UNIVERSITY OF LJUBLJANA

FACULTY OF ECONOMICS

AND

INTERNATIONAL CENTER FOR PROMOTION OF ENTERPRISES

(ICPE), LJUBLJANA

MASTER'S DEGREE THESIS

DIRECT TAX REFORMS IN INDIA- POLICY INITIATIVES AND DIRECTIONS

MANOJ PANDEY

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NEW DELHI, OCTOBER, 2006 **MANOJ PANDEY**

Author’s Statement

I, Manoj Pandey, hereby certify to be the author of this Master’s Degree thesis that was written under mentorship of Prof. Tine Stanovnik and in compliance with the Act of Author’s and related Rights-Para 1, Article 21 I herewith agree this thesis to be published on the website pages of ICPE and the Faculty of Economics.

New Delhi, Date: …………… **Signature: ……………………**

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GLOSSARY OF ABBREVIATIONS

AIR	Annual Information Return
Assocham	Associated Chambers of Commerce and Industry of India
CAG	Comptroller and Auditor General of India
CBDT	Central Board of Direct Taxes
CIB	Central Information Branch
CPLGS	Central PAN Ledger Generation System
DG	Director General
EET	Exempt Exempt Taxed
ERACS	Electronic Return Acceptance and Consolidation System
FBT	Fringe Benefit Tax
FRBM Act	Fiscal Responsibility and Budget Management Act
GDP	Gross Domestic Product
Govt.	Government
GST	Goods and Services Tax
IMF	International Monetary Fund
LIC	Life Insurance Corporation of India
MAT	Minimum Alternate Tax
MoU	Memorandum of Understanding
MP	Member of Parliament
No.	Number

NZ	New Zealand
NCC	National Computer Centre
NHB	National Housing Bank
NSDL	National Securities Depository Limited
OECD	Organization for Economic Co-operation and Development
OLTAS	Online Tax Accounting System
PAN	Permanent Account Number
P&V	Personnel and Vigilance
Re.	Republic
RIN	Risk Intelligence Network
Rs.	Indian Rupee
STT	Security Transaction Tax
TCS	Tax Collection at Source
TDS	Tax Deduction at Source
TEE	Taxed Exempt Exempt
TES	Tax Expenditure Statement
TIN	Tax Information Network
ULIP	Unit Linked Insurance Plan
UTI	Unit Trust of India
VDIS	Voluntary Disclosure of Income Scheme

UNITS OF MEASUREMENTS

1 Lakh	=	100,000
1 Million	=	10 Lakh
1 Crore	=	10 Million
1 Billion	=	1000 Million

Chapter - 1

Introduction

Taxation plays a critical and pivotal role in the process of advancement and growth of any country. Objectives of the tax policy of any country are akin to its general economic policy. Taxes constitute major sources of revenue for the government. Taxes are levied so that investment is made in the resources to enable a country to develop, grow and make progress. A sound tax system is vital for development of the public finances of any country. The main objectives of tax policy can be said to be allocative, distributional and stabilizational (Musgrave, 1973, p.6-21).[1] Due to the importance of taxation in fiscal policy, it is often said that economic history of a country is determined by its fiscal history (Schumpeter, 1954, p.7).

India has a three-tier federal structure (the Union Government, the State Governments and the Urban/Rural Local Bodies). The power to levy taxes and duties is apportioned between the Union Government and the State Governments in accordance with the provisions of the Indian Constitution. The State Government may further delegate any of its fiscal powers to local authorities. Tax system in India comprises of direct taxes as well as indirect taxes[2]. Except for land revenue and agricultural income tax, all other direct taxes are levied and collected by the federal government. At the federal level, Central Board of Direct Taxes (CBDT) has been given responsibility of all matters relating to various direct taxes in India and the Board derives its authority from Central Board of Revenue Act, 1963.

1.1 Description of the problem

In view of various changes within and outside, developing countries implemented a series of economic reforms during the 1980s and the 1990s. During these decades, re-assessment of the role of the government in economic development took place, which led to a shift in favour of assigning a greater role to the private sector including foreign enterprises. This necessarily required re-examination of the structure of tax systems. The impetus for reform

[1] Allocative function of tax policy is linked with the process by which utilization of resources is divided between private and social goods. Distributional function concerns distribution of income and wealth and stabilization policy is related to a set of policies for maintaining high employment, a reasonable degree of price stability and an appropriate rate of economic growth.

[2] While direct taxes mainly consist of personal income tax, corporation tax, wealth tax, land revenue and agricultural income tax, indirect taxes comprise mainly of customs, union excise duties, service tax, state excise duty, stamp and registration fees, sales tax, taxes on vehicles and entertainment tax.

in tax system came primarily from the need to raise additional revenues to deal with the problem of continuing and in some cases, rising deficits, but since structural reform of the real sector of the economy was also being attempted, efficiency considerations were also an important cause (Chelliah,1996, p.82). While it was felt that there is a need to raise revenues to fund the activities of the government, economists were also tasked with figuring out how to design a revenue system that is both efficient and equitable (Ulbrich, 2003, p.158).

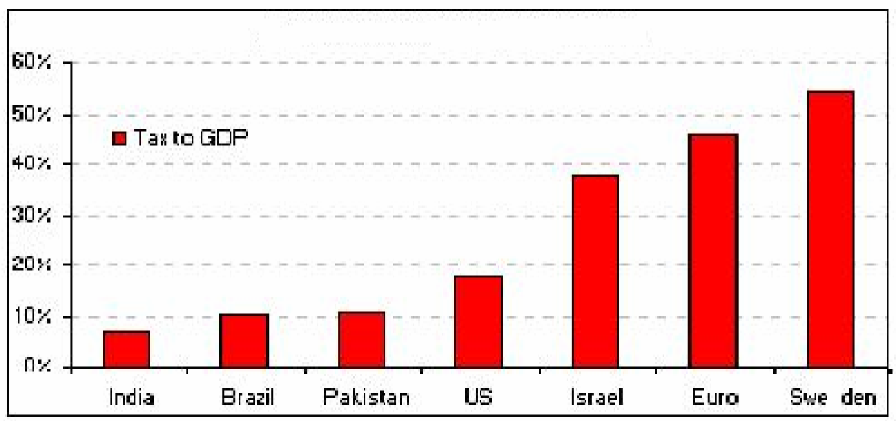
India too launched a series of programmes of economic policy reforms in 1990s. Reforms were primarily undertaken in response to fiscal crisis it faced in 1991 and aimed to attain macro-economic stability. Genesis of economic reforms lies in problems that had slowed down the process of economic development in India in late 1980s and 1990s. By mid-1991, India's foreign exchange reserves had declined to just two weeks of import coverage. Public debt had reached monstrous level. The debt service burden rose from 10% of current account receipts and 15% of export earnings in 1980-81 to 22% of current account receipts and 30% of export earnings in 1990-91. Rising fiscal deficits and monetization of a substantial portion of it led to inflationary pressures and to growing deficit in the current account of the balance of payments which became prime mover for change.

Restructuring the tax system at federal level was central to the entire process of economic reforms. Direct tax reforms at federal level formed key component of wider reforms in fiscal and economic sector. Like in other developing countries, in India also the tax reforms aimed at correcting fiscal imbalances (Ahmed and Stern, 1991, p.1). Post-1991, tax reforms in India were clearly in response to the fiscal difficulties that emerged in the late eighties and reached crisis proportion by 1991 (Sreekantaradhya, 2000, p.17). Objectives behind these reforms, to put in the words of Bagchi (1998, p.313), were two fold: one, to reduce the dependence on foreign trade taxes and orient the tax structure towards an open and competitive economy by removing its inefficiencies and second to improve the buoyancy of the tax revenues on a sustainable basis so that the current budgets of the government could be balanced and eventually yield some surpluses to finance public investments. One of the factors, which motivated tax reforms, was the desire to maintain or enhance international competitiveness as more and more developing countries sought to participate in the process of globalization (Islam, 2001, p.1). It was realized that fiscal and monetary options were no longer driven by domestic compulsions alone; they had to broadly conform to certain internationally acceptable norms of what constitutes the sound fundamentals of an open and competitive economy (Reddy, 2002, p.281).

On the recommendations of Tax Reforms Committee constituted in 1991 under Chelliah, several policy initiatives were taken in the direction of federal tax reforms in 1990s.

However, fiscal problems in India are still far from over. The revenue deficit instead of declining rose to 4.4.% in 2002-03 from 3.3.% in 1990-91. There has been decline in overall tax-GDP ratio in comparison to tax - GDP ratio in late 1980s. The central tax- GDP ratio, measured using central gross taxes peaked at 10.6% in 1986-87. It dropped to 8.8.% in 1993-94 and to 8.3% in 1998-99. Although it rose up to 9.3% in 2003-04, yet tax-GDP ratio is still very low in India. While countries like Sweden have a tax- to- GDP ratio as high as 54%, Indian tax –GDP ratio is amongst the lowest. Among the developing countries too, India's tax to GDP ratio is not very encouraging as is evident from Figure-1.1 .

Figure-1.1: Tax-GDP Ratio : A Cross Country Comparison



Data Pertains to Federal/Central Government tax collection

Source: (www. Equitymaster.com, June 8, 2004)

In order to address these problems the government constituted two Task Forces under Dr. Kelkar to look into various aspects of direct and indirect taxes and suggest reforms. Fiscal Responsibility and Budget Management (FRBM) Act has been enacted by the Central Government, which has become effective from 5th of July, 2004. The FRBM Act aims at reduction of revenue deficit by an amount equivalent of 0.5% or more of GDP at the end of each year, beginning with 2004-05. Following the enactment of FRBM Act, a Task Force was constituted under Dr. Kelkar to draw medium term frameworks for fiscal policies to achieve FRBM targets. The Task Force among other things proposed sweeping reform measures in tax system including removal of tax exemptions and simplification of tax procedures to wipe out revenue deficit and lower fiscal deficit to less than 3.0 per cent of GDP by 2009.

The fiscal adjustment path shown by the Task Force is basically revenue led. Outlining the urgency of tax reforms, the Finance Minister of India in his Budget Speech for financial year 2004-05 informed the Parliament, ' It is government's intention, as announced by the Prime Minister to undertake major tax reforms to improve tax- to-GDP ratio, expand the tax-payer base, increase tax compliance and make tax administration more efficient.' Various stakeholders have also started pushing for reforms in tax system. Associated Chambers of Commerce and Industry of India (Assocham) have called for more reforms stating that the government needs to enhance its tax-GDP ratio to over 15% in order to help tide over its major public finance crisis (The Financial Express, Net Edition, 4th of January,2006).The Economic Survey of India 2005-06, has put a great emphasis upon further reforms and raising tax-GDP ratio stating that it is critical to raise the tax-GDP ratio to 13% by 2008-09. Apart from high growth in GDP, it envisages increase in revenue by deepening the tax reforms through wider taxpayer base, withdrawal of tax exemptions, moderate tax rates, reliance on voluntary compliance with an effective penal mechanism and simplification and digitisation of tax administration.

Although tax-GDP ratio has declined in 1990s when the reform process was initiated, it is not that strategy of tax reforms has not worked. The decline in tax-GDP ratio is partly due to the 'costs of reforms' reflecting reduction in customs and excise duties to increase competition and enhance efficiency. At the same time, it also reflects costs of incomplete reforms (World Bank, 2003,p.23). As far as direct taxes are concerned, strategy of reforms appears to be working well .

As against 1.9% of GDP in the year 1990-91, direct taxes contributed around 4.4% of GDP in the year 2004-05. Share of direct taxes in the total tax revenue of the centre has gone up from 19.15 % in 1990-91 to about 45% in the year 2005-06. Thus, over the years the government has been quite successful in raising direct tax revenues. The trend is expected to continue in the future as well. Rate of growth of direct taxes has been found to be higher than rates of growth of GDP at current prices. Direct taxes are seen to be significantly buoyant while indirect taxes and total taxes show at most unit buoyancy. Increase in the share of direct taxes and decline in the indirect taxes clearly indicates that the strategy of tax reforms followed since 1991 is basically working (Bajpai, et al, 1999, p.107). Sreekantaradhya (Deccan Herald, March 19, 2005) views this phenomenon as India maturing into a developed country with a modern tax system, wherein the ratio of the revenue generated from direct taxes is more than that of indirect taxes. Table-1.1 shows the trend of increasing contribution of direct taxes in overall tax collection since reforms.

Table -1.1 : Growth Rates and Buoyancies

Major Taxes

	Direct Taxes			Indirect Taxes	
	Gross Tax Revenue	Corporation Tax	Other Income Tax	Customs	Excise Duties
Growth * Rate (%)	10.29	18.16	13.64	2.79	10.28
Buoyancies @	0.95	1.72	1.39	0.18	0.92

* Growth rate computed over 1996-97 to 2004-05 @ Buoyancies computed over 1996-97 to 2003-04

Source: Karnik Ajit, Impressive Grandstanding but Empty Coffers, Economic and Political Weekly, Vol XL, No 14,April 2-8, 2005.

Steps have been and are being taken to improve direct tax structure, increase direct tax collections and bring efficiency and efficacy in direct tax administration. Although significant steps have been taken, yet much more is to be done in the area of direct tax reforms. Foremost problem in taxation system is too large a dominance of a complex and obsolete indirect taxation. Direct taxes still are in an infant state; both as weight as well as structure (Bernardi, et al, 2005, p.1). Share of direct taxes as a percentage of GDP and also in the total gross revenue of the centre has to go up from the present existing level as has been envisaged in Report of Task Force on Implementation of FRBM Act, 2003. The Task Force has projected that if reforms proceed in right direction as suggested by it, by FY 2008-09 direct taxes as percentage of GDP would go up to 6.46% from the present level of around 4.4%, taking the overall total tax-GDP ratio to 12.96% of GDP from around 9.3 % in FY 2003-04 at federal level. Since the policy of tax reforms aims at increasing the share of direct taxes in the total tax revenues at the centre, it is necessary to find ways to improve direct tax collections so that tax-GDP ratio goes up and objective of reining in huge fiscal deficit and public debt is met.Concern has been expressed relating to eventual monetization of persistent deficits which have potential inflationary consequences. Concern has also been expressed that rising public debt burden may relate to the insolvency or bankruptcy of national exchequer (Buiter and Patel, 1994, p.94-95). To strengthen and support the overall economic reforms initiated in 1991, further reforms in the area of direct tax are urgently called for.

Tax structure in most developing countries is complex, inelastic, inefficient, inequitable and quite simply unfair (Shirazi and Shah, 1991, p. 459-71). The tax system in India is also no different. The direct tax reforms in India, therefore, should aim at removing the complexities in the tax structure and formulating a suitable policy of tax incentives and evolving a tax system, which is just and fair and as simple as possible. While legislative measures are required to bring necessary and required changes in direct tax structure, improvement in tax administration also assumes great importance in the entire context of reforms. It is also necessary that tax reforms grant more autonomy to the tax administration. To operate a tax administration effectively requires that chief executives have some autonomy over the setting of organizational goals and recurrent operations vis-a-vis the political system and donors. Obviously, it needs 'adequate' resources, too, without which autonomy has little practical meaning (Odd-Helge Fjeldstad Lise Rakner, 2003, p.1).Tax policy is dependent on design of the tax system to be achieved, mechanics to achieve it and implementation strategy which depends on the political support and nature of administration. Any policy for further reforms must take into account all these aspects.

1.2 Purpose of the thesis

In backdrop of above, the thesis endeavours to analyse various policy initiatives taken so far in the realm of direct tax reforms in India at federal level and give a systematic approach to the question how to augment tax-GDP ratio by ushering further reforms in direct tax system. Among other things, the thesis has an intention to initiate broad discussions regarding need for more reforms in the federal direct tax structure in India which shall provide more resources to the government. Following aspects are examined in the thesis:

i) Reform measures taken so far and ways by which reform process in the area of direct tax at federal level may be taken forward.

ii) How share of direct taxes in total revenue be enhanced at the federal level and ways be found to improve collections so that overall tax-GDP ratio goes up?

iii) How to remove complexities in the tax structure to make it as simple as possible in the overall context of tax reforms?

iv) What measures may be initiated to expand taxpayer base, widen the tax-net and increase compliance in the overall strategy of tax reforms?

v) How to bring improvement in federal direct tax administration to make it more efficient and effective?

1.3 Goals of the thesis

Considering the above questions, the endeavour of the thesis is to study comprehensively various dimensions of the possible reforms in the direct tax structure in India and to find out the ways to achieve better direct tax-GDP ratio. The thesis also endeavours, in brief, to analyse the reform measures taken by OECD countries in direct tax structure and relevance of those measures in formulation of policy in India. The goal of the thesis is to look into following aspects:

i) Find ways of taking further steps towards reforms in direct tax system in India.

ii) Determine ways to increase share of direct Taxes at federal level and improve direct tax collections in order to boost tax-GDP ratio.

iii) Determine ways to remove complexities in the tax structure to make it simple, fair and transparent.

iv) Find measures to expand taxpayer base, widen tax-net and increase tax-compliance in the overall strategy of tax reforms.

v) Determine measures to improve tax administration in order to make it efficient and effective.

1.4 Methodology of the thesis

In course of preparation of the thesis, exploratory studies have been undertaken. In the ambit of exploratory research strategy, detailed search of the literature has been carried out. Literature review has been performed in order to get secondary data.

Apart from documentary sources viz.-books, journals, reports of various committees constituted to look into tax reforms; multiple sources like area based sources viz.-government reports, budget documents, economic surveys and time-series based sources like statistical reports published by government have also been consulted. Tertiary literary sources called search tools have been used to locate relevant secondary literature. Besides, a questionnaire was administered to 51 taxpayers[3] by adopting random selection method to

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[3] Questionnaire was administered to taxpayers belonging to different categories, viz; salaried employees, small traders and those having income from business.

ascertain the views of the taxpayers on the existing tax system and on-going tax reforms programmes of the government.

1.5 Structure of the thesis

This thesis proposes to include eleven chapters followed by a section on the bibliography. Chapter 1 is the introductory chapter, which provides the description of the problem of low tax - GDP ratio in India and the need for direct tax reforms to augment tax revenues for the government. It also states the purpose, the goal and the methodology of the thesis. Chapter 2 discusses the previous initiatives towards direct tax reforms in India. Chapters 3 and 4 contain details of initiatives for reforms in the areas of personal income taxation and capital gains taxation respectively. Chapter 5 focuses upon reforms in corporation tax. In chapter 6, reforms in the areas of taxation on wealth and gift are analysed. While chapter 7 discusses issues pertaining to taxation of agricultural income which at present does not fall under federal tax net; in chapter 8 reforms initiated in OECD countries have been discussed and analysed. Chapter 9 discusses various issues involved in reforms in tax administration. The chapter brings out that effective reforms in tax administration are essential for reforms since tax policy is inextricably linked with tax administration. Chapter 10 contains major findings and recommendations which have evolved through the process of review and analysis undertaken in earlier chapters. Finally, chapter 11 contains the conclusions of the thesis.

Chapter - 2

HISTORY OF DIRECT TAXATION IN INDIA AND PREVIOUS INITIATIVES FOR REFORMS

2.1 History of direct taxation

It is generally believed that taxes on income and wealth are phenomena of modern days. However, there is enough evidence to show that taxes on income in some form or the other were levied even in ancient days in India. There are references in ancient scriptures like Manu Smriti and Arthashastra to a variety of taxes. About taxes prevalent in Ancient India, Sarkar (1978, p.78) has observed that the admixture of direct taxes with indirect taxes secured elasticity in the tax system, although more emphasis was laid on direct tax. In modern days, income tax was introduced for the first time in India in 1860 when India was a colony of Britain. The organisational history of the Income Tax Department dates back to the year 1922. The Income Tax Act, 1922 gave for the first time a specific nomenclature to various income tax authorities and laid the foundation of a proper system of administration. In independent India, till the year 1961, direct taxes were administered as per provisions of Income Tax Act, 1922.

2.2 Reform measures in direct tax system after Independence till 1991

Structure of direct taxation in India underwent fundamental changes since independence. To study and investigate direct taxes in independent India, Income-tax Investigation Commission headed by Sir Srinivasa Varadachariar was constituted under the Taxation on Income (Investigation Commission) Act, 1947. The Commission gave its report in December 1948 and made a number of recommendations to plug loopholes for preventing tax evasion and tax avoidance and also to simplify various provisions of law and procedures. Based on the Commission's recommendations, a comprehensive Income-Tax (Amendment) Act, 1953 was passed.

First initiative to bring improvement in the tax system was made by Taxation Enquiry Commission of 1953-54 constituted under Dr. John Mathai. Taxation Enquiry Commission was appointed not only to study the structure of taxes on income but also to carry out an in depth study of the central taxes and their administration. The Committee also looked into ways of improving the income distribution through progressive taxation. The government did not find the major recommendations of the Commission regarding taxation on agricultural income and treating the family as a unit of assessment acceptable. However, its recommendations for reducing the exemption limit, increasing the tax rates and introduction of development rebate were duly implemented.

Thereafter, studies were made by famous economist Nicholas Kaldor to suggest reforms in Indian Tax system. Kaldor Committee submitted its report on the Indian Tax reform in 1956. Kaldor recommended the broadening of the tax base through the introduction of an annual tax on wealth, the taxation of capital gains, a general gift-tax and a personal expenditure tax. For reducing the scope of tax evasion, Kaldor Committee suggested the introduction of the institution of a comprehensive tax return for all direct taxes and the introduction of a comprehensive reporting system on all properties transferred and other transactions of a capital nature. The Committee was of opinion that rates should be lowered and that maximum rate of income tax should not be more than 45%. The recommendations of Kaldor for introduction of new taxes were accepted and taxes on expenditure, capital gains, wealth and gifts were introduced in direct tax system in India. Kaldor's suggestions for reducing the tax evasion and tax avoidance were referred for consideration to the Direct Taxes Administration Enquiry Committee.

Direct Taxes Administration Enquiry Committee was set up in June 1958 to advise the government on the administration, organisation and procedures necessary for implementing the integrated scheme of direct taxation. Its mandate was also to study the need for eliminating tax evasion and avoiding inconvenience to the assessees. It was chaired by Sri Mahavir Tyagi, M.P. and was popularly known as 'Tyagi Committee'. The Committee was of view that augmentation of revenue should be the primary purpose of tax policy. In the year 1956, the Law Commission was asked to revise the Indian Income-Tax Act, 1922. The Commission's recommendations became the basis for the enactment of the Income-Tax Act, 1961 (the existing Act for direct tax administration) while the earlier Act of 1922 was repealed.

After Tyagi Committee, Committee for Rationalisation and Simplification of Tax Structure was constituted under Bhoothalingham, which submitted its report in 1967. Amongst others, the Committee suggested measures for rationalization and simplification of personal income tax and corporation tax. The Committee also suggested donee based gift tax.

Direct Taxes Enquiry Committee set up in 1971 under Wanchoo carried out major study in the area of direct taxes. The Committee looked into aspects of tax evasion and accumulation of black money. The Committee was of view that factors like high tax rates, controls and licences, ineffective information were major problems in Indian direct tax system. The Committee also opposed voluntary disclosure as a means of controlling the growth of black money. In place of voluntary disclosure, it favoured more stringent measures of enforcement mechanisms like searches and seizures. Later on Committee on Taxation of Agricultural Wealth and Income (1972) was constituted under K.N.Raj to explore ways to bring agricultural income and wealth to tax. The Committee under K.N.Raj suggested several options in this direction. One of them was to bring agricultural income under income tax net through integrated system of agricultural and non-agricultural income[4]. Major step towards tax reforms were taken in 1985-86 when Long Term Fiscal Policy was launched. Under this policy, tax rates were lowered and attempts were made to rationalize tax incentives. However, it was only after 1991 that significant reform measures were initiated.

2.3 1991 - A watershed in tax reforms

During late 1980s and 1990, tax systems witnessed significant changes, as many countries cutting across ideologies and varying levels of development initiated reforms. Besides efficiency considerations, these tax reforms had to address the issue of replacing public enterprise profits with taxes as a principal source of revenue and aligning tax policy to change the development strategy. The supply side tax reforms of the Thatcher-Reagan era also was guiding force in initiating tax reforms in developing countries. Tax reform as a component of broader fiscal reforms was at the heart of the stabilization and adjustment process in many developing countries (World Bank, 1991, p, 1). However, as has been stated by Rao (2005 , p.4) unlike most developing countries, which were guided in their tax reforms by multilateral agencies, Indian tax reform attempts have largely borne a domestic brand.

Indian Tax system, which evolved to conform to the public sector dominated import substituting industrialization for almost 45 years after independence had to be reformed to facilitate liberalised open economy (Rao, 2005, p.1). Indian tax system, before the reforms were undertaken, was characterized by: (1) a high dependence on indirect taxes, (2) low average effective tax rates and (3) high marginal effective tax rates and large tax-induced distortions on investment and financing decisions. Therefore, reforms undertaken by India aimed at improving fiscal consolidation, lowering the marginal tax burden and reducing tax-induced distortions. Besides, these reforms also aimed at creating a stable and predictable market environment. The reforms represented a major break from the 'inward-oriented, state directed, public-sector driven' approach pursued since independence. Collapse of Soviet Union and the spectacular growth of China after its opening up in 1978

[4] Due to practical difficulties the Committee however ruled out this option. Even today, agricultural income is not under tax net of federal government.

played a major role in disenchantment with the earlier development strategy (Srinivasan , 2000).

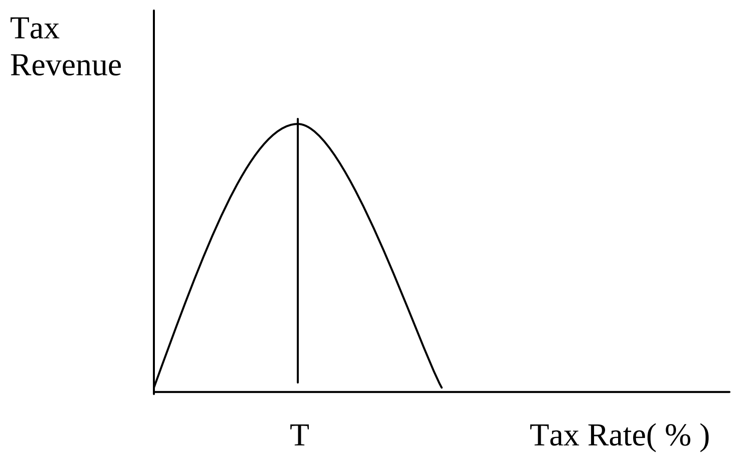
There has been a change in the philosophy of tax reform over the years. This is result of the changing perception of the role of the state. There is emphasis upon minimizing distortions in tax policy, which implies reduction in the marginal rates of taxation with a view to keeping the economy competitive. Further, it is also observed over the years that there has been a shift from vertical equity in which both direct and indirect taxes are subject to high marginal rates with minute differentiation in rates to horizontal equity in which the taxes are broad-based, simple and transparent, and subject to low and less differentiated rates (Rao, 2000, p.60).

Conventionally, at least three different models of tax reform may be found in existence. One important model studying the philosophy of taxation and which focuses on the design of a tax system is optimal taxation. Optimal tax theory encompasses a range of models that focus on particular aspects of the tax system. However, all these different models share three features. First, each model specifies a set of feasible taxes for the government such as commodity taxes and the government's revenue needs. Second, each model specifies how individuals and firms respond to taxes. Third, each model states that the government has an objective function for evaluating different configurations of taxes. In the simplest of the models, the government's objective is seen as minimizing the excess burden generated by the tax system while raising a set amount of revenue. Ahmad Ehtisham and Nicholas Stern are among the proponents of this model.

The second model propounded by Harberger (1990), draws much more on practical experience. According to this model, while efficiency is clearly desirable in the design of tax policy, administrative capability is equally important. The principal concern according to this approach is to design a system that will minimize tax-induced distortions and at the same time be administratively feasible and politically acceptable. It has been suggested in the model that tax reformers should pay less attention to the economic methodology and more to the best practice experiences.

Another model in the field of tax policy is the supply-side tax model (SST). The model emphasises the need to broaden the base with minimal exemptions and preferences and to have low marginal tax rates. There are two versions of supply-side tax policy. One propounded by theoretical supply side economists and the other given by popular supply-side economists. While the former lays emphasis upon reform of the tax system in all its aspects, the latter lays emphasis upon reform of the taxation in particular, especially by reducing the top marginal tax rates. The best exponent of this view is Arthur Laffer who has suggested that beyond some tax rate, higher tax rates will shrink the tax base so much that revenues will actually decline. Laffer curve supposes that for a given economy there is an optimal income tax level to maximize tax revenues. If the income tax is set below this level, raising taxes will increase tax revenue. And if the income tax level is set above that level, then lowering taxes will increase tax revenue.

Figure -2.1: **Tax Revenues and Tax Rates Represented by Laffer curve**



Recent reform approaches in India combine elements of all three models discussed above (Rao, 2000, p.61). These incorporate both theory and past reforms experiences and take into account administrative, political and information constraints in designing and implementing reforms. The recent approach takes into account that a broader base requires lower rates to be levied to generate a given amount of revenues. It also takes into account that broadening the tax base helps to ensure horizontal equity. Based on the approach to reforms as discussed above, post-1991 tax reforms in India aimed at restructuring the direct tax structure for increasing the share of direct taxes in the total revenue of the centre.

Tax reforms Committee constituted under Dr. R.J. Chelliah in response to new economic policy initiated in 1991 came out with new tax proposals which basically aimed at supply-side tax policy with a view to broadening the tax base and rationalising rates of not only income tax but also of other taxes so as to remove all tax related distortions. Apart from raising the share of direct taxes in the total revenue, tax reform measures also aimed at improving tax buoyancy. After Chelliah Committee, Advisory group on Tax Policy and Tax Administration constituted by Planning Commission of India in 2001 under Dr. Parthasarathi Shome also gave their valuable recommendations to the government on tax reforms. Significant recommendations were made by Task Force constituted under Dr.

Vijay Kelkar in 2002 to examine various issues involved with direct tax structure and direct tax administration.

2.4 Objectives of direct tax reforms since 1991

In 1980s the taxation system in India faced problems of inadequate tax revenue and regressive tax structure as it leaned too heavily upon indirect taxes. Further, tax evasion crippled revenue yield. High marginal rate of taxation was eroding the capacity and sapped the incentive to save and invest. There was lack of horizontal equity as well as vertical equity. Recognizing that tax policy is an important determinant of the efficiency, equity and quantity of available public resources, debates on Indian tax policy have sought to grapple with three major issues a) adequacy of the tax base and efforts b) the efficiency of the tax structure and c) the incentive and equity effects of the tax policy (Rathin, 1978, p.336). Tax reforms initiated in India after 1991, like in any country, aim at meeting multifarious objectives. First and foremost, as has been discussed before, tax reforms attempt to boost the collection of tax revenues with the purpose of meeting growing expenditure and bringing down the fiscal deficit.

Second, reform process underlines the philosophy that there should not be too frequent discretionary changes in tax rates and that objective of higher tax-GDP ratio must be achieved without raising the tax rates as such. The policy of tax reforms pursued since 1991 aim at lowering the tax rates and broadening the tax base with the idea that better compliance would lead to higher revenue realization.

Third, the reforms also consider that inappropriate tax system may cause distortions leading to inefficiency. If the tax were less discretionary, then it would be possible to minimize the efficiency cost. Welfare of a taxpayer may be reduced due to the loss of income as a result of heavy tax leading to what is called a “substitution effect.[5] (Sreekantaradhya 2000, p. 9).Thus, the reforms aim at minimizing the efficiency cost of taxation[6].

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[5] When the tax burden rises with the increase in income, after a certain point taxpayer might feel that the after-tax income is not high enough to compensate for the extra effort to be put in to earn that income and consequently he might prefer leisure to work. One job or one form of business may be substituted for the other.

[6] Efficiency cost or excess burden is the difference between the resources that the Government gains and the sacrifice that is made by the taxpayers (World Bank, Lessons of Tax Reform, Washington, D.C., 1991, p.22).

Fourth, tax reforms aim at evolving a tax system with an appropriate policy of tax incentives. Although steps have been taken towards rationalisation of incentives, there is a necessity of reviewing the incentives from time to time to re-justify their continuance. It is required that those incentives which have outlived their utility must be phased out.

Equity has been taken as an important objective of recent tax reforms. The connotation of this is that direct tax system should be designed in such a way that the burden to the taxpayers is related to their ability to pay. Further, there is justice or fairness in taxation, which can be ensured through horizontal and vertical equity[7].

Sixth, objective of the tax reform is also to make the tax system as simple as possible. Tax laws are, by their very nature, very complex and the taxpayers are unable to comprehend them. The procedures to be followed in meeting the tax liability are also quite often very complex and it is very difficult for the taxpayer to comply with the requirements. This gives room for litigation and harassment. Thus, tax system must be very simple.

Seventh, reforms also take into account the fact that if the economy of a country is to be integrated with the rest of the world and if foreign investment is to be attracted, tax level and structure will have to be more or less similar to what is prevailing in other countries.

Success of any attempt to reform the tax system depends upon the efficiency of the system of tax administration and therefore, tax reforms also aim at improving the tax administration. It is empirically proved that no amount of reforms can serve the purpose unless they are accompanied by efficient administration .

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[7] Fairness in taxation depends upon how the rich and the poor are treated which is called vertical re-distribution and how those who are equally rich or poor are treated, i.e. horizontal re-distribution.

Chapter -3

REFORMS IN PERSONAL INCOME TAX

3. 1 Rationale for taxation on income and its features in India

Tax on personal income is considered as fair basis of taxation in developed as well as developing economies. Acceptance of personal income as an important tax base is based on the premise that an individual's income reflects in true sense one's ability to contribute to the exchequer. Tax on personal income is also related to nation's economic performance. Receipts from the individual income tax tend to rise more steeply in economic booms and drop more sharply in recessions as individual income itself is quite sensitive to changes in the level of overall economic activity. Furthermore, tax on personal income in most of the cases is regulated by a progressive rate structure. Result of progressive rate structure is that a rise in individual income creates additional income taxable at a higher rate. Conversely, a drop in individual income causes some taxpayers to be taxed at a lower rate. Personal income tax takes into account needs of taxpayers, is adaptable to progressive rates and its yield can also be elastic.Due to these reasons, tax on personal income has a great appeal.

Personal income tax in India has schedular features as it makes distinction between different sources of income e.g. income from agriculture is excluded from taxation and capital gains are taxable at a different rate although the incidence of income tax falls upon all non-agricultural incomes such as salaries, income from property, investments, business and profession or vocation, income from other sources etc.

3.2 Shortcomings in income tax system in India

Indian personal income tax system was plagued by a number of deficiencies which necessitated reforms. It suffered from low yield, extremely limited coverage and low level of compliance. Contribution of personal income tax to the total revenue of the Union Government was quite dismal. In 1990-91 the personal income tax constituted only 9.3 % of total revenue of the Central Government and as percentage of GDP it was only 0.94% of GDP in 1990-91. Although there is some improvement in yield, coverage and compliance since 1991 when reforms measures were initiated, as percent of total gross revenue of the Union Government contribution of personal income tax still was only 16.2% in 2004-05. As percentage of GDP, the share of personal income tax stood at 1.58 % of GDP in 2004-

05. Table 3.1 exhibits details of share of personal income tax in the total revenue of Central Government.

Table - 3.1 : Sources of Tax Revenues (Rs. In Crore)								
	1990-91 Actuals	**1995-96 Actuals**	**2000-01 Actuals**	**2001-02 Actuals**	**2002-03 Actuals**	**2003-04 Actuals**	**2004-05 (Prov.)@**	**2005-06 BE**
Personal Income Tax	5371	15592	31764	32004	36866	41379	48312	66239
Corporation Tax	5335	16487	35696	36609	46172	63562	83566	110573
Customs	20644	35757	47542	40268	44852	48629	57655	53182
Excise	24514	40187	68526	72555	82310	90774	99155	121533
Service Tax	--	862	2613	3302	4122	7891	14200	17500
Taxes as percentage of GDP*								
Direct(a)	1.9	2.8	3.2	3.0	3.4	3.8	4.2	5.0
Personal Income Tax	0.9	1.3	1.5	1.4	1.5	1.5	1.5	1.9
Corporation Tax	0.9	1.4	1.7	1.6	1.9	2.3	2.7	3.1
Indirect(b)	7.9	6.5	5.6	5.1	5.4	5.3	5.5	5.4
Customs	3.6	3.0	2.3	1.8	1.8	1.8	1.8	1.5
Excise	4.3	3.4	3.3	3.2	3.4	3.3	3.2	3.4
Service Tax	0.00	0.1	0.1	0.1	0.2	0.3	0.5	0.5
Total#	10.1	9.4	8.9	8.2	8.8	9.2	9.8	10.5
Taxes as percentage of Revenue								
Direct(a)	19.1	30.2	36.2	37.0	38.4	41.3	43.3	47.9
Personal Income Tax	9.3	14.0	16.8	17.1	17.0	16.3	15.8	17.9
Corporation Tax	9.3	14.8	18.9	19.6	21.3	25.0	27.4	29.9
Indirect(b)	78.4	69.1	62.9	62.1	60.7	57.9	56.1	51.9
Customs	35.9	32.1	25.2	21.5	20.7	19.1	18.9	14.4
Excise	42.6	36.1	36.3	38.8	38.1	35.7	32.5	32.8
Service Tax	0.0	0.8	1.4	1.8	1.9	3.1	4.7	4.7
@ Provisional and unaudited as reported by Controller General of Accounts, Department of Expenditure, Ministry of Finance								
# includes taxes referred to in (a) and (b) and taxes of Union Territory and 'other taxes'								
* refers to Gross Domestic Prices at current Market prices								
Notes 1: Direct taxes also include taxes on expenditure, interest, wealth, gift and estate duty								
Source : Economic Survey, Ministry of Finance, Government of India, 2005 - 06, p.27								

If the contribution of personal income tax in total tax revenues in India is compared with that of OECD countries, it is found that it is very low. Table-3.2 below shows the share of personal income tax in total revenue of OECD Countries.

Table-3.2: Taxes as percentage of GDP among OECD countries

Country	Personal Income	Social Contributions	Corporate/ Profits	Value Added	Excises	All Taxes- All Levels	Distance from OECD Average
Australia	12.3	-	4.5	4.0	4.4	30.1	-6.8
Austria	10.4	14.9	3.1	8.2	3.4	45.4	8.5
Belgium	14.5	14.4	3.6	7.2	3.3	45.8	8.9
Canada	13.0	5.1	3.5	5.1	3.1	35.1	-1.8
Czech Rep.	4.8	17.1	4.2	6.9	4.0	38.8	1.9
Denmark	26.3	2.2	3.1	9.7	5.4	49.8	12.9
Finland	14.1	12.4	4.9	8.5	4.7	46.1	9.2
France	8.0	16.3	3.4	7.5	3.5	45.0	8.1
Germany	10.0	14.6	0.6	6.7	3.5	36.8	-0.1
Greece	5.4	11.4	3.4	8.6	4.4	36.9	-
Hungary	7.6	11.6	2.4	9.9	5.0	39.0	2.1
Iceland	14.5	3.0	1.2	10.1	4.0	36.5	-0.4
Ireland	8.9	4.4	3.6	6.2	3.6	42.0	-7.0
Italy	10.9	12.2	3.6	6.2	3.6	42.0	5.1
Japan	5.5	10.3	3.5	2.4	2.1	27.3	-9.6

Table contd. from page 18

Country	Personal Income	Social Contributions	Corporate/ Profits	Value Added	Excises	All Taxes- All Levels	Distance from OECD Average
Korea	3.8	5.0	3.3	4.7	5.7	27.2	-9.7
Luxembourg	7.2	11.2	7.5	6.1	4.6	40.7	2.8
Mexico	-	3.2	-	3.6	5.9	18.9	-18.0
Netherlands	6.5	14.2	4.1	7.4	3.6	39.5	2.6
NZ	14.5	-	3.8	8.7	1.7	33.8	-3.1
Norway	10.5	8.9	9.4/1	8.1	4.9	43.3	6.4
Poland	7.9	10.2	2.0	7.3	4.7	33.6	-3.3
Portugal	6.0	9.1	3.6	8.1	5.1	33.5	-3.4
Slovak Rep.	3.5	14.4	2.2	7.4	3.3	32.3	-4.6
Spain	6.9	12.6	2.8	6.0	3.5	35.2	-1.7
Sweden	16.4	15.3	2.9	9.1	3.5	51.4	14.5
Switzerland	9.8	7.8	3.1	4.1	2.5	30.6	-6.3
Turkey	7.7	7.2	2.4	8.1	5.5	36.5	-0.4
United Kingdom	11.3	6.3	3.5	6.8	4.4	37.3	0.4
USA	12.2	7.1	1.9	-	1.8	28.9	-8.0
OECD (Avg. uweighted)	10.0	9.4	3.5	6.9	4.0	36.9	

Source : OECD Statistics (1965-2002) .Tax Administration in OECD Countries : Comparative Information series (2004), p.63.

The above details clearly show that personal income tax in India faces problem of low yield. In addition, it is also associated with the problem of limited coverage. At present out of a population of around 1.1 billion, less than 3% of the population is covered under income tax net. There are a number of factors, which explain the problem of limited coverage. First, agriculture sector is outside the personal income tax net. Second, the tax department has not been able to fully cover small and unorganized businesses. It is estimated that ten million men and women work as street hawkers and vendors. Organized sector of the economy employs only 3% of the workforce. Overwhelming majority, almost nine out of ten people are self-employed (Varma, 2004, p.74-75). Majority of the unorganized sector is outside the tax net. In effect, revenue from personal income tax in India comes virtually from the salaried class and the organized sectors of the economy.

Personal income tax in India is also beset with the problems of poor compliance. There is massive tax evasion and tax avoidance in India. High marginal rates which prevailed for a long time contributed much towards poor compliance. One of the ramifications of higher marginal tax rates was that income tax in India became full of exemptions, allowances and deductions. Cumbersome rules and procedures also provided incentives to evade tax and that adversely affected the revenue yield. Due to these reasons, income tax gradually assumed a nomenclature among taxpayers as voluntary tax.

3.3 Initiatives for Reforms

To overcome these deficiencies and to attain objectives like revenue productivity, horizontal and vertical equity, appropriate reforms were considered necessary. Policy of tax reforms evolved around the assumptions that lowering of tax rates, broadening of the tax base and rationalization of the incentives are the ways to overcome the deficiencies in personal income tax . Reforms since 1991 are mainly focussed in these directions.

3.3.1 Personal Income Tax Rates

An important and pertinent task before tax administration is to design a personal income tax rate schedule that is equitable and efficient. This is because the rates of tax affect economic behaviour of taxpayers i.e. choice between work and leisure, the choice between consumption and savings, and also the compliance behaviour of taxpayers. A highly progressive tax rate schedule, while meeting the ends of vertical equity causes higher distortion in the economic behaviour of taxpayers and therefore promotes inefficiency. Further, high rates of taxes induce tax evasion, thereby undermining the effective impact on equity. The Report of Task Force on Direct Taxes (2002), the Report of the Advisory

Group on Tax Policy and Tax Administration for the Tenth Plan (2001) enumerated following principles for designing the rate schedule:

a) The basic exemption limit must be at a moderate level.

b) There must be an appropriate balance between the tax liability at the lowest levels, administrative cost of collection and compliance burden of the smallest taxpayers.

c) The ability of the tax administration to render quality services to taxpayers significantly affects the choice of the exemption limit.

d) The number of tax slabs should be few and their ranges fairly large to minimise distortions arising out of bracket creep.

e) The maximum marginal rate of tax should be moderate so that the distortions in the economic behaviour of taxpayers and incentives to evade tax payments are minimised.

Personal income tax rates in India were quite high in earlier times. At its peak in 1973-74, with the exemption limit at Rs.5000 the minimum marginal rate of tax was at 10 per cent, and the maximum marginal rate of tax was as high as 85 per cent. The rates spread over eleven tax slabs. In addition, there was also a surcharge of 10 per cent where the total income was below Rs.15,000, and a rate of 15 per cent in other cases. Therefore, the effective maximum marginal statutory rate was 97.75 per cent. This shows that the progressivity of the tax system was very high. The large number of tax slabs also distorted the progressivity of the tax system due to bracket creep. Keeping in view the recommendations of the Wanchoo Committee (1971), marginal tax rates were reduced to 75% in 1974-75, 67% in 1976-77, 50% in 1985-86, 40% in 1992-93 and 30% in 1997-98. Tax Reforms Committee constituted under Chelliah in 1991 observed “As is well known, our general approach is that the best results, in terms of compliance (and, therefore, revenue), efficiency and equity are obtained through a system incorporating moderate rates on a broad base”. Consistent with earlier recommendations, the Task Force on Direct Taxes (2002) also recommended reduction in tax rates and fewer slabs. Along the lines of the recommendations of Task Force, in Budget 2005-06, the tax rates were fixed as under:

Table-3.3: Personal Income Tax Structure after the Budget 2005-06

Income Level	Tax Rates
Below Rs 100,000[a]	Nil.
Rs 100,000- 150,000	10 percent of the income in excess of Rs 100,000/-
Rs 150,000-250,000	20 percent
Above Rs 250,000	30% There is a surcharge of 10% if income exceeds Rs 10,00,000/-

[a] **Limit for women is Rs 135,000/- and for senior citizens is Rs 185,000/-**

Source: Budget Documents 2005-06, Ministry of Finance, Government of India.

The above changes in respect of exemption limit and tax structure have led to a regime of moderate tax rates with the hope that this will contribute to an improvement in tax compliance. It is often argued in economic theories that high tax rates depress employment, investment and growth. Although empirical evidence to this effect is mixed, cross-country studies generally confirm the negative impact of a high tax burden on economic activity (Poirson, 2006, p.3). In India reduction in tax rates has caused positive impact on tax buoyancy and compliance; the personal income tax as a percentage of GDP has gone up from 0.94% in 1990-91 to 1.58% by 2004-05.

3.3.2 Widening the tax base

Looking at a trend of number of assessees in the decade of 1990s, it is seen that in the year 1995-96, the number of effective assessees was 1,06,64,514. By the year 2003-04, it grew up to 2,92,02,396. Thus, there has been increase in number of assessees over last seven years. In the year 2004-05, however, the number of assessees again declined to 2,71,58,561. Table 3.4 shows the number of effective assessees during the period 1995-96 to 2004-05.

Table-3.4 : Number of Effective Assessees

Year	Company	Individual	H.U.F	Firms	Trusts	Others	Total
1995-96	187574	8798212	406456	1192193	42769	37310	10664514
1996-97	227228	9761426	412470	1158319	49629	34471	11643543
1997-98	274319	11194953	437251	1172647	51865	36701	13167736
1998-99	295327	15135956	469730	1228023	83847	41328	17254211
1999-00	309627	17653745	507843	1272217	87165	46427	19877024
2000-01	334261	20662926	553194	1336861	63999	51035	23002276
2001-02	349185	23734413	607519	1378706	97272	58784	26225879
2002-03	365124	25935556	644489	1345232	117304	57224	28464929
2003-04	372483	26624224	654848	1338613	154276	57952	29202396
2004-05	373165	24792990	620468	1235373	71375	65190	27158561

Source: Administrative Hand Book, Directorate of Research and Publications, Income Tax Department, Government of India, 2006, p.115.

The growth in effective assessees since 1995-96 reflects the fact that the reduction in rates has yielded positive results in broadening the tax base. However, the very fact that with a population of about 1.10 billion, India has a tax base of less than 3% personal income tax assessees necessitates the requirement of broadening of the tax base so that it yields more coverage and more revenue. It is also a cause of concern that in the year 2004-05, the number of effective assessees has actually declined in comparison with 2003-04. Bringing hard-to-tax groups under the tax net is one solution to this problem and one way of bringing hard-to-tax groups to tax cover is presumptive taxation. Under presumptive taxation, assessment is made using certain indicators of income rather than the actual income. In absence of direct information proxies are also sometimes used.

Presumptive Taxation

Presumption in direct taxation has received a great deal of attention in developing countries as a part of the search for fiscal correction. Due to massive evasion and non-compliance, pursuit of vertical equity through global progression has become increasingly subordinate to the search for improved equity through expansion of tax base (Shirazi and Shah,1991,p.459-71). Presumptive norms can be used either to generate estimated income actuals, or potential incomes in terms of what is possible with average effort. Both these forms may be used as a base-broadening accretion to the structure of conventional income taxation in place in less developed countries (Rajaraman ,1995, p. 1103-1132). The term presumptive taxation covers a number of procedures under which the `desired' base for taxation (direct or indirect) is not itself measured but is inferred from some simple indicators which are more easily measured than the base itself (Ahmad & Stern, 1991, p.276). Presumptive methods by nature cannot be exact, but may well be preferable to ad-hoc judgmental assessments using unspecified criteria (Tanzi and Casanegra,1987, p.1-18). Apart from being simple and easy to administer, the presumptive tax system has also some incentive features in the sense that if a person earns less than the estimated amount of income , the tax burden will be heavy and if he earns more than the estimated amount he need not have to pay any tax on the amount earned in excess of the estimated amount and that provides the incentive to efficiently use the resources (Sreekantaradhya,2000, p.24). Presumptive taxation also serves the objective of equity by creating an opportunity for collecting tax from those who are not paying any income tax for reasons of non-availability of proper accounts for determining the income. Where the estimated income is taxed, both the revenue and the taxpayer are aware that it is not the acutal income that is taxed but rather some substitute of it (Lapidoth, 1997, p.151).

Presumptive methods can be rebuttable or irrebuttable (Thuronyi, 1996, p.401-403). Rebuttable methods include administrative approaches to reconstructing the taxpayer's income, and may or may not be specifically described in the statute. If the taxpayer disagrees with the result reached, the taxpayer can appeal by proving that his or her actual income, calculated under the normal tax accounting rules, was less than that calculated under the presumptive method. By contrast, irrebuttable presumptive assessments are specified in the statute or in delegated legislation. Because they are legally binding, they are defined precisely. Irrebuttable presumptions can be of two types: i) minimum tax, where tax liability is no less than that determined under the presumptive rules and ii) exclusive, where tax liability is determined under the presumption alone, even if the regular rules might lead to a higher liability. Presumptive methods can also be distinguished according to the degree of discretion to tax officials. Some presumptive methods are quite mechanical, allowing no discretion, for example, methods based on a percentage of gross receipts or of a firm's assets. Other methods, such as the net worth method, involve a large degree of discretion. Presumptive methods can be further distinguished according to the types of taxpayers who are targeted. In general terms, three groups of taxpayers have been the source of problems against which presumptive methods have been directed. The most common problem is non-compliance by small businesses and professionals. A second problem is non-compliance by individuals (this may be related to the first, but the focus is on amounts that individuals have taken out of their businesses or received from other sources and used for consumption). A third group of targeted taxpayers is businesses as a whole including large companies. It has been suggested that for the income tax, the small businesses may be subjected to a Minimum Alternate Tax (MAT) based on both gross assets and turnover, whichever yields higher revenue. The tax rate of MAT should be set to equivalence with the lower marginal income tax rate under the assumption of a reasonable rate of return on capital (Shome, 2004, p.28).

Presumptive norms establish the link between tax liability and observable entity specific indicators. The type of indicator selected determines the form of presumption chosen (Rajaraman,1995, p.1103-1132). There can be a number of methods of presumptive taxation. Particular presumptive methods which are in practice are as follows:

i) Reconstruction of income: This method is applied if the taxpayer has failed to file a return or has substantially understated his or her income, and transactions giving rise to income cannot be traced. In such cases, the tax administrators are usually authorized to assess income on their best judgement. This could involve use of a method such as net worth, bank deposits or expenditure method.

ii) Percentage of gross receipts: Under this method, legislation provides a minimum tax type of presumption whereby the taxable income of a business can be no less than a specified percentage of assets of business.

iii) Asset based taxation: Several countries including Argentina, Colombia, Mexico and Venezuela have adopted minimum taxes on a fixed percentage of assets of business.

iv) Industry-specific methods: Many countries use industry specific methods for framing presumptive taxation. Ghana applies a minimum tax based on an individual's profession or trade. Countries like France use contractual method (Forfait). Contractual method differs from other presumptions in that its application is based on advance agreement between the taxpayer and the tax authority to base the tax liability on estimated income instead of actual incomes. Similar approach is prevalent in countries like Belgium.

Some countries tax particular types of income or income from specific industries on the basis of turnover, with presumptive deductions based on ratios developed for the industry or type of income in question. France allows deduction fixed as a specified percentage of gross receipts e.g. in case of income from the rental of immovable urban property. Standard assessment guides (tachshivim as used in Israel, subsequently replaced by tadrihim) and similar methods are used in several other countries. Tachshiv is based on various ascertainable factors, which are developed for particular industries. For example, a restaurant may be taxed on the basis of location, number of seats, and average price of items on the menu. The objective is to determine net profit. The tachshiv does involve an element of agreement between taxpayers and the tax authorities, but the agreement is on the tachshiv in general (being negotiated with industry representatives), not on its application to particular taxpayers.

v) Based upon outward signs of lifestyle: A presumptive minimum tax based on outward signs of lifestyle has been in operation in a number of countries. In France while assessing, not only ownership but effective enjoyment of assets such as vacation homes & Yachts is taken into account. Under Article 168 of General Tax Code of France, the items that are taken into account for determining tax are rental value of the principal residence, rental value of secondary residences, number of domestic employees, automobiles, motorcycles, pleasure boats, airplanes, horses, hunting rights and golf club membership. For each item, a fixed amount per unit is taken into account or the amount spent or value of the item is multiplied by a specified figure. The total is then compared with taxable income computed under normal methods. If the presumptive calculation exceeds the normal calculation by more than one-third in both the current year and the preceding year, then the taxpayer is taxed on the amount resulting from the presumptive calculation. Countries like Lesotho and Mali also use presumptive methods based on outward signs of life style.

vi) Taxation of agriculture**:** In many countries[8] income from agriculture is taxed on a presumptive basis.The usual approach is to base the tax on the area of land and its quality since land is easily observable, non-substitutable, non-concealable and stable indicator of income from agriculture. A system based on land measured in physical units stratified by soil quality and irrigation, using updated product prices and region specific yields, as in French Forfait, is likely to be both simpler and more transparent (Rajaraman,1995,p.1103-1132).

[8] France is one country where agriculture is covered under presumptive taxation.

Presumptive taxation is in vogue in a number of countries. France, Israel, Bolivia, Chile, Costa Rica, Ecuador, Guatemala, Mexico, Paraguay, Uruguay, Ghana, Sierra Lone, Lesotho, Nigeria, Mali, Cameroon, Niger, Morocco, Gabon are some countries which have applied presumptive schemes for small business and professionals. Attention must be paid to how a particular presumptive method will work in India. Often it is seen that taxation of income of persons in the informal sector, organized small sector and other self-employed groups leads to undue harassment which in turn leads to their reluctance to come under the tax net. This necessitates need for a simpler system, which would induce them to pay income tax. Tax Reforms Committee in 1991 looked into the feasibility of presumptive taxation in India and on the recommendations of the Tax Reforms Committee, Budget 1992-93 made provisions for presumptive taxation for Individuals and Hindu Undivided Family engaged in retail trading having an annual turnover of Rs 5,00,000 or more. They were given the option to pay a lumpsum of Rs 1400 per annum without going through the trouble of filing a return. However, the collection on this account was not very encouaging and the scheme was abolished in the year 1997-98.

Earlier presumptive taxation scheme has now been replaced by an estimated income scheme according to which, in the case of retailers having turnover of Rs 8 to 40 lakh[9], 5% of the turnover is taken as income. In the Budget for 1994-95, Estimated Income scheme was introduced in case of contractors. As per the provisions of Income Tax Act, 1961 contractors having turnover upto Rs 40 lakh can estimate their income at the rate of 8% of the gross receipts. In this scheme, maintenance and audit of books of account is not required. Similarly as per provisions of Sec. 44AE of Income Tax Act, 1961, truck owners[10] could estimate their income taking income of Rs 2000 per month per truck in case of heavy transport motor vehicles and Rs 1800 per month per vehicle in case of light commercial and medium vehicles. With effect from 1.4.2005, tonnage tax[11] has been introduced for the shipping companies. Notional income in such cases is determined based on the tonnage of the ship.

There is a need to extend the application of presumptive taxation in other areas also to broaden the tax base. In Zambia presumptive taxation has been implemented on mini buses, buses and taxi operators. Similar system can be introduced in India for small taxi operators, bus and mini bus operators. As has been brought out by Thuronyi (1996, p.7) presumptive techniques may be employed for a variety of reasons. One is simplification, particularly in relation to the compliance burden on taxpayers with very low turnover. Second is to

[9] 1Lakh = Rs 100,000

[10] Upto 10 trucks

[11] Chapter XII-G of IT Act, 1961. A company with at least one qualifying ship may join. Qualifying ship is one with a minimum of 15 tonnes and a valid certificate.

combat tax avoidance or evasion. Third, by providing objective indicators for tax assessment, presumptive methods may lead to a more equitable distribution of the tax burden, when normal account based methods are unreliable because of problems of taxpayer compliance or administrative corruption. Fourth, rebuttable presumptions can encourage taxpayers to keep proper accounts, because they subject taxpayers to a possibly higher tax burden in the absence of such accounts. Fifth, presumptions of the exclusive type can be considered desirable because of their incentive effects - a taxpayer who earns more income will not have to pay more tax. Finally, presumptions that serve as minimum taxes may be justified by a combination of reasons (revenue need, fairness concerns, and political or technical difficulty in addressing certain problems directly as opposed to doing so through a minimum tax).

While presumptive taxation is one of the means to overcome weakness in tax administration of a country it also leads to efficiency and equity. It is used mostly as a proxy for an income tax on small businesses. While small business is the major engine of employment creation and growth it is as well a major challenge in terms of compliance management (Pashev, 2005, p.2). If used judiciously , presumptive taxation may broaden the tax base by increasing the number of taxpayers and their tax payments, and it may reduce tax evasion - all at a relatively low cost. Further, it may have substantial spillover benefits in facilitating the movement of small taxpayers from the informal to formal sector and as a source of information to reduce evasion (Bulutoglu, 1992, p. 258).

Annual Information Return

As a measure of widening of tax base, with effect from 1.4.2005 concept of Annual Information Return (AIR) has been introduced. As per the provisions of Section 285BA of the Income-tax Act, 1961, AIR of ‘high value financial transactions’ is required to be furnished by ‘specified persons’ in respect of ‘specified transactions’ registered or recorded by them during a financial year. Information will be used for identifying non-filers and to ask them to file return of income. The ‘specified persons’ required to file Annual Information Return and the ‘specified transactions’ for which AIR is applicable are listed in Rule 114E of the Income-tax Rules, 1962. Briefly, these are as per Table –3.5.

Table -3.5 : Class of persons and nature of transactions covered under AIR

Sl.No. (1)	Class of person required to file AIR (2)	Nature and value of transaction (3)
1	Banking company to which Banking Regulation Act, 1949 applies	Cash deposits aggregating to ten lakh rupees or more in a year in any savings account
2	Banks to which Banking Regulation Act, 1949 applies , Any other company or institution issuing credit card.	Payments made in respect of a credit card aggregating to two lakh rupees or more in the year.
3	Trustee or authorized manager of Mutual Fund	Receipt from any person of an amount of two lakh rupees or more for acquiring units of that Fund.
4	Company or institution issuing bonds or debentures.	Receipt from any person of an amount of five lakh rupees or more for acquiring bonds or debentures issued by the company or institution.
5	Company issuing shares through a public or rights issue.	Receipt from any person of an amount of one lakh rupees or more for acquiring shares issued by the company.
6	Registrar or Sub-Registrar	Purchase or sale by any person of immovable property valued at thirty lakh rupees or more.
7	Authorised officer of the Reserve Bank of India	Receipt from any person of an amount or amounts aggregating to five lakh rupees or more in a year for bonds issued by the Reserve Bank of India.

Source: Rule 114 E of Income Tax Rules, 1962.

Permanent Account Number (PAN)

In India, every taxpayer is required to have a PAN which is a unique number given to him or her which he or she is supposed to quote in returns of income. Further every tax deductor is also supposed to quote PAN in his or her return prescribed under the laws relating to Tax Deduction at Source (TDS). With a view to broaden the tax base, PAN has been made compulsory for a number of transactions[12].With effect from 1.10.2006, PAN has been made mandatory for all the entities/persons trading in cash market by Securities and Exchange Board of India. Provision for suo-motu allotment of PAN has also been introduced as a measure for widening of tax base[13].

Taxation of Fringe Benefits

Fringe benefit tax has been introduced in the statute as yet another measure of widening the tax base. A fringe benefit may be regarded as any form of employee remuneration other than salary and wages or other payments that are subject to income tax (eg. termination payments, superannuation). Fringe benefits tax (FBT) is generally payable where:

i) a benefit is provided;
ii) the benefit is provided in respect of the employment of the employee;
iii) the benefit is provided by the employer (or an associate of an employer or a third party under an arrangement); and
iv) the benefit is provided to an employee or an associate (family member) of the employee.

Under the existing Income Tax Act, anomalies and inequities were created because of the way in which fringe benefits were treated for tax purposes leading to erosion of tax base and resulting in poor tax yield. Thus, from the point of view of both equity and revenue, reform of taxation of fringe benefits was considered necessary. There are a variety of ways by which the fringe benefits are at present available to legislators, administrators, and government and public sector employees and top personnel in organized private sector. Tax Reforms Committee, 1991 were of view that if a progressive income tax is to be levied and levied equitably, all the perquisites should be converted into money and added to the salary and the total income should be taxed. The Committee also suggested that the existing provisions for taxation of perquisites in the hands of employee should be tightened, made more comprehensive and the employer should be made to pay tax on the fringe benefits, which remain untaxed in the hands of the employees. On the lines of suggestions of Tax Reforms Commitee and practices prevalent in other countries, in the Budget 2004-05, fringe benefit tax was introduced.

Under the new scheme, fringe benefits which can be attributed to individual employees are taxed under salary income of employees. In addition, fringe benefits that are of a collective

[12] S.139A of the IT Act , 1961
[13] The amendment takes effect from 1st June, 2006.

nature and cannot be attributed to individual employees are to be taxed in the hands of the employer. However, there is no intent to separate out the "personal" element of these business expenses from the "work-related" element. An ad-hoc proportion of these expenses is to be evaluated as fringe benefits and subject to a flat rate. The Memorandum to the Budget 2005-06 while explaining the rationale of the introduction of fringe benefit tax stipulates, "It is proposed to adopt a two-pronged approach for the taxation of fringe benefits under the Income-tax Act. Perquisites, which can be directly attributed to the employees, will continue to be taxed in their hands in accordance with the existing provisions of Section 17(2) of the Income-tax Act and subject to the method of valuation outlined in Rule 3 of the Income-tax Rules. In cases, where attribution of the personal benefit poses problems, or for some reasons, it is not feasible to tax the benefits in the hands of the employee, it is proposed to levy a separate tax known as the fringe benefit tax on the employer on the value of such benefits provided or deemed to have been provided to the employees"[14].

Introduction of fringe benefit tax is a major step towards widening the tax base and bolstering the direct tax collections. In the year 2004-05, about Rs 4,000 crore were collected under this head. However, legislators, government officials are still out of the purview of the fringe benefit tax. This situation requires immediate remedy as it violates the principle of horizontal equity since some of the sections of taxpayers enjoy these benefits without attracting levy of tax , while others do not.

Tax Deduction at Source (TDS)

Another important device for widening the tax base is Tax Deduction at Source (TDS). TDS is an important measure for bringing those incomes to tax, which go unreported for tax purposes. Tax Reforms initiated after 1991 introduced a number of provisions for deducting tax at source. The Income Tax Act, 1961 at present provides for deduction of tax at source [15] for a number of incomes. The list of TDS as per the provisions of Income Tax Act, 1961 includes:

a) Payment of salary (Sec. 192).
b) Interest on securities (Sec. 193).
c) Payment of dividends except referred to under Section 115-O (Sec. 194).
d) Interest other than interest on securities (Sec. 194A).
e) Winning from lottery or crossword puzzles (Sec. 194B).

[14] For the purpose of bringing fringe benefits to tax, a new Chapter XII-H has been inserted in the Income-tax Act,1961 which provides for the levy of additional income-tax on fringe benefits

[15] Amount up to which tax is required to be deducted at source varies for different kind of transactions.

f) Winning from horse races (Sec. 194BB).

g) Payment to contractors and subcontractors in pursuance of any work of contract including supply of labour contract (Sec. 194C).

h) Insurance commission covering all payments for procuring Insurance business (Sec. 194D).

i) Payment to non-resident sportsman (including athlete) or sports association or institution (Sec. 194E).

j) Payment in respect of deposits under NSS,1987 (Sec. 194EE).

k) Payment on account of repurchase of Units by Mutual Fund or UTI (Sec. 194F).

l) Commission to stockists, distributors, buyers and sellers of lottery tickets including remuneration or prize on such tickets (Sec. 194G).

m) Commission or brokerage (Sec.194-H).

n) Payment of rent (Sec. 194 I).

o) Fees for professional & technical services (Sec. 194J).

p) Income in respect of units of Mutual Fund specified under Section 10(23D) or UTI (Sec 194K).

q) Any compensation/consideration or enhanced consideration/compensation paid up to 31.05.2000 on account of compulsory acquisition under any law of any capital asset (Sec.194 L).

r) Any compensation/consideration or enhanced consideration/ compensation on account of compulsory acquisition under any law of any immovable property (other than agricultural land) (Sec.194 LA).

s) Any interest or any other sum chargeable to tax (other than salary and dividends referred to u/s 115-O) payable to a non-resident or a foreign company (Sec.195).

t) Income in respect of units of UTI or of Mutual Fund specified under section 10(23D) payable to a unit holder being a non-resident or a foreign company before 1.4.2003 (Sec. 196A).

u) Any income from units purchased in foreign currency including long-term capital gain arising in respect of units referred to in S.115AB of I.T.Act, 1961 payable to an offshore fund (Sec. 196B).

v) Income (by way of interest or dividends or long-term capital gains) arising from foreign currency bonds or global depository receipts of Indian Company to a non-resident u/s 115AC but excluding dividends referred to u/s 115-O (Sec. 196C).

w) Income (other than capital gains) in respect of securities referred to u/s 115AD, payable to a foreign institutional investor but excluding dividends referred to u/s 115-O (Sec. 196D).

Although provisions relating to TDS have been introduced to cover a number of transactions, it is necessary that they are followed vigorously. Further, more areas need to be brought under the cover of TDS. This will not only result in widening of tax base but also effective collection of taxes. Many a times, the taxes are not deducted properly or are not deducted at all. Sometimes the taxes are deducted but not paid to the government. The returns of TDS must be thoroughly scrutinised to detect the potential taxpayers who do not file returns of income, although required by law.

3.3.3 Rationalizing the incentives for savings

One important objective of tax reform has been rationalization of incentives for savings built in tax system of India. This would not only result in higher tax yield but also in widening of tax base. Incentives had been provided in the personal income tax system of India in order to increase the rate of savings. However, over the years number of such incentives has increased, making the tax system complicated. Further, there is hardly any evidence to prove that tax incentives have on their own increased investment or saving for which these incentives were devised. It is also observed that scaling back of tax incentives and exemptions has almost always had a positive effect on tax policy, tax revenue, tax compliance and tax administration. Moreover, reduction in the intensity of tax incentives automatically translates to reduction in tax expenditure. Thus, even if gross tax revenues remained the same, net tax revenues would be higher. Often the tax incentives become a source of litigation. Tax incentives also have the potential of increasing the discretionary power of tax administrators. The results of exemption raj comprising of complex allowances and exemptions are two-fold. While on one hand filing the income tax return becomes complex, on the other hand tax administrators themselves face acute difficulties in carrying out assessments due to both time and resource constraints.

Issue of tax exemptions and deductions in respect of saving instruments has been extensively studied by various committees and expert groups[16]. Task Force has discussed that there are two alternative ways of devising an income tax which neutralizes bias of tax on income against savings and effectively uses consumption as a tax base; (a) Exempt Exempt Taxed (EET) method and (b) Taxed Exempt Exempt (TEE) method. Under EET method, the contributions to a saving plan /scheme are deductible from the gross income, the income of the plan/scheme is exempt from tax and the withdrawal along with benefits in the form of interest and dividend etc. is subjected to tax. Under the method of TEE,

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[16] The issues have been discussed in detail in the reports of the Tax Reforms Committee headed by Raja J.Chelliah, Advisory Group on Tax Policy and Tax Administration for the Tenth Plan (May, 2001), headed by Dr. Parthasarathi Shome and Expert Committee to Review the System of Administered Interest Rates and Other Related Issues , September, 2001 in past. Task Force on Direct Taxes (2002) and FRBM (2004) have also considered these issues in their report.

contribution to a saving plan/scheme is out of post tax income, the income is exempt from tax and the withdrawal along with the benefits in the form of interest and dividend etc. is exempt from tax. In most countries income tax structure has been designed in order to neutralize the bias against savings by following one of the two methods. Most of the OECD countries follow the EET method. Indian tax system at present is full of exemptions and deductions. Basically the system of incentives in Indian Tax system is covered by Exempt, Exempt and Exempt method. Under the existing income tax provisions in India, financial savings of households are generally exempted from taxation at all the three stages of savings, viz., contribution, accumulation and withdrawals. As has been observed by Task Force on Direct Taxes (2002) this liberalized treatment has impacted economic efficiency, equity and revenue efforts. The tax treatment of various financial instruments under the tax statue is summarized in Table 3.6.

Table -3.6: Tax Treatment of financial savings

S.No	Nature of Instrument	Treatment of Contribution	Treatment of Accumulation	Treatment of Withdrawal	Method
1	Gratuity	Exempt	Exempt	Exempt	EEE
2	Pension/Deferred Annuity Plans	Exempt	Exempt	Exempt	EEE
3	Life Insurance Policy	Exempt	Taxable	Exempt	ETE
4	Provident Fund	Exempt	Exempt	Exempt	EEE
5	Superannuation Fund	Exempt	Exempt	Exempt	EEE
6	Notified Securities, Bonds, Annuity Certificates, Saving Certificates, and other certificates	Exempt	Exempt	Exempt	EEE
7	9% relief bonds	Taxable	Exempt	Exempt	TEE
8	Public Sector Bonds/Debentures	Taxable	Exempt	Exempt	TEE
9	Deposit scheme for retiring employees	Exempt	Exempt	Exempt	EEE
10	Certain pension Funds of LIC (Sec. 80CCC)	Exempt	Exempt	Taxable	EET
11	Medical Insurance(Sec. 80D)	Exempt	Taxable	Exempt	ETE

Table contd. from page 34

S.No	Nature of Instrument	Treatment of Contribution	Treatment of Accumulation	Treatment of Withdrawal	Method
12	Any security of Central or State Govt.	Exempt	Exempt	Exempt	EEE
13	National Saving Certificates (VI, VII, VIII issue)	Exempt	Exempt	Exempt	EEE
14	Debentures of any Institution, Authority, Public Sector Company or Co-operative society notified by the Govt.	Taxable	Exempt	Exempt	TEE
15	National Deposit Scheme	Taxable	Exempt	Exempt	TEE
16	Any other deposit scheme framed by the Central Govt. and notified	Taxable	Exempt	Exempt	TEE
17	Post Office (Monthly Income Account)	Taxable	Exempt	Exempt	TEE
18	Units of Mutual Fund	Exempt	Exempt	Exempt	EEE
19	Units of UTI	Exempt	Exempt	Exempt	EEE
20	Deposits in Bank or Banking Co-operative societies	Taxable	Exempt	Exempt	TEE
21	Deposits in any other Bank	Taxable	Exempt	Exempt	TEE
22	Deposits with Industrial Financial Corporation	Taxable	Exempt	Exempt	TEE
23	Deposits with Local Development Authorities	Taxable	Exempt	Exempt	TEE
24	Deposits by a member of Co-operative societies	Taxable	Exempt	Exempt	TEE
25	Deposits with Housing Finance Companies	Exempt	Exempt	Exempt	EEE
26	Deposit scheme of NHB	Exempt	Exempt	Exempt	EEE
27	ULIP	Exempt	Exempt	Exempt	EEE

Table contd. from page 35

S.No	Nature of Instrument	Treatment of Contribution	Treatment of Accumulation	Treatment of Withdrawal	Method
28	10 yrs or 15 yrs Account Post Office Saving Bank (Cumulative time deposit) Rules, 1959	Exempt	Exempt	Exempt	EEE
29	Purchase of house property	Exempt	-	Exempt	E-E

Source: Report of the Task Force on Direct Taxes, Ministry of Finance and Company Affairs, Government of India, December, 2002, p.98-99.

Task Force on Direct Taxes (2002) and Task Force on FRBM (2004) while examining various aspects of issues relating to tax exemptions inter-alia observed that there are various distortionary effects of the existing method of tax treatment of financial instruments. Some of the distortionary effects listed by the two Task Forces are as under:

i) Saving instruments with similar maturity but different tax concessions result in different tax yields, which involve a distortion of signals for investments.

ii) Incentives encourage not necessarily just savings but also diversion of funds.

iii) There is a bias in favour of investment in short-term instruments, thereby creating serious distortions in the allocation of savings.

iv) Some of the incentives encourage debt as against equity (for example, tax rebate for repayment of instalments of housing loans).

v) Some of the incentives enjoy both deductibility in investment and of interest (viz. National Saving Certificates under existing Sec.88 as well as Sec. 80L of I.T. Act, 1961-now omitted) leading to inordinately high effective rates of return. In turn, these serve as a benchmark for rates of return and therefore lead to high cost of borrowing across all sectors in the economy.

vi) Often rates of return are de-linked from holding periods. Because of this, the public sector crowds out the private sector through offers of quick and perceptibly safer returns.

vii) Exemption for capital income without limit under a progressive income tax amounts to having a progressive income tax only on work income. This leads to unjustified distortion.

viii) Existing tax treatment of saving schemes has adversely affected the equity of the tax system. Deductions from income favour upper bracket taxpayers disproportionately making provisions regressive.

ix) Roll over of capital gains is biased in favour of taxpayers with income on capital gains and distorts horizontal equity. Since the large taxpayers generally have a large proportion of their incomes from capital gains, the roll over provisions are biased in favour of the rich distorting the vertical equity.

x) Tax incentives in present form particularly for government guaranteed instruments have the effect of increasing the floor interest rates across the economy.

xi) Tax concessions involve various economic costs to the government - in terms of interest payment and foregone revenue. Transaction costs on this account amount to around 40%.

Keeping in account the inefficient nature of EEE method, the Task Force on FRBM recommended adoption of EET method. On the lines of recommendations of Task Force and recommendations of earlier committees, government has taken steps to rationalise the incentives provided in the Income Tax Act, 1961. Following measures have been taken in recent years in this direction:

i) Standard deduction has been withdrawn. All prevailing sectoral caps/rebate under Sections 88,88B and 88C have been removed.

ii) Investment in financial instruments hitherto eligible for rebate under Section 88 has been made eligible for deduction from income under Section 80C with a overall cap of Rs 100,000/-.

iii) Deduction provided in respect of interest on certain securities under Section 80L of the IT Act, 1961 has been withdrawn.

iv) In the Budget 2006-07, exemption available under Section 10(23G) to certain kind of income from investment in infrastructure has been removed.

v) Income from investment of contributions under Section 10(23A) has been made taxable.

vi) Exemption available under Section 54ED[17] has been withdrawn.

vii) Tax exemption under Section 80P granted to co-operative banks in respect of their profits and gains from the business of banking or providing credit facilities to its members has been eliminated.

viii) Scope of the tax exemption under Section 54EC granted for roll over of long term capital gains in specified bonds has been restricted.

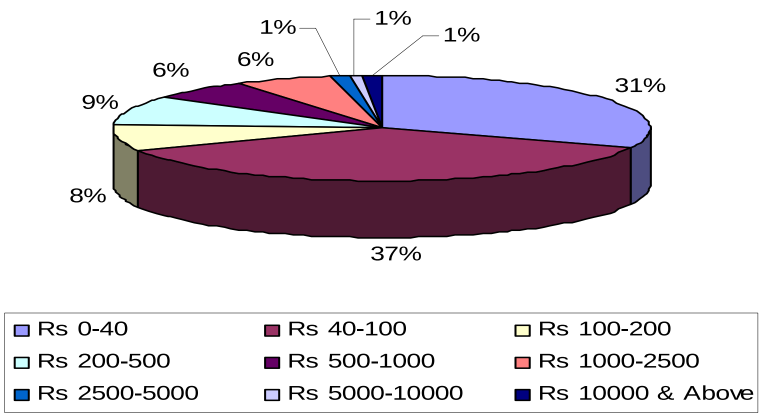
In the Budget 2005-06, it was announced that a committee has been set up to examine the various issues relating to adoption of EET regime. On the lines of the recommendations of various committees in the past and report of two Task Forces, in the month of May, 2006 the Central Board of Direct Taxes has come out with a discussion paper asking comments from the taxpayers regarding removal or continuance of various exemptions and deductions provided in Income Tax Act, 1961. Altogether 162 deductions and exemptions have been outlined and comments have been invited from taxpayers for removal or continuance of these exemptions and deductions. It is required that urgent steps are taken towards phasing out/eliminating all the deductions and exemptions.

3.3.4 Tackling avoidance and evasion

One of major problems associated with personal income tax has always been the high rate of evasion and avoidance. From the data vailable for the year 1999-00 (Fig.3.1 below) it is seen that about 68% of the returns are filed disclosing the returned income range of Rs 0 - Rs 100,000; while only 3% of the returns are filed disclosing returned income of more than Rs 25,00,000. This is because while there are a number of deductions and exemptions which reduce taxable income, there is also a tendency of reporting less income than actually earned.

[17] The existing provisions of section 54ED provided that the capital gains arising from transfer of long term capital asset, being listed securities or units of a mutual fund or of the Unit Trust of India shall be exempt from tax, to the extent such gains are invested in equity shares forming part of an eligible issue of capital, made by a public company, and offered for subscription to the public.

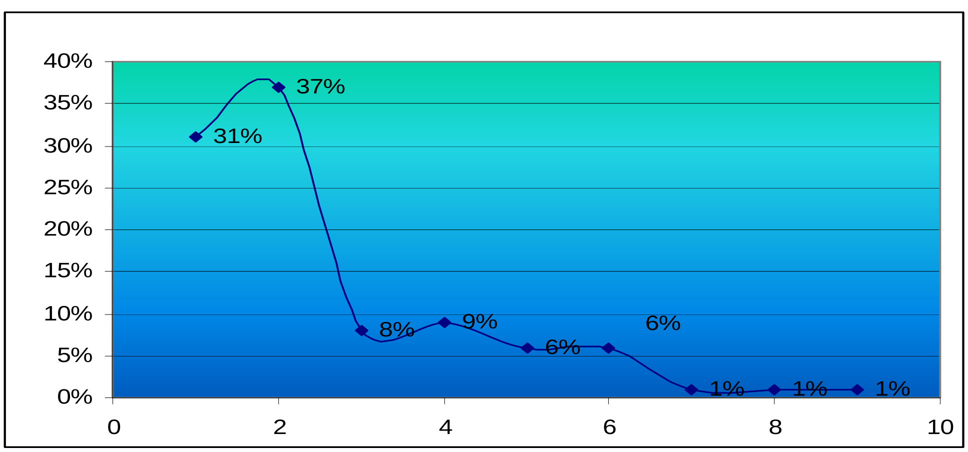
Figure - 3.1 : Returned income by its range (1999-00) in thousands



Source: Statistical Abstract India 2003, Central Statistical Organisation, Ministry of Statistics and Programme Implementation, Government of India.

From the above data it can be construed that the distribution of the returned income is more concentrated in the lower income range.

Figure - 3.2 : Distribution of returned income (1999-2000)



Evasion and Avoidance are two aspects which are required to be effectively tackled from the standpoints of both yield and equity since widespread tax evasion blunts the allocative signals of the tax system and impedes resource moblization (Acharya, 1988, p.294). Several voluntary disclosure schemes have been introduced from time to time, latest being VDIS in 1997-98. However, such schemes act as disincentive to the honest taxpayers. Direct Tax Enquiry Committee (1971) was very critical of voluntary disclosure scheme.

The Committee noted that resorting to such a measure during normal times and that too frequently would only shake confidence of the honest taxpayers in the capacity of the government to deal with the law breakers. In fact, enforcement machinery should be made more stringent to provide huge disincentive to the dishonest taxpayers once rate regime is liberalised. Arousing social conscience, denial of privileges, vigorous prosecution, intelligence and investigation, taxation of agricultural income are some measures suggested to curb evasion (Ray, 1981, p. 137-141).

Government has taken initiatives recently towards tightening of enforcement machinery which has yielded results. To penalise cases of falsification of books of account or documents, provisions have been made in Income Tax Act, 1961 (Section 277A) that if any person wilfully and with intent to enable any other person to evade any tax or interest or penalty, makes or causes to be made any entry or statement which is false and which the first person either knows to be false or does not believe to be true, in any books of account or other document relevant to or useful in any proceedings against the first person or the second person, the person shall be punishable with rigorous imprisonment for a term which shall not be less than three months but which may extend to three years with fine.

Several other measures have also been taken in recent years to control tax avoidance and evasion. A new Section 115BBC has been inserted seeking to tax any income comprising anonymous donations received by any university or any hospital or other institutions referred to under various sub-clauses of Section 10(23C) or any trust or institution referred to under Section 11. Commissioner of Income Tax has been empowered under the provisions of Section 12AA of I.T. Act, 1961 to cancel the registration of a trust if it is found that the activities of the trust are not genuine or they are not being carried in accordance with the objects of the trust. In Finance Act, 2004 it has been provided that deduction shall not be allowed in respect of interest, commission or brokerage, fees for professional, technical services, payment to contractor/sub-contractor on which tax has not been deducted at source, or if deducted then not deposited within the prescribed time [18]. Further, business loss cannot be set-off against salary income [19].

Banking Cash Transaction Tax

Effective from June 1, 2005 Banking Cash Transaction Tax has been introduced chargeable at 0.1 percent on the following:

[18] Sec.40a of I.T.Act, 1961
[19] Sec.71 of I.T.Act, 1961

a) Withdrawal of cash (by whatever mode) exceeding Rs 25,000 on any single day from an account (other than a savings bank account) maintained by any individual or Hindu Undivided Family with any scheduled bank. Withdrawal of cash (by whatever mode) exceeding Rs 1 lakh on any single day from an account (other than a savings bank account) maintained by a person other than an individual or Hindu Undivided Family with any scheduled bank.
b) Receipt of cash exceeding Rs 25,000 from any scheduled bank on any single day on encashment of one or more term deposits, whether on maturity or otherwise, in case such term deposit or deposits are in the name of an individual or Hindu Undivided Family .
c) Receipt of cash exceeding Rs 1 lakh from any scheduled bank on any single day on encashment of one or more term deposits, whether on maturity or otherwise, in case such term deposit or deposits are in the name of a person other than an individual or Hindu Undivided Family.

With effect from A.Y.2006-07, taxpayers are required to attach a cash flow statement along with the return of income. Cash flow statement shall be a summary of income, receipts such as gifts, loans, investments and expenditure of the taxpayer during the year. The cash flow statement is essentially meant to check whether the taxpayer has made investments and met all expenses from his earnings and receipts during the year. The cash flow statement shall be matched with Annual Information Return filed by third parties and then find out whether taxpayer has undisclosed income.

Reform process in personal income taxation has taken significant strides in lowering of tax rates and broadening the tax base. However, the reform process has to be pursued vigorously to fully realize the benefits of reforms and carry forward those benefits to logical ends. Broadening of tax base and rationalization of tax incentives are some of the ways which need to be pursued for effective implementation of tax reforms.

Chapter - 4

TAXATION OF CAPITAL GAINS: RECENT INITIATIVES FOR REFORMS

4.1 Meaning and rationale of Capital Gains Taxation

Capital gain is income derived from the sale of an investment. Capital gains are the increase in the market (or implicit) value of an asset, or set of assets, between two dates. Taxes on capital gains form part of income tax in India. Capital gains tax was first introduced in India in the year 1947-48. It was abolished and re-introduced in the year 1957-58 on the recommendations of Kaldor Committee.

One of the obvious motives for imposing capital gains taxation is financial need. During the nineteenth century, this need was caused by national emergencies. After the Second World War, especially in Britain and Canada the need stemmed from the desire to establish the welfare state. The second reason for levying the capital gains tax is the imperative to create a fair system of taxation. Capital gains need to be taxed for horizontal equity and for improving distribution. There is stabilization objective behind taxation of capital gains as well since in times of prosperity more tax can be realized from capital gains. Since the taxation of capital gains is more important to the influential class of society than the treatment of any other type of income it has been extremely controversial over the years.

As per the the existing provisions, period of holding distinguishes one capital asset from the other. A capital asset which is held for more than three years is categorized as a long-term capital asset. However, if the capital asset is in the nature of equity, it is categorised as a long-term capital asset if it is held for more than one year. All capital assets other than long-term capital assets are termed as short-term capital assets. The profits and gains arising from the transfer of short-term capital assets are treated as short-term capital gains. These gains are included in the total income of a taxpayer for taxation at the rates applicable to him. Similarly, the profits and gains arising from the transfer of a long-term capital asset give rise to long-term capital gains. Since long-term capital gains represent accumulation of income over a period of time, the cost of the asset is adjusted for inflation during the period of holding. Long term capital gains are taxed at concessional rate of 20%. Furthermore, the long-term capital gains are fully exempt if the proceeds are invested in specified savings plan / schemes.

There are various problems associated with taxation of capital gains. First, capital gains are not recurrent in nature; they are irregular and illusory. Second, capital gains on assets push up the taxpayers to higher income brackets and increase their tax liability. Capital gains tax also reduces the amount available for investment since the actual amount realized by the seller of an asset is less than sale price and this further affects investment. Further, capital gains tax distorts the investment pattern in the economy. Because capital gains are taxed only when realized, high capital gains tax rates discourage the realization of capital gains and encourage the realization of capital losses. Investors are induced to hold appreciated assets because of capital gains tax and such investors are said to be “locked in”. This is the reason why the capital gains tax is different from almost all other forms of taxation and it assumes characteristics of voluntary tax. Since the tax is paid only when an asset is sold, taxpayers can legally avoid payment by holding on to their assets.

4.2 Reforms in Capital Gains Taxation

Tax Reforms Committee, 1991 looked into various aspects of taxation of capital gains. As per recommendations of Tax Reforms Committee, measures like indexation for inflation were introduced. Taxing nominal gains raises the effective tax rate on real capital gains and can lead to imposition of a tax in cases of real economic losses. A large percentage of reported capital gains reflect the effects of inflation with the capital gains of lower and middle-income taxpayers commonly representing nominal gains but real economic losses. Thus, indexation of the cost or basis of an asset was rightly proposed to correct for inflation. Task Force on Direct Taxes (2002) considered various aspects of capital gains taxation. It was recommended by the Task Force that concessional treatment of long-term capital gains through a reduced schedular rate of tax must be abolished. In effect, it means that the long term capital gains should be aggregated with other incomes and should be subjected to tax at normal rates. This recommendation was made keeping in view of the overall recommendations of liberalized personal income tax rate schedule which reduces the adverse impact in the form of increased tax burden arising from bracket creep. Task Force also recommended that exemption for roll over of long-term capital gains should also be abolished except in case of investment in a house or investment in bonds of National Highway Authority of India until completion of Golden Quadrilateral project and North-South and East-West corridors.

The Task Force also recommended elimination of long term capital gains on equity and reduction in tax rate to 10% on short-term capital gains arising out of transfer of equity. The recommendations of the Task Force are in alignment with the fact that capital is highly mobile now-a-days across international markets during the last two decades.This has forced the policy makers to re-orient their tax polices with respect to capital gains tax. In view of recommendations of Task Force, Budget 2004-05 abolished long term capital gains on equity and reduced the levy of short term capital gains to 10% from normal rates. The Budget also introduced a new tax called Security Transaction Tax (STT).

Several countries have considered STT either as a substitute for capital gains tax or as an independent tax. The general trend has been to impose either capital gains tax or STT. There are also instances of both types of taxes prevailing simultaneously such as in France and Denmark. STT is imposed in one form or other in several countries like Argentina , Australia, Belgium, Brazil, China, France, Greece, Italy, Indonesia, Malaysia, Pakistan, Singapore, UK and Zimbabwe. However, capital gains and STT are not comparable. While capital gains tax is based on certain canons of taxation, STT is essentially a turnover tax. Economists trace academic debate as regards STT to Keynes. The intuitive rationale behind this proposal was to discouarge speculative transactions. The idea was further developed by Tobin (1984) and Stiglitz (1989). Although even in countries with highly developed security markets STTs do not raise significant amounts of revenue, they have many advantageous characteristics. As experts like King (2004, p.73-84) view, STTs are usually simple and inexpensive to collect and are becoming even more so as the technology employed in financial markets improves. Because STTs are simple, compliance costs for taxpayer and their agents are also likely to be low. In addition, STT has a strong potential to raise revenue, can be used as an instrument to reduce stock market volatility, can improve market efficiency and allocate social wealth.

The stated objective of introduction of this tax in India is to raise additional resources and also to plug the leakage of tax revenue. After the Budget 2006-07 the rates of STT are as under:—

(i) at the rate of 0.125% on the value of transactions of delivery based purchase of an equity share in a company or a unit of an equity oriented fund, entered in a recognised stock exchange, to be paid by the buyer.

(ii) at the rate of 0.125 % on the value of transactions of delivery based sale of an equity share in a company or a unit of an equity oriented fund, entered in a recognised stock exchange, to be paid by the seller.

(iii) at the rate of 0.025% on the value of transactions of non-delivery based sale of an equity share in a company or a unit of an equity oriented fund, entered in a recognised stock exchange to be paid by the seller.

(iv) at the rate of 0.017%, on the value of transactions of derivatives being option or future, entered in a recognised stock exchange.

(v) at the rate of 0.25% on the value of transactions of sale of units of an equity-oriented fund to the mutual fund.

The bond market is fully exempt from the Security Transaction Tax.

There is no firm figure as regards the revenue received by the government from capital gains from securities as it is mixed up with personal income tax. According to press reports it may be around Rs 1000 crore per annum (Bhoi, 2005, p.759-764). Collection from Security Transaction Tax reported in the year 2005-06 is around Rs 2500 crore. Thus, there is significant gain on account of revenue due to the introduction of Security Transaction Tax.

Reduction in tax rate on short term capital gains on equity is also a step in right direction. Reduction in capital tax rates provides a rough adjustment for the taxation of inflationary gains. In addition it encourages people to save more by allowing them to keep more of the total return earned on saving and make savers more willing to provide equity capital to businesses. Lower capital gains tax may also bring in more tax revenue rather than less. Cutting the tax rate on capital gains has two opposite effects on tax collections. On the one hand, taxing each Rupee of realized capital gain at a lower rate reduces revenue. On the other hand, a lower rate means that there are more Rupees of realized gains to tax because people have less reason to stay locked in. The reduction in the rates of taxation in case of capital gains on equity are in alignment with the policies followed by several countries which have reduced or abolished capital gains on equity in order to encourage inflow of foreign capital.

As far as assets other than equity are concerned keeping in view of the recommendations of Task Force, tax on both short term and long term capital gains has been retained. As has been discussed ,Task Force (2002) had recommended that long term capital gains on assets other than equity be clubbed with other income and be subjected to tax at normal rates and there should not be any preferential treatment on this account [20]. Equity implies that all capital gains income should be taxed at the same rates as other income. Only in a case where the responsiveness to tax rates is greater for capital gains than for other forms of income, a lower rate for capital gains may be provided than for other income as it would reduce the excess burden of the income tax (Auten, 1999, p.60). Since the income tax rates have been reduced and are comparable to many other countries, the government may

[20] Short term capital gains on assets other than equity are already taxed at normal rates.

consider the recommendations of Task Force and tax the long term capital gains arising out of transfer of assets other than equity at normal rates.

At present there are a number of provisions which grant exemption or deduction from capital gains taxation if the sale proceeds are invested in certain specified assets. As has been recommended by the Task Force (2002), except for investment in residential house or investment in bonds meant for construction of highway projects, all other roll over exemptions need to be phased out or abolished and all capital gains be brought to tax fully at normal rates. The income distribution effects of lowering or raising capital gains tax rates has been an important issue while taking a decision on capital gains rate changes. Since capital gains are more concentrated among high-income households than other forms of income, therefore capital gains rate cuts when personal income tax rates have already been reduced considerably may prove to be regressive. Thus, it is necessary that instead of reducing the tax rates, deductions or exemptions be phased out so that the appropriate and correct income is brought to taxation.

Chapter – 5

STRUCTURE AND REFORM IN CORPORATION TAX

5.1 Structure and rationale of Corporation Tax

Corporation tax is levied on profits of companies. Income of a company constitutes an important tax base, which is exploited for revenue realization by almost every country. Corporation tax is justified on several grounds. First, corporate income provides an important tax base for mobilization of resources for the country. Second, most of the companies enjoy monopoly position and make huge profits. Part of the profits can be collected by the state to meet public expenditure. Thus, corporation tax acts in part as a tax on monopoly rents or pure profits (Ahmed and Stern, 1991, p. 81). Third, if tax on companies is not levied, then foreign owners who are not subject to personal income tax will completely escape tax. Fourth, corporations enjoy the privilege of limited liability as a result of which mobilization of a large amount of capital for investment is possible by the virtue of which it gets opportunity to earn profits. Since the government confers this benefit on the companies, it has right to take away a part of the benefit conferred on the companies.

Fifth, corporate income tax closes some of the gaps in the personal tax system. If tax is levied only on the dividends earned by the shareholders, there are possibilities that retained profits of the corporations will escape taxation. To avoid this it is necessary to levy tax on profits of companies. Sixth, taxation of foreign capital income may be desirable to exploit international market power. Seventh, when economic profits (rents) are not fully taxed under the domestic system in both capital-exporting and capital-importing countries, there is a case for both the countries to impose taxes on foreign capital. Eighth, in all instances in which multinational firms reap "location-specific rents", source countries can impose tax on such profits without affecting investment (Bird, 1996, p.8).

Moreover, because so much of modern economic activity flows through the conduit of the corporation, it is very convenient to impose taxes at this level. Corporations generally keep better records and transactions through them are easier to locate and track than individuals. Given political constraints on high direct taxes, a source-based corporation tax may be the best way available to tax immobile factors.

Economists argue that corporation tax may not be desirable as numerous distortions and costs are created as a result of corporate taxes. As Bird (1996 , p.1) argues, “in all, the analysis in the public finance literature of the potential "dark side" of corporate taxation is extensive and sufficiently persuasive to convince most economists that there is very little, if anything, to be said for corporation taxes. On the contrary, there may be substantial economic gains from reducing and even eliminating such taxes”. On the contrary, popular opinion favours taxing corporations taking a view that they do not pay enough in taxes. The governments tend to honour the general public opinion to avoid any discontentment.

Bird (1996, p.3) has suggested broadly three answers to the question why to tax corporations; (1) because it is desirable to do so, (2) because it is necessary to do so to achieve certain objectives, (3) because it is convenient to do so, or for some combination of these reasons. Taxes on corporations in some instances might be a desirable means of collecting public revenues in ways that would either improve economic well-being, not harm economic well-being, or impose costs on those beyond the political pale. Existing international tax regime also makes it virtually essential for countries to impose taxes on corporate profits.

History of corporation tax in modern India may be traced back to 1860 , the year in which personal income tax was imposed. Based on the British model, originally tax on corporate income was supposed to be an income tax paid by the companies on behalf of the shareholders. Tax paid by the companies on behalf of shareholders on dividends declared could be deducted from the shareholder’s own income tax liability on distributed profits. In addition to this tax, a super tax was introduced in the 1940s. This was commonly called corporation tax. Shareholders got no credit for this super tax. In 1960-61, a major change was introduced. Corporation came to be treated as a completely separate legal entity for tax purposes and the income tax paid by the companies ceased to be tax paid on behalf of the shareholder. No tax credit was allowed to the shareholder from the income tax paid by the companies. Under the new system, a company was liable to pay income tax on its undistributed profits and the shareholder was again to pay tax on the dividends which were includible as part of his total income. This was criticised by many as amounting to double taxation. In 1997-98 dividend tax in the hands of shareholders was abolished; instead now the domestic companies pay tax on their distributed profits.

5.2 Major issues in Corporate Tax Reform

5.2.1 Classical vs Integrated system

One of the major issues in corporate taxation has been whether classical corporate structure should be adopted or fully integrated system is more viable. Under a classical corporate tax system, income tax is levied separately, both on company income and on dividends received by shareholders. The case for integration is based upon the principle that tax should be levied according to “ability to pay”. Corporate bodies are only a conduit through which income flows to individuals who are their ultimate owners. Thus, corporate income should only be taxed in the hands of the individuals to whom it accrues.

Task Force on Direct Taxes (2002) after deliberating upon various aspects of both the systems recommended a type of integration in which tax at the corporate level may be levied at the rate which is the maximum of personal income tax and all dividends and long term capital gains in the hands of the shareholders are exempt. However, as the Task Force (2002) has argued this system would serve as an integration model only if the accounting profits bear the full burden of corporate tax i.e., the effective corporate tax liability is equivalent to the statutory corporate tax rate. This is possible if there is no divergence between the taxable base for companies and accounting profits, which generally arises due to various tax incentives and artificial deductions. The government has initiated the process towards implementing the recommendations of the Task Force. Tax rates have been reduced and dividend tax along with long term capital gains have been made exempt in the hands of shareholders. However, it is necessary that all the recommendations of the Task Force (2002) are implemented in totality and not in piecemeal manner. While the corporate tax rate has been almost aligned with the maximum marginal tax rate on individuals and taxation of long term capital gains and dividends in the hands of shareholders has been abolished,the existing tax incentives and deductions have not yet been eliminated/abolished.

5.2.2 Tax Incentives

It is undisputable that taxation structure in India like in most of the developing countries is full of exemptions and deductions. Tax incentives have become a matter of great criticism and it has been strongly recommended by various Committees on tax reforms that the exemptions and deductions should be phased out gradually. Tax incentives go against the principles of fairness and sap the strength from the tax system. Tax Reforms Committee, 1991 observed that for a thorough reform of the tax system towards simplicity and equity it is absolutely necessary to eliminate all incentives/concessions in the tax system except for the essential few. Task Force on Direct Taxes (2002) also concluded that tax incentives must be abolished stating that they are inefficient, iniquitous, impose greater taxpayer compliance and administrative burden, result in revenue loss and complexity of the tax laws, and encourage tax avoidance and rent seeking behaviour.

Tax Expenditure Statement (TES) or the statement of revenue foregone introduced for the first time in the Union Budget 2006-07 shows that the estimate of revenue foregone due to tax preferences during the financial year 2004-05 adds up to Rs 158,661 crore, out of which the corporate income tax alone constitutes 36%. TES shows that there were 350 corporates that accounted for 40.7% of the gross profits, but they accounted for only 11.24% of the taxes paid. The effective rates of tax paid by them were less than 10%. Studies conducted by Swift (2006, p.917-933) and Sullivan (2006, p.96) show that tax expenditures impact budget severely. Some of the effects of tax expenditure/ tax incentives on budget may be listed as under:

i) Tax expenditure reduces tax revenue, which affects the budget balance.
ii) Tax expenditures, because they are funded from the tax base affect prioritizing fiscal allocations.
iii) Tax expenditures reduce the effectiveness and efficiency of public resource allocation.
iv) Tax expenditures increase complexity of the tax system and enormously complicate tax administration.
v) Tax expenditures that are loosely subject to financial discipline/ scrutiny provide an opportunity for abuse by Govt. officials and legislators.

According to studies made by the Task Force (2002), effective tax rate of a sample of 3777 companies in 1999-00 was 21.7 per cent as against the statutory rate of 38.5 per cent. Similarly, the effective tax rate of a sample of 2585 companies in 2000-01 was 21.9 per cent as against the statutory rate of 39.55 per cent. Table-5.1 shows trends in the effective corporate tax rate between the years 1996-97 and 2002-03.

Table -5.1: Trends in the effective corporate tax rate

		Effective corporate tax rate	
Year	Statutory Rate	Manufacturing	Banking and Finance
1996-97	43.00	21.36	26.82
1997-98	35.00	20.85	25.55
1998-99	35.00	21.40	21.55
1999-00	38.50	21.29	24.75
2000-01	39.55	21.00	27.88
2001-02	35.70	19.62	30.22
2002-03	36.75	23.53	28.11

Source: Report of the Task Force on FRBM Act, 2003, Ministry of Finance, Government of India, July, 2004, p.116.

To align the effective tax rate with statutory tax rate which is now almost at par with that of maximum rate of personal income tax, it is imperative that tax incentives are phased out and exemptions are eliminated to make the corporate tax structure simple, transparent and equitous. Steps have been taken by the government towards rationalization of tax incentives. Accordingly, deductions listed below hitherto available under I.T.Act, 1961 have been eliminated in phased manner:

i) Deduction in respect of profits and gains from projects outside India (Sec. 80HHB).
ii) Deduction in respect of profits and gains from housing projects in India (Sec.80HHBA).
iii) Deduction in respect of export turnover (Sec.80HHC).
iv) Deduction in respect of earnings in foreign exchange available to an approved hotel or an approved tour operator or travel agent (Sec.80HHD).
v) Deduction for export of computer software (Sec.80HHE).
vi) Deduction for export or transfer of film software (Sec.80HHF).
vii) Deduction in respect of royalties from certain foreign enterprises(Sec.80-O).
viii) Deduction in respect of certain incomes from foreign sources (Sec.80R, 80RR, 80RRA).

It has been provided by Finance Act, 2006 that no deduction under Sections 80 IA[21], 80 IAB[22], 80-IB[23] or S.80-IC[24] shall be admissible unless returns of income are filed by the entities on or before the due date of filing of returns of income. It has been discussed in the chapter on reforms in personal income taxation system that Central Board of Direct Taxes has come out with a draft circular seeking opinion from all the stakeholders for elimination of the existing exemptions and deductions. Government should take immediate steps to remove from the statute all the deductions and exemptions which have made the entire tax structure complex, cumbersome and discretionary. Further, keeping in view of recommendations of Task Force (2002) on reduction in rates of depreciation for Plant and Machinery, the Budget 2005-06 reduced the rates of depreciation on Plant and Machinery from 25% to 15%. The Task Force had also recommended that the rates of depreciation on all assets must be similar for the tax purposes and for the purposes of Companies Act. Government should take immediate steps in this direction and amend the rules of depreciation accordingly. Bagchi and others (2005, p.380-84) and Shome (2006, p.192-193) list some of the negative influences of incentives as under :

[21] Deductions in respect of profits and gains from industrial undertakings or enterprises engaged in infrastructure development.
[22] Deductions in respect of profits and gains by an undertaking or enterprise engaged in development of special economic zones.
[23] Deduction in respect of profits from an industrial undertaking other than infrastructure development undertakings.
[24] Special provisions in respect of certain undertakings or enterprises in special category states.

i) Regionally based incentives tend to determine investment primarily as a reflection of the tax structure, often encouraging low-value added activities; they tend to shift investment to one area at the cost of another area without having a significant effect on total investment leading to economic disarray.

ii) They exacerbate the legitimization of the underground economy because available cash can be shown as profits attributable to a company enjoying tax benefits. Thus, the cash gets reported in the regular economy without paying tax on it.

iii) By eroding the tax base they force governments to rely on high rates of tax for revenue which breed evasion and generate pressures for more breaks.

iv) They open up loopholes for which safeguards have to be built into law to guard against misuse, thereby cluttering up the tax statute, adding to compliance and administrative costs.

v) Incentives also undermine the equity of tax system by randomly relieving the tax burden on different groups, after favouring the rich as they can get the advantage of the breaks to a greater extent than others.

Recently a study was made assessing revenue loss on account of various incentives and exemptions (Bagchi,et al, 2005, p.35). It has been estimated that revenue loss on account of non-taxability of agricultural income is around Rs 10,000 crore and loss on account of tax holidays to export companies and firms in special economic zones amount to Rs 10,000 crore. Similarly, loss on account of deductions under Chapter VIA like Sections 80IB and 80IA has been estimated at Rs 2000 crore and loss on account of deductions given for loans against house property has been estimated at Rs 6000 crore. It has also been estimated that loss on account of deductions under Section 80Ib(10) to developers and builders amount to around Rs 8000 crore and loss on account of provisions governing charitable trusts and donations is to the tune of Rs 8000 crore.[25] These studies support the contention that incentives must be eliminated immediately for revenue gains.

[25] Need for revisiting incentives is felt in this study which has found that majority of trusts have income from business and out of 12 lakh NPOs (Non-Profit Organizations), only 70,000 are on income tax register.

5.2.3 Rate Structure

Till tax reforms were initiated in India in 1990s, corporate tax rates were quite high. The rate structure was also complicated because of the distinction existing between the widely-held companies and closely-held companies. The former were being taxed at a lower rate than the latter. In 1984-85 (the year which saw some initiatives in the field of reforms in direct tax) rates on widely held companies and closely held companies were as high as 57.75% and 68.25% respectively. Non-domestic companies were taxed at 73.5%. In 1991 the rates applicable were as follows:

Widely-held companies	-	40%
Closely-held companies		
(Trading or investment)	-	50%
Other companies	-	45%
Foreign companies	-	65%

It was in the Budget for 1994-95 that a major attempt at reform of corporate tax structure was made with a view to encouraging the corporate sector to increase its savings and investment and to acquire greater competitive strength. In 1994-95 distinction between widely held and closely held companies was removed and a uniform rate of 40% was fixed for all domestic companies. In the case of foreign companies, rate was reduced to 55%. Since 1994-95 there has been a constant review of the tax rates. In the Budget 2005-06, the rates were further reduced. Tax rate in the case of a domestic company was reduced from 35% to 30% (although there is a surcharge of 10% also). Tax rate and surcharge in the case of foreign company was fixed at the rate of forty per cent and two and half percent respectively. In addition, education cess at the rate of two per cent was also leviable on all the companies. As the Memorandum to Budget 2005-06, states that the corporate rates were reduced with the following objectives:

i) To reduce ex-ante cost of capital and provide larger internal accruals for modernisation and expansion;

ii) To remove any disincentive to firms from incorporating by equating the corporate tax rate with the top marginal personal income tax rate; and

iii) Provide deserved relief to those corporations that bear the heavier part of the corporate tax burden.

Significant steps have, thus, been taken towards reduction of corporate tax rates. Scaling back of the corporate income tax reflect to some extent the twin objectives of administrative feasibility and better tax compliance. But it was also motivated by the forces of globalization and the increased international movement of capital that necessitated keeping the tax rate low and competitive in line with global trends (Shome, 2006, p.192-193). Brazil has reduced corporate tax rate from 50 percent to 25 percent in 1996. Chile , Indonesia , Malaysia , Philippines, Singapore, Thailand have also reduced tax rates on corporations significantly. India levies tax on domestic companies at rate of 30 percent which is comparable with developed countries like Australia (30 percent) and UK with a progressive rate structure of 15 percent to 35 percent.

As discussed in the preceding pages, there is an array of tax incentives in India that have tended to reduce the effective corporate tax rate much below than the statutory tax rate. Therefore, there is no case for further reduction in rates unless steps are also taken for elimination of deductions and exemptions. In a regime of integration where dividends and long term capital gains are not taxed in the hands of the shareholders, the statutory tax rates should not be lower than effective tax rate and this can be achieved only when the existing deductions and exemptions are phased out or eliminated.

5.2.4 Revenue Yield

It has been recognized that in a developing economy, corporation tax has to play more important role than the personal inome tax because of the difficulties associated with the administration of the latter. Revenue yield of corporation tax cannot be called satisfactory even though its contribution is more than that of personal income tax. Table -3.1 on page 17 illustrates revenue yield from corporation tax in India. The figures in the table show that yield from corporate tax in India is quite low as compared to the yield in OECD countries as can be seen from table –3.2 on page 18.

Reasons for the low revenue yield of corporation tax are presence of wide-ranging incentives and concessions and existence of a large number of Zero Tax Companies until recently. Further, complex system of corporate taxation has also affected the revenue realization from corporations .

5.2.5 Erosion of Tax Base

It was empirically established that in the 1980s and early 1990s a large number of companies were not paying taxes even if they earned huge profits. The companies, which earned huge profits but did not pay any tax, came to be called Zero Tax Companies[26]. Government in order to bring them under tax net introduced Minimum Alternate Tax (MAT) in the Budget for 1996-97. Under the scheme of MAT, where the total income of a company after availing of all deductions is less than 30% of the book profit, it will be presumed that its income is 30% of book profit and will be taxed accordingly. MAT [27] has served the purpose of bringing Zero Tax Companies under tax net. There are arguments that MAT must be scrapped from the statute book. However, Minimum Alternate Tax (MAT) must be eliminated from the statute only when all the exemptions and deductions are phased out and statutory tax rates and effective tax rates are aligned completely. However, till the exemption-raj exists, MAT needs to be retained. Experts like Bagchi (1995, p.380-384) and Rajaraman (1995, p.1103-1132; 1996, p.1941-1952) have advocated levy of asset based MAT. It has been estimated by Bagchi that introduction of a 2% asset based MAT on the 350 largest companies will lead to 75% increase in collections.

In Argentina asset based MAT is levied. Argentinean design of a gross asset base with no deductions of liabilities and coverage of all sectors including the financial sector has the nature of simplicity. Simple asset based MAT as in case of Argentina may be a better solution instead of the existing provisions of MAT in India. However, the dose of MAT must be administered only till the time there is divergence between effective tax rate and statutory tax rate. The problem of Zero Tax Companies and bringing them under tax net is tackled automatically once all those deductions and exemptions are eliminated, the presence of which ensure that such companies do not pay any tax, even if they have positive income.

Several measures have been taken towards reforms in corporate tax structure in India. Reduction in tax rates is a step in right direction. However, much more is required to be done in other areas. Once the rates have been reduced, it is necessary that all deductions and exemptions are eliminated. There cannot be piecemeal reforms. As Task Force (2002) noted with concern, “Past experience shows that while tax rates were reduced, successive governments failed to implement the phased withdrawal of incentives. As a result, we have reached a point where the corporate tax rates are close to their resting points and yet the statute continues to be riddled with exemptions and deductions. Any attempt to sequence

[26] Zero Tax Companies in India were identified as those companies which were earning substantial before tax profits and paying handsome dividends, but paying no income tax.

[27] In USA, Alternate minimum Tax (AMT) has been prescribed. But it differs from MAT in India. AMT requires taxpayers to do their taxes a second time by adding back income and deduction to the regular income tax. After completing the AMT tax return, taxpayers subtract the AMT exemptions and compute tax at prescribed rates. Taxpayers then compare the amount of tax computed under the AMT with the tax due under the regular tax and pay whichever amount is higher.

the reduction in the corporate taxes and the withdrawal of exemptions and deductions could lead to disastrous impact on revenue flows. The two must necessarily be implemented simultaneously”. These concerns of Task Force must be addressed to clear the corporate tax laws from the cobwebs, to avoid any uncertainty as regards policy decisions and to avoid any adverse impact on revenue flows.

Corporation tax has developed into a complex system over the years as a result of ad-hoc changes made from time to time. Corporation tax reforms are essential; first, from the point of view of revenue and equity and second from the point of view of creating a suitable environment for the growth of both domestic and foreign investment. A major area of concern in this regard is wide-ranging special incentives causing erosion of tax base and low revenue yield. It is necessary that government takes immediate steps to eliminate the existing deductions /exemptions so that there is unequivocal alignment between effective tax rate and statutory tax rate and any further revenue loss is avoided.

Chapter - 6

INITIATIVES FOR REFORM IN TAXATION OF WEALTH AND GIFT

Apart from personal income tax and corporate tax, the Indian tax system comprises certain other taxes which are of the nature of capital taxes viz; tax on wealth and a tax on gift[28]. These two taxes were introduced as components of Kaldor's integrated system of taxation as per the provisions of Wealth Tax Act, 1957 and Gift Tax Act, 1958.

6.1 Reasons for levying Wealth Tax

The Wealth Tax Act is important direct tax legislation. It is a tax on the benefits derived from property ownership. Stated objectives behind introduction of bill for wealth tax were a) that it would reduce the possibility of tax evasion b) that it would take into account the tax paying capacity of an individual and c) that it had a large measure of egalitarianism built into it both conceptually and operationally without dis-incentive effect. Levy of wealth tax was described as a measure to alter the tax structure in a way that would ensure more effective and at the same time a more equitable basis for taxation.

Policy makers and economists justify tax on net wealth on a number of grounds. Generally, arguments advanced in favour of a wealth tax are grouped under four main heads: a) horizontal equity b) efficiency in resource use c) reduction in inequality and d) administrative control. Wealth has appeal as a supplementary measure of the ability to pay. A person with, say, income of $ 20,000 and wealth of $20,000 is clearly better off than one with income of $ 20,000 and no wealth other than his earning capacity. The former can receive income without exerting himself, and he can, if he wishes, consume more than his current income by using up his wealth. Furthermore, he can invest in an enterprise that will employ both his wealth and his personal talents (Goode, 1984, p.133). Therefore, justification for wealth tax lies in the fact that there is additional ability to pay which is required to be tapped. Tax on wealth is also justified on the grounds of distributive justice and reducing inequalities. Wealth tax acts as supplement to income tax in a sense that it acts as cross check and in a way improves compliance. A tax on income does not by itself take into account the claim on overall resources that wealth confers. As Bhoothalingham Committee reported, "The wealth tax system should continue if for no reason then for ensuring in the long –term that income tax is properly administered". The share of wealth tax has always been less than one percent and even if it is abolished, the revenue impact

[28] Gift Tax was in force till 1998.

will not be much. But it serves the objective of reducing inequalities and also provides a mechanism through which evasion of income tax can be minimized.

Wealth tax is also administered to discourage the possession of unproductive wealth. This encourages the optimum utilization of resources for productive purposes especially in a developing economy. Development economists were particularly interested in the possible benefits of taxes on wealth. Kaldor recommended the enactment of wealth taxes in developing countries. He was of belief that the holders of substantial economic resources in developing countries had the capacity to pay higher taxes than those with similar incomes but with less wealth.

Wide disparity of wealth found in many developing countries may exacerbate political or social problems. Major concentration of wealth held by a relatively small number of people can have unfortunate political and social side effects; to the extent these concentrations can be reduced through wealth taxation, the side effects can be ameliorated. (Gordon and Rudnick, 1996, p.297).

Wealth constitutes an independent tax base that is appropriately tapped by an annual tax on net wealth. Taxes on wealth are sometimes described as being more economically efficient than taxes on income. The principal policy goals behind a wealth tax might include (1) a modest reduction in current concentrations of substantially great wealth, (2) a modest reduction of the concentration of similar wealth in the future, (3) the social and political benefits to be achieved from realizing these goals, and (4) the general raising of tax revenues.

6.2 Problems in administering wealth tax in India and measures for reforms

Administration of wealth tax in India was associated with a number of problems. First, there existed some inequities because of the problems associated with valuation and because of exclusion of certain assets from taxation. Second, there was no indexation for the inflation in the case of wealth tax. Third, combined incidence of income tax, wealth tax and other taxes like property tax was quite high making the tax burden quite heavy. Tax Reforms Committee of 1991 made important recommendations in respect of taxation of wealth in India. Most important recommendation of the Tax Reform Committee was that the wealth tax should be confined only to unproductive form of wealth. The Tax Reforms Committee also recommended that exemption limit should be raised to Rs 15 lakh. Rate of tax on wealth was recommended at one percent of value of taxable wealth. The Committee further recommended that net value of taxable items of wealth of minors should be aggregated with that of the parents. It was also recommended that all income tax assessees whose total income exceeds Rs 1 lakh should file a net wealth statement.

To implement the recommendations of Tax Reforms Committee, several changes have been made. In the Budget for 1992-93, recommendations of Tax Reforms Committee that a distinction should be made between productive and non-productive wealth should be made and only non-productive wealth should be subjected to wealth tax was accepted and implemented. Basic exemption limit was fixed at Rs 15 lakh and rate of wealth tax was fixed at one percent of the value of net wealth. One may say that wealth tax virtually stands abolished in India. Productive assets are free from wealth tax without any limit and only certain unproductive assets are considered as 'assets' for the purpose of wealth tax, unless these are used for business or profession[29]. Taxing only unproductive assets is a progressive step since the productive assets are free to be used without attracting any tax. Simultaneously, possession of unproductive assets is discouraged.

In post reform era, a study was undertaken by the office of Comptroller and Auditor general of India (CAG) to examine: (i) the efficiency with which the provisions of the Wealth Tax Act are implemented (ii) the quality of wealth tax assessments and (iii) any escapement of tax payable to the government at any stage of the wealth tax assessment. It has been noticed that while the number of wealth tax assessees has declined from 5.45 lakh in 1994-95 to 2.25 lakh in 1998-99, the number of income tax assessees comprising of individuals, HUFs and Companies in the higher income range of Rs.5,00,000 and above increased from 86,820 to 3,30,589. This indicates that the assessees are not filing the wealth tax returns even though they have taxable assets having value exceeding Rs 15 lakh.

The report of CAG has also noted that there have been cases of persistent lapse on the part of the assessing officers to link and correlate the records of income tax and wealth tax although the Central Board of Direct Taxes have already issued instructions for proper co-ordination amongst assessment records pertaining to different direct taxes and for simultaneous disposal of income tax and wealth tax assessment cases so that there is no evasion of tax. Further, there has been a significant decline in the revenue under wealth tax during the period 1994-95 to 1998-99 covered in the review as large number of assessees are either not filing the returns of net wealth or not disclosing true taxable wealth. It has also been noted in the report that Income Tax Department has not identified new wealth tax assessees through survey operation/other measures despite recommendations of Public Accounts Committee and instructions issued by the Board. Table 6.1 shows total number of wealth tax assessees, total number of wealth tax returns for disposal and assessments

[29] Taxable assets are mentioned in S.2 (ea) of Wealth Tax Act, 1957.

actually completed during the year 1994-95 to 1998-99 as per the studies made by CAG. It also shows total number of returns of wealth received during this period.

Table - 6.1 : Number of wealth tax assessees and assessments (Figures in lakh[30])

Year	No. of Wealth Tax Assessees	No. of Pending returns at the beginning of the year	No. of returns received	Total No. of returns due for disposal	No. of assessments completed	No. of pending returns	Percentage of returns received to the total number of assessees (7 to 2)
(1)	**(2)**	**(3)**	**(4)**	**(5)**	**(6)**	**(7)**	**(8)**
1994-95	5.45	1.81	3.06	4.87	4.19	0.68	56
1995-96	3.90	0.68	1.85	2.53	1.53	1.00	47
1996-97	3.00	1.00	1.54	2.54	1.75	0.79	51
1997-98	2.45	0.79	1.06	1.85	1.59	0.26	43
1998-99	2.25	0.26	1.19	1.45	1.07	0.38	53

Source: (URL: http//www.cag.nic.in/reports/d_taxes/2001-book2/chapter1.htm) Chapter on administration of the wealth tax act including valuation of assets and functioning of the valuation cell.

Figures in the above table outline the need for immediate corrective action in the field of wealth tax in India. An integrated system prescribing a common single return for income tax and wealth tax may be introduced for proper co-ordination in assessment work. The department should identify new wealth tax assessees through survey operations or some other identification procedures. Computerised information through Annual Information Returns may be one of the sources for enhancing wealth tax efficacy. Indirect controls for determining wealth tax compliance can be provided by requiring proof that the wealth tax has been paid for certain transactions as the sales and transfers of immovable property, transfers of vehicles, banking transactions in cash. Although Goode (1984,p.140) concludes that "[a] net wealth tax, although attractive in principle, must be judged impractical in most developing countries”, yet modern net wealth taxes, if designed with ease of administration in mind can be effective, even in developing and transitional countries.

[30] I lakh = 100,000

6.3 Reforms in Gift Tax

Like wealth tax, gift tax was also introduced on the recommendations of Kaldor Committee. Gift tax came to inception after the enactment of Gift Tax Act, 1958 and was in force till 1998. It was a tax on transfer of any movable or immovable property from one person to another without consideration in money or money's worth. A basic exemption limit was provided and any gift made in excess of this limit, attracted tax at the specified rate. As per the provisions of Gift Tax Act, tax on gift was leviable on the donor.

There was an argument that since the justification of gift tax was checking evasion of estate duty, after the abolition of the latter, it had no merit for continuance. Further, it was argued that since share of gift tax was insignificant from the revenue point of view, it could be abolished. Tax Reforms Committee, 1991, however, did not agree with the view that the gift tax had become redundant after the abolition of Estate Duty and it made out a case for the continuance of gift tax.

As per the recommendations of Tax Reforms Committee exemption limit on gifts was raised from Rs 20,000/- to Rs 30,000/-. In the Budget for 1998-99, decision was taken to abolish the gift tax on grounds of insignificant revenue yield and failure of the Gift Tax Act as an instrument to curb tax evasion and avoidance. Accordingly, gifts made after 1.10.1998 do not attract gift tax. However, the fact remains that the gifts are being used to camouflage assessable income. In order to curb this tendency a new provision has been made according to which gifts of more than Rs 25,000/- received from unrelated persons are now brought to tax as income of the recipient. Finance Minister of India in his Budget Speech 2004, explaining the new provision announced:

> "... Members are aware that I abolished gift tax in 1997. That decision remains, but a loophole requires to be plugged to prevent money laundering. Accordingly, purported gifts from unrelated persons, above the threshold limit of Rs 25,000 will now be taxed as income. Gifts received from blood relations, lineal ascendants and lineal descendants, and gifts received on certain occasions such as marriage will continue to be totally exempt."

Consequently, Section 2 (24) of the Income-Act, 1961 has been amended to widen the definition of income. Explaining the amendment, the Memorandum forming part of Finance Bill stated:

> " It is proposed to insert a new sub-clause in the definition of income so as to provide that any sum received on or after the September 1, 2004, by an individual or a Hindu undivided family from any person, in cash or by way of credit, otherwise

> than by way of consideration of goods and services shall be included within the definition of income under Section 2(24) of the Income-tax Act. It is also proposed to provide a general threshold limit of Rs 25,000."

In addition to above, in the case of an individual's marriage, it has been provided that the aggregate of gifts received up to Rs 100,000 will not be charged to tax. It is necessary that new provisions are strictly implemented to curb any tendency to camouflage unaccounted income. Returns of income filed by different assessees must be carefully seen and scrutinized. Provisions may be made in the return of income to disclose gifts so that proper checks may be kept on any attempt to launder unaccounted money. Since certain gifts are now treated as income in the hands of recipient, suitable amendments may be made for deduction of tax at source by the person who gives gifts to any other person. This will ensure early and easy realization of taxes on account of such gifts. The person who receives the gifts may subsequently claim credit for such deduction of tax at the time of filing of return of income.

Capital taxes like wealth tax and gift tax if properly devised and efficiently and honestly administered can play a major role in fulfilling the objective of reducing economic inequalities. The tax administration in India should design these two taxes appropriately; both to tackle tax evasion and to keep a check on laundering of unaccounted income.

Chapter -7

TAXATION OF AGRICULTURAL INCOME

7.1 History of taxation on Agricultural Income in India and drawbacks

One sensitive aspect in the overall scheme of taxation in India is tax on agricultural income. In modern India, tax on agricultural income can be traced back to Income–Tax Act of 1860. Tax on agricultural income continued till 1886 when it was abolished. Thereafter, upto 1935 agricultural income was completely exempt from taxation. As per Government of India Act, 1935 under British Rule and thereafter as per Constitution of India, 1950 in independent India, power to levy tax on agricultural income has been given to provinces.

There are several drawbacks in the existing system of taxation on agricultural income. There is a lack of uniformity in the sense that only eight states[31] are levying tax on agricultural income at present. Even among the eight states there is no uniformity in respect of rate schedule, coverage and exemptions. Further, there is limited coverage due to which revenue realization is very low. Tax on agricultural income was only around 0.13% of total tax revenue of the states in 1998-99 [32].

7.2 Proposals for reforms

A comprehensive study of taxation of agricultural income and wealth was made by the Committee on Taxation of Agriculture Wealth and Income known as K.N.Raj Committee constituted in 1972. The Committee found that integrated taxation of agricultural and non-agricultural incomes by the centre would permit equal treatment of agricultural and non-agricultural income. However, the Committee also noted that since agricultural taxation is a state subject, without a constitutional amendment centre cannot levy tax on agricultural income. Task Force on Direct Taxes (2002) examined the issue of tax treatment of agricultural income and observed as under:

i. Non-levy of tax on agricultural income distorts both horizontal and vertical equity.

ii It also encourages laundering of non-agricultural income as agricultural income i.e. it has become a conduit for tax evasion.

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[31] These states are Assam, Bihar, Kerala, Tamil Nadu, Karnataka, Orissa, Maharashtra and West Bengal. (Source: Sreekantaradhya B.S., Structure and Reform of Taxation in India, Deep and Deep Publications Pvt. Ltd., Delhi, 2000, p. 80).

[32] Source: Reserve Bank of India , Report on Currency and Finance, 1997-98.

Task force (2002) found both the arguments as empirically verifiable. A close look at the tax returns of a large number of taxpayers in Mumbai by the Task Force revealed that a number of taxpayers had fraudulently claimed large amount of income from agricultural operations. Since such income enjoyed exemption from the central income tax and there was no such tax effectively in place in the states, such taxpayers enjoyed favourable treatment vis-a-vis those earning equivalent level of income from non-agricultural activities. To this extent horizontal equity was distorted. Similarly, the favourable treatment of agricultural income also adversely affected vertical equity. Based on the sample of claims of agricultural income in the returns of income in Mumbai, the Task Force estimated revenue loss of Rs.1000 crore from laundering of non-agricultural income as agricultural income.

Given the distortionary impact of continued exemption of agricultural income and the tax assignment under the Constitution, the Task Force recommended the following:-

(a) A tax rental arrangement should be designed whereby states should pass a resolution under Article 252 of the Constitution authorising the central government to impose income tax on agricultural income. The taxes collected by the centre would however be assigned to the states.

(b) Tax from agricultural income for the purposes of allocation between states should be the difference between the tax on total income (including agricultural income) and the tax on total income net of agricultural income.

(c) Where a taxpayer derives agricultural income from different states, the revenues attributable to a state will be in the ratio of the income derived from a particular state to the total agricultural income.

(d) A separate tax return form should be prescribed for taxpayers deriving income from agriculture.

According to Task Force, these measures will help mobilise additional resources for the states without the attendant problem of administering the agricultural income tax.

Recommendations of the Task Force need to be implemented immediately by the government particularly looking to the fact that there is huge revenue loss on this account. It would be better if a unified system of agricultural and non-agricultural income is adopted. For this purpose, taxation of agricultural income should be taken out of the state list through a constitutional amendment and a integrated system of taxation of agriculture and non-agricultural income must be introduced.

There was a time when it did not make much sense to tax income from agriculture. That was before economic reforms were initiated in India. Along with a number of other developing countries, India followed a policy of squeezing agriculture to transfer the sector’s surplus to industry for capital formation. This involved repressing farm prices even as industrial prices were kept high through protection. The non-farm sector bought farm produce cheap while farmers had to buy all the industrial output they bought at inflated prices. Thus, there was disguised taxation through adverse terms of trade. However, now industrial tariffs have been reduced even as the prices of a variety of Indian agricultural produce have been allowed to rise to global levels. Terms of trade have now improved for agricultural sector. In such circumstances, there is little justification for according income from farming a treatment different from non-farm incomes. The issue involved is not just horizontal or vertical equity among taxpayers. Exemption of farm incomes from taxation often becomes a conduit for large-scale evasion of tax on non-farm income. Removing the exemption of farm income from taxation would put an end to this form of evasion.

Finn G. Andersen and others (2002, p.1-131) have conducted detailed studies on the practice of taxation prevalent in agricultural sector in different countries. In America, the farmers can opt for federal corporation tax or federal income tax; however they are bounded by their choices for five years. Incomes from farm and forestry do not represent separate kind of incomes. These incomes are determined and taxed like incomes from other businesses of a comparable size. However, there are some elaborate regulations regarding farm income. In Canada, farmers’ incomes from farm and forest operations are taxed as business income although there are some tax advantages also for farmers. In Germany, agricultural income is calculated according to four different methods: (a) book keeping, (b) keeping an inventory, (c) flat method (‘unit valuation’), and (d) income valuation by the financial administration. Farms are obliged to keep records if they exceed a certain size. The agricultural industry in UK is taxed in almost the same way as other industries and the farmers are obliged to keep accounts as other tradesmen for the purposes of tax computation. French farmers face in principle the same rules for taxation and are subject to the same taxes as other self-employed tradesmen.

In many countries, income from agriculture is taxed on a presumptive basis. The usual approach is to base the tax on the area of land and its quality. An estimate is made of the normal income that can be earned, given the productivity of that type of land, average costs of production, and the price of products. Relief may be provided for when the harvest in an area is bad. For example, in France farmers with a turnover of 500,000 francs or less are eligible for the presumptive basis of taxation. The taxable income from agriculture is determined according to (1) the area of land that is under cultivation or could be placed under cultivation, (2) the type of crop, and (3) the region. For each region, a committee composed of representatives of the tax administration and farmers determines the average profit for each type of crop annually. If a natural disaster leads to crop loss in a region, then individual farmer who suffered from the calamity may apply for a reduction in tax on that basis. The basic rules for the presumptive taxation of agriculture are set forth in the statute. The presumptive taxation of agriculture is also prevalent in other countries like Belarus and Russia.

As discussed above, tax on agricultural income is levied in different countries of the world in one way or other. It is imperative that in India also, agriculture income is brought to tax uniformly in all the states. Federal government must be empowered to levy tax on agricultural income as in the case of non-agricultural income. Along with tax on income, tax on wealth may also be levied on farmers as is levied at present in the case of non-agriculturists. As the exemption limit for levying tax on income and wealth is now Rs. 100,000 and Rs. 15,00,000, concerns that small and marginal farmers shall be subjected to tax are unfounded. Since it would require constitutional amendment to bring tax on agricultural income under federal income tax net, immediate steps may be taken to amend the constitution. This may require building consensus among states on the issue which may take some time. To begin with, steps may be taken to build necessary consensus to tax the agricultural income of non-agriculturists and integrate their farm and non-farm income. Subsequently, the tax net may be extended to cover the farm income of agriculturists as well.

Chapter - 8

TAX REFORMS IN OECD COUNTRIES

8.1 Characteristics of reforms in OECD countries

Tax reform has attracted a great deal of attention in the OECD countries in recent years. Since 1980s almost all countries in OECD have undertaken structural reforms changing the way of functioning of the existing tax systems. The OECD member countries have taken a comprehensive view towards tax reforms rather than taking reforms on piecemeal basis and in isolation. As Owens (2006, p.131-164) points out ' These tax reforms have been driven by the need to provide a more competitive fiscal environment, one which encourages investment, risk-taking, and entrepeneurship, and provides increased work incentives.' Initiatives for reforms have been taken realising that existing tax structures were unfair, unnecessarily complex and subject to avoidance and evasion. It was also recognised that a combination of already large tax revenues and highly distortionary tax systems made it difficult to increase taxes in face of budgetary constraints.

Almost all the tax reforms of the last two decades in these countries can be characterized by rate-reduction and base-broadening. These reforms were on the lines of reforms initiated by the United Kingdom in 1984 and the United States in 1986. There has been reduction in the marginal rates of personal and corporate income tax since reforms were initiated. In the mid-1980s, OECD countries had top marginal income tax rates in excess of 65 percent. Today most OECD countries find themselves around or below 40 per cent and top rates are at the most around 50 per cent. Similarly, top statutory corporate income tax rates have been reduced from around 45 per cent to around below 35 per cent. Tax reforms in OECD countries also accompany reduction in the effective tax rate on dividends, which reflect the reduction of corporate income tax rates, personal income tax rates on dividends or both.

8.2 Reforms in different OECD countries

The corporate tax reforms initiated in Belgium in October 2001, with effect from 2003, involved an enlargement of the corporate tax base, enabling a significant reduction in the statutory corporate tax rate. Significant corporate tax rate reductions also took place in Canada as a result of strong economic growth and following significant base broadening in recent years.

In September 2003 the government in Finland lowered the statutory corporate tax rate from 29 to 26 per cent and the personal income tax rate from 29 to 28 per cent. In addition, the wealth tax limits were increased and the tax rates lowered. In France, the corporate tax rate was decreased from 42 per cent in 1998 to 35.4 per cent in 2002. Tax reforms have also been initiated in Germany since 2001, aimed at improving the international competitiveness of the German economy. The statutory federal corporate tax rate was cut to a uniform 25 per cent from the year 2001. Reforms also accompanied significant cuts in personal income taxes in Germany to provide a competitive boost to unincorporated businesses.

In the United Kingdom the main corporate income tax rate was cut from 33 to 31 per cent in 1997 and further to 30 per cent in 1999. Like in many other countries, the tax cuts were larger for small and medium-sized companies. Significant statutory corporate rate reductions have also been witnessed in the Czech Republic and Slovak Republic. In Iceland corporate tax rate was reduced from 30 per cent to 18 per cent in 2002 and Ireland reduced its general corporate income tax rate from 31 per cent in 1998 to 12.5 per cent in 2003. Hungary reduced its statutory corporate rate by two percentage points to 16 per cent; while Mexico took one percentage point off to lower its rate to 33 per cent. In addition, Portugal reduced its corporate tax rate by over 5 percentage points to 27.5 per cent, while Poland cut its rate by 8 percentage points to just 19 per cent. Austria has decided to reduce its corporate income tax rate from 34 per cent to 25 per cent from 2005.

Along with reduction in tax rates, a number of measures were introduced to expand the tax base in almost all the OECD countries. The main measures include non- deductibility of regional taxes, reinforcement of measures to avoid under-capitalization and increased control over the claim of exemptions.

As a part of the reform process, governments in OECD countries have established a variety of institutional arrangements for the administration of tax laws. These include the creation of unified and semi-autonomous bodies; single directorates with little autonomy within the formal structure of the Ministry of Finance; and multiple directorates with little autonomy within the formal structure of the Ministry of Finance. In six OECD countries, there is a unified body responsible for both tax and customs administration operations and in around 11 countries, the tax body is also responsible for the collection and enforcement of social contributions. There is a clear trend to allocate other tasks of a non-taxation nature to the national revenue body (Owens, 2005). Such tasks include government valuation tasks, the payment of various social welfare benefits, the collection of non-tax government debts and the maintenance of population registers.

There has been considerable emphasis upon bringing suitable changes in the organizational structure of revenue bodies realizing that they can have significant implications for their overall operational efficiency and effectiveness. The earliest organizational model employed by tax administrators was based principally on “type of tax” criterion. While this model served its purpose, it was eventually seen to have numerous shortcomings, including: (1) an inherent duplication of functions;(2) inconvenience for taxpayers with multiple tax dealings;(3) complicated compliance management implications;(4) a propensity for uneven and inconsistent treatment of taxpayers across taxes; and (5) under-utilization of staff. To address these sorts of problems, tax administrators have resorted to organizing their operations largely on a ‘functional’ basis (Owens, 2006, p.131-164).

Under the functional basis, staffs are organized principally by functional groupings and generally work across taxes. This approach to organizing tax work was introduced to enable greater standardization of work processes across taxes to simplify computerization and arrangements for taxpayers, and to generally improve efficiency. Today, over two-thirds of OECD countries have adopted the functional model as the primary method for structuring tax administration operations. A more recent trend among a number of OECD countries has been to organize operations principally around ‘taxpayer segments’ recognizing that each group of taxpayers has different characteristics. This model was adopted for the US Internal Revenue Service, as part of the 1998 Restructuring Act. Advantage of the ‘taxpayer segment’ type of structure is that grouping key functional activities within a unified and dedicated management structure increases the prospects of improving overall compliance levels. While application of the ‘taxpayer segment’ model is still in its early stages of use, many countries have partially applied this approach by establishing large taxpayer units to fully administer the affairs of their largest taxpayers. In many developing countries large taxpayer units (LTUs) have been established. In 1980s IMF had also recommended establishment of LTUs in developing countries. Establishing of LTUs has allowed many countries with scarce resources to begin implementing reform measures for immediate and visible results. (Baer, et al, 2002, p.36).

Undisputedly, an effective program of taxpayer services is a critical objective of all revenue authorities. The general complexity of tax laws coupled with the population of taxpayers to be administered require that fundamentally all revenue authorities must rely substantially on taxpayers’ voluntary compliance to achieve the desired and expected outcomes. Over the last decade or so, the goal of improving voluntary compliance has led many revenue authorities to adopt a more strategic approach to the provision of services to taxpayers. Studies conducted by Owens (2005) would show that this has manifested itself in the following sorts of ways:

i) Differentiating service delivery activities across the various segments of taxpayers, recognizing that taxpayer populations are not homogeneous.

ii) Treating taxpayers as persons/bodies with rights that are codified in the form of charters etc. and publicized; treating taxpayers as clients or customers.

iii) Recognizing that it is often more cost effective to leverage service actions through taxpayers' representatives.

iv) Consulting widely with taxpayers and/or their representatives prior to the implementation of changes.

v) Taking advantage of modern technology offerings.

vi) Demonstrating accountability by publicizing the levels of performance achieved against the service standards set.

vii) Ensuring that there is an appropriate balancing of resources between service and enforcement activities to achieve the outcomes being sought.

viii) Systematically identifying weaknesses in service delivery and developing organizational action plans to address those weaknesses.

A particular feature of efforts over the last 5-10 years has been the harnessing of new technologies to improve taxpayers' access to the information required by them, and the delivery of associated services. Owens (2005) has listed developments in this area as under:

i) There has been substantial progress in the scope and nature of electronic services including internet offered to taxpayers and their agents.

ii) Substantial progress has been made in the use of electronic filing by taxpayers and their agents for personal income tax administration purpose.

iii) There has been considerable growth in the provision of electronic payment facilities.

iv) There is a clear trend of revenue authorities in most member countries devoting an increasing share of their administrative budgets to IT investments.

v) Call centre phone operations, supported by modern phone technology are becoming an increasingly significant element of the service delivery strategy of many revenue authorities in OECD countries.

Reductions in tax rates result largely from recognition that lower taxes can bring improvements in economic efficiency. Further, attitudes towards tax compliance are shifting, with more taxpayers being prepared to engage in aggressive tax planning, often involving the use of tax havens. Coupled with this, there is a great demand for governments finance in the field of health care, pensions and other social areas. Under these circumstances, governments in OECD are under extreme pressure to enhance their expenditures and at the same time make their tax systems more competitive.

8.3 Recent trends and directions of reforms

Although each country pursuing its tax reforms is guided by specific circumstances, yet as found by Owens (2005) recent experience of OECD countries suggests that there are some general principles of good tax design. These general principles are simplification, fairness and lower rates coupled with widening of tax base. It has also been recognized that complexity and special tax exemptions can create serious obstacles to growth, creating uncertainty and giving companies greater financial returns from distorting their decisions to take advantage of special tax provisions than from simply improving efficiency. Thus, tax system should be designed to remove obstacles to growth.

Recent tax reforms show that some countries are moving towards a more comprehensive income tax system, others towards dual income tax and yet others towards flat taxes. Majority of OECD countries follow some sort of comprehensive income tax system which is characterized by a system where net income from all sources is aggregated and above the basic allowance is taxed according to a progressive tax schedule. This implies that wage and capital income are taxed at the same rates and that the value of tax allowances increases with income. Dual income tax is characterized by a system where a maximum income tax rate on comprehensive net income above the basic allowance is combined with additional taxation of gross income from labour and pensions above certain thresholds. This implies that labour income is taxed at higher rates than capital income, and that the value of tax allowances is independent of the income level. Norway, Sweden, Denmark, Finland follow this tax system. In flat income tax system comprehensive net income above the basic allowance is taxed at a single positive rate. This implies that wage and capital income are taxed at the same rate, and that the value of tax allowances is independent of the income level. Flat tax[33] proposals typically combine the introduction of a single tax rate with proposals for extensive base-broadening initiatives, while progressivity is achieved by using a basic tax allowance. Dual income tax systems combine a single tax rate on capital income and a progressive rate schedule for labour income, typically with a broad tax base. Comprehensive income tax system usually combines a progressive rate schedule for all sources of income with more extensive use of tax relief than in flat and

[33] Robert Hall and Alvin Rabushka first advocated flat tax.

dual income tax system. In practice, no OECD country has fully implemented any of these three main types of income tax system. Most countries are using “semi-comprehensive”, “semi-dual” or “semi-flat” income tax systems.

One of the most important public policy debates in many western countries today concerns the introduction of a flat tax to replace their complicated and highly distorted systems of taxation. Introduction of flat tax is worth examining in the context of other developing countries as well (Lal, 2006). In its pure version a flat tax replaces multiple marginal tax rates with a single marginal tax rate and abolishes the complex systems of allowances, deductions, exemptions and reliefs.

The advantages of a flat tax are its simplicity and transparency and the removal of various disincentives and distortions caused by existing tax system. However, in most developed countries with mature tax systems the most likely losers from a flat tax are likely to be the past beneficiaries who may use the democratic process to resist it. The back tracking on the proposal in the US, Germany and probably in the UK suggests that a full-blooded flat tax may be infeasible in these mature tax systems (Owens, 2005).

Tax reforms in OECD countries may serve as a guiding force for all developing countries in carrying out their own agenda. Of course, reforms in each country would depend upon the peculiarity of socio-economic and political conditions; however, following a general trend of tax reforms in developed countries, the tax reforms in developing countries share common strands as well. Past ten years have seen a remarkable convergence of views among all segments of the development community - policy makers, academics and the major multilateral institutions on what policies are good for development. Common ingredients of programmes of structural adjustment include trade liberalization and greater openness to foreign investment, greater reliance upon market forces in both the real and financial sectors, reduction in the role of the public sector in favour of the private sector, all underpinned by a sustained pursuit of macro-economic stability through low fiscal deficits (Ahluwalia, 1994, p.1). Need for basic reform in the tax system as an essential component of structural adjustment has been recognized as one of the critical elements in the strategy of stabilisation and structural adjustment.

Chapter - 9

REFORMS IN DIRECT TAX ADMINISTRATION

9.1 Role of tax administration in the context of tax reforms

Success of any attempt to reform the tax system depends upon the efficiency of the system of tax administration and therefore any attempt at tax reforms should also aim at improving the tax administration. Tax administration plays a crucial role in determining the real (or effective) system as opposed to statutory tax system[34]. Where the tax administration is weak, tax compliance is poor, resulting into revenue loss due to evasion and avoidance. It is widely recognized that tax policy and tax administration are intrinsically linked, so much so that it has even been said that in developing countries, tax administration is tax policy (Casanegra and Bird,1992 , p.1). Therefore, the interpretation and implementation of the tax laws has to play an important role even when the tax structure is carefully designed and crafted.

Tax revenue yield is influenced by both tax policy and tax administration (Faria and Yucelik , 1995, p. 267).This linkage has been expressed formally as:

$$\text{Tax Revenue/GDP} = (\text{Tax base/GDP}) \times (\text{Tax Collected})/\text{Tax Base}$$

Faria and Yucelik establish that the maximization of the first term on the right hand side of the equation represents the concern of tax policy while that of the second term represents the concern of tax administration. This ordering brings out the key insight that the tax base must first be clearly defined through the tax policy and then fully captured for revenue purposes through tax administration. If tax administration is tax policy, as is widely recognized, role of the tax administration must be clearly identified. The Task Force on Direct Taxes (2002, p.29) has stated that the fundamental role of tax administration is a) To render quality taxpayer services to encourage voluntary compliance and b) To detect and penalize non-compliance. In the overall ambit of these fundamental roles, the Task Force considered following separable component activities as functions of the tax administration:

[34] The concept of effective and statutory tax system is discussed by Tanzi , (1987,p.236-241) in Tanzi Vito: 'Quantitative characteristics of the Tax system of Developing countries'. David Newbery and Nicholas Stern, ed., Theory of Taxation in Developing countries, New York, Oxford University press, 1987 ,p.694

1. Taxpayers education and services.
2. Collection, collation, dissemination, storage and retrieval of information.
3. Verification (appraisal/assessment of information).
4. Collection of taxes.
5. Taxpayers grievances redressal system.
6. Accountability.

During the last two decades with change in the role of state, there has been a shift in traditional role of the tax administration as well. Earlier the tax administration perceived its role mere as an enforcement agency. However, with increase in number of taxpayers mere enforcement mechanism cannot help in evolving effective tax administration. There has to be a greater reliance now on self - assessment and trust on taxpayers and tax administration is required to facilitate compliance through the provision of quality taxpayer service.

9.2 Deficiencies in Indian tax administration and need for taxpayer services

At present the Income tax administration in India is providing a range of services to facilitate compliance viz; publishing pamphlets, brochures, booklets, providing web-based information and tax return forms to taxpayers. As part of reaching out to tax payers, tax administration has also come out with the schemes of Saral (simple) and Sampark (contact). During the year 2006-07, as a part of taxpayer service, facility to file returns of income with post offices was also provided. With a view to widening the tax base and providing facilities to taxpayers, new scheme to facilitate submission of returns through Tax Return Preparers has been introduced with effect from 01.06.2006. Thus, the tax administration in recent days has taken major steps towards providing education and services to the tax payers. However, a cross-country survey of taxpayer service done by Task Force on Direct Taxes (2002) indicates that the relatively more successful tax administrations provide relatively high levels of taxpayer service.There has been much more emphasis and spending upon providing taxpayer education and taxpayer services in many countries of the world - both developed and developing as compared to India. The present scope of taxpayer service in India is too narrow compared to the range of services offered by other tax administrations across countries as can be seen from Table -9.1.

Table -9.1: Taxpayer Information Programs in Selected Countries

		Argentina	Canada	Chile	Colombia	Jamaica	Mexico	Trinidad	USA	India
A	**Publications**									
1	Tax Guides	X	X	X	X	X	X	X	X	X
2	Pamphlets and Bulletins	X	X		X	X	X	X	X	X
3	Technical Publications		X		X	X	X	X	X	X
4	Audio Cassettes for visually impaired		X							
5	Newspaper Tax supplements			X	X	X	X	X	X	
6	Reminders in Press			X						X
B	**Media**									
1	Radio or Television Commercials	X	X	X	X	X	X	X	X	
2	Special Television Programme		X		X	X		X	X	
3	Video Cassettes		X				X		X	
4	Press Conferences			X			X		X	
C	**Television Contacts**									
1	Television Assistance	X	X	X	X	X	X	X	X	
2	Tele-refund		X				x			
3	Tele-information		X						X	
D	**Personal Contacts**									
1	Walk in service		X	X	X	X	X	X	X	X
E	**Correspondence**									
1	Individually drafted letters		X	X		X		X	X	
2	Standardised letters		X	X		X		X	X	

Table contd. from page 75

		Argentina	Canada	Chile	Colombia	Jamaica	Mexico	Trinidad	USA	India
F	**Other programs**									
1	Volunteers		X					X	X	
2	High School Programme	X	X	X		X	X	X	X	
3	Rural Tax scene kits		X						X	
4	Native outreach		X						X	
5	Training for new business							X	X	
6	Participation in seminar conferences		X		X		X		X	

Source: Report of the Task Force on Direct Taxes, Ministry of Finance and Company Affairs, Government of India, December, 2002, p.32.

Taxpayer services in India suffer due to inadequate budgetary support and lack of sufficient policy initiatives. Taking into account these constraints and the best international practice in the area of taxpayer services, the Task Force (2002) recommended following measures to expand the present scope of the taxpayer service programmes with a view to covering the range of taxpayer services indicated.

i) Introduction of a telephonic system (by voice message) to remind taxpayers of important dates and the provision of preformatted programmed floppy diskettes through retail outlets.

(ii) Increase in expenditure on taxpayer service from the present level of about one percent of the total expenditure on tax administration to at least five percent.

iii) Setting up of taxpayer clinics in different parts of the country to enable taxpayers to walk in for any kind of assistance.

(iv) Providing easy access to taxpayers through Internet and e-mail and extend facilities such as tele-filing and tele-refunds.

(v) Designing special programmes for retired people, low-income taxpayers and other such groups with special needs who cannot afford expensive services of tax consultants.

It is necessary that the above suggestions are implemented in totality at the earliest. A reasonable degree of understanding of the tax system and its role in the society is a must for building up a spirit of co-operation in the public and this understanding requires public education on the tax system (Muten, 2006, p. 54). Taxpayers' services and taxpayers' education form necessary constituent of tax reforms and it is necessary that a concrete permanent policy is evolved towards these for building effective tax administration. In addition, it is also necessary that the steps being taken at present in this direction are made known to the taxpayers. There is a need for proper and sustained media campaigns, press releases and advertisements to make taxpayers aware of the government's initiatives.

Taxes are compulsory payments to government for which the taxpayer in general receives no specific benefit. But the taxpayer is entitled to the general benefits of governance; and if the taxpayer is dissatisfied with the balance between public benefits and tax burdens, he may consider moving to another jurisdiction - another city, another state, another country. Charles Tiebout made this fundamental observation in 1956, which is still of great relevance. The costs of moving are rapidly falling and the opportunities for moving are greatly increasing, both for firms and households. The Tiebout Hypothesis applies not only locally but also globally. As has been observed by Hufbauer (2000), Jurisdictions that want to avoid a shrinking tax base and dwindling revenues must accordingly deliver quality government services at competitive costs.

9.3 Collation, Collection, Dissemination, Storage and Retrieval of Information - Use of Information Technology

Taxpayer identification and registration are key components of tax enforcement. It is required that a taxpayer information system is in place with unique identity number system so that the information relating to various transactions may be collected and collated. At present, Income Tax Act[35] provides for allotment of a Permanent Account Number (PAN). Further, the act also provides that PAN must be quoted by the taxpayers in case of certain transactions. Task Force for Direct Taxes (2002) has recommended for adoption of PAN as Citizen Identification Number. The recommendations of Task Force to make PAN a Citizen Identification Number will serve the goal of mapping all the transactions of taxpayers and also obviate the need for issuing different identification numbers by different agencies. It is also required that quoting PAN be made compulsory for all kind of transactions. This will not only enable the tax department to keep a watch on transactions of existing taxpayers but also help in the identification and registration of new taxpayers.

[35] Section 139 A of IT Act , 1961

Hitherto, the tax department used to collect information about taxpayers by using taxpayers' own declarations and by adopting the methods of searches and surveys. It has now been recognized that in the process of tax reforms the use of information technology may be a useful tool for collection, collation, dissemination, storage, retrieval, and verification of information. It has also been felt that the assessment of most modern taxes requires the ability to marshal the numerous pieces of information needed to determine the base of the tax and the rate to be applied. In line with this philosophy of using information technology for collection, collation and verification of information, concept of Annual Information Return (AIR) has been introduced. Annual information return filed by third parties in digital form has replaced the existing procedure in which the Central Information Branch (CIB) spread all over the country, used to collect from predetermined sources information relating to financial transactions from various external and internal sources. Often the material collected was not put to use. Further the cost of collection of data was also very high. The use of AIR has led to not only less costly collection of information but also has led to unearthing astonishing figures of expenditure, which has hitherto gone unnoticed by the tax administration. Over 67,900 high-value property transactions (property value exceeding Rs 30 lakh[36]) have been reported in the year 2005-06. In addition, as on March 31,2006, over 18.32 lakh high-value transactions (worth Rs 13,84,097 crore[37]) have been reported. According to AIR, the number of transactions involving cash deposits in Bank (exceeding Rs 10 lakh), crossed over 5.25 lakh cases on March 31,2006 involving Rs 48,347 crore. Transactions worth Rs 7,65,697 crore took place in mutual funds alone. Over 3.62 lakes credit card-related transactions (exceeding Rs 2 lakh) were reported with total value crossing Rs 5,830 crore. Transaction amount through bonds and debenture was at Rs 95,246 crore.

Although the Annual Information Return has enabled the department to collect and collate significant pieces of information, it is also necessary that a constant and regular flow of data is maintained. Electronic Data Interchange may be of great help in receiving regular information from different agencies. It is required that different agencies and departments are linked with tax department using Electronic Data Interchange.

The use of information technology and modernization in tax administration is result of recommendations of working group constituted by the government in 1993 to suggest a comprehensive computerized plan. The working group suggested layered approach to

[36] 10 Lakh = 1 Million.

[37] 1Crore = Rs 10 Million.

computerization and implementation of the plan in phases. As a result, National Computer Center (NCC) was set up at Delhi. At present besides NCC, 36 Regional Computer Centers are also operational. As a part of plan of use of I.T. in tax administration, National Securities Depository Limited on behalf of Income Tax Department has established Tax Information Network (TIN) which serves as a repository of nationwide tax related information. It has made online application and allotment of PAN[38] and TAN (Tax Accounting Number) possible. The TIN system has also led to e-TDS, e-TCS (electronic Tax Deduction at Source and electronic Tax Collection at Source) and also e-tax filing. Further, Income Tax Department has launched the Electronic Furnishing of Return of Income Scheme in 2004. Under this scheme, eligible assessees can file their returns of income electronically through persons authorised to act as e-return intermediaries.

TIN has three key sub-systems. The TIN system revolves around these three key elements which explain the functioning of the entire system. The three key elements in brief are as under:

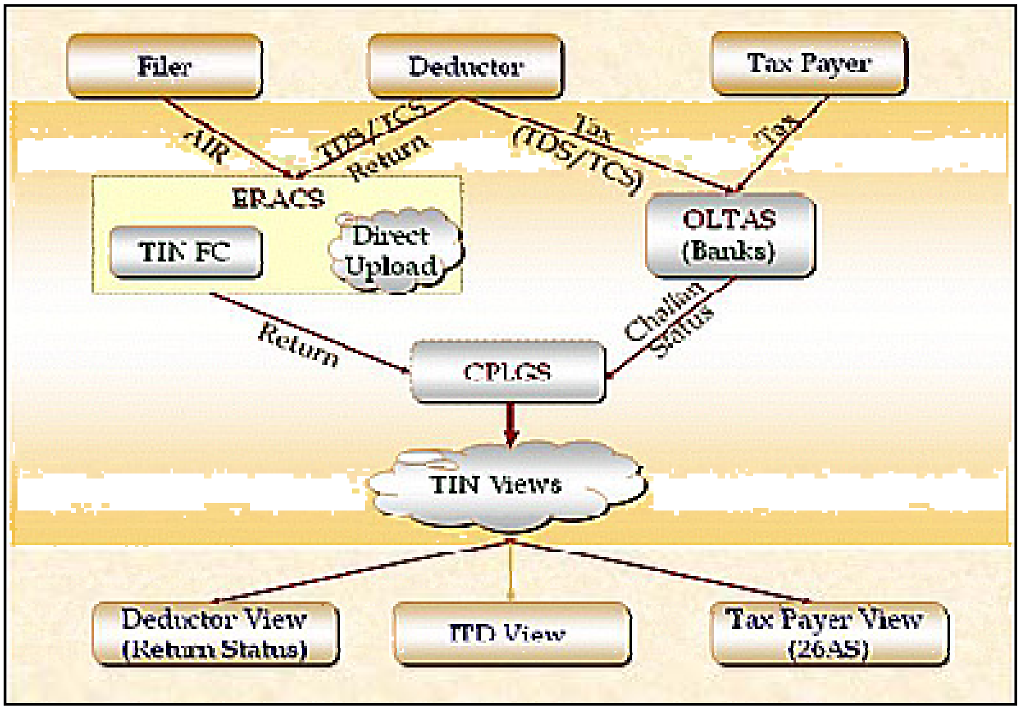
i) **Electronic Return Acceptance and Consolidation System (ERACS)** which consists of an infrastructure for interface with the taxpayers and a web-based utility for upload of electronic returns of Tax Deduction at Source (TDS)& Tax Collection at Source (TCS) and Annual Information Return (AIR) to the central system of TIN.

ii) **Online Tax Accounting System (OLTAS)** for daily upload to the central system, the details of tax deposited in various tax collecting branches across the country.

iii) **Central PAN Ledger Generation System (CPLGS)** which is the central system that consolidates for each PAN, details of tax deducted/collected on its behalf which is obtained by matching the TDS/TCS returns submitted by the deductors/collectors with the tax deposit (challan) information from the banks, details of the tax deposited directly by the taxpayer with the bank and details of major expenditure by the PAN holder from the AIR filed by specified entities.

[38] Facilities set up in over 500 cities. At present one can apply for PAN online, track status of his application and also apply for Tatkal (immediate) allotment of PAN.

Figure: 9.1- Diagrammatic presentation of TIN



Source: URL:http://www.tin-nsdl.com/AboutTIN.asp

The failure of the tax administration to issue refunds continues to be a major source of public grievance. This is partly due to its inability to promptly process the returns, whose numbers have increased substantially in the last three years and partly due to the cumbersome process for issuing of refunds. The tax department first provided that salaried employees for specified amount of revenue (Rs 25,000) can get their refunds credited in their bank account. The scheme has further been extended to all categories of taxpayers for any amount in cities of Ahmedabad, Bangalore, Bhubaneshwar, Chennai, Hyderabad, Kanpur, Kolkata, Mumbai, Nagpur, New Delhi, Patna and Thiruvananthapuram. This has been made possible due to Income Tax Department’s Electronic Clearance Scheme. Once income tax return is processed, the refund will be credited directly to bank account. The tax department has also initiated the process of starting a service wherein one can log in and check the status of refund. Still refunds remain a major problem of grievance among the taxpayers. Thus, it is necessary that refunds are issued in stipulated time. While with this measure, a major source of tax payer grievance would also be taken care of; this would obviate the need for giving interest on delayed refunds.

While the use of information technology system has led to enhanced taxpayer's services and reduced interface with the taxpayers, it has also led to the effectiveness in tax administration. Efficiency gains from application of modern technology have been listed by Chakravarti (2004) as under:

i) The number of income tax returns processed on computers increased from 0.4 million in 2000-01 to 20.4 million in 2003-04 [39].
ii) Refunds issued doubled from 2.6 million in 2001-02 to 5.6 million in 2003-04.
iii) The number of allotted Permanent Account Numbers (PANs) soared to nearly 36 million by late 2004 , greatly helped by the outsourcing of PAN allotments to the NSDL and UTI.
iv) In 2004, the software giant, Infosys, uploaded only one disc for filing its employees TDS returns, the previous year it had to file nearly 20,000 separate TDS returns[40].
v) By one estimate, TIN has eliminated the circulation of nearly 70 million A-4 sheets of paper.

The Income Tax Department is now moving towards towards Business Process Re-engineering nationwide to connect 745 Income Tax Offices in 510 cities to create national databases. A single data base is being created which would consolidate 36 regional databases. This would ensure jurisdiction free filing of returns. A National Data centre with Business continuity and Disaster Recovery Sites has been planned along with All India Network linking all Income Tax Offices.

The Task Force on Direct Taxes (2002) recommended Risk Based Assessment based upon identification of cases through a random non-discretionary centralized method deploying the PAN base in place of existing discretion based system of selection of returns for audit (scrutiny). The Income Tax Department has implemented this recommendation in part. The cases for scrutiny are selected aided by computers. This has reduced discretion and increased transparency in the entire audit process. Task Force on FRBM (2004) also recommended setting up a Risk Intelligence Network (RIN) based upon access of four kinds of information : corporate income tax transactions and filings, GST transactions and filings, customs transactions and filings and public domain databases about the firm. It has

[39] Computerised processing at 60 networked stations. In other places, stand-alone PCs are being used.

[40] During the year, 22,750 e-TDS returns have been received by the Tax Department. Besides, over 600 facilitation centres have been set up in 235 cities for receipt of e-TDS returns.

also been recommended that information collected through TIN and RIN must be shared both by authority responsible for implementing customs , excise duties as well as direct tax administration. The tax administration must proceed towards implementation of this recommendation as it would lead to curbing unaccounted transactions to a large extent.

Information technology should also be effectively used for tracking down and collecting outstanding demand. Trends in the raising of regular demand and its collection shown in the Table-10.1 reflect that the tax department in India needs to gear up its machinery for collecting the outstanding tax dues.

Table-9.2: Trends in the Raising of Regular Demand and its Collection (In crore)

Financial Year	Arrear demand at the beginning of the year	Fresh demand	Collection out of fresh demand	Collection out of arrear demand	Reduction of demand due to appeals etc	Total collections against arrear as well as fresh	Arrear demand at the close of the year
1996-97	29260	16934	1951	2320	7117	4271	34806
1997-98	34806	18345	1724	2845	6755	4569	41827
1998-99	41827	19388	2021	3049	11284	5070	44861
1999-00	44861	25934	3399	2982	10456	6381	53958
2000-01	53958	25944	3837	4970	13696	8807	57399
2001-02	57399	38958	4525	4030	10989	8555	76813
2002-03	76813	37350	7700	5670	22469	13370	78324
2003-04	78324	46225	11391	5540	14614	16931	93004
2004-05	93004	49599	15414	7083	20786	22497	99320

Source: Administrative Hand Book, Directorate of Research and Publications, Income Tax Department, Government of India, 2006, p.116.

From the above figures it is clear that arrear demand in the year 2004-05 was around 75% of the total direct tax collection of around Rs 132,000 crore. In this direction it is necessary for evolving an effective tax administration by which collection lags are reduced which can be done by way of taking measures like shortening assessments & payment periods and establishing system of provisional payments (Casanegra, et,al, 1992, p. 252).

9.4 Autonomy in Tax Administration

In the overall context of tax reforms, one very important issue that has been addressed by a large number of countries is the organizational structure of tax department. Task Force on Direct Taxes (2002) noted that one of the important general organisational issues for tax administration in India relates to the placement of the tax administration in relation to the Ministry of Finance. The Task Force noted that while traditionally the tax administrations have been placed within the Ministry of Finance, tax administrations are increasingly attracted to the Canadian model where the tax administration is placed outside the Ministry of Finance with full autonomy. To make the Central Board of Direct Taxes (which is responsible for administering the direct tax laws in India) more effective, requisite autonomy should be given. Although Ministry of Finance may have overall control, the Board should have autonomy in financial and administrative matters and the Chairman of the Board should report directly to the Finance Minister on all policy matters - administrative as well as financial.

However, once autonomy is granted it is necessary that the tax administration is made accountable. On the question of accountability of the tax administration, the Task Force on Direct Taxes has recommended the following:

(i) The control of the central government over the tax administration be exercised through a Memorandum of Understanding (MoU) between the Central Board of Direct Taxes and the central government.

(ii) The MoU should, inter-alia, specify the financial commitment of the central government for tax administration.

(iii) The MoU to provide for full financial autonomy and control over deployment of human resources to the CBDT. The central government should only specify the general guidelines for financial expenditure and deployment of human resources.

(iv) The MoU should be for a period of five years specifying observable performance indicators for CBDT and the financial resources that would be made available to CBDT on a year-to-year basis.

(v) The CBDT should have exclusive power for designing the enforcement strategy, subject to the condition that it is non-discriminatory and transparent.

9.5 Accountability in Tax Administration

It is a common refrain among taxpayers across the country that there is lack of accountability in tax administration and actions are often taken which are suggestive of malafides. It is necessary for the tax administration to act with full responsibility, integrity and honesty. Corruption must be effectively tackled. Leakage costs as Shaw (1991) calls that portion of tax revenues that flows into the pockets of officials rather than into the coffers of government; may simply be transfers in economic terms but they may nonetheless result in significant distortions as new taxes are introduced and tax rates are increased in attempting to make up for the revenue loss. The taxpayers should feel that the tax officials are working for the society and not for self-enrichment. This will lead the taxpayers to become more vigilant towards their tax paying duties and they will pay taxes without any dissatisfaction. In case tax officials do not act as per rule book and err with malafide intention, severe action should be taken against them under conduct rules. Further, as a confidence building measure, as the Task Force has recommended the Central Board of Direct Taxes should release annual information (giving Chief Commissioner wise break-up) of number of complaints received from the public or acts of omission or commission identified through internal mechanism or by external agencies and the result of official enquiry into such complaints. The information must be provided separately for officers and staff. It has also been suggested that the ultimate accountability of the tax administration is to the citizens. The recommendations of Task Force that with a view to enhancing accountability of (and transparency in) tax administration, it is important that the CBDT publishes an annual report of its own that is tabled in Parliament and put on its web site, will ensure greater transparency. These recommendations if accepted and implemented would ensure a great degree of accountability among tax officials.

In the public perception, the Income tax department is identified with search[41] and survey[42] operations. Often there is complaint and grievance from the tax payers who are subject to these operations. Sometimes the taxpayers complain of forced declaration of unaccounted income. These complaints may be true or it may be just to distract the attention of tax department from further investigations. To make the tax officials accountable and also to

[41] Under the provisions of S.132 of I.T.Act, 1961 tax department may search the business and residential premises of tax offenders to unearth unaccounted income/wealth and also make seizure of unaccounted assets provided there is warrant of authorisation to that effect.

[42] Under S.133A of I.T. Act, 1961 the tax department may visit only business premises of any taxpayer for verification of books of account, cash or stock. Unlike search, however, no seizure can be effected.

thwart baseless allegations, as has been recommended by the Task Force (2002), executive instructions must be issued that no search/survey team should obtain any surrender whatsoever. Although some steps have been taken viz; administrative directions have been issued for not asking for surrender, it needs to be strictly followed. Further, it is also recommended that all statements recorded during the search should be video recorded. This will indeed add to the confidence of the taxpayer in the impartiality of the system. However, it may be also ensured that once a tax evader is caught then heavy penal and prosecution measures may be taken against him as it would serve not only as deterrence to dishonest taxpayers but also a sort of reward to honest taxpayers in a way that while dishonest taxpayers are punished, honest taxpayers are recognized.

Recognizing the need for a measure of resolving taxpayer’s grievances, institution of Ombudsman has been created by the government which will help redress taxpayer grievances. To begin with, the institution of Income Tax Ombudsman will operate in four metropolitan cities-Mumbai, Kolkata, Delhi and Chennai. It has been specified that grounds on the basis of which complaint can be made include delay in issue of refunds beyond time limits, delay in disposal of rectification application, delay in giving effect to the appellate orders and delay in allotment of Permanent Account Numbers.

However, some more steps are required in this regard. The Income Tax Act specifies the categories of orders in respect of which a judicial remedy can be availed. There are several orders for which there is no judicial remedy and the administrative redressal mechanism is ineffective. This results in considerable dissatisfaction amongst taxpayers. In this regard, Income Tax Act should be amended to provide that all orders/intimation imposing any additional burden should be made appealable.

9.6 Infrastructure in Tax Department

While accountability is necessary for effective tax administration, it is necessary that working conditions of tax officials may be improved. Task Force realizing the appaling working conditions and lack of infrastructural facilities has expressed their feelings by saying that it was aghast at the physical environment prevailing in most tax offices. Visit to a tax office would reveal that the infrastructural facilities in tax department are pathetic. While the taxpayers adopt all modern techniques of tax evasion, the tax department in India is not adequately equipped. There is shortage of personnel staff, lack of modern gadgets and operational vehicles. A number of the tax offices are located in rented private buildings. The officers are not having residential accomodation. There is total dissatisfaction among tax officials about their poor working conditions. Tax Inspectors are required to make field investigations.Tax Recovery Officers are required to collect and recover taxes. But they lack even basic infrastructural support like vehicles to perform their jobs. Unless the tax officials are given reasonable better working conditions, effective tax administration may not become a reality. As per estimates, cost as a percent of total tax collection in India is around 0.66% which is one of the lowest. Thus, the government must come out with immediate blueprint for providing basic facilities to the tax department so that the tax officials have the incentives to work for the desired goals and their morale must remain high. Investment in infrastructure has multiplier effect in collection of taxes and better tax administration and thus issue of better infrastructure in tax departments must be immediately addressed.

9.7 Incentives to Tax Officials

Tax experts have advocated giving incentive measures to the tax officials for effective and efficient tax administration. It is also required that there is a proper Human Resource Management in place as a part of incentive scheme. As a part of incentive measure, each jurisdiction must also be given targets for improving infrastructural facilities and staff welfare measures.The jurisdiction will qualify for the incentives only when it performs well on the indices of staff welfare and tax payer services in addition to collection targets.

A number of countries have recently introduced incentive reforms for tax auditors in their tax administrations which have yielded desired results. Mexico, for instance, used such measures as part of a comprehensive reform of the administration during the period 1988-92. The new system instituted within each office a bonus fund comprising about 60 percent of additional collections. This fund is distributed among members of the office in proportion to the distance of the official from the discovery and collection process.Brazil also introduced a similar reform at around the same time. A bonus program went into effect in 1989 as part of an overhaul of the tax system. The program created a bonus fund for distribution among tax officials, that amounted to about 68 percent of total fines collected. These are divided between individual and group rewards in a 70:30 split. The group rewards are in turn divided among different agencies on the basis of their relative performance evaluation. As a result, tax revenues rose substantially as a proportion of GDP (5.4 percent in 1990 to 9 percent in 1991). It is however recognized that incentives must accompany other organizational reforms as well. There must be enhanced supervision of the work of tax collectors. The Peruvian reform effort placed emphasis on improving the quality of tax administration personnel by encouraging early retirement of those unable to pass competence tests or those whose records included reports of unethical behaviour, by instituting stricter screening and promotion criteria for new recruits.

Incentive reforms will be facilitated by accompanying organizational changes and design of incentive system must be sensitive to institutional environment within which the concerned bureaucracy operates (Mookherjee, 1997, p.35-36). It is also desirable while instituting incentive schemes that discretionary power of tax officials is reduced. Attempts can be made to prevent bilateral face-to-face contact between taxpayers and tax collectors, either by requiring audits to be conducted ex-parte, or by methods like Risk Assessment Techniques and Risk Intelligence Network. Information technology can help mitigate numerous problems in controlling discretionary behaviour of the tax officials.

Success of the incentive schemes will also depend on autonomy over a range of decisions concerning budgetary allocations and procurement. Recent reform efforts in the tax administrations of some countries (including Argentina, Colombia, Ghana, Jamaica, and Peru) have increased autonomy over budgets, administration, personnel, procedures, and control. Thus, incentive reforms must be facilitated by accompanying organizational changes within tax administration, including changes in supervision systems, information and control procedures, staffing policy, and increased autonomy and accountability at all levels. Further, an ideal system would involve a system of incentives that percolates through all levels of the bureaucracy.

9.8 Imperatives for reforms in Tax Administration

As has been stated by Bahl and Vazquez (1992, p.66), analysis of poor tax administration in developing countries centres on following:

a) Procedures used are antiquated and staff are poorly paid and badly trained.
b) Tax systems are too complicated.
c) Unwillingness of government to enforce the existing system.

Governments in developing countries may also choose some degree of poor tax administration as part of their development strategy. Goode (1981, p.8) argues that since resources may be used less efficiently in the public sector, it may be that tax evasion is a safety valve in the economy against excessive or poorly designed taxes.

Tax laws may be quite well designed and detailed. But unless the accompanying tax administration is able to handle those laws, it may be difficult to implement the desired tax legislations. In the long run it has to be ensured that tax administration instruments facilitate rather than ignore or hinder the implementation of tax policy goals. Simple reforms of personnel policy inside the Indian Income Tax Administration can imply significant enforcement and compliance gains which would reduce the cost of collection per unit of yield (Das-Gupta, Gosh **a**nd Mookherjee, 2003, p.1). Studies conducted by Das-Gupta (2004, p.39-68) show that gross compliance costs for 2000-01 are estimated at between 5.6 and 14.5 per cent of corporation tax revenues.Another study conducted by Das-Gupta (2004a, p.32) has estimated the compliance cost to be as as high as 49% of personal income tax collections and between 6% and 49% of tax paid, with bulk being legal costs of compliance (although Das-Gupta has expressed reservations regarding adequacy and quality of sample, the fact remains that compliance cost in India is high).

It is empirically proved that controlling the tax evasion is better achieved by a more efficient tax administration among other policy tools. Reforms in tax administration are more likely to succeed if they are comprehensive rather than incremental. Partial attempts at reform may achieve only limited success. Sustained determination to reform at the highest levels of government is an essential prerequisite for comprehensive reform in tax administration. Successful tax administration reforms have three ingredients in common-simplification, strategy and commitment. Tax structure needs to be simplified for ease of compliance and administration; strategy is required suitable to the specific circumstances of each country; gimmicks or quick fixes are no substitute for a comprehensive strategy and there must be a strong political commitment to the improvement of tax administration (Casanegra and Bird, 1992, p. 13). As a part of their recommendations in respect of overall reforms in tax administration, Report of Task Force on Direct Taxes (2002) has laid emphasis upon building up of a world class tax system. In order to build and thereafter maintain and sustain a world class tax system, it is necessary that a world class tax administration takes the charge.

Direct taxes improvements in the rate structure are in line with international best practice of moving towards modest tax rates (Ahluwalia, 2002). As this requires reliance on improved tax administration to increase revenues, it is very important to get on with the task of modernizing the tax administration through introduction of computerization and other modern methods. Policy changes without administrative change are nothing (Bird, 1991, p.39). It is very critical to ensure that changes in tax policy are compatible with administrative capacity (World Bank, 1991, p.51).

The essential elements required for successful tax administration reforms include: an explicit and sustained political commitment, a team of capable officials dedicated to the tax administration reform, a well-defined reform strategy, additional resources for tax administration and changes in incentives for both taxpayers and tax administrators. As Ahluwalia (2002, p. 100) points out, experience of other countries shows that a tax reform which brings about a system change could generate additional revenues of 3% of GDP in a relatively short period without necessarily increasing tax rates. In order to make effective reforms in direct tax structure, reform of tax administration is necessary. Administrative dimension should be placed at the center rather than the periphery of tax reform efforts (Bird, 1989, p.315). Tax Administration must send a clear signal to its employees that administration must change, if it is to be effective. The way to convey this message is to completely change the organizational structure (Casanegra, et al, 1992, p.140). Evolution of a tax system is dependent not only upon supply factors such as ready availability of easily taxed economic activities but also "demand factors" such as societal institutions like governance and corruption and "framing" institutions such as the size of shadow economy-inequalities in the distribution of income and "tax-morals' (Bird , et al, 2004,p.284-289). A sustainable tax system is based upon a fair tax system and the responsive government achieved with a strong connection between tax payments and supply of public goods (Bird, et al, 2004, p. 287).

No doubt recently initiatives have been taken in right direction to bring changes in tax administration, however, much more is desired. Reform in tax administration is essential in the context of overall tax reforms. A discussion paper of Department of Economic Affairs, Ministry of Finance (1994, p.334) aptly sums up the imperative for reforms in tax administration by stating "we must recognize that reform of tax policies will be infructuous without simultaneous and systematic reform and modernization of the entire system of tax administration". Some of the steps suggested above viz; investing more in the area of providing taxpayer services, using I.T. as integral part of tax administration, providing autonomy to the tax administration, awarding incentives and fostering accountability may be instrumental in bringing improvement in tax administration as well as in enhancing tax collections which is required for fiscal consolidation. With the initiatives for simplification, introduction of accountability, granting autonomy, giving incentives, providing infrastructural facilities and e-governance, the tax administration may be made much more effective than it is at present.

Chapter - 10

FINDINGS, RECOMMENDATIONS AND CONCLUSIONS

10.1 Major Findings

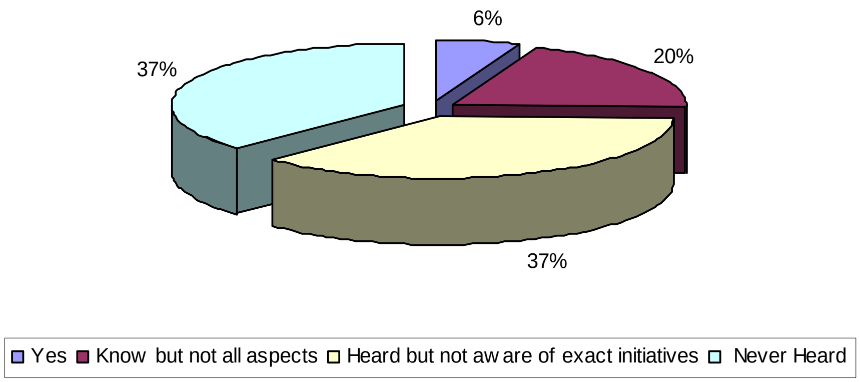
As has been discussed in the previous chapters, the decades of 1980s and 1990s were marked by sweeping changes in the direct tax structure and direct tax administration throughout the world - both developed as well as developing countries. India also initiated steps in 1990s to reform its tax system which had grown complex and cumbersome, riddled with exemptions and deductions. Looking at the history of tax revenue in broad perspective, one may say that the structural movement has been from taxation on agriculture to foreign trade and then to tax on consumption and finally to tax on net income of individuals and businesses (Hinrichs, 1966, p.106). Study of tax revenue by type of tax and country group as a percentage of GDP would reveal that with an increase in per capita income, reliance upon taxes on income also grows[43].

In India the changeover to the typical "modern" tax system where personal income and corporate income tax play a dominant role has not been fully accomplished, although it has gained momentum in last ten years. The share of direct taxes in total central revenue has gone up from about 19% in 1990-91 to around 45% in 2004-05.The direct tax -GDP ratio for the central government has gone up from 1.8% to around 4.4% in the same period. Thus, as a result of reforms the Indian tax system has begun to move away from the traditional features of the Musgrave's "early stage" (Musgrave, 1969, p.125-167). However, economic structures and administrative capabilities still severely constrain features of tax system in India like any other developing countries. The large share of agriculture in the economy and the prevailing small scale unorganized operations are impediments in the way of the correct determination of business income. As a result, tax on income is effectively applied just to wage earners and organized sectors of economy.

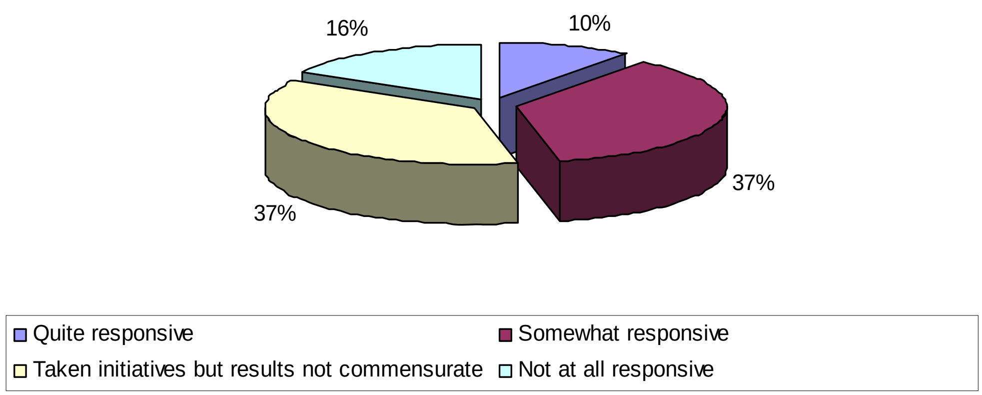
In order to assess the results of reform on tax system, awareness among tax payers about various reform programmes initiated by the government and perception of taxpayers about the fairness of the tax system, a questionnaire was administered to a group of taxpayers by the method of random selection. A copy of questionnaire which was administered is enclosed as appendix to the thesis. The survey on various issues shows the following results.

[43] Information contained in IMF, Government Financial Statistics Year Book, 1989, World Development Report, 1989 reveals that with an increase in income reliance upon income tax also grows.

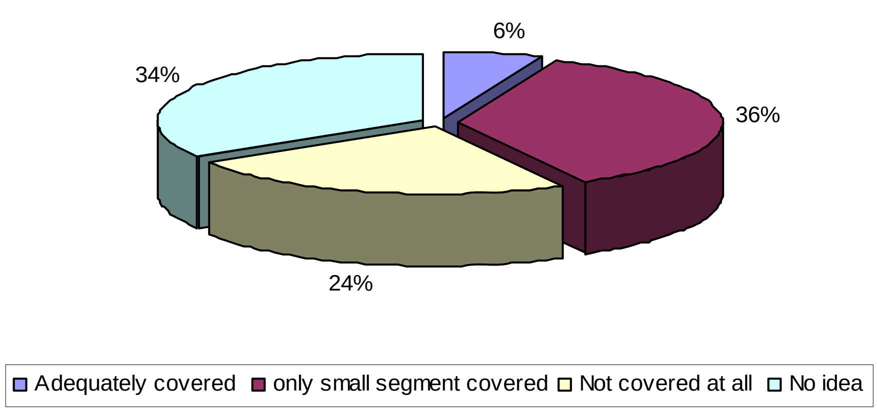
a) **Fig-10.1: Awareness about taxpayer services programme of Income Tax Department**



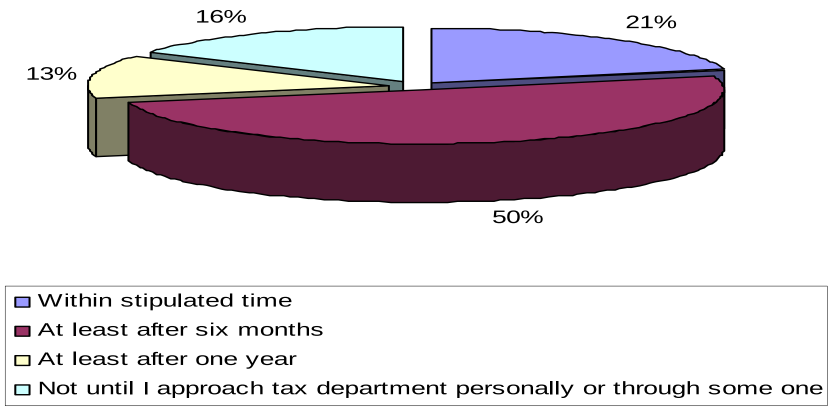
b) **Fig-10.2: Perception regarding attitude of tax department towards taxpayers**



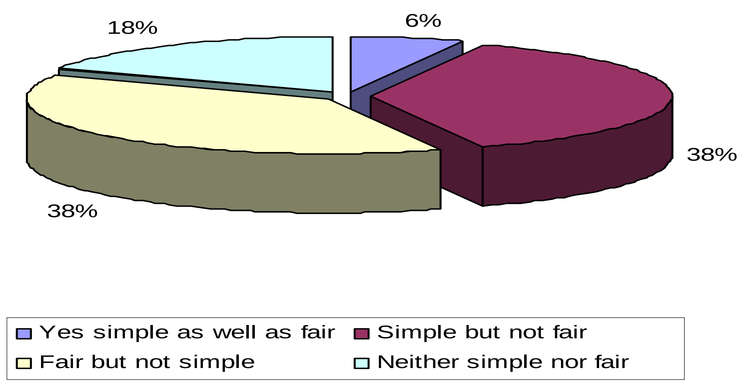
c) **Fig-10.3: Perception regarding coverage of non-organized sector/small traders under the tax net**



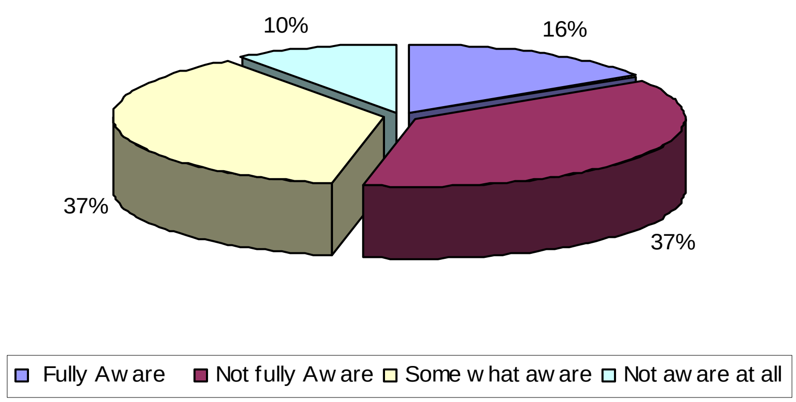
d) **Fig-10.4: In what period of time one gets refund, if it becomes due**



e) **Fig-10.5: Opinion about simplicity and fairness of the tax reforms**



f) **Fig-10.6: Awareness of tax reforms initiated by government in recent years**



The survey yielded following observations:

i) That there is very little awareness about the reform programme undertaken by the tax department among the taxpayers.

ii) That there is lack of awareness among taxpayers about taxpayer service programme.

iii) Majority of the taxpayers feel that the tax department is non-responsive towards the taxpayers.

iv) Majority of the taxpayers feel that the tax system is either not fair or not simple or both.

v) There is a problem regarding issue of refunds in time.

vi) A vast majority of taxpayers feel that non-organized sector/small traders are not covered adequately under the tax net.

The principles that have guided the framing of tax proposals are need for growth in revenue, simplification, fairness, rationalization of the tax regime and effective tax compliance. It has been recognized that simple tax systems characterized by low rates applied to a very broad tax base generally lead to fewer economic distortions, greater certainty for the taxpayer as well as lower administrative and compliance costs. The tax system should be characterized by fairness and it should have both vertical as well as horizontal equity. Special tax exemptions, reliefs and regimes often violate the principles of horizontal equity and their elimination would produce a gain in revenue while improving economic efficiency. A good tax system removes obstacles in growth. Recent reforms in taxation system can be viewed as a continuation of efforts to improve efficiency in the allocation of real capital, to strengthen the competitive position of businesses and establishing an equitable sharing of tax burdens between capital and labour income.

Various countries depending upon their socio-economic and political conditions have adopted different strands of reforms. However, one common strand of the tax reforms in all the countries has been bringing changes though legislations. It has been felt that reform in the tax structure is not possible without initiating appropriate legislative changes necessary for reduction in tax rates , eliminating the exemptions and widening the tax base. Legislation should provide the government with the ability to fine tune the tax system and manage changes in the economy. Through legislations the tax laws may also be made simpler. Income Tax Act , 1961 in India has become too complex even to be understood by tax experts. Complexity in the tax system while on one hand comes in way of tax compliance; it also leads to a lot of discretion in the hands of tax administrators. In place of existing Income Tax Act, it would be better if a new act were enacted which is simple and easily discernible. Various sections in the new act may be well defined taking into account all implications. While on the one hand this would be of considerable help to tax officials in administering the direct tax laws, it will also reduce the compliance cost.

Improvement in tax administration is a necessary component for effective tax reforms along with legislative changes. Efforts should be made to increase the capabilities of personnel handling the tax administration by focussing on a culture of efficiency, service and integrity. It is found that apart from payment of taxes themselves, taxpayers also face various costs in complying with direct tax laws. These include administrative costs, the costs of financial planning in order to reduce the tax burden and opportunity costs such as when tax refunds are delayed. This needs to be curbed.

10.2 Recommendations

10.2.1 Elimination/Abolition of Tax Incentives

On the lines of trend in developed as well as developing countries, tax rates have been reduced in India both in the case of personal income tax as well as tax on corporations. The existing rates are competitive and are at par with other nations (rates are in fact lower than the other nations if effective rate of taxation is taken into account).Before effecting a further rate cut, it is necessary that all exemptions and deductions are eliminated. Reduction in rates will produce rational results and will help in increase in collections only when the exemptions and deductions are eliminated/ abolished. Strong case for eliminating the deductions and exemptions from the statutes exists, with the reduction of the corporate tax rate to 30% in the Budget for 2005-06 and with effective reduction in personal income tax rates over the last two years. It is required that all tax preferences which lead to significant revenue loss and economic distortions are eliminated completely. As has been discussed earlier, Tax Expenditure Statement forming part of Union Budget 2006-07 shows that during the financial year 2004-05 tax preferences add up to Rs 158,661 crore, out of which the corporate income tax alone constituting 36%.

Tax breaks are inefficient and costly instruments of public policy. They fail to promote the objectives meant to be served to any significant extent. On the contrary they entail loss to revenue which remains often un-quantified and thus unknown. In many countries while tax rates were reduced in course of tax reforms, there was complete elimination of incentives and deductions from the rule book as well. For example, in Indonesia while the maximum tax rate was reduced to 35%, all the so-called incentive provisions were also withdrawn.

10.2.2 Need for widening the tax base

Elimination of exemptions and deductions shall serve as an effective measure for widening the tax base. However, bringing in a large number of potential taxpayers into the tax net is a real task before the tax officials. Tax gap continues to be large and the personal income tax is not able to capture its entire potential. At present only about 3% of 1 billion of Indian population is under personal income tax net. Attempt should be made to identify the potential taxpayers and bring them on tax records. To achieve this, it is necessary that tax department in India does have complete information about all tax assessees. The department in India has already adopted Permanent Account Number in this direction, which may also serve as Citizen Identification Number for other agencies. External sources of information, particularly corporate bodies and all government agencies should be tapped to detect entities that should be on tax records. Tax Information Network which has become operational may be effectively used for this purpose. Effective use of PAN and Tax Information Network together may help considerably in identifying the potential assessees and widening the tax base. Along with widening the tax base, effective implementation of PAN and TIN will also help in evolving required base for Risk Intelligence Network.

Presumptive taxation may be another way of widening the tax base as well as enhancing the tax collection. A successful presumptive tax should serve primarily to prepare small businesses for self-assessment and secondarily to enhance revenue. Presumptive methods are not only simple, but they can also be used for efficiency and equity goals. Apprehensions are often raised that a) problems are encountered in selecting factors that should form the base of a presumptive income tax b) there is likelihood that the presumptive tax will tend to be shifted in an arbitrary and haphazard manner and c) there is possibility that the use of presumptive techniques will actually discourage the keeping of books and records. But there is a need that exists in developing countries for simple methods to tax the hard-to-tax groups that escape income taxation at present. Presumption offers a way by which substantive base-broadening can be achieved in developing countries because of their economic structure and because the information vacuum in which tax administration in these countries are forced to function. Some of the areas/assessees where presumptive taxation may be applied include mini bus operators, bus operators, taxi operators, self-employed persons, tuition agencies and vendors not keeping any fixed establishment. Presumption based upon outward signs of lifestyle will be effective tool in tackling tax evasion in India; more so with Annual Information Returns now providing enormous set of data about high spenders.

In the developed and developing world, taxing the "hard-to-tax" is a challenge for governments. Well-designed presumption for small business and self-employed professionals can be revenue yielding as is borne out by the Israeli decision to bring it back, after the experience of a significant fall in revenues when the earlier system of Tachshiv was revoked in favour of conventional self-declaration. In case of corporate bodies presumption of Minimum Alternate Tax on gross assets of the companies may be the best alternative. However, asset based MAT is desirable only till exemptions and deductions are not eliminated. Once the effective rate of taxation is aligned with the level of statutory tax rate, there will be no need for levy of asset based MAT.

Broadening of tax base can be achieved significantly by bringing agricultural income under tax net. To begin with, major farmers or farming units may be asked to file returns of income under regular rules of taxation, whereas small agricultural units should be subjected to a simple scheme of presumptive taxation based on area, general quality and location. In order to detect new assessees, the tax department should also conduct careful scrutiny of Annual Information Returns (AIRs). Information about high spenders must be captured through AIRs and they should be brought on tax records.

Net under TDS may be further widened. At present, individuals and Hindu Undivided Families are exempted from the responsibility of TDS in a number of transactions. TDS may be made applicable in case of individuals and Hindu Undivided Families as well. The reason for this is the fact that in many cases the firms take shelter of these entities by creating incomes in their names to evade the provisions of TDS. Further, TDS compliance by those entities whose incomes are exempt from tax, which are loss making and large government departments may be monitored periodically. Other areas which should be monitored may include payment of airing charges to TV channels for broadcast of programmes, commission paid by airline companies to travel agents, payment of fees by hospitals, medical institutes to consultant doctors and payments by media companies in form of commission to advertising agencies. To widen the tax base, TDS may be extended to following other areas;

i) Commission paid to the distributors and sub-distributors by firms, companies and other legal persons under the Income Tax Act, 1961.

ii) Amount paid in respect of value addition by the manufacturers.

iii) Lease rent or rent on machinery and plants and debited to the accounts of a concern.

iv) Market fees paid during purchase and sale of agricultural produce and debited in books of any concern.

v) Royalty paid on account of publications.

vi) Incentives in whatever name; in kind or cash paid on account of extra sales or bringing extra business.

vii) Payment made on account of repairs of machinery and plants.

viii) Payment on account of franchises.

ix) Payment in form of gifts taxable as income in the hands of recipients.

Tax Measures like Fringe Benefits Tax, Banking Cash Transaction Tax have been introduced in order to curb the problems of poor tax yield and poor tax base. As regards fringe benefit tax, system adopted by Israel as has been discussed by Elkins (2005, p.15-20) may be looked into by the tax planners. In Israel, legislation provides that costs incurred for the purpose of providing un-attributable benefits are not deductible expenses in the computation of employer's taxable income. Disallowing the deduction is merely a technique to transfer the tax burden from employee-unidentifiable and therefore unassessable to the employer, thus, ensuring that the benefits do not escape taxation. Expenses disallowed under the described provisions are referred to as "surplus expenses". In case of tax - exempt organizations, surplus expenses are subject to tax at the rate of 90%. In case of organizations not enjoying tax-exempt status, but reporting losses they are required to pay an advance equal to 45% of surplus expenses. Advance is creditable against future tax liability but is otherwise non-refundable. As Elkins (2005, p 20) points out, surplus expenses regime merely puts un-attributable fringe benefits on the same footing as cash compensation or assignable fringe benefits and should therefore be considered normative. In pursuit of horizontal equity, government departments and undertakings should also be brought under the ambit of fringe benefit taxes. The Ministers and Officials of ministries/departments must be covered under fringe benefit tax net. Government ministries/departments like Railways, Airlines give free passes/free or concessional tickets to employees. These benefits should be brought under tax net, a step desirable for greater horizontal equity.

10.2.3 Strengthening Tax Collection Machinery

Tax collection machinery needs to be strengthened to recover massive tax arrears. In this direction, one major attempt should be to get taxpayers to file returns accurately and on time, while reducing the manual workload involved so that resources can be redirected to the relationship and compliance activities. Simultaneously, tax payers should be made to pay tax by the due dates, payments be processed quickly and accurately, payments be accounted for correctly and all outstanding dues be pursued without delay. As a measure of collection of regular demand folloing measures need to be taken :

a) Each jurisdictional office should have adequate infrastructural facilities. The jurisdictions should have adequate number of vehicles for the purpose of facilitating movement of the tax inspectors to collect taxes.
b) Suitable incentives need to be given for collection of taxes to the Tax Recovery Officers.
c) Taxpayers should be given incentives for early payment of regular demand like non-levy of penalty or reduced penalty.
d) Appeals may be decided quickly within a time frame.
e) Taxpayers must be allowed to prefer appeal only when at least 50% of the tax is paid and proof for payment is produced.

10.2.4 Encouraging Voluntary Compliance

There is necessity of inspiring voluntary compliance by effectively detecting and prosecuting non-compliance. Aim should be to discover misstatements in filings, accounting mistreatments in taxpayers' books and other anomalies directed towards preventing leakage from the tax net. Concept of blue returns as it exists in Japan needs to be introduced in India as well. In Japan blue return system is intended to improve tax payers' book-keeping and encourage honest self-assessment. Special privileges are granted to taxpayers who are allowed to file blue returns. A taxpayer who has income from business, real estate, or timber and who keeps proper accounting records may file a blue return if he or she submits an application by 15th of March and obtains the approval of tax authorities by the end of that year. Once a taxpayer obtains approval, he or she is entitled to file a blue return for all susbsequent years. The Director of the Tax Office approves the application on the condition that the taxpayers' books are kept in accordance with the official requirements. Such system may be replicated in India as well.

10.2.5 Reforms in Tax Administration

Since tax policy is akin to tax administration, reforms are necessary which would evolve a modern system of tax administration. Poor state of tax administration has been a major reason for low levels of compliance and high compliance costs. Given the complexity in the tax structure and poor information system, the tax system often assumes the character of negotiated payments. Tax administration will prove its effectiveness if it is able to cope up with shortfall in key areas viz; unregistered taxpayers, stop-filing taxpayers, tax evaders and delinquent taxpayers.

There should be all round efforts to provide a consistent, seamless service across the taxpayer life cycle. The relationship with taxpayers may be based on the idea of 1) bringing taxpayers into the system, 2) investing time in the relationship to help them understand how to be compliant and 3) maintaining the relationship over the long term. For bringing improvement in tax administration, refund procedures should be streamlined and anti-corruption machinery must be strengthened. Regular post facto sampling and review of appeal cases may be one mechanism to guard against discretion and improve tax administration.

Information technology may provide the tax department means to manage its manual workload and direct resources to service and compliance activities. However, information technology should not be implemented in isolation from other areas of improvements. Interactive channels shall provide benefits both to taxpayers and the tax department and thus be introduced. Internet portals that enable taxpayers to see their tax accounts, file returns and make payments, give taxpayers extended service hours and greater convenience while reducing the workload for the tax department need to be adopted. Pre-populated or pre-filled returns may reduce taxpayer's compliance burden and also reduce administrative costs. Countries like Denmark, Sweden, Norway, Estonia, Iceland and Finland have successfully adopted this practice. The pre-populated tax returns may be posted on internet and the taxpayer may be given specific time to respond. If the response is not received within the stipulated time then the tax department may take action accordingly; either raising demand or sending refund electronically. In case the return is accepted as such, the taxpayer will get the intimation electronically. Mobile kiosks, mobile technology and field workers providing services with the relevant technology can be very effective in taxpayer services. The successful use of information technology in Spain as part of bringing improvement in tax administration is worth emulating.

There should be massive investment in infrastructure in the tax department. The tax department lacks enough infrastructure facilities, which puts a dampening effect on the morale of the tax officials. If top quality service is to be provided to the taxpayers it is essential that top class facilities are available to the tax department. It would be of immense benefit to the government if more investments were made in the infrastructure.

It is also recommended that Central Board of Direct Taxes is given autonomy on the lines of tax administration in Canada. The Central Board of Direct Taxes may be granted administrative as well as financial autonomy while it may work overall under Ministry of Finance. While autonomy is required for independent functioning, accountability must also be enforced at all levels.

Greater challenges before the tax administration are tackling low levels of compliance and long processing cycles. While a high percentage of registered taxpayers may file and pay by the due dates, the returns filed may understate the tax due, and there is often still a large informal economy outside the tax net. These problems are particularly evident where the taxpayer does not view the tax department as efficient and effective or as actively enforcing the law.

Tax administrators may be given incentives for bringing more assessees under tax net and on tax registers. However, in order to make the scheme meaningful it is necessary that the officers are rewarded only for those cases where the new assessees remain on record for at least three years and do not go out of tax net. Incentives may also be decided on the basis of conversion of presumptive tax assessees into regular tax assessees.

Success of any tax reforms will depend upon how well the executive leadership team champions the process, which includes communicating and committing to measures of success. Given that tax departments play a strategic role for the nation, they should be accountable to more strategic measures. Performance should be measured on their ability to deliver true outcomes, i.e., their ability to maximize revenue collections, minimize the transaction burden of taxpayers, promote voluntary compliance and their capacity to manage and facilitate the fiscal policies of the nation. Defining overall performance metrics and cascading the performance metrics down to a granular is must for efficient administration. This involves a cultural change towards meritocracy and a more corporate environment. The officers and staff must be posted in the investigation wing (the wing responsible for carrying out search operations) with a great deal of caution. A committee consisting of Chief Commissioner of Income Tax, Director General of Income Tax and Director of Income Tax holding charge of investigation wing of a particular charge must select only those officers and staff to handle these posts who are known to be men of honesty, integrity and commitment. Similarly, committee consisting of Member (Investigation) of the Board, Member (Personnel), DG (Investigation) concerned and DG (Vigilance) should select officers for the post of Director (Investigation). For the post of DG (Investigation), a committee consisting of Chairman, Member (Investigation) and Member (Personnel) should be constituted.

Tax system should be built upon strong pillars of public relations and campaign, counselling, guidance and scrutiny. Taxpayer service and education may be made the back bone of a strong and vibrant tax system. The main purpose of taxpayer service and education is to create tax awareness among taxpayers, tax agents, employers and the other stakeholders especially on taxpayers' rights and responsibilities. Following measures are suggested in order to create a better understanding and increase confidence in tax administration among taxpayers:

a) Classes on taxes at all levels - tax officials may go to schools and talk about the importance of taxes.

b) Sponsoring school essay contests on topics related to tax.

c) Certificate of appreciation to schools contributing to promotion of tax education.

d) Setting up model tax office for tax education system.

e) Seminar for taxpayers, regular TV and radio program, TV and radio spots.

f) Publishing newspapers and magazines.

g) National tax monitors system for enhancing taxpayers' understanding of tax administration.

h) Creating tax counsel systems.

i) Special counters every day of the month to provide integrated services with senior officer's assistance made available.

j) Interactive web site.

k) Setting up of service centres and call centres with facility of direct interaction at service counters at branches nationwide.

l) Creating taxpayers' counters at shopping malls, fair grounds and other strategic places.

On the lines of Japanese tax administration, Indian tax administration may consider establishing a system of tax consultation machinery. In Japan, tax consultation machinery consists of three different systems: Tax Counsel Officers who are used to enhance organization and publicity activities as well as taxpayers' awareness and tax concerns, tax answer system, which is an automatic computer system that answer frequently asked questions through the internet, voice-phone and facsimiles and the co-ordination officers, who are in charge of handling complaints from taxpayers with co-ordination duties and also provide advice and guidance. China also has a system of taxation service hall, which is in charge of handling the consultation of the taxpayer and China utilizes the voice-phone and the internet providing the answers of tax consultation. While emphasis should be upon greater reliance on taxpayers in order to support the overall tax system built upon faith and self-assessment a criminal investigation system should be built and strengthened. A strict criminal investigation system shall go a long way in supporting accurate and fair taxation.

Compliance behaviour of taxpayers in a country has much to do with its community's culture. It is ultimately peer pressure that compels people to pay their proper taxes. Cultural change, however, does not come about easily or quickly. Hence there is the need for persistent efforts to create an environment that fosters such changes. Tax administration should take steps towards creating such environment, so that compliance behaviour of taxpayer can be improved.

A successful tax reform process would also require political leadership to mobilize support and counter special incentives. Process of reforms in India has followed a gradualist approach. The attempt to reform the tax system has been rather slow. Since 1990s steps have been taken, but they are not at desired pace. The policies of reforms have to go along with broad economic reforms. So far the reforms have been tried by adopting consensual approach. Various interest groups and pressure groups come in the way of broad based reforms. It is necessary that some drastic measures be taken to bring a changeover in the system.

Studies made by Transparency International India (2005, p.12) on Korean tax reform, may serve as important guidelines for carrying out reforms in tax administration in India. Foremost objective of Korean tax reform was to earn the trust of taxpayers through fair taxation and transparent tax administration. This was done through following four-part approach:

a) Designing world-class taxpayer service which could be achieved through

i) Alleviating the need to visit tax offices by providing more responsive services including IT solutions such as the home tax service which allows all tax matters to be dealt with over the Internet.

ii) Weekly Newsletter with useful tax information published and available via e-mail.

iii) National Tax Consultation Center to quickly resolve nationwide tax inquiries through telephone, fax, mail and e-mail on a one-stop service basis.

iv) Appointment of taxpayer's advocates at each District Tax Office to represent tax payers' interests and actively help them resolve unfair situations.

b) Reform of tax audit system through

i) Transparency and predictability of the selection process of subjects for the tax audit using a computerized method.

ii) Computer analysis method to ensure that honest taxpayers are not selected and tax evaders are identified and brought to book.

iii) Reduction in ratio of subjects for the tax audit to the taxpayer population.

iv) Inclusion of those subjects for the tax audit whose returns are evaluated as inaccurate or dishonest through the computer analysis.

v) Announcing tax audit policy and selection criteria (for scrutiny) in advance to increase transparency of tax audit system and to relieve tax-payers anxieties.

vi) Separation of service unit from the investigation unit within the tax audit department so that system of checks and balances could be in operation.

vii) Minimizing arbitrary tax assessments by tax inspectors.

viii) Accumulation and analysis of tax collections records of each audit according to the tax officer's name.

c) Eliminating corruption by making tax administration more transparent by adopting

i) Prohibition of lobbying for obvious tax evasion.

ii) Subjecting those who offer a bribe to intensive tax investigation.

d) Establish a tax culture where taxes are willingly paid by

i) Acknowledging honest taxpayers through introduction of exemplary taxpayers' award.

ii) Extending preferential treatment to exemplary taxpayers through various benefits such as a 3-year exemption from tax audit, and VIP client status at financial institutions.

iii) Establishing a Tax Point System to give taxpayers various benefits relative to the amount of tax that they had paid.

iv) Expanding citizens' awareness of the immoral and criminal aspects of tax evasion.

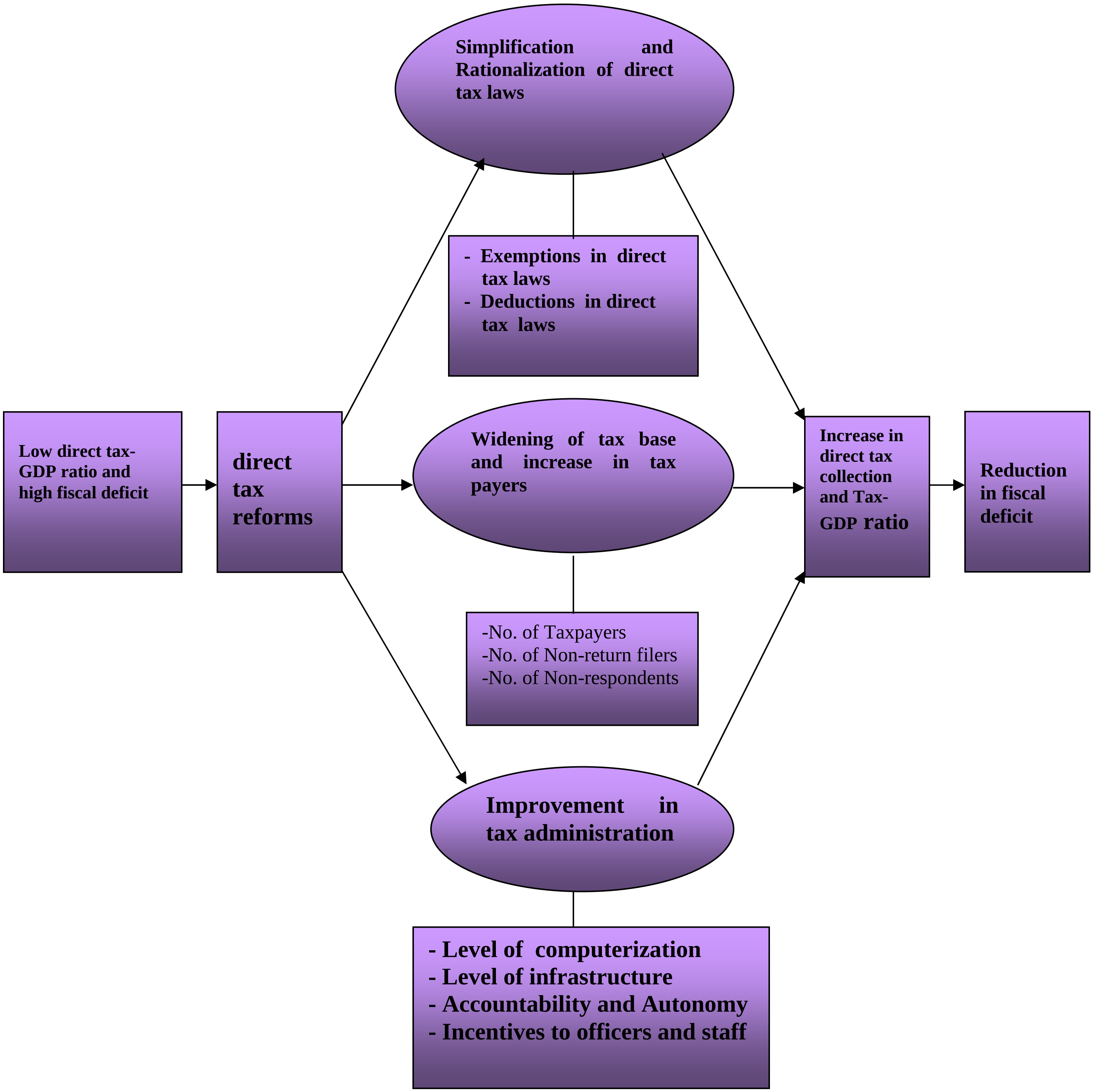
v) Subjecting those cases to intensive tax investigation where there are instances of tax evasion through fictitious transactions, profit manipulation, transfer pricing, or tax haven.

It is required that tax administration follows the above mentioned principles followed by Korean tax administration.

10.3 Suggested Model

10.3.1 The model in Figure -10.7 would show that through simplification of tax laws, widening of tax base and improvement in tax administration, tax-GDP ratio can be enhanced and consequently fiscal deficit can be reduced.

Figure: 10.7 Model of Proposed Structure of Tax Reforms



The above model incorporates necessary variables required for effective direct tax reforms. In the whole process of reforms what is required is system change in the entire tax administration.

Tax Administration should meet challenges of convincing taxpayers that the tax department and its representatives act in accordance with the law that there is a high standard of internal controls and that the integrity of financial processes is maintained. This will create an environment in which more taxpayers will voluntarily comply. Last few years have seen many initiatives to improve tax administration to make the systems more friendly and transparent for honest assessees while providing deterrence to the evaders. There have been attempts to deploy information technology and modern risk assessment methods to direct taxation system. The task now should be to sustain these programmes with requisite resources, zeal, enthusiasm and backing from policy makers.

Objectives of taxation policy in developing countries like India are basically the same which guide fiscal policies in developed countries viz; economic goals of allocative efficiency, economic growth, stability and optimum income distribution. However, it may also be appreciated that there are vast differences in economic conditions, in cultural, legal and political environment within which economic policy must operate. It must be recognized that all the principles of taxation cannot be of universal application. Therefore, variations in economic and fiscal conditions typical to Indian conditions should receive due consideration in formulating the tax system.

An important factor underlying the motivation to conceal incomes has been the fact that cost of evasion is perceived to be much lower than the cost of compliance. Measures are required to be taken to increase the cost of evasion. Further, steps are also necessary to move towards a system which encourages voluntary compliance and avoid harassment to honest taxpayers, while dealing severely with tax evaders. The direction of reforms in OECD countries and Korean attempts to bring transparency in the system as discussed in previous pages serve as models for building fair and responsive tax administration. If taxpayers perceive that their preferences are adequately represented and supplied with public goods then their willingness to contribute increases. Innovative methods now need to be applied treating the taxpayer as customer or a client by changing the traditional role perception of the tax administration. Reforms in taxation are linked with increasing trend of globalization. The tax reforms in India are at present proceeding in the right direction. The need is to pursue them more vigorously and sensibly keeping in view the need for integration of Indian economy with the rest of the world.

10.4 CONCLUSION

Taxation is a key tool of economic policy. It has significant effects on savings and investment, on the allocation of resources between alternative sectors of economy and efficiency with which resources are utilised. Tax reform in a country includes broad issues of economic policy as well as specific problems of tax structure, design and administration. Major steps have been taken towards reforms in direct tax structure in India as it has been recognized that an effective system of direct taxation is vital in mobilization of resources for the purpose of accelerated economic development. Effort is required towards enhancing the share of direct taxes in total tax revenues over time so that the fiscal system as a whole becomes more progressive. Raising tax revenue is vital if the government is to meet its social welfare obligations, provide for infrastructure development and at the same time keep deficits in check.

When reforms were initiated, the system was archaic with complex and cumbersome procedures. A multiplicity of rates, numerous exemptions and large areas of discretion, all of these contributed to evasion by taxpayers and also non-responsive tax administration. Short term requirements and administrative constraints led to the evolution of a complex tax system. Thus, systemic change is essential for bringing simplicity, efficiency, effectiveness in tax administration and also enhancement in tax collection. In personal income taxation, reduction in rates has proved to be a step in right direction. However, along with reduction in rates, widening of tax base and elimination of tax preferences are also essential for building up equitable and efficient tax system. The introduction of Security Transaction Tax and Banking Cask Transaction Tax has proved to be quite effective in garnering more tax revenues. Along with these measures, scope of TDS also must be widened to cover more areas to widen the tax base and enhance the revenue yield.

In corporate taxation too it is essential that all the deductions and exemptions are eliminated to align the effective and statutory rate of taxation. Though steps have been taken towards the above direction, major legislative changes are required to remove all the exemptions and deductions existing on the statute.

While a low registration rate is a big problem, low and inconsistent responsiveness by the tax administration also are major hindrances in effective tax administration and consequently effective tax reforms. This discourages taxpayers from interacting with the tax agencies which contributes to improper filing and other compliance problems. Limited enforcement, deliberate tax evaders, inaccurate and late tax filers and tax defaulters also are major problems before the tax administration. Receivables or arrears recovery are often not pursued in a timely manner and are subsequently written off, which tends to encourage other taxpayers not to comply with requirements.

Simplicity, fairness, careful planning and execution coupled with tough enforcement is required for meaningful reforms. Effective tax and administrative reform can play an important role in nation building. In a country like India where poverty level is high and overall direct participation in the formal economy is low, a strong and powerful message is to be communicated about the virtues of the community's tax obligations.

Improved administration is considered to be one of the reasons for increase in tax to GDP ratio from 13% in 1989 to 20% in 1990 in Argentina. In Bolivia enhanced effectiveness in tax administration led to increase in tax receipts from approx.1% of GDP in 1985 to 7.4% in 1990. In Uruguay, collections grew by 40% in real terms during 1984-1990. In Bolivia, one of the penal measures introduced was penalty of temporary closure of establishments for tax related offences and for not issuing proper invoices. In India also such methods may be resorted to.

The activities which are peripheral and not core like allotment of PAN, receiving returns, processing the returns may be outsourced with overall control of tax administration and core activities being retained with tax department. New systems and procedures that take full advantage of computerisation should be established. This will lead to prompt identification of stop-filers and delinquent taxpayers and will free tax staff for more productive uses, particularly in the area of audits. In adopting new computer systems, however, it is important to determine first how this new technology can be used to enhance the smooth functioning of tax administration. Quick assessment and effective follow up of tax assessment cases are areas, which may be accomplished by effective use of Information Technology. However, without developing a comprehensive strategy of how the basic administrative functions will be accomplished and then setting priorities, the tax administration could end up serving the computers rather than the converse. It is also required that after all round computerisation, staff especially those reallocated to more productive areas must be retrained.

Government planners should not use poor tax administration as a shield for poor design of tax policy. To be successful, reforms need to be well planned and holistic, addressing overall strategy, organization and job design. It is desirable that taxmen must be involved in all economic initiatives and plans.

The time has come to enact a new Income Tax Act, which embodies the principle that a good tax system is characterized by simplicity, fairness and neutrality in the allocation of resources. A tax system with multiple deductions in the hands of revenue administrators not only adds to distortions but also involves considerable transaction costs. Need is to improve the built-in revenue raising capacity of the tax system so that the automatic growth in revenue is greater than in the past. The tax system should be such that it becomes growth elastic and gets in line with the tax system of other fast growing and developed countries. Design of a good tax system is a central problem in managing a country's public finance. One of the canons of taxation is stability. Therefore, too frequent changes in tax structure may be avoided since they are a source of uncertainty, which has the potential of discouraging tax compliance and creating difficulties for effective tax administration.

Further Study

This research has attempted to suggest ways and recommendations to bring improvement in tax-GDP ratio through reforms in tax structure and tax administration. Further studies may be carried out with special reference to the systemic reforms in the design and implementation of the structure and operation of the direct taxes in Indian federal polity. The thrust of the further study may be to suggest further ways of enhancement of the productivity of the tax system while looking at the issues of broadening the base of taxes, reducing the tax rates and lowering the rate differentiation; making tax system comprehensive, simple and transparent.

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Appendix

Questionnaire

Note:This questionnaire is designed to elicit your opinion about the policies of Government towards Income Tax reforms undertaken in recent years, in particular with reference to tax payer education and tax payer services. Kindly give your valuable opinion on recent initiatives.

Name (Optional) ---

Income per annum: --

Sources of Income: ---

Questionnaire: Please encircle your choice

Q.1 **Are you aware of tax reforms initiated by Government in recent years?**

Options: a) Fully Aware b) Not fully Aware c) Some what aware d) Not aware at all

Q.2 **How do you know that Government has initiated reforms in Tax system?**

Options: a) Through books and articles b) Through magazines c) Through Government campaigns d) No idea

Q.3 **Do you know about recent initiatives about use of IT in tax department?**

Ans a) Yes b) Know but not all aspects c) Heard but not aware of exact initiatives d) Never Heard

Q.4 **Do you know about tax payer services programme of Income Tax department?**

Ans a) Yes b) Know but not all aspects c) Heard but not aware of exact initiatives d) Never Heard

Q.5 What is the attitude of the Income Tax Department towards tax payers?

Ans a) Quite responsive b) Somewhat responsive c) Taken initiatives but results not commensurate d) Not at all responsive

Q.6 Do you think that non-organized sector/small traders are covered adequately under the tax net?

Ans a) Adequately covered b) only small segment covered c) Not covered at all d) No idea

Q.7 How do you prepare your tax returns?

Ans a) online b) Self c) Through tax practitioners d) Through authorized return preparers

Q.8 How do you file your tax returns?

Ans a) Online b) Self c) Through tax practitioners d) Through authorized return preparers

Q.9 In what period of time do you get refunds, if it becomes due?

Ans a) Within stipulated time b) At least after six months c) At least after one year d) Not until I approach tax department personally or through some one

Q.10 Do you think that the tax laws are simple and fair?

Ans a) Yes simple as well as fair b) Simple but not fair c) Fair but not simple d) Neither simple nor fair

Date: ---------------------------- Place: ------------------------