



Tax Reforms in India since 1991: An Overview

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ABSTRACT

When the Indian economy faced an unprecedented macroeconomic crisis in 1991, fiscal consolidation constituted a major objective of the policy response. For this purpose, it became necessary to: (a) enhance tax and non-tax revenue, (b) curtail current expenditure growth, (c) restructure public sector undertakings, including disinvestment, (d) improve fiscal-monetary co-ordination, and (e) deregulate financial system. The need for improvements in budgetary practices led to the enactment of the Fiscal Responsibility and Budget Management (FRBM) Act, 2003 which ushered the Indian economy in an era of fiscal consolidation based on fiscal policy rules. Tax reforms introduced by the Government since 1991 have helped to build a structure which is simple, relies on moderate tax rates but with a wider base and better enforcement. Moreover, they have helped in correcting structural imbalances in the tax system. They are soft on industry with a view to create new investment climate and make India internationally competitive. By lowering the tax rates, the Government expects speedy industrial development and hence buoyancy in tax revenues.

The country is keenly awaiting implementation of Direct Taxes Code (DTC) and National Level Goods and Services Tax (GST). GST is India's most ambitious indirect tax reform. Lack of political consensus is holding up progress and implementation of GST. This paper gives a vivid account of recent reforms in the Indian tax system as a part of the on-going policy of liberalization and globalization of the Indian economy.

Keywords: *Income tax, Excise duty, Sales tax, VAT, Service tax, Customs duty.*

1.0 Introduction

Tax reforms in India since June 1991 have helped in correcting structural imbalances in the tax system. They are *soft* on industry with a view to create new investment climate and make India internationally competitive.

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By lowering the tax rates, the Government expects speedy industrial development and hence buoyancy in tax revenues. This paper discusses the recent reforms in the Indian tax system, both for direct as well as indirect taxes, as a part of the on-going policy of liberalisation and globalisation of the Indian economy. The paper is divided in the following sections. Section 2 and 3 outline the reforms related to income tax and wealth tax. Section 4, 5, 6 and 7 deal with reforms related to different indirect taxes namely excise duties, services tax, customs duty and sales tax respectively. Section 8 takes a brief look at the proposed Direct Tax Code and section 9 concludes.

2.0 Income Tax

Besides being the main source of direct tax revenue for the Government, income tax is an effective instrument to realise various socio-economic objectives of national policies.

A company is liable to income tax however small its income may be while a basic exemption is allowed to individual taxpayers. Basic exemption is allowed to permit a minimum standard of living or some level of income which does not reflect the taxpaying capacity of a person. For the financial year 2013-14 (i.e. assessment year 2014-15), the basic exemption limit is Rs. 2,00,000 for general category of individual taxpayers. For senior citizens (60 years and above) it is Rs. 2,50,000 and for very senior citizens (80 years and above) it is Rs. 5,00,000.

Broadly speaking, the present system of income tax is *global* in nature in that it does not discriminate between different sources of income. Income from various sources is pooled together for determining tax liability. Elements of schedular system (under which different sources of income are taxed differently) exist insofar as agricultural income is excluded from the tax base, and long-term capital gains, though included in the definition of income, are given special concessions.

Income tax revenue originates mainly from two taxpaying entities, viz. companies, and individuals. Although the concept of taxable income and the procedure for its computation is the same, except for minor differences, for all taxable entities, the income tax rates vary among different entities. From the standpoint of differential tax treatment, the tax on companies (also referred to as

corporation tax) and firms is essentially a proportional tax while the tax on non-corporate entities (also referred to as personal income tax) is basically a progressive income tax. The different constituents of the non-corporate entities, viz. individuals, Hindu undivided families etc., are subject to varying rates of income tax. Likewise, the rate of tax on corporate entities differs depending on whether a company is *domestic* or *foreign*. In general, a domestic company is taxed at a lower rate than a foreign company.

Prior to the enactment of the Finance Act, 1994, a distinction existed among domestic companies, viz. widely-held companies, and closely-held companies. Widely-held companies were subject to lower tax rates as compared to closely-held companies. Again, prior to the enactment of Finance Act, 1991, domestic companies were categorised into industrial and trading companies. The industrial companies were taxed at a lower rate than the non-industrial companies.

A notable feature of the rate structure is the imposition of surcharge on income tax wholly for the purpose of the Centre.

Presently (financial year 2013-14), domestic companies and firms pay 30 per cent and foreign companies 40 per cent tax on their profits. 30 per cent is the maximum rate of tax on incomes of individuals.

Recommendations of the Task Force on Direct Taxes (Chairman: Vijay Kelkar), 2002 Pertaining to Income Tax: At the time of presenting the first batch of supplementary demands for grants to Parliament in July 2002, the Finance Minister had proposed setting up of two task forces to recommend measures for simplification and rationalization of direct and indirect taxes. Accordingly, two task forces were set up in September 2002 under the chairmanship of Dr. Vijay Kelkar, Adviser to Minister of Finance and Company Affairs.

The Task Force on Direct Taxes presented its consultation paper to the Government on November 2, 2002. The discussion paper on indirect taxes was presented on November 25, 2002. These consultation papers were made public to facilitate an informed discussion on tax policy.

After taking in to account the response on the discussion papers, the Task Forces submitted their final reports to the Government in December 2002. These Task Forces made important recommendations on toning up tax administration to put in place a system that is simple, effective and at par with international

standards.

The main recommendations on direct taxes related to raising of exemption limit of personal income tax, rationalization of exemptions, abolition of concessional treatment to long-term capital gains, and abolition of wealth tax. In respect of indirect taxes, the main recommendations related to widening of the tax base, removal of exemptions, expansion in the coverage of service tax etc.

The Task Force on Direct Taxes was assigned the following Terms of Reference:

- Rationalisation and simplification of the direct taxes with a view to minimizing exemptions, removing anomalies and improving equity;
- Improvement in taxpayer services so as to reduce compliance cost, impart transparency and facilitate voluntary compliance;
- Redesigning procedures for strengthening enforcement so as to improve compliance of direct tax laws; and
- Any other matter related to the above points.

2.1 Personal Income Tax

The Task Force recommended a two rate schedule for personal income tax (Table 1).

Table 1: Rate Structure of Personal Income Tax Recommended by the Task Force on Direct Taxes

Income level	Tax rates
Below Rs. 1,00,000	Nil
Rs. 1,00,000 – 4,00,000	20 per cent of the income in excess of Rs. 1,00,000
Above Rs. 4,00,000	Rs. 60,000 plus 30 per cent of the income in excess of Rs. 4,00,000

Source: Government of India, Ministry of Finance and Company Affairs, *Report of the Task Force on Direct Taxes* (Chairman: Vijay Kelkar), December 2002, p. 71.

The Task Force recommended the abolition of surcharge on income tax. It was of the opinion that revenue gain from levy of surcharge is generally illusory since such a levy has the effect of increasing the marginal rate of tax, which adversely affects compliance.

It recommended that residents but not ordinarily residents must be subjected

to tax on their global/world-wide income at par with residents. To do so, this unusual category of *resident but not ordinarily resident* taxpayers should be deleted. Most countries across the world provide for only two statuses: residents and non-residents.

It recommended that standard deduction under Section 16 (1) of the Income Tax Act should be eliminated. However, the exemption of conveyance allowance subject to a ceiling of Rs. 9,600 should be continued. This should serve as a reasonable deduction for employment related expenses.

As regards tax treatment of agricultural income, the Task Force recommended as follows:

- A tax rental arrangement should be designed whereby States should pass a resolution under Article 252 of the Constitution authorizing the Central Government to impose income tax on agricultural income. The taxes collected by the Centre would however be assigned to the States.
- Tax from agricultural income for the purpose of allocation between States will be the difference between the tax on total income (including agricultural income) and the tax on total income net of agricultural income.
- 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.
- A separate tax return form should be prescribed for taxpayers deriving income from agriculture.

It recommended the elimination of the tax incentives for savings under Section 88, Section 80L, Section 10 (15) (i), Section 10 (15) (iib), Section 10 (15) (iic), Section 10 (15) (iid), Section 10 (15) (iv) (h) and Section 10 (15) (iv) (i) of the Income Tax Act. It insisted that these benefits must be immediately withdrawn and not through a sunset clause

It recommended that the basic exemption limit for senior citizens should be Rs. 50,000 more than the exemption limit for the general class of individual taxpayers. To put it differently, the exemption limit for senior citizens should be Rs.1,50,000 as against Rs. 1,00,000 for the general category of individual taxpayers. It further recommended that the exemption limit for senior citizens should be revised as and when the exemption limit for the general category of

individual taxpayers is revised. Still further, it recommended that this benefit of higher exemption limit should also be extended to widows.

2.2 Corporate Tax

The Task Force on Direct Taxes made the following recommendations for the reform of corporate income tax:

1. Reduction in corporate tax rate from the existing levels of 36.75 per cent to 30 per cent for domestic companies and to 35 per cent for foreign companies.
2. Exemption of dividend from taxation in the hands of the shareholders. There will also be no tax on distribution of dividends by a company.
3. Exemption of long-term capital gains on listed equity.
4. Elimination of Minimum Alternate Tax under Section 115JB.
5. Removal of the distinction between unabsorbed depreciation and unabsorbed business loss.
6. Removal of various deductions under Section 10 and Chapter VIA of the Income Tax Act with immediate effect and not by a sunset clause.
7. Depreciation rates for the purposes of depreciation allowance under Section 32 should be reduced to 15 per cent for the general category of plant and machinery and to appropriate lower rates for other categories of block of assets.
8. Elimination of Section 33AB relating to tea development allowance.
9. Elimination of Section 33AC relating to reserve for shipping business.
10. Elimination of Section 33B relating to rehabilitation allowance.
11. Elimination of Section 35 relating to scientific research.
12. Elimination of Section 35AC relating to expenditure on eligible projects.
13. Elimination of Section 35CCA relating to expenditure by way of payment to associations and institutions for carrying out rural development programmes.
14. Elimination of Section 36 (1) (iii) in respect of interest on borrowed capital.
15. The provision for bad and doubtful debts allowable under Section 36 (1) (viiia) of the Income Tax Act will henceforth be restricted to the amount of provision debited to profit and loss account as audited subject to the maximum amount of provisioning permitted under the prudential guidelines issued by the Reserve Bank of India.

2.3 Capital Gains

The Task Force recommended that concessional treatment of long-term capital gains through a reduced scheduler rate of tax must be abolished. In other words, the long-term capital gains would be aggregated with other incomes and subjected to taxation at the normal rates.

3.0 Wealth Tax

Following the recommendations of Professor Nicholas Kaldor, an *integrated direct tax system* was introduced in India in the mid-1950s. Kaldor, a British economist, was invited by the Government of India in 1956 to examine the Indian tax system in the light of the revenue requirements of the Second Five Year Plan launched in the same year. Kaldor's review of Indian taxation was restricted to personal and business taxation and was widely debated. It may be recalled that an extensive review of the Indian tax system had already been undertaken by the Indian Taxation Enquiry Commission, 1953-54.

In 1957 and 1958, three new taxes were introduced, viz. wealth tax, expenditure tax, and gift tax. Estate duty was already in operation since 1953. The basic philosophy underlying the introduction of the system of integrated direct taxes was to prevent evasion and avoidance of direct taxes and thereby to reduce inequalities of income and wealth. However, the yield from wealth tax, expenditure tax, gift tax, and estate duty has never been of much significance in the Central tax structure. The meagre revenue collection ultimately led to the abolition of expenditure tax, estate duty and gift tax in 1966, 1985 and 1998 respectively. Wealth tax continues to be in operation.

Wealth tax liability is computed by applying the rate schedule to net wealth (i.e. taxable wealth). The rates of wealth tax are given in Schedule 1 of the Act.

Presently (financial year 2013-14) wealth tax is charged at the flat rate of 1 per cent in the case of all assessees having taxable wealth exceeding Rs. 30 lakh.

In view of the meagre revenue and problems of administration and compliance, the Task Force on Direct Taxes (Chairman: Vijay Kelkar) recommended the abolition of wealth tax.

4.0 Union Excise Duties

Triple Rate Excise Structure: Multiple rates of commodity taxes have long been considered a weakness of the indirect tax system of India. Admitting the problems created by the multiplicity of rates, the Finance Minister in his 1999-2000 budget speech observed, “The multiple rates of indirect tax are generally recognised to be a major source of misclassification, tax evasion and avoidance and cumbersome litigation. The multiplicity also encourages inefficient allocation of resources. Over a 100 countries in the world now enjoy the benefits of a Value Added Tax (VAT) with very small number of rates in each case.” (Government of India, Ministry of Finance, 1999-2000)

Thus, in a landmark move, the Finance Minister announced in his 1999-2000 budget a triple rate excise structure. In other words, the then existing 11 major ad valorem rates were reduced to 3, viz. a central rate of 16 per cent, a merit rate of 8 per cent and a demerit rate of 24 per cent. This was done by (a) merging the existing rates of 5 per cent, 10 per cent and 12 per cent into the existing 8 per cent rate, (b) creating a new rate of 16 per cent by merging the existing 13 per cent, 15 per cent and 18 per cent rates into it and (c) fixing a new rate of 24 per cent in substitution of the existing rate of 25 per cent. The initiative of the Finance Minister to rationalise the rate structure of excise system was widely appreciated. For the financial year 2013-14, the normal rate of excise duty is 12 per cent.

Task Force on Indirect Taxes, 2002: The Task Force on Indirect Taxes (Chairman: Vijay Kelkar) recommended the following excise duty structure (Table 2).

Table 2: Central Excise Duty Structure Recommended by the Task Force on Indirect Taxes

0 per cent	For life-saving drugs and equipments, security items, food items, necessities and the like, and agricultural products.
6 per cent	For processed food products and matches.
14 per cent	Standard rate for all items not mentioned against other rates.
20 per cent	For motor vehicles, air-conditioners and aerated water.
Separate rates for tobacco products and their substitutes (like pan masala).	

Source: Government of India, Ministry of Finance and Company Affairs, *Report of the Task Force on Indirect Taxes*, December 2002, p. 181.

As regards duty exemption for the small scale sector, the Task Force recommended:

- Duty exemption should be extended to only small units with a turnover of Rs. 50 lakh.
- Duty exemption limit for the larger SSI units should be gradually brought down to Rs. 50 lakh as per the following time frame: from Rs. 100 lakh to Rs. 75 lakh by the year 2004-05 and from Rs. 75 lakh to Rs. 50 lakh by the year 2005-06.

5.0 Taxation of Services

Service sector is very wide in its range. It includes, *inter alia*, health care, education, social security, leasing, entertainment, credit rating agencies, telecommunications, transport, publicity and advertising, insurance, banking, legal and financial services.

Constitutional Amendment: A scrutiny of List II (State List) in the Seventh Schedule of the Constitution of India shows that State Governments are empowered to tax entertainment and professional services (entries 16 and 18 of List II).

The Central Government had no specific powers to tax services when it introduced service tax on select services in 1994. It was done under its residual powers of taxation vide Entry 97 of List I (Union List in the Seventh Schedule). The collection of service tax was entrusted to the excise department.

However, the Constitution (Eighty-eighth Amendment) Act, 2003 put service tax in the Union List by inserting Entry 92C in that List. Furthermore, service tax was put under Article 268A of the Constitution which specifies that the principles of collection and appropriation of taxes on services will be determined by Parliament. In other words, revenue from service tax is outside the purview of the Finance Commission.

The compositional shift in favour of the service sector, brought about by the rapid expansion of the service sector, is in line with the development experience of a number of countries. It is well-known that as an economy develops, the shares of industrial and service sectors in GDP increase at the cost of the agricultural sector.

The Indian tax system has traditionally relied on commodity taxation for generating revenue for the Central and State Governments. The two major commodity taxes of the Central Government are excise duties and customs duties while at the level of the States, sales tax is the main commodity tax, accounting for about two-thirds of States' own tax revenue.

The extension of excise duties to more and more commodities of the industrial/manufacturing sector has now reached a saturation point. However, the service sector remained outside the tax net till 1994. This pattern of tax structure development in India was contrary to the experience of most other countries where taxation of commodities and services grew hand in hand.

Presently, service tax is levied on as diverse services as credit rating on the one hand and mechanised slaughter houses on the other. It is clear that service sector in India constitutes a tax base with vast potential which has not been exploited as yet.

For the financial year 2013-14, the standard rate of service tax is 12 per cent.

6.0 Customs Duties

Prior to tax reforms initiated in 1991, import tariff had a variety of rates for different items, and even for the same item depending on its end use. Such a cumbersome system led to legal disputes pertaining to import classifications and encouraged corruption in the administration of customs tariff.

Radical reforms have been introduced in the import tariff since 1991. These reforms were necessary because the customs tariff had become, over the years, very complicated in terms of multiple rates, innumerable exemptions, excessive controls, and elaborate procedures. These infirmities of the customs tariff often led to delays, harassment, corruption, and litigation. Moreover, rationalisation and simplification of the customs duties was needed to move towards a market economy, freedom of trade, and opening up the Indian economy to the outside world. The country has moved towards moderate rates of taxation with a view to improve compliance and reduce litigation.

In India, about 99 per cent of customs revenue is derived from import duties which are levied on a wide range of commodities. Apart from revenue function,

import duties act as policy instrument to provide protection to domestic industry, conserve and ration scarce foreign exchange, and frame external trade policy of the Government. Export duties, accounting for the rest of 1 per cent revenue, are imposed on a few commodities, namely coffee, mica, black pepper, hides and skins, and leather. Government has generally refrained from levying export duties in order to ensure competitiveness of India's exports in the world market.

Continuing the process of reducing the high level of protection to domestic industry to foster competition and promote efficiency, the peak rate of import duty was reduced from 65 per cent to 50 per cent in 1995, and further down to 40 per cent in the 1997-98 budget. Still further, the Finance Minister reduced the peak rate of basic customs duty from 40 per cent to 35 per cent in his 2000-2001 budget, thereby reducing the total number of customs duty rates from 5 to 4, i.e. 35 per cent, 25 per cent, 15 per cent and 5 per cent. After successive downward revisions, the peak rate of import duty on non-agricultural products stands at 10 per cent at present (financial year 2013-14).

Import Duty Structure Recommended by Task Force on Indirect Taxes (Chairman: Vijay Kelkar), 2002: The Task Force laid down a broad approach to customs tariff reforms in India. It envisages a zero duty for essential items, 10 per cent duty for raw materials, inputs and intermediate goods and 20 per cent for final goods by 2004-05. Following introduction of States' Value Added Tax (VAT), these duties are proposed to be further reduced to 5 per cent for basic raw materials, 8 per cent for intermediate goods, 10 per cent for finished goods and 20 per cent for consumer durables by 2006-07. However, in order to reap efficiency gains from further opening up of the economy, systemic changes in customs procedures and trade facilitation based on modern best practices, which rely on self compliance, may be necessary.

As regards customs exemptions, the Task Force recommended removal of all exemptions except in case of:

- Life-saving goods.
- Goods of security and strategic interest.
- Goods for relief and charitable purposes.
- International obligations including contracts.

The Task Force recommended the following pattern of import duty (Table 3).

Table 3: Import Duty Structure Recommended by the Task Force on Indirect Taxes

0 per cent	For items like life-saving drugs and equipments, sovereign imports (defence and security related goods) and imports by RBI.
For other goods by 2004-05	10 per cent for raw materials, inputs and intermediate goods. 20 per cent for consumer durables.
By 2006-07	5 per cent for basic raw materials like coal, ores and concentrates, xylenes etc. 8 per cent for intermediate goods which will be used for future manufacture (capital goods, basic chemicals, metals etc.) 10 per cent for finished goods other than consumer durables. 20 per cent for consumer durables.

Source: Government of India, Ministry of Finance and Company Affairs, *Report of the Task Force on Indirect Taxes*, December 2002, p. 169.

7.0 Sales Tax/VAT

Prior to tax reforms initiated in early 1990s, sales tax was characterised by a multiplicity of tax rate and exemptions, lack of uniformity across States, large number of exemptions and concessions, and differing procedures for tax collection. In mid-1990s, most states had agreed to phase out the incentive related exemptions and implement floor rates of sales tax. As part of the nation-wide efforts to redesign commodity taxation and the implementation of CENVAT at the level of the Centre, many States have modified their sales tax regimes to launch a state level VAT under the scheme prepared by the Empowered Committee for this purpose.

7.1 Minimum Rate Agreement among States

To avoid the unhealthy competition of offering tax concessions to attract trade and industry to their respective regions, the Chief Ministers agreed, at their conference in New Delhi on February 9-10, 1989, that all the States would adopt the minimum floor level rates as recommended by the Committee of Sales Tax Commissioners in its report of 1984 in respect of 29 identified items.

7.2 Switch Over to VAT: At a conference of Chief Ministers and Finance Ministers of the States in New Delhi on November 16, 1999, States and Union Territories decided to put an end to all sales tax-based incentives to industry and enforce floor rates of sales tax with effect from January 1, 2000. They also decided to move over to the simple, transparent and efficient regime of Value Added Tax (VAT) with effect from April 1, 2001.

At a Conference of Chief Ministers and Finance Ministers of various States held on July 5, 2001 in New Delhi, the report of the Empowered Committee of State Finance Ministers on VAT, headed by West Bengal Finance Minister Asim Kumar Dasgupta, was accepted and adopted for the introduction of VAT with effect from April 1, 2002. The VAT design recommended by the Committee had the following elements.

1. The VAT system will eliminate the cascading burden of taxation by setting off the tax paid on inputs against that on output.
2. There will be one category of tax-exempted commodities for all the States.
3. There will be two VAT rates: a uniform 4 per cent for all States on goods of basic necessities and a uniform floor rate of 10 per cent for other commodities (except a few items such as bullion and liquor).
4. A uniform set of procedures for VAT assessment will also be followed by all the States, including the use of Permanent Account Number (PAN) as a common business identifier.
5. The States which do not implement 100 per cent uniform floor rates of sales tax by July-end 2001 should be penalised by discontinuing Central Government assistance.
6. The Centre has undertaken to make good any revenue loss to States on their switch over to VAT. A committee of State Finance Secretaries would evolve clear and measurable criteria for judging revenue loss, if any, due to the introduction of VAT.

At the Conference of State Finance Ministers held on January 23, 2002 a final decision was taken that all States and Union Territories would introduce VAT from April 2003. This position was reiterated by all States at the Conference of State Chief Ministers held on October 18, 2002. Empowered Committee of State Finance Ministers endorsed the suggestion that every State Legislation on VAT should have a minimum set of common features. Accordingly, a model VAT Bill

was circulated to all the States. Introduction of VAT is expected to increase revenue buoyancy, as the coverage expands to value addition at all stages of production and distribution chain.

At a meeting of the Finance Ministers of all States/Union Territories on January 17, 2003, States and Union Territories again reiterated their firm commitment to introduce VAT from April 1, 2003. It was decided that the VAT legislations of all States and UTs would have common provisions in respect of all important matters and that a simple VAT legislation with maximum convergence would be implemented. It was also agreed that along with the introduction of VAT, the origin based Central Sales Tax would be phased out. It was also agreed that the Additional Duties of Excise (Goods of Special Importance) Act would be suitably amended to empower States to levy sales tax/VAT on sugar, textiles and tobacco with a ceiling rate of 4 per cent. This would be done without affecting the existing levy of Additional Duties of Excise on these items by the Union Government

In view of the apprehensions expressed by a large number of States about possible revenue losses in the initial years of introduction of VAT, an assurance was given to the States that the Government of India would compensate the States to the extent of 100 per cent of revenue loss in the first year (2002-03), 75 per cent of the loss in the second year (2003-04) and 50 per cent of the loss in the third year (2005-06).

The Empowered Committee of State Finance Ministers agreed upon the following sequence of steps to ensure introduction of VAT in place of retail sales tax system in States.

1. Passing of VAT legislation and framing of rules and regulations.
2. Computerisation of dealers who will fall within the ambit of VAT.
3. Training of tax officials, traders and consumer associations.
4. Publicity for consumers.
5. Implementation of VAT, assigning VAT identification numbers to tax payers.
6. Implementing transitional measures for introduction of VAT.

Task Force on Indirect Taxes, 2002: The Task Force on Indirect Taxes (Chairman: Vijay Kelkar), unanimously acknowledged that VAT is a major reform in the indirect tax system of India. For a smooth and speedy

implementation of VAT at the level of Centre and States, it made the following recommendations.

1. A publicity awareness programme should be started jointly by the Central and State Governments and the former should extend financial support for this, if required. Since State VAT is expected to be implemented from 1.4.2003 it is also necessary that the publicity awareness programme should be implemented at the earliest.
2. An attempt should be made towards uniformity of all State legislations, procedures and documentation relating to VAT.
3. The issue of compensation, if it arises, must be primarily tackled through mutually acceptable mechanism of additional resource mobilization through service tax and not through budgetary support.
4. With the introduction of VAT, all other local taxes be discontinued.
5. Whereas additional duty of excise may continue for textiles up to 2005, it may continue even thereafter for cigarettes which should not be subjected to VAT.
6. The VAT scheme should provide for grant of credit of duty by the importing State for the duty paid in the exporting State, in the course of inter-State movement of goods.

For the stability and continuity of VAT, the possibility of a VAT Council or a permanent suitable alternative, vested with adequate powers to take steps against discriminatory taxes and practices and eliminate barriers to free flow of trade and commerce across the country, should be explored.

At a meeting of the State Finance Ministers with the Union Finance Minister on June 18, 2004, it was decided that all States will introduce a uniform VAT from April 1, 2005. The proposed VAT will replace the taxes levied by different States like sales tax and octroi. Coinciding with the introduction of VAT, the Central Government will bring down the Central Sales Tax (CST) rate from 4 per cent to 2 per cent. The CST will be phased out in 2006-07. It was also decided that traders with an annual turnover up to Rs. 5 lakh will be exempt from VAT. This decision was aimed at ending traders' opposition to VAT. It may be recalled that States have missed at least five deadlines for the introduction of VAT, mainly due to resistance from trading community.

The Government's experience of implementing VAT has, in general, been positive. This new system of indirect taxation has been received well by majority of the stakeholders. The Empowered Committee set up for the purpose has been constantly reviewing the progress of implementation of VAT in different States. The EC has advised the States to constantly interact with trade and industry to remove their apprehensions. Further, the States have been asked to ensure that the benefits of VAT due to input tax credit and reduction in tax rates (wherever applicable) are passed on to the consumers.

8.0 Direct Taxes Code (DTC)

In the Central Government Budget for 2009-10, the importance of continuing the process of structural changes in direct taxes was reiterated and a comprehensive code to this effect was envisaged. A Discussion Paper along with a draft Direct Taxes Code was put in the public domain on August 12, 2009. The Code seeks to consolidate and amend the law relating to all direct taxes, namely income tax, dividend distribution tax and wealth tax so as to establish an economically efficient, effective and equitable direct tax system which will facilitate voluntary compliance and help increase the tax-GDP ratio.

All the direct taxes have been brought under a single code and compliance procedures unified, which will eventually pave the way for a single unified taxpayer reporting system. The need for the Code arose from concerns about the complex structure of half a century old Income Tax Act, 1961, which has been amended a large number of times, making it incomprehensible to the average tax payer. The Discussion Paper states that marginal tax rates have been steadily lowered and the rate structure rationalized to reflect best international practices and any further rationalization of the tax rates may not be feasible without corresponding increase in the tax base to enhance revenue productivity of the tax system and improve its horizontal equity.

A three-fold strategy for broadening the base has been articulated in the Code.

The first element of the strategy is to minimize exemptions that have eroded the tax base. The removal of these exemptions would (a) increase tax-GDP ratio, (b) enhance GDP growth, (c) improve equity (both horizontal and vertical), (d)

reduce compliance costs, (e) lower administrative burdens and (f) discourage corruption.

The second element of the strategy seeks to address the problem of ambiguity in the law which facilitates tax avoidance.

The third element of the strategy relates to checking of erosion of the tax base through tax evasion.

Following are the salient features of the proposed Direct Taxes Code.

1. The Discussion Paper discusses the principles of residence-based taxation of income and source-based taxation of income in terms of international best practices that are mixes of the two. Under the Code, residence-based taxation is applied to residents and source-based to non-residents. A resident of India will be liable to tax in India on his worldwide income. However, a non-resident will be liable to tax in India only in respect of accruals and receipts in India (including deemed accruals and receipts).
2. The draft Code simplifies the dualistic concepts of *previous year* and *assessment year* used in the Act and replaces them with the unified concept of *financial year* and decrees that all rights and obligations of the taxpayer and the tax administration will be made with reference to the *financial year*.
3. The Discussion Paper argues for special treatment of capital gains under an income tax regime for two reasons. Firstly, taxing gains each year, as they accrue, would strain the finances of an individual who is yet to receive these gains in hand. Secondly, the capital gain realized when a capital asset is sold is usually the accumulated appreciation in the value of the asset over a number of years. The *bunching* of such appreciation in the year in which the asset is sold pushes the seller into a higher marginal tax bracket, if the value of the asset is sufficiently high. As such, if no special treatment is accorded to capital gains, a progressive income tax would discriminate against those whose income from capital assets is in the form of capital gains as compared to those whose income is derived from interest or dividends. The Code also seeks to eliminate the present distinction between short-term investment asset and long-term investment asset on the basis of the length of holding period of the asset.
4. On tax incentives, the Discussion Paper argues that they are inefficient, distorting, iniquitous, impose greater compliance burden on the taxpayer and

on the administration, result in loss of revenue, create special interest groups, add to the complexity of the tax laws, and encourage tax avoidance and rent-seeking behaviour. Based on a comprehensive review, the Code proposes that profit-linked tax deductions will be replaced by investment-linked deductions in areas of positive externality.

5. The draft Code argues against area-based exemptions which allocate/divert resources to areas where there is no comparative advantage. Such exemptions also lead to tax evasion and avoidance. It proposes that area-based exemptions that are available under the Income Tax Act, 1961 will be grandfathered.
6. The draft Code proposes to rationalise the tax incentives for savings through the introduction of the Exempt-Exempt-Taxation (EET) method of taxation of savings. Under this method, the contributions are exempt from tax (this represents the first E under the EET method), the accumulations/accretions are exempt (free from any tax incidence) till such time as they remain invested (this represents the second E) and all withdrawals at any time would be subject to tax at the applicable personal marginal rate of tax (this represents the T under the EET method).

Direct Taxes Code Bill was introduced in Parliament in August 2010. The Code is now proposed to be introduced from April 1, 2014.

9.0 Conclusion

The tax reforms initiated by the Government since 1991 have focused on simplification and rationalisation of both direct and indirect taxes with the aim of increasing revenues. The various Committees constituted for this purpose in the past two decades have given recommendations for restructuring and rationalisation of personal income tax, corporate income tax, wealth tax, excise duties, import tariff, tax administration and enforcement machinery. More recently, the major reform in the field of direct taxes has been the introduction of the Direct Tax Code (DTC) Bill which aims to consolidate and comprehensively amend the existing Income Tax Act, 1961 and Wealth Tax Act, 1957 through a single legislation so as to establish an efficient and equitable direct tax system. In the area of indirect taxes, the Government has proposed National Goods and

Service Tax (GST) that will be a comprehensive indirect tax levy on manufacture, sale and consumption of goods as well as services at the national level. These reforms are expected to bring the Indian tax system in line with international best practices.

References

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