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UNDERSTANDING THE TRAJECTORY OF TAX REFORM IN INDIA: IMPLICATIONS AND CHALLENGES

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ABSTRACT

Over the past two decades, there have been significant changes in the tax systems of countries with various economic structures and levels of development. The reasons behind these reforms have varied across countries, and the focus of the reforms has shifted over time, reflecting the prevailing development strategies and ideologies. In many developing nations, the primary catalyst for tax reforms has been the urgent need to boost revenue to address looming fiscal crises. As the saying goes, "fiscal crisis has been proven to be the mother of tax reform." However, these reforms are often reactive and designed to address short-term revenue needs, rather than being part of a comprehensive, long-term strategy to improve the overall effectiveness of the tax system.

Keywords: Tax Reform, Indian Economy, Economics, Income Tax, Finance, Fiscal Crisis, Tax Reform Committee

1. INTRODUCTION

A key driver behind recent tax reforms in many developing and transitional economies has been the need to create a tax system that can support international competition. The shift from a centrally planned development model to one based on market-driven resource allocation has altered the state's role in economic development. Moving away from a public-sector-led, heavy industry-focused, import-substitution strategy to a model that allocates resources based on market signals has required substantial changes in the tax system. In an export-oriented open economy, the tax system must not only generate the necessary revenue to support social and physical infrastructure but also minimize market distortions. Consequently, the tax system needs to adapt to the demands of a market economy to maintain international competitiveness. Similar to other countries, the tax reforms in India during the 1990s were largely driven by crisis, but these reforms were based on thorough analysis. This paper aims to examine the evolution of India's tax system, with a particular focus on the systemic reforms in the design and implementation of taxes within India's federal structure.

2. TRANSITIONAL PHASES

As development strategies shifted toward market-driven resource allocation, the traditional approach of raising revenue primarily to support a large public sector, without considering economic consequences, was abandoned.

Modern tax reform strategies focus on minimizing distortions in tax policies to maintain economic competitiveness. This involves reducing the marginal rates of both direct and indirect taxes and minimizing tax rate differences to avoid unintended distortions in relative prices. To achieve this, tax bases are broadened. As a result, the focus has moved from vertical equity, where both direct and indirect taxes had high marginal rates with minimal differentiation, to horizontal equity, where taxes are broad-based, simple, transparent, and subject to lower and more consistent rates. Equity is now understood to mean improving the living conditions of the poor, primarily through expenditure policies and human resource development, rather than by reducing the income of the rich as was the goal in the 1950s and 1960s. Three main models of tax reform have emerged from traditional tax theory.

The Optimal Tax (OT) model is theoretically sound but impractical in application due to the high information and administrative costs of designing such a system. While efficiency and equity are central to tax policy, the OT model's trade-offs have proven difficult to apply in real-world scenarios. The Harberger Tax (HT) model is also grounded in theory but is more practical. It emphasizes that while efficiency is important, administrative capability is even more crucial. The goal here is not to design an optimal system but to focus on minimizing tax-induced distortions while ensuring the system is administratively feasible and politically acceptable. Harberger suggests that tax reformers should prioritize practical experiences over complex economic methodologies. The HT model for developing countries includes measures such as a uniform tariff and a broad-based VAT (value-added tax). The Supply-Side Tax (SST) model advocates for a reduced role of the state in the economy. It proposes cutting public expenditure by lowering direct tax rates, which in turn minimizes disincentives to work, save, and invest. The model stresses the need for a broad tax base with few exemptions and low marginal rates, once again focusing on minimizing price distortions and reducing rate differentiation.

Recent tax reforms have combined elements from all three models, blending theoretical foundations with practical reform experiences. These reforms consider administrative, political, and informational constraints in their design and implementation. The core of this approach is to increase tax revenue productivity while minimizing distortions in relative prices. A best-practice approach has been adopted, aiming to make tax systems more comprehensive, simple, and transparent. These reforms generally involve broadening the tax base, reducing tax rates, and lowering differentiation in rates across both direct and indirect taxes. A broader tax base allows for lower rates while generating the same level of revenue, which in turn reduces disincentives to work, save, and invest, and enhances tax compliance. Broadening the tax base also ensures horizontal equity, reduces the influence of special interest groups on tax policy, and lowers administrative costs. In terms of indirect taxes, the reform agenda includes implementing a broad-based VAT with minimal exemptions, supplemented by a few luxury excises. For import duties, quantitative restrictions should be replaced with tariffs, export taxes should be eliminated, and tariff dispersion should be minimized. Personal income tax should apply to all but the smallest income groups, and much of it should be collected through withholding. For harder-to-tax groups, presumptive taxation should be used. Emphasizing horizontal equity also requires strengthening tax administration, enforcement, and the development of proper information systems and automation.

3. FROM THE 1950S TO THE 90S

Tax revenue trends can be divided into three distinct phases. The first phase, from the 1970s to the mid-1980s, saw a steady increase in the tax-to-GDP ratio, in line with robust economic growth and an accelerated rate of economic expansion. In 1970-71, the tax ratio was around 11 percent and rose consistently to 14.6 percent by 1980-81, continuing to increase during the early 1980s. This growth was fueled not only by the economy's higher growth trajectory but also by the gradual replacement of quantitative restrictions with tariffs as part of initial economic liberalization in the 1980s. However, an economic downturn triggered by a severe drought in 1987 led to stagnation in tax revenues until 1992-93. After the economic crisis of 1991 and the subsequent tax reforms, particularly the reduction of tariffs, there was a drop in the tax ratio. While the tax ratio peaked at around 17 percent in 1987-88, it fell to 13.9 percent in 1993-94 before recovering gradually to 14.6 percent by 1997-98. Despite this recovery, the overall level of tax revenues remains insufficient to meet the resource needs of the economy, even though it is relatively high compared to other developing countries. In terms of the composition of tax revenue, the share of direct taxes steadily declined from 21 percent in 1970-71 to approximately 14 percent by 1990-91. Following the 1992 tax reforms, revenue from direct taxes grew more quickly than revenues from other taxes and GDP, and by 1997-98, direct taxes accounted for about 24 percent of total tax revenue, an increase of almost ten percentage points. Both corporate and individual income taxes saw growth, though taxes on agricultural land and income continued to decrease.

Despite the agricultural sector contributing over 30 percent of GDP, its contribution to tax revenues was only about 0.5 percent. Customs duties experienced the fastest revenue growth from 1970 to 1992-93, when significant tariff reductions were implemented. Some analysts suggest that the skewed development of the tax system is partly due to the constitutional arrangements, which devolve revenue from personal income tax and union excise duties to the states. Even after reforms in 1992-93, while revenue from import duties declined due to tariff cuts, the decline in revenue from union excise duties was more pronounced. In India’s federal system, both central and state governments have revenue-raising powers, with the states accounting for around 37 percent of total revenues. The Seventh Schedule of the Constitution outlines the revenue sources for both levels of government. The central government primarily collects taxes on non-agricultural income, corporate profits, excise duties (except on alcohol), and customs duties. State governments, on the other hand, have the authority to levy taxes on agricultural land, income and wealth, excise duties on alcohol, sales taxes, motor vehicle taxes, stamp duties, and registration fees. The 72nd and 73rd Constitutional amendments also assign certain tax sources to local urban and rural governments, with property taxes and taxes on the entry of goods for consumption, use, or sale being the most important. However, local governments generally have very limited revenue-raising powers, and most of their expenditure is funded through revenue transfers from state governments.

An analysis of revenue trends reveals that both central and state governments follow a similar pattern, though the decline in the central government's tax-to-GDP ratio has been more rapid than at the state level. This is largely due to the tariff reductions required by the structural adjustment program at the central level, whereas the state governments have seen fewer significant reforms, resulting in only a marginal decline in their tax ratio. Since independence, several attempts have been made to improve the tax system, primarily aimed at boosting revenue productivity to finance development plans. Although economic efficiency has often been considered a goal in these reforms, the recommendations have generally not prioritized this objective. Furthermore, when efficiency-related recommendations were made, they were often not implemented if they meant a loss of revenue. The first major reform attempt was the Tax Reform Committee of 1953, which sought to generate resources for the Second Five-Year Plan (1956-60). This committee aimed to raise savings and investment, transfer resources from the private to the public sector, and achieve a degree of redistribution. Since then, numerous reform attempts have been made, though most have been partial. For example, the expenditure tax recommended by the Kaldor Committee in 1957-58 had to be withdrawn after three years due to insufficient revenue generation. Policymakers' efforts to redistribute income through income taxes led to high marginal tax rates, which resulted in moral hazard problems and widespread tax evasion.

The Direct Taxes Enquiry Committee of 1971 recommended lowering these rates significantly. On the indirect tax side, the Indirect Taxes Enquiry Committee of 1972 attempted to simplify the tax system. Various state-level committees also worked on tax rationalization and simplification, primarily to raise more revenue for public consumption and investment needs. Despite these rationalization efforts, tax rates remained high for much of the period. In the early 1970s, for example, the combined marginal tax rate, including the surcharge, reached as high as 93.5 percent, creating strong incentives for tax evasion. In response, the Direct Taxes Enquiry Committee recommended reducing the marginal rate to 77 percent in 1974-75 and further to 66 percent in 1976. Similarly, the highest wealth tax rate was reduced to 2.5 percent. The most significant reform before 1991 was the introduction of the Modified Value Added Tax (MODVAT) in 1986, which was initially applied to a limited range of manufactured goods and gradually expanded over the years. Although attempts were made to simplify and rationalize the tax system, these efforts cannot be considered comprehensive.

4. THE TRC (TAX REFORM COMMITTEE)

Tax reform since 1991 was initiated as part of the broader structural reforms following the economic crisis of that year. In line with best practice approaches, the Tax Reform Committee (TRC) combined economic principles with conventional wisdom to recommend comprehensive changes to the tax system. The TRC's report was divided into three sections. The first interim report outlined the guiding principles for reform and applied them to key areas such as taxes on income and wealth, tariffs, and domestic consumption taxes. The first section of the final report focused on improving the administration and enforcement of both direct and indirect taxes, which had been neglected. The second part addressed restructuring the tariff system. The main principles of the TRC's recommendations were to broaden the tax base, lower marginal tax rates, reduce rate differentiation, and enhance the efficiency of tax administration and enforcement. The reforms were designed to achieve revenue neutrality in the short term while improving the tax system's revenue productivity over the medium to long term. The overall goals of the TRC were to: (i) reduce the share of trade taxes in total tax revenue, (ii) increase the share of domestic consumption taxes by converting excise taxes into VAT, and (iii) boost the contribution of direct taxes. The TRC proposed a reduction in the rates of major taxes, such as customs duties, individual and corporate income taxes, and excises, while maintaining progressivity without encouraging tax evasion. It recommended broadening the tax base by minimizing exemptions and concessions, simplifying tax laws and procedures, building proper information systems, and modernizing the tax administration. The TRC also suggested converting domestic production taxes into a value-added tax (VAT) and extending it to the wholesale level in agreement with state governments, with the additional revenues allocated to the states.

The TRC's recommendations for customs duties were the weakest, with suggested tariff rates of 5, 10, 15, 20, 25, 30, and 50 percent by 1997-98. These rates were intended to vary by the stage of processing and consumer goods, with higher rates on luxury items. However, this system faced criticism for being unprincipled and for creating excessive rate differentiation, which resulted in high protection for non-essential goods. Furthermore, the TRC did not propose a coordinated domestic trade tax system, partly because it did not have the mandate to address state-level taxes. However, it did recommend extending the central VAT to the wholesale level, with revenues assigned to the states. The government accepted many of the TRC's recommendations and implemented them in phases. While not all recommendations were fully followed, especially in strengthening administration and enforcement, most of the reforms have been put into place. It is important to note that the pace and scope of reforms have not entirely matched the TRC's original proposals. Regarding personal income taxes, the most noticeable reforms included significant reductions in tax rates. The number of income tax brackets was reduced to three, with rates of 10%, 20%, and 30%. Additionally, the exemption limit was gradually raised to Rs 50,000, meaning a salaried individual earning up to Rs 75,000 would not need to pay tax, thanks to the standard deduction. Incentives for savings were also introduced, with exemptions for investments in small savings and provident funds up to certain limits. Efforts were also made to bring the self-employed into the tax net, with individuals in large cities meeting specific criteria (e.g., owning a house, car, credit card, or having traveled abroad) required to file tax returns. Empirical data show that these reductions in tax rates significantly improved tax compliance.

As a result, revenues from personal and corporate income taxes increased, despite the lower tax rates. A voluntary disclosure scheme was introduced in 1997-98, allowing tax defaulters to pay their due taxes without penalties. For corporate income taxes, the rates were reduced progressively for both domestic and foreign companies, to 35% and 48%, respectively. The dividend tax at the individual income tax level was abolished. However, little progress was made in broadening the corporate tax base, as tax preferences and exemptions for certain sectors (e.g., housing, tourism, infrastructure, software development, etc.) led to many companies benefiting from "zero-tax" status. To address this, a Minimum Alternative Tax (MAT) was introduced in 1997-98 to ensure that companies paid at least a minimum level of tax. In terms of tariffs, both average and peak tariff rates were dramatically reduced. The unweighted average nominal tariff was 125% in 1990-91, and the peak rate was 355%. By 1997-98, the peak tariff rate had dropped to 40%, and the average tariff rate was around 25%. Further reductions are planned to bring India's tariff levels in line with those in Southeast Asian countries over the next five years. Despite efforts to reduce rate differentiation, the number of tariff rates remains high, and the variations have, in some cases, increased. This has created strong incentives for the assembly of consumer durables and luxury items. There has also been significant progress in simplifying and rationalizing union excise duties. The number of rates was reduced, and the tax was increasingly converted from a specific tax to an ad valorem tax for most commodities. The introduction of the Modified Value Added Tax (MODVAT) allowed for input tax credits on excise duties, which has been extended to almost 80% of the goods covered by excise duties.

The base of the tax was broadened by removing exemptions and levying excise duties at the lowest rate of 8%. Additionally, measures were introduced to simplify the small-scale sector's tax burden, and the government reduced the availability of MODVAT credit to 95% to curb misuse. Another key reform since 1991 was the introduction of a selective tax on services. Although the Constitution does not assign this tax base specifically to either the center or the states, the central government used its residuary powers to impose a service tax starting in 1994-95. Initially covering just three services (telephones, non-life insurance, and stock brokerage), the service tax base has since expanded to include a wide range of services, such as transport, car rentals, air travel agents, consultants, real estate, and security services. Efforts to improve the administration and enforcement of taxes have also been significant, though full implementation has lagged. In addition to introducing periodic amnesties, measures have been taken to reduce tax arrears through simplified assessments. Many pending cases have been resolved through out-of-court settlements, and special tax courts have been proposed to handle tax disputes. With assistance from the Canadian International Development Agency (CIDA), the government has initiated a program to computerize tax returns and develop a management information system.

5. CONCLUSION: IMPLICATIONS AND CHALLENGES

The economic crisis of 1991 led to a significant drop in revenues. While the tax reforms were designed to be revenue-neutral, the reduction in tax rates naturally resulted in lower revenues. Since the tax base did not increase in proportion, the overall revenue trend declined. The tax-to-GDP ratio, which was over 16% in 1990-91, sharply dropped to below 14% by 1993-94. Though there has been some improvement since then, the ratio remains under 15%, which is still a concern (India 1994). Thus, while the reforms aimed to maintain revenue levels, they initially led to a loss, though it was expected that revenues would recover in the years following. Despite significant cuts in both individual and corporate income tax rates, tax revenues have increased considerably. The share of revenue from direct taxes has grown both as a percentage of GDP and total tax revenue. Direct taxes, which accounted for less than 14% of total revenue in 1990-91, surged to 24% by 1997-98. However, it remains unclear how much of this increase can be attributed to higher public sector wages following the implementation of pay commission recommendations, improvements in compliance due to lower tax rates, and administrative reforms. The decline in the tax-to-GDP ratio since the reforms can largely be attributed to the lower yield from indirect taxes. A reduction in customs revenue was expected, given the high tariffs that had to be cut drastically. Similarly, excise duties were meant to compensate for the loss in import duty revenue, but this did not occur, and instead, excise revenue declined sharply. Data shows that revenue from import duties as a percentage of GDP fell by 1.3 percentage points, from 3.9% in 1990-91 to 2.6% in 1997-98. The decline in excise duty revenue was even steeper, dropping by 1.5 percentage points from 4.6% to 3.1% in the same period.

Consequently, the share of excise duties in total revenue fell by about 7 percentage points (from 28% to 21%), while customs duties dropped by 6 percentage points (from 24% to 18%). To improve the overall tax ratio, there needs to be a focus on boosting the revenue productivity of domestic indirect taxes. The heavy reliance on import duties for revenue, rather than using them as an instrument of protection, is another issue. It has been argued that the central government lacks an incentive to raise revenue from taxes shared with the states. Under the current fiscal arrangement, the central government shares 87.5% of the personal income tax and 47.5% of union excise duties with the states. This has created a moral hazard, leading the central government to focus on taxes that are not shared. As a result, revenues from taxes shared with the states have declined, while revenues from non-shared taxes have steadily increased (Joshi and Little, 1996). Even after eight years of tax reforms, many challenges persist. The tax-to-GDP ratio has not returned to pre-reform levels, and while income tax coverage has improved, much more needs to be done to capture hard-to-tax groups. Domestic trade taxes have continued to decline, hindering efforts to reduce tariffs, which is necessary for improving allocative efficiency. The design of tariffs needs to be revisited to ensure lower rates and reduced dispersion to align effective rates of protection with policy objectives. Reform of excise duties is still ongoing, and much work remains in simplifying and rationalizing state and local consumption taxes. Moreover, creating a comprehensive management information system and automating tax returns remain essential for improving tax administration. Tax reforms should evolve into a continuous, systemic process rather than being reactive and crisis-driven. For direct taxes, while the revenue ratio has risen, the full potential has not been realized.

Lower tax rates seem to have improved compliance, but much of the increase may be due to public sector wage hikes. The tax base still needs expansion to include hard-to-tax groups, and the number of tax returns has risen from less than 0.5% of the population to over 2%, though this has not resulted in a proportionate increase in revenue. The inability to capture hard-to-tax groups has led to pressure for raising the exemption limit and increasing deductions. Additionally, there is room for rationalizing savings incentives and expanding the coverage of tax deductions at source. In corporate income taxes, the focus should be on broadening the tax base by reducing tax concessions and preferences. However, recent governments have continued to introduce new tax incentives, complicating the system and creating a large gap between nominal and effective corporate tax rates. As companies exploited these concessions, the government introduced a Minimum Alternative Tax (MAT) to ensure a minimum level of taxation, which only further complicated the system. The design of tariffs also needs significant reconsideration. The TRC's recommendation of seven tariff categories, varying by the stage of production, would result in large disparities in effective protection rates. Lower tariffs on necessities and higher rates on luxury items create high levels of protection for certain goods. It is crucial to reduce the highest tariff rate to 15-20% and limit the number of tariff categories to no more than three to help Indian manufacturing become internationally competitive in the medium term.

The most critical challenge in restructuring the tax system is the development of a coordinated consumption tax system. The separate taxes levied by the center (excise duties), states (sales taxes, state excise duties, taxes on motor vehicles, etc.), and local governments (octroi) often fall on the same tax base, resulting in a chaotic and non-transparent system with cascading taxes and price distortions. A dual VAT system, with the center levying a manufacturing-stage VAT and states implementing a destination-based retail VAT, could address these issues. However, neither the center nor the states have made significant progress in this area. For the center, excise duties should be entirely ad valorem, with rate rationalization and systematic tax credits. At the state level, transforming state taxes into VAT will require careful calibration, including rationalizing rates, providing tax credits, eliminating competing incentives, and zero-rating inter-state sales. A significant challenge in implementing a destination-based retail VAT at the state level is that states currently lack the authority to tax services. While the center can tax selected services, neither the center nor the states have complete control over this tax base. A proper Goods and Services Tax (GST) system would require constitutional amendments, but this could provide an opportunity for the central government to encourage states to reduce or eliminate taxes on inter-state sales, facilitating the implementation of a destination-based VAT.

CONFLICT OF INTERESTS

None.

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