenue productivity of the tax system in the medium and long term.

The overall thrust of the TRC was to (i) decrease the share of trade taxes in total tax revenue; (it) increase the share of domestic consumption taxes by transforming the domestic excises into VAT and (iii) increase the relative contribution The important proposals put forward by the TRC included reduction in the rates of all major taxes, viz.

customs, individual and corporate income taxes and excises to reasonable levels, maintain progressivity but not such as to induce evasion.

The TRC recommended a number of measures to broaden the base of all taxes by minimizing exemptions and concessions, drastic simplification of laws and procedures, building a proper information system and computerization of tax returns, and a thorough revamping and modernization of the administrative and enforcement machinery. It lso recommended that the taxes on domestic production should be fully converted into a value added tax, and this should be extended to the wholesale level in agreement with the states, with additional revenues beyond the post-manufacturing stage passed on to the state governments.

In the case of customs, the TRC recommendations were the weakest.

The TRC recommended tariff rates of 5, 10, 15, 20, 25, 30 and 50 to be achieved by 1997-98. The tariff rate was to vary directly with the stage of processing of commodities, and among final consumer goods, with the income elasticity of demand (higher rates on uxuries). Implementation of reforms since 1991 The government accepted the recommendations of the TRC and has implemented them in phases.

Although it did not entirely follow the recommendations and is yet to implement many of the measures to strengthen the administration and enforcement machinery, most of the recommendations have been implemented.

It must also be noted that the pace and content of reforms have not been exactly true to TRC recommendations. As regards the personal income taxes, the most drastic and visible changes have been seen in the reduction in personal and corporate income tax rates. In the case of personal income taxes, besides exemption, the number of tax rates has been reduced to three and the tax rates were drastically reduced to 10, 20 and 30 per cent.

At the same time, the exemption limit was raised in stages to Rs 50, 000.

Combined with the standard deduction, a salaried taxpayer up to an income of Rs 75, 000 need not pay any tax. In addition, saving incentives were given by exempting investment in small savings and provident funds up to a specified limit. Attempts have also been made to bring in the self-employed income earners into the tax net. Every individual iving in large cities covered under any of the specified conditions (ownership of house, cars, membership of a club, ownership of credit card, foreign travel) is necessarily required to file a tax return.

Empirical evidence shows that this drastic reduction in the marginal tax rates has improved the compliance index significantly2. Thus, revenues from personal and corporate income taxes have shown appreciable increases after the reforms were initiated in spite of the fact that the rates of tax have been reduced significantly. Voluntary disclosure scheme to allow a one time mnesty to tax defaulters by paying the necessary tax was introduced in 1997-98. domestic and foreign companies to 35 per cent and 48 per cent respectively.

The dividend tax at the individual income tax level has been abolished.

However, very little has been done in terms of broadening the base of corporation tax. In fact, besides depreciation allowances and exemptions for exporters, generous tax holidays and preferences are given for investment in various activities (housing, medical equipment, tourism, infrastructure, oil refining, free trade zones, software development, telecommunication, sports etc.). Consequently, the tax base has not rown in proportion to the growth of corporate profits. As many corporate entities took generous advantage of all these tax preferences, there were a number of " zero- tax" companies.

To ensure minimum tax payments by them, a Minimum Alternative Tax (MAT) was introduced in 1997-98. In the case of tariffs, there has been a drastic reduction in both the average and peak tariff rates. In 1990-91, the unweighted average nominal tariff was 125 percent and peak rate was 355 per cent. These were progressively reduced over the years. The peak rate of import duty in 1997-98 was 40 per cent and the average rate of tariff is ust about 25 per cent.

It is proposed to reduce the tariffs further to the levels prevailing in the South-East Asian countries in the next five years.

In terms of rate differentiation, the number of tax rates continues to remain high. While in the initial years, there was an attempt to reduce the rate differentiation, in more recent years, the variations have, in fact, increased. Again, the pattern of tariffs with the rates varying with the stage of processing has resulted in very high incentives given to the assembly of consumer durables and luxury items of consumption. There has been a considerable simplification and rationalization of union excise duties as well.

Besides reduction in the number of rates, the tax has been progressively converted from a specific into ad valorem levy in respect of the majority of commodities.

The facility of providing credit on input taxes under the MODVAT(modified value added tax) too has been progressively extended to a larger number of commodities. As of now almost 80 per cent of the goods covered under excise duties are provided with the MODVAT facility. The base of the tax was broadened by removing the exemptions and levying excise duty at the lowest rate (8 er cent).

There has also been a simplification of the tax on the small-scale sector. As the government realized that there was considerable misuse, availability of MODVAT credit was reduced to 95 percent instead of 100 per cent. Another important change that has been brought about since 1991 is the introduction of a selective tax on services.

The constitution does not assign this tax base specifically either to the centre or the states. However, the central government by invoking residuary powers has introduced a tax on services since 1994-95.

Beginning with three services (telephones, non-life insurance and stock brokerage), he base of the tax has been broadened to cover a large number of services such as transporters, car rentals, air travel agents, architects, interior designers, management rating agencies, market research agencies, underwriters, private security/detectives, real estate agencies and mechanized slaughter houses. There have been significant attempts to

improve the administration and enforcement of the tax as well, though progress in actual implementation has not been commensurate.

Besides amnesties given from time to time, efforts have been made to reduce arrears by introducing simplified assessment procedures.

A large number f pending cases in courts have been decided through out of court settlements. There have also been attempts to establish special tax courts to deal exclusively with tax disputes. With the assistance of the Canadian International Development Agency (CIDA), the government has started an ambitious programme of computerizing tax returns and building a management information system.

Revenue implications of reforms The economic crisis of 1991 resulted in a significant decline in revenues. Although the tax reforms were intended to be a revenue neutral exercise, the natural consequence of a significant decline in tax rates was to reduce revenues. As there was no commensurate increase in the tax base, the revenue naturally showed a declining trend.

Thus, the tax-GDP ratio, which was over 16 per cent in 1990 91, declined sharply to less than 14 per cent in 1993-94. Although thereafter there has been some improvement, it still remains less than 15 per cent and this remains a matter for concern (India 1994).

Thus, the reforms in the Indian context have in fact, caused an immediate loss of revenues, though in the next few years, they are likely to reach pre-reform levels. Interestingly, in spite of significant reductions in the rates of oth individual and corporate income taxes, the revenues have shown a

significant increase. The share of revenue from direct taxes showed a significant increase as a proportion of GDP as well as total tax revenue.

The contribution of revenue from direct taxes, which was less than 14 per cent in 1990-91, increased sharply to 24 per cent in 1997-98.

However, it is not clear to what extent the increase in revenue productivity is due to increase in public sector wages following the implementation of pay commission recommendations, how much of this is attributable to better compliance arising from lower marginal tax rates and how much due to dministrative measures. The decline in the tax-GDP ratio since the reforms were initiated has to be attributed to lower yield of indirect taxes. Naturally, some reduction in customs revenue was only to be expected as the prevailing tariffs were extremely high and had to be drastically reduced.

For the same reason, the reforms in excise duties were to be calibrated to compensate revenue loss from import duties. This, however, did not happen and in fact, the revenue from union excise duties showed a drastic decline.

Analysis shows that the revenue from import duties as a ratio of GDP declined by 1. 3 percentage points from 3. per cent in 1990-91 to 2. 6 per cent in 1997-98. However, decline in the revenue from excise duties was faster, by 1.

5 percentage points from 4. 6 per cent to 3. 1 per cent during the same period.

Consequently, the share of per cent) as compared to a 6 percentage point decline in the share of customs (from 24 to 18 per cent). Significant

improvements in the tax ratio, therefore, have to come from improvement in the revenue productivity of domestic indirect taxes. The continued heavy reliance on import duties as a source of revenue rather than as an instrument of protection is an issue that merits some discussion.

It has been ointed out that the central government does not have the incentive to raise revenues from the taxes that are shared with the states.

According to the existing intergovernmental fiscal arrangement, the central government should share 87. 5 percent of the net collections from personal income tax and 47. 5 per cent of gross revenues from union excise duties with the states. This is alleged to have created a moral hazard problem and it is stated that the central government concentrates on those taxes which are not shared. Consequently, while the share of revenues from the taxes that are shared with the states have declined, the revenues from the ources that are not shared have shown a steady increase.

Conclusion After eight years of tax reform, as already mentioned, a number of disquieting features in the tax system still remain. Improving the productivity of the tax system continues to be a major challenge in India. The tax ratio is yet to reach the pre- reform levels. The most important challenge in restructuring the tax system in the country is to evolve a co-ordinated consumption tax system. Development of dual VAT – a manufacturing stage VAT by the centre and a consumption type destination based retailed stage VAT by the states is a solution, which needs to be progressively pplied.

However, neither the centre nor the states have made appreciable progress in this regard. To achieve this, in the case of the centre, the excise duties

should be levied entirely as ad valorem levies. The rates should be rationalized into a maximum of two and tax credit should be provided on a systematic basis. For this, developing a proper information system is imperative. At the state level, transforming the state taxes into VAT has to be calibrated even more carefully.

A major difficulty in evolving a destination based retail stage VAT at the state level arises from the fact that the tates do not have the power to levy tax on services.

As mentioned earlier, the states can levy sales taxation of only goods. Taxation of services is not assigned to either the centre or the state, but the former levies taxes on selected services based on power to levy taxes on residual items. Proper levy of goods and services tax would, therefore, require an amendment of the Constitution.

The central government can use this as a leverage to persuade the states to reduce and eventually eliminate the taxation on inter-state sales so that a levy of destination based VAT becomes a reality.