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Tyranny of the Status Quo: The Challenges of Reforming the Indian Tax System[§]

ABSTRACT The paper reviews Indian tax policy and recent reforms. Against a best-practice framework, it examines changes in policy and in tax revenue trends at the Union and State levels to help identify the major shortcomings of India's tax system. A fragmented constitutional assignment of taxes on agricultural and non-agricultural income to the Union and State governments makes it difficult to levy a comprehensive income tax and opens the door to tax avoidance and evasion. Multiple objectives imposed on the tax system result in a plethora of exemptions and preferences, causing significant loss of revenue and creating unintended distortions. The government tends to tax sectors where it can raise revenue easily in an ad hoc manner, causing further distortions. The difficulty in taxing unorganized sector incomes further narrows the tax base. Tax abuse by multinational companies evading tax through base erosion and profit shifting may be equally important. A poor organizational setting and low administrative capacity have been other constraining factors. The "tyranny of the status quo" arises because those who gain from tax reforms tend to be ungrateful and those who lose tend to be vengeful, explaining why tax reforms have been slow and often ineffective in India.

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1. Introduction

This paper reviews tax policy and tax reforms in India. India faces the major challenge of raising resources to meet public expenditure requirements while minimizing tax distortions. Taxes matter because they affect citizens and businesses. Taxes change the behavior of people, and particularly the behavior of economic agents, in a variety of ways. They determine the incentives to work, save, and invest. No one likes paying taxes. Some use ingenious ways to avoid them, others may unhesitatingly evade them, and only a few may consider it their legitimate duty to pay them.

Writing on economic policy, Lord Keynes said,

> The ideas of economists and political philosophers, both when they are right and when they are wrong, are more powerful than is commonly understood. Indeed the world is ruled by little else. Practical men who believe themselves to be exempt from intellectual influences are usually the slaves of some defunct economist. Madmen in authority, who hear voices in the air, are distilling their frenzy from some academic scribbler of a few years back …. Soon or late, it is ideas, not vested interests, which are dangerous for good or evil. (Keynes,1936)

However, experience everywhere has shown that the impact of vested interests on tax policies is significant. Johnson and Myles (2011, p. 323) note,

> In the real world, proposals for tax reform are constrained by politics. Those who lose from tax reforms tend to be vengeful while those who gain from them tend to be ungrateful. This can lead to tax policy, perhaps, more than any other policy, to a "tyranny of the status quo."

This paper is an attempt to understand the challenges of overcoming this tyranny.

There are a number of reasons for undertaking a review of Indian tax policy. First, despite reforms attempted in India, the ratio of tax to GDP has remained remarkably stagnant and in recent years has even shown a decline. The pressure to contain fiscal deficits requires a sharp focus on identifying tax reforms. Second, the motivation for reforming the tax system has also arisen from the desire to impart greater competitiveness to the economy. Third, the federal nature of the country has posed constraints in calibrating and coordinating tax policies to evolve broad-based direct and indirect tax systems. The fragmented assignment of income tax and lack of coordination in calibrating the reform of internal and external indirect taxes have posed difficulties in evolving a harmonized and competitive income and consumption tax system in the country. Fourth, recent years have seen widespread dissatisfaction among multinational companies and frustration among tax collectors, highlighting the difficulties of taxing international capital on the one hand, and legal and administrative ambiguities in the tax system on the other.

On tax reforms, it is important to distinguish between minor changes in the tax system undertaken on an annual basis and reforms that are undertaken to change the nature of the tax system (Auerbach 2009). Given the significant impact of the tax system on economic activity, it is important for the tax system to be simple, stable and predictable, and therefore, changes in the tax system should not be disruptive. At the same time, minor changes are often necessary to take into account the conditions and conveniences of tax authorities and taxpayers. Tax reforms, in contrast, involve major shifts in the direction of policy, which is what this review focuses on: an analysis of the tax system in India, trends in tax revenues, various reform proposals, and progress in their implementation. At the same time, it must be noted that any reform is not an event, but a process, particularly in democratic societies.

The review in a way revisits and updates a similar review undertaken 10 years ago for the *India Policy Forum* (Rao and Rao 2005–06; 2010). Revisiting the Indian tax system is useful because the economy has changed, as has the political landscape, and as have the structure of taxes and the application of technology to tax administration. There has also been considerable public discussion on reforming both direct and indirect taxes recently. Besides considerable discussion on replacing multiple commodity taxes with a destination-based value-added tax on goods and services, the government has placed two discussion papers on the Direct Taxes Code (DTC) in the public domain. Therefore, a detailed review of the tax system in India is timely. Section 2 provides a framework to identify the characteristics of a good tax system in light of new developments in theory and global practice. Section 3 analyses recent changes and proposals on tax policy reforms and recent trends in Union and State revenues. In Section 4, some important tax policy reform successes are discussed. The major shortcomings of the Indian tax system and the need for further reforms are discussed in Section 5. Section 6 brings together proposals for reforming the tax system and the final section provides concluding remarks.

2. What Makes for a Sound Tax System?

Tax policy stands on the tripod of three equally important components, namely its architecture, engineering, and management (Bird 2008).

Architecture provides the design of tax policy guided by its objectives. Engineering relates to the mechanics of applying the design, dependent on the nature and quality of the systems and institutions involved in tax collection. Management determines the implementation strategy and action, depending on political support and the competence of the tax administration and its application of technology and information systems. Architecture, engineering, and management are inter-dependent. A tax policy, even if optimally designed, is only as good as its administration. At the same time, even the most competent administration cannot enhance revenue or minimize distortions if the design of the tax system is overburdened with multiple objectives. The objective of tax policy should be to raise revenues in the least distortionary manner. Tax implementation and administration become easier when the design is simple and the system is transparent, particularly in developing countries such as India, where administrative constraints can be severe.

With multiple objectives, administrative constraints, and many vested interests, it is important to have a framework for what constitutes an ideal tax system to see the departures from the ideal, to try to move towards it, and to have clarity in objectives. Of course, a single model cannot suit every country. Nor is it appropriate to assume that in the absence of taxes we would have a perfectly competitive economy with Pareto-efficient resource allocation and, therefore, that lump-sum taxes are the best, and in the absence of such taxes, we need to seek second-best solutions. When economic, political, and administrative conditions vary, as do the responses of economic agents to any change in tax policy, every country has to choose its own tax system. Nonetheless, general principles can be helpful both for tax design and reforms.

The thinking on tax policy has undergone significant changes over the years. The traditional view has been that income tax is good for reducing inequalities in incomes and should, therefore, be a preferred instrument for raising resources. An increase in the share of direct taxes in the total revenue was, therefore, considered desirable. Theory posits that the optimal tax rate schedule should depend on the distribution of abilities. In the absence of lump-sum taxes, the search for a second best optimum shows that increasing marginal tax rates to tax people with high abilities could result in disincentives for them to earn more income. Thus, as shown by Mirrlees (1971), high marginal tax rates would lead to high economic distortions relative to the revenues raised. Further, research has shown that the distortions can be significant when labor supply is relatively inelastic, which implies that the distortions from high marginal tax rates could adversely impact wage rates, thereby defeating the very purpose of reducing inequality (Feldstein 1995). Given the difficulties in getting information on abilities and efforts, it is suggested that a flat tax could be close to being optimal.

In the case of commodity taxes, Ramsey (1927) showed that distortions can be minimized by levying higher tax rates on commodities with low compensated price elasticities of demand. Tax rates for different commodities and services would then have to be designed varying inversely with their compensated price elasticity of demand to achieve an equi-proportionate reduction in their demand in response to a tax. The information required for designing such a tax system is well beyond the realm of availability, and administering a tax with multiple rates is well beyond the capacity of any tax administration. Rate differentiation could also provide scope for special interest groups. Further, since commodities with inelastic demand are the ones that constitute a larger proportion of the consumption basket of the poor, there is a clear conflict between efficiency and equity.

While the optimal theory of direct and indirect taxes provides useful insights, their practical application in tax design has been more limited. Indeed, the perfect and costless information assumed in these models simply does not exist. They also do not take into account administrative capacity, compliance costs, and enforcement tools. The focus of these models is on determining optimal tax bases and rates. Furthermore, these models essentially analyze behavioral responses in consumption and production decisions and not responses in terms of tax avoidance and evasion. There is also an implicit assumption that taxpayers understand and react rationally to the tax system, and therefore, governments have no reason to influence the perceptions of taxpayers (Slemrod and Gillitzer 2014).

Optimal tax theories emphasize efficiency. The presumption is that in the absence of taxes, the economy operates at a perfectly efficient frontier. However, another branch of literature, which analyzes market imperfections, argues that it is possible to design tax systems to correct market distortions. Stiglitz (2010, p. 14), for example, states,

> [A]nother important strand of research in the past quarter century has analyzed a large number of market imperfections, including those from imperfect and asymmetric information. Tax distortions may interact with market distortions in various ways. In particular, taxes may be used to *correct* market distortions. One distortion may, at least partly, undo the effects of the other.

Unfortunately, this would also require perfect knowledge and information about the nature of market imperfections and about the responses of economic agents to tax changes.

Optimal theories of direct and commodity taxes can only provide broad guidance in calibrating real-world tax systems. As stated by Frank Hahn (1973, p. 106), "Optimum formulas are either guides to action or nothing at all." Despite this pessimism, theoretical advances have helped us understand what constitutes a desirable tax system and develop best practice approaches to calibrating tax policies.[1] One of the most important lessons from optimal taxes is the focus on distortions. This has led to recommending uniformity and simplicity in designing and reforming taxes. While the Haig–Simons income tax was traditionally considered the bedrock of a tax system, there is much less consensus on this today in view of the undesirable economic effects of capital taxation. In fact, there has been a movement towards dual income taxation, with capital income taxed at lower and less progressive rates (Auerbach 2008). In many countries, the balance has shifted in favor of a broad-based value-added tax on goods and services (GST). Even as income taxes continue, the step progressivity that existed in most countries in the world in the 1950s and 1960s, including in the US and UK, is no longer in fashion. There is much less emphasis on high and steeply increasing marginal rates, an influence of the principles arising from optimal tax theories.

The most important objective of tax policy is to raise revenue. But revenues must be raised by minimizing the three costs associated with taxation, namely the cost of collection, compliance costs, and distortion costs. Minimizing administrative and compliance costs requires the tax system to be simple and transparent, and tax policy not to be loaded with multiple objectives but designed mainly to raise revenues in an equitable manner. Raising the same amount of revenue with lower tax rates requires a broadening of the tax base with minimum exemptions and preferences, and an effective administration and intelligence system to ensure compliance. While raising revenue is important and taxes exist primarily to meet this objective, the focus of tax policy and reforms should be on enhancing long-run revenue productivity and not meeting short-term exigencies through ad hoc changes.

Thus, as Bird and Zolt (2008) argue, a best practice approach to tax policy and reforms requires governments to move towards a broad-base-low-rate (BBLR) approach, a simple and transparent tax system that avoids arbitrary tax differentiation across people and economic activities. Distortions increase exponentially with tax rates and most countries desist from levying taxes at high rates. Therefore, in order to raise the given amount of revenue, the base should be broadened by minimizing exemptions and preferences.

1. The most recent attempt to distil balanced and well-grounded tax reform proposals in the UK was the Mirrlees Review. See Gordon (2011).

An important part of the tax advice given to most developing countries is to transform their consumption taxes into a broad-based value-added tax on goods and services (GST) with uniform rates. Even as the optimal tax theorists show that neutrality requires levying of commodity taxes with multiple rates varying inversely with the price elasticity of demand, the move has been towards evolving uniform tax rates for reasons of lack of information, administrative convenience, and more importantly, as Harberger (1990) argues, to avoid political pressures.

In most developing countries, including India, taxes are deployed to fulfil a variety of objectives besides raising revenues in an equitable manner. These include raising the levels of saving and investment, promoting investments in particular activities, regional development, enclave development to overcome institutional and infrastructure bottlenecks, exports, and use of particular technology. Even when the objectives are clear, for example, promoting investment or exports, it is difficult to ascertain the effectiveness of specific tax incentives. Very often these can be redundant and ineffective, and may merely contribute to complicating the tax system and opening up avenues for the avoidance and evasion of taxes. Often, they result in an uneven tax burden, with domestic companies bearing a higher burden than foreign companies. Although experience suggests that sound macroeconomic factors, competitive infrastructure, effective governance, and stable and predictable policies are the most important determinants of investment, most countries continue to extend a variety of incentives to attract investments, which not only causes significant revenue losses from tax expenditures but also results in distorting resource allocation.

The major challenge is to design the tax system to incorporate fairness in its impact. The most important lesson from optimal taxation is that distortions increase exponentially with tax rates and, therefore, even when the tax is seen to be progressive, its adverse effects on economic activity and employment may negate the progressivity. Furthermore, too much attention to the fairness of individual taxes is misplaced. When the tax system is designed to reduce distortions, it may contain some individual taxes that may be considered regressive. What matters is the effect of the tax system as a whole and not the impact of individual taxes on the distribution of incomes (Bird and Zolt 2005; 2008; Johnson and Myles 2011).

While it is important to assess the impact on redistribution of the totality of taxes, the notion that in the presence of a good income tax there is no need to impart progressivity to commodity taxes may be misleading. In most developing countries, the coverage of income tax is low, capital is mobile, and there are difficulties in enforcing an effective income tax (Stiglitz 2010).

Therefore, to the extent redistribution is considered as an objective, it may be necessary to design consumption taxes to ensure that they are not regressive by exempting unprocessed food and by taxing essential items at a lower rate. At the same time, it is important to ensure that the list is kept narrow because when a commodity or a service is taxed at lower rates, high income groups also benefit from the lower rate.

The general presumption is that since indirect taxes are regressive, direct taxes should be designed to reduce inequalities and, therefore, the traditional approach is to design highly progressive personal income tax systems and levy high rates on corporate incomes. This has, however, come into serious questioning. First, it is possible to design non-regressive consumption taxes by exempting essential unprocessed food items. Second, the effectiveness of personal income tax in reducing inequality itself is doubtful because only a small proportion of the people pay income tax in developing countries. This is due to the fact that in most of these countries, income tax is neither comprehensive nor progressive, and much of the revenue comes from withholding taxes and very little from the self-employed businesses due to poor information systems and the existence of a large unorganized sector. High rates of taxes on corporate incomes, given the high mobility of capital, could drive out businesses and a tax on capital might turn out to be a tax on labor. Furthermore, progressive tax systems are not costless. They increase administrative and compliance costs and, even more, economic efficiency costs. When the distortions are taken into account, the adverse impact of economic activity on the incomes of the poor may outweigh the gains from progressivity. The experience in most countries has shown that personal income tax has not been an effective instrument for reducing inequalities and, therefore, inferences about progressivity in the distribution of the tax burden being merely based on the ratio of direct and indirect taxes are misplaced (Bird and Zolt 2005).

Empirical studies in both developed and developing countries have shown that the tax system has not been effective in redistributing incomes. A study by Pechman (1985) using alternative assumptions about the distribution of the burden of individual taxes for the period 1966–85 has shown that the US tax system is not significantly progressive. Similarly, a careful study of the Chilean tax system by Engel et al. (1999) showed that the tax system was, in fact, moderately regressive, with the Gini coefficient increasing to 0.4861 after the tax, from 0.4883 earlier. Therefore, the focus of redistribution in fiscal policy needs to shift from reducing the incomes of the rich to increasing the incomes of the poor, and this implies that the focus of the redistributive instrument should shift from the tax to the expenditure side of the budget.[2]

Recent discussions on optimal tax systems have brought back the issue of an appropriate tax base and taxing income versus consumption. Most versions of a consumption tax avoid taxing normal returns on savings/capital. Of course, evolving an expenditure tax may not be an option; also, it will not be possible to impose a zero effective tax rate on normal returns to capital. Nevertheless, a consensus among tax theorists is that labor and capital incomes should be taxed differently due to their differential responses to taxation. In fact, Auerbach et al. (2010) recommend the replacement of the present system of corporate taxation with a destination-based VAT on goods and services, with labor costs deductible in addition to other input costs.

While doing away with the corporate tax would be socially unacceptable in any country, a comprehensive value-added tax on goods and services is an important instrument in any modern tax system. The tax is found to be particularly important to overcome a decline in revenues when developing countries embark on their rationalization of import duties. This is demonstrated in the study by Keen and Ligthart (2005), which shows that revenue-neutral tariff reductions, accompanied by a price-neutral GST, will enhance both revenue and efficiency. A revenue increase arises from the self-enforcing nature of the tax. An efficiency increase arises as it avoids distorting input prices and, to that extent, reduces production inefficiency (Keen 2007). Emran and Stiglitz (2005), however, contest the claim that GST, being a tax on recorded transactions, when combined with weak administrations in developing countries can work as a tax on the formal sector. In contrast, Keen (2007) considers the GST as one of the least costly ways of taxing the informal sector due to its self-enforcing nature. Although B2B sales provide information on input purchases to enable the tax administrations to do their job better, both sides can easily evade tax through collusion, especially if one of them is a fraudulent enterprise with a VAT number and there is no check on B2C transactions, and they are wide open to fraud. The impact of the GST is best seen empirically; as long as the gains from participating in the formal market are greater than the tax loss, the taxpayer would prefer to pay the tax and it is here that the simplicity of

2. As Harberger (1990, p. 13) argues, "Society is not going to bring about major changes in the income distribution by operating either on the tax side or on the expenditure side of the budget of the public sector…. it is more realistic to think of the struggle against poverty to be a major goal." He recommends that this should be done by helping the poor in meeting their basic needs and providing opportunities for advancement by ensuring access to education and healthcare to those who cannot afford it. For similar arguments also see Bird and Zolt (2008).

the tax becomes important. Thus, as Bird and Gendron (2007) argue, "On the whole, while further theoretical and particularly empirical research on the effects of VAT in developing and transitional countries is needed, the case for VAT in most such countries remains solid."

Thus, GST is an important component of modern tax design in most developing countries. A destination-based GST is considered neutral as it removes the taxation of inputs and capital goods. In terms of total impact, a retail sales tax levied at the last point is equivalent to VAT. However, under sales tax, if the last seller evades the tax, the revenue is completely lost, whereas under VAT only the last transaction escapes the net. Given that the tax paid at each stage is only on value added at that particular stage, the incentive for evasion is less under a VAT. More importantly, as crediting the tax paid at the previous stage of transaction requires invoices, the tax is self-enforcing. In addition, harmonization of VAT registration numbers with income tax permanent account numbers can throw up valuable information for the income tax administration, which can significantly improve the compliance of the latter.

As mentioned above, management of the tax system is an important leg in the tripod of tax policy, and this is provided by tax administration, including its information systems. A tax policy is only as good as it is administered and, therefore, it is important to keep in mind the capacity of the tax administration in designing a tax system, while at the same time constantly upgrading administration capacity and the application of technology in tax administration. Confidence and trust between the tax administration and taxpayers is important in tax compliance and, therefore, tax administration should be transparent and should consider taxpayers as agents rather than adversaries. A complementary part of administration is the building of a proper information system, its exchange among tax departments, and application of technology for tax administration and enforcement. Tax administration should be an independent department that is insulated from political pressures. Another important part of a good tax system is an efficient taxpayer service. This would help in building the trust of the taxpayers and in improving tax compliance.

Thus, a good tax system is one that minimizes administrative cost, compliance cost, and distortion cost to the economy. It should have a broad base, low marginal rates, and less differentiated rates with a simple structure. Fairness in tax policy should be judged in totality and not by individual taxes. Furthermore, tax policy has not been found to be effective in bringing about a redistribution of incomes and, therefore, the focus should shift from reducing inequality to alleviating poverty, which is better done through the expenditure side of the budget. An important component of a good tax system is a comprehensive GST. In a multilevel fiscal system, it is important to coordinate tax reforms between different levels of government so that they do not work at cross purposes (Rao and Sen 2013). It is not enough to focus on the design of the tax structure; building capacity as well as orientation in tax administration is equally important. A good tax system is supported by a good information system, not only to enforce tax but also to calibrate changes with full information. A hallmark of a good tax administration is a taxpayer service, which not only builds confidence among taxpayers, but also improves compliance. The use of information technology promotes transparency and provides information for the enforcement of taxes.

3. Trends in Indian Tax Policy and Revenues

The basic framework for the levy of taxes by the Union of India and States is provided in the Indian Constitution's Seventh Schedule, which, following the principle of separation, assign taxes to either the Union or State governments. The Union Government can levy taxes on non-agricultural income, wealth, and corporate income, on services, and customs and excise duties. The tax powers assigned to the States include taxes on agricultural income and wealth, the tax on the sale and purchase of goods, excise duties on alcoholic products, taxes on motor vehicles and goods and passengers, stamp duties and registration fees on property transactions, entertainment tax, and taxes and duties on electricity. The Union Government can levy a tax on the inter-state sale of goods, which can be collected and appropriated by the States.[3] States have the powers to levy taxes on professions, trades, and employment, and while some States levy the tax themselves, some others have passed the power on to local governments. The State List also includes taxes on immovable properties, and the tax on the entry of goods for consumption, use, or sale, which are generally assigned to local bodies.

The legal separation of tax powers in the Constitution was done to minimize overlap and avoid disharmony. However, the separation is entirely legal and cannot avoid the economic inter-dependence of the tax bases. The separation

3. Article 301 of the Constitution mandates that "Subject to other provisions …, trade, commerce and intercourse throughout the territory of India shall be free." Article 286 prohibits any State from imposing a tax on the inter-state sale or purchase of goods. However, it authorizes the Union Government to formulate principles for such a levy. Thus, after the 6th amendment to the Constitution, Entry 92A was added to the Union List, which authorized the Union Government to levy the tax to be collected and appropriated by the States.

of income tax from agricultural and non-agricultural sources has provided a route to evade and avoid tax on non-agricultural income by misclassifying it as agricultural income. Similarly, the excise duty on manufactured products levied by the Union is nothing but a sales tax at the point of first sale, which has created a significant overlap in the consumption tax system. In assigning the sales tax on the sale or purchase of goods to the States, the Constitution has favored revenue autonomy for the States over fiscal disharmony. However, States do not have the power to levy the tax on services, and it is not possible, therefore, to evolve a comprehensive GST unless the Constitution is amended. As a result, coordination and harmonization of consumption tax reform between the Union and States and among the States themselves is a major challenge, as is seen in the ongoing impasse on introducing GST.

The division of tax powers requires coordination in calibrating tax reforms between the Union and State governments, which in the Indian context has been a problem. For example, opening up the economy in 1991 required a substantial reduction in customs duties. The solution to overcome revenue loss would have been to coordinate the reform of domestic trade taxes with a reduction in import duties to evolve a broad-based GST. However, as the power to levy sales tax lay with the States, the reduction in customs duty was not accompanied by the replacement of a cascading type sales tax with a comprehensive value-added tax, and this resulted in a net loss of revenue of over two percentage points of GDP between 1991 and 2001. Furthermore, even as the discussion on the introduction of destination-based GST at the Union and State levels in a coordinated manner has continued for over a decade, its implementation has faced several problems. Thus, Constitutional tax assignments have posed constraints on evolving a national harmonized tax system since it has not been possible to amend the Constitution to meet the requirement of changing times.[4]

During the initial years after India's independence, tax policy was designed to meet the objectives of planning in a mixed economy framework. The details of how tax policy evolved then is not discussed here as it has been detailed in an earlier paper (Rao and Rao 2005-06). Essentially, tax policy was considered a major instrument to finance a public-sector-led import-substitution industrialization strategy and to reduce inequalities in income and wealth arising from the industrial license regime. Tax policy was also one of the instruments for prioritizing the allocation of resources among

4. There is a clear trade-off between sub-national fiscal autonomy and tax disharmony. In regard to tax assignments, the founding fathers of the Constitution seem to have preferred the former.

different sectors of the economy. The multiplicity of objectives assigned to tax policy is a legacy in part of this planned era.

3.1. Reform of Union Taxes

Since 1991, a number of attempts have been made at reforming both direct and indirect taxes at the Union level to simplify and rationalize the tax system. The Tax Reform Committee (TRC) with Raja Chelliah as the Chairman, appointed immediately after the 1991 economic reforms were initiated, made far-reaching recommendations for the simplification and rationalization of both direct and indirect taxes (Government of India 1991; 1993). These recommendations were implemented during 1991–95, and the direction of reforms set in these recommendations continued thereafter. A comprehensive review of the tax system was made in 2003–04 in the two reports chaired by Vijay Kelkar on direct and indirect taxes (Government of India 2003a; 2003b). In addition, reviews have been done on specified taxes, such as the *Report of the Expert Group on Taxation of Services* (Government of India 2001a) and *Report of the Advisory Group on Tax Policy and Tax Administration for the Tenth Plan* (Government of India 2001b). More recently, the Tax Administrative Reform Committee chaired by Parthasarathi Shome has comprehensively dealt with the reform of tax administration, including revenue forecasting and research, in a series of four reports (Government of India 2014; 2015).

Successive governments have attempted to reform both the direct and indirect tax systems to improve their revenue productivity by expanding the tax base and simplifying and rationalizing tax structures. In the case of non-corporate income tax, as per the recommendations of the Chelliah Committee, the number of tax brackets was reduced to 3, with the highest bracket taxed at 40 percent (as against 50 percent earlier). This was further rationalized to reduce the highest marginal rate to 30 percent in 1997. However, a surcharge and a cess were levied later to earmark revenues for elementary and higher education. At present, tax is levied at 10 percent for incomes above ₹2.5 lakhs up to ₹5 lakhs,[5] 20 percent on incomes between ₹5 lakhs and ₹10 lakhs, and 30 percent above that. In addition, there is an education cess of 3 percent. On incomes above ₹1 crore, there is also a surcharge of 12 percent, which implies that the marginal tax rate for those earning above ₹1 crore works out to 36.66 percent.

5. The exemption limit for those above 60 years of age is ₹3 lakh.

The important administrative measures taken to expand the tax base include: (a) every individual living in a large city and covered by any one of six conditions (ownership of a house, ownership of a car, membership in a club, ownership of credit cards, foreign travel, and a telephone subscriber) is required to file a tax return, and (b) expanding tax deduction at source beyond salaries to most transactions, including interest and dividend receipts and payments to contractors.

In the case of corporate tax, based on the recommendations of the TRC, the distinction between closely held and widely held companies was done away with and tax rates were unified at 40 percent in 1993–94. In 1997–98, the corporate rate was further reduced to 35 percent, and the 10 percent tax on dividends was shifted from individuals to companies. Since then, the measures adopted have lacked direction. The dividend tax rate was increased to 20 percent in 2000–01, then reduced again to 10 percent in 2001–02, and levied on shareholders rather than the company. The policy was reversed once again in 2003–04, with the dividend tax imposed on the company. In the 2015–16 budget, the Finance Minister has promised to reduce tax preferences progressively and reduce the corporate tax to 25 percent in the next three years.

The legal framework for the levy of income tax in India goes back to the Income Tax Act, 1961. The various amendments to the Act carried out over the last 55 years have made it unwieldy and complex. With a plethora of exemptions, concessions, and deductions introduced over the years, the income tax system has become complicated, leading to ambiguity and discretions in interpretation. This has increased both administrative and compliance costs and has piled up arrears on account of disputes, besides causing serious distortions in resource allocation. Further, the Act has not kept pace with the changes in international business models and mechanics of the multinationals. This provides scope for evasion and avoidance, invites adverse international publicity, and blocks a huge amount of revenue in litigations. Keeping these in view, the first discussion paper on the DTC was put out in the public domain with the principal objective of simplifying and rationalizing the tax and phasing out various tax preferences to make it broad-based. As expected, everyone wanted tax rates to be low and tax concessions to be abolished on all sectors except their own. After taking the feedback into account, the Finance Ministry put out a second discussion paper in which the objective of expanding the base was substantially diluted. The Union Finance Minister in his 2015–16 budget speech has given a sound burial to the proposal stating that he does not intend proceeding in producing a new DTC.

The thrust of reforms on indirect taxes since 1991 has been to reduce and rationalize customs duties, simply and unify excise duties, and expand the base of service tax. In the case of customs duties, tariff rates have been lowered, quantitative restrictions replaced by tariffs, and the dispersion in the rates reduced. In 1990–91, duty rates ranged from 0 to 400 percent and the peak rate was over 150 percent. The peak rate had been lowered progressively to 15 percent by 2005–06. The number of duty rates covering 90 percent of duty collected was reduced from 22 in 1990–91 to 4 in 2003–04. At the same time, a special additional duty was imposed on goods imported into the country on the rationale that if the commodity was domestically produced and sold inter-state, it would have attracted a tax rate of 4 percent. This duty was abolished in January 2004, only to be reintroduced in 2005–06. The weighted average of import duties has steadily declined from 77.2 percent in 1991–92 to 9 percent in 2007–08. Despite these attempts to rationalize, there are still a large number of rates including specific rates. Higher rates are specified for agricultural products. Furthermore, lower tariffs rates are applied on inputs, resulting in very high effective rates of protection on the outputs.

Ill-prepared tax reforms can be more harmful than any reform. This was clearly demonstrated in the reform of Union excise duty undertaken in 1986–87. The Jha Committee (Government of India 1976) had recommended in 1976 that Union excise duties should be transformed into a manufacturing stage value-added tax. It had, however, recommended that this should be preceded by adequate preparation in terms of converting the specific duties into ad valorem ones, unifying the rates, and building capacity in tax administration to administer the new tax. However, the measure was introduced without any prior preparation, resulting in the emergence of a highly complicated tax with several tax rates, both specific and ad valorem, with presumptive ways to provide input tax credit and refund of the duty on exports, and called a modified vat (MODVAT). This “learning by doing” approach resulted in huge complications in MODVAT, excessive tax credits and a huge loss of revenue. After 1991, based on the recommendations of the TRC, the process of converting specific duties into ad valorem was initiated. Even so, the number of tax rates continued to be large, and this perpetuated the problem of misclassification and disputes. Subsequent years have seen substantial convergence of tax rates until 2008–09, when there were again attempts to reduce the rates on some items including processed food items. At present, most of the commodities are subject to two rates, one levied at a lower rate (6 percent) and the second at the general rate (12.5 percent), though some items are taxed at different rates including specific rates (cement, cigarettes). Clearly, there is considerable scope for further rationalization by lowering the threshold from the prevailing ₹1.5 crore, pruning the exemption list from about 300 items prevailing at present, and moving items like processed food into the higher rate category.

The Constitution did not originally assign the power to levy tax on services either to the Union or to State governments. However, taking advantage of the residual powers assigned to it under Article 246, the Union Government introduced the levy on three services: non-life insurance, stock brokerage, and telecommunications in 1994. Later, the 88th Amendment of the Constitution specifically empowered the Union Government to levy the tax by inserting Entry 92-C in the Union List. The list of taxable services was steadily expanded and finally in the budget of 2012–13, the tax was applied to all services except those specified in the negative list. Initially, the tax was levied at 5 percent, and thereafter increased to 8 percent in 2003–04 and to 10 percent in 2004–05. This was brought down to 8 percent in the aftermath of the global financial crisis, but was increased to 10 percent, and the education cess (0.3 percent) was levied in 2010. The 2012 Budget increased the tax to 12 percent (excluding the education cess) and in the 2015–16 Budget, it was raised to 14 percent by adding additional cess for *Swachh Bharat*.

The Expert Group on Taxation of Services in 2011 had recommended switching over to the negative list, unifying the threshold and rates between excise duty and service tax, and enabling input tax credit between goods and services to evolve a manufacturing stage GST (Government of India 2011). It took over 11 years for the government to move over to the negative list. Perhaps, had the recommendation to introduce the manufacturing state GST been implemented, the transition to a full-fledged GST would have been easier, as it would have provided valuable experience to make a smoother transition at the State level without much acrimony. In fact, the expert group had also recommended that the power to levy service tax be shared with the States and in return, inter-state sales tax be abolished to reform the sales taxes levied in the States into a destination-based GST. Instead, the reform in 2005 resulted in the partial roll over of the value-added tax only on goods at the State level. The issue of evolving a broad-based dual GST continues to remain elusive. This issue is discussed in greater detail below.

3.2. Reform of State Taxes

Although the Constitution assigns the power to levy a number of taxes to the States, only the tax on sale and purchase of goods is a broad-based tax generating about 60 percent of the States' own tax revenues. In general, the States raise 38 percent of the total tax revenues raised in the country. Other important State taxes include stamp duties and registration fees on property transactions, excise duties on alcoholic products, and taxes on transport by way of motor vehicles tax and passengers and goods tax. Land revenue and agricultural income tax have ceased to be important from the point of view of revenue. There are also less important taxes such as entertainment tax and electricity duty. Many States have assigned profession tax, property tax, and entry taxes to local bodies. An important development over the years has been the gradual phasing out of the tax on the entry of goods into a local area for consumption, use, or sale. All the States except Maharashtra have abolished the levy. Another important development over the years has been the gradual reduction in the rates of stamp duties and registration fees on immovable properties. The rates which were above 10–12 percent in most States in the early part of the millennium have been reduced to an average of 6 percent over the years.

The major reform at the State level was the introduction of value-added tax on goods from 2005–06. Discussion has been going on for the introduction of dual GST by the Union and State governments. As mentioned above, the expert group on the taxation of services recommended in 2001 that the Union Government could introduce the GST in the manufacturing state and the States could transform their cascading type sales taxes into a destination-based GST by enabling them to levy tax on services by amending the Constitution. The Empowered Committee of State Finance Ministers has put out two papers for public discussion. However, consensus on a number of issues relating to the structure and operation of the tax is yet to be reached between the Union and States and among the States. The reform is supposed to transform the prevailing value-added tax, which is partly origin-based due to the continuation of Central sales tax into a destination-based GST.[6]

Even though both the Union and States see the GST reform as important, a number of issues need to be finalized before the tax can be implemented (Rao 2013). The target date for implementation of GST has been repeatedly changed as the Union and States, as well as the States among themselves,

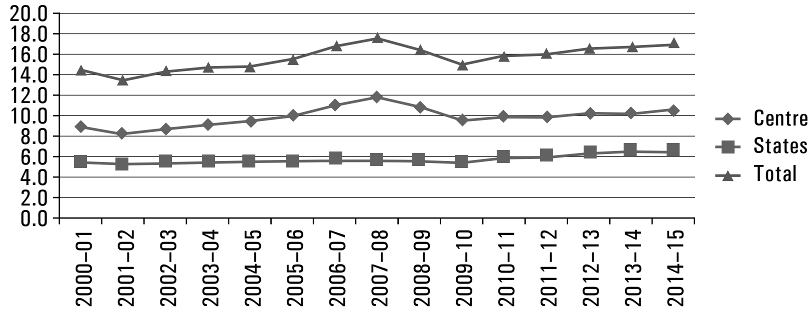
6. Central sales tax is levied by the exporting state. The tax, which was 4 percent, was brought down to 2 percent in 2008, and this was supposed to be done away with and after imposition of the GST, to make the GST completely destination-based. The Union Government agreed to pay compensation for the loss of revenue in 2010 when the GST was to be implemented. However, with no consensus emerging, the implementation date was shifted. The Union Government's refusal to pay compensation after 2010 also resulted in a trust deficit between the Union and States, and in the process, the reform itself took a back seat. The discussion has resumed after the Union Government agreed to pay the compensation.

have not been able to agree on many issues. In his 2008–09 Budget, Mr Chidambaram declared that the reform would be implemented in April 2010. The rate of inter-state sales tax was reduced from 4 percent to 2 percent in preparation for moving over to a destination-based GST and the Union Government agreed to compensate for the revenue loss until 2010 when the GST was supposed to have been implemented. However, consensus on many of the issues relating to the structure and operation of the new levy could not be reached and successive finance ministers had to postpone its implementation. The Thirteenth Finance Commission recommended that compensation for any loss of revenue to the States should be paid only if the States implemented a "flawless GST," and this put the clock back as the States wanted to negotiate and settle for a compromise structure. The reluctance of the Union Government to give compensation for reducing the rate of central sales tax from 4 percent to 2 percent beyond 2010 created a serious trust deficit, and progress in evolving a consensus stalled as a result. The present Finance Minister, in his keenness to embrace the reform, has now set April 2016 as the date of implementing the tax. The 122nd Constitution Amendment Bill has been passed in the Lok Sabha, but not in the Rajya Sabha, where it has been referred to the Select Committee of the Rajya Sabha. The Select Committee has made recommendations, with a dissenting note by members of the Indian National Congress. The Government has received the report of the committee under the chairmanship of the Chief Economic Adviser on the rate structure for the GST. However, lack of political consensus continues to plague the passage of the Bill in the Rajya Sabha. Even if the Bill had been passed in the Budget Session in February 2016, it is unlikely that the reform can be implemented before April 2017. Issues relating to the GST reform are discussed in greater detail below.

3.3. Tax Revenue Trends in India

There have been several studies on the trends in tax revenues across different countries and these bring out four important generalizations (Bird and Zolt 2005; IMF 2011; Tanzi and Zee 2000). First, the tax–GDP ratio varies positively with the level of development of the country. Second, the tax–GDP ratio in developing countries has shown an increase, though in developed countries, it has tended to plateau. Third, in terms of composition, the general tendency has been to replace tariffs with domestic trade taxes, particularly the value-added tax on goods and services. Finally, the share of consumption taxes has shown an increase over the years in both developed and developing countries, with the value-added tax becoming important due to its high revenue productivity.

FIGURE 1. Percentage of Tax to GDP in India 2000–15



Source: Indian Public Finance Statistics, Ministry of Finance, Government of India.

International comparisons can provide broad trends and directions for policy calibration . Analysis shows that India's tax revenue is substantially lower than the average for countries with comparable level of development. The analysis of Bird and Zolt shows that the average for the middle-income countries (with per capita incomes ranging from USD 1000 to USD 17,000) had a tax–GDP ratio of 22 percent. Similarly, the more recent study by the IMF covering 174 countries shows that the average tax ratio for middle-income countries (with per capita GNP ranging from USD 995 to USD 3,945) for the time period 1980–2009 was close to 18 percent. India's tax ratio at 16.4 percent of GDP compares unfavorably with this international experience (Table 1 and Figure 1).

In India, the tax–GDP ratio is not only low by international standards, but it has also been stagnant or declining over the years. The average tax–GDP ratio in India during the decade of the 1980s was 14.7 percent but declined to 13.9 percent during the 1990s. In fact, after economic reforms were initiated in 1991, the tax ratio declined from 15.3 percent in 1991–92 to 13.3 percent in 2001–02. More recently, there has been a steady increase in the ratio after 2003–04 to reach the highest level at 17.5 percent in 2007–08. However, following the deceleration in economic growth and, more importantly, reduction in the tax rates of Union excise duty and service tax in 2009–10 as a part of the stimulus following the global financial crisis, it has remained stagnant at about 16.5 percent in subsequent years. This low and stagnant tax ratio has limited the fiscal space of the government to spend on much needed expenditures on physical infrastructure and human development.

The decline in the tax–GDP ratio during the 1990s, its sharp increase from 2003–04 to 2007–08, and the subsequent decline were mainly due to movements in Union tax revenues. The Central Government's tax ratio

TABLE 1. Trends in Tax–GDP Ratio at Union and State Levels (percent)

	Union			*States*			*Total*		
Year	*Direct*	*Indirect*	*Total*	*Direct*	*Indirect*	*Total*	*Direct*	*Indirect*	*Total*
1950–60	1.57	2.77	4.33	0.65	1.69	2.34	2.22	4.46	6.68
1961–70	1.93	4.49	6.42	0.44	2.48	2.92	2.37	6.97	9.34
1971–80	2.21	6.21	8.42	0.26	3.71	3.97	2.47	9.91	12.39
1981–90	1.96	7.77	9.74	0.20	4.79	4.99	2.17	12.56	14.73
1991–2000	2.64	6.21	8.85	0.16	4.97	5.13	2.80	11.18	13.98
2001–08	4.43	5.46	9.89	0.15	5.57	5.72	4.58	11.03	15.61
2007–08	6.26	5.63	11.89	0.13	5.43	5.56	6.39	11.06	17.45
2008–09	5.68	5.07	10.75	0.14	5.37	5.51	5.83	10.43	16.26
2009–10	5.67	3.97	9.64	0.15	5.66	5.81	5.82	9.63	15.45
2000–11	5.63	4.55	10.19	0.16	5.99	6.15	5.79	10.55	16.34
2011–12	5.42	4.45	9.87	0.15	6.28	6.43	5.57	10.73	16.29
2012–13	5.48	4.77	10.25	0.14	6.33	6.47	5.62	11.10	16.72
2013–14	5.54	4.42	9.96	0.14	6.44	6.59	5.69	10.87	16.55
2014–15	5.53	4.36	9.89	0.14	6.49	6.64	5.67	10.85	16.53
2008–2015	5.55	4.50	10.05	0.15	6.18	6.33	5.69	10.68	16.37

Source: Public Finance Statistics, Ministry of Finance, Government of India (various years). For 2013–14 and 2014–15, the Budget documents of the Union government and article on State Finances: A Study of Budgets 2014–15, Reserve Bank of India.

Note: The data for 2014–15 refer to revised estimates for the Union government and budget estimate for the States.

declined from 10 percent in 1991–92 to 7.9 percent in 2001–02, or looking at its average tax ratio over a decade, from 9.7 percent in the 1980s to 8.8 percent in the 1990s. The decline was mainly on account of indirect taxes, which fell from 6.2 percent during the 1980s to 5.5 percent during the 1990s. More recently, the sharp increase in the tax ratio from 2003–04 to 2007–08 and the decline thereafter was also due to revenue trends in Union taxes. The ratio of State taxes relative to their GDP, in contrast, was broadly constant until 2008–09, and showed a steady but slow increase thereafter.

The trends in the level and composition of Union taxes after 1991–92 presented in Table 2 show three distinct phases. The first phase from 1991–92 to 2001–02 was marked by a sharp decline in revenues relative to the GDP, mainly due to a decline in customs and excise duties. During this period, the Union Government's tax revenues relative to GDP declined by over two percentage points. This was due to the decline in indirect taxes from 7.6 percent in 1991–92 to 5 percent in 2001–02. The average growth rate of tax revenues during this period was just about 12.7 percent, indicating a buoyancy of 0.87. This was mainly due to a decline in revenues from both customs and excise duties; the former declined from 3.3 percent to 1.7 percent of GDP, while the latter declined from 4.1 percent to 3.1 percent. The decline in Union excise duties at a time when customs duties were falling as a result of the opening up of the economy shows a lack of coordination in calibrating domestic and foreign trade taxes. The decline in revenue from excise duties during the 1990s also shows that the reform of Union excise duty in 1987 leading to the introduction of MODVAT caused a decline rather than an increase in tax revenues. In contrast, the average buoyancy of direct taxes was 1.5 as this revenue grew at 19.3 percent during the 1990s. As mentioned earlier, the reduction in the number of tax brackets after the recommendations of the tax reforms committee and reduction in tax rates, particularly in 1996–97, led to a significant increase in compliance and in revenue productivity (Das-Gupta 2002). In contrast, the growth rate of indirect taxes remained low at 10.6 percent, indicating a buoyancy of 0.7.

The trend in Union tax revenue from 2001–02 to 2007–08 is marked by an acceleration in the growth of revenue from income and service taxes. The revenue from corporate and personal income tax increased at an average annual rate of 27.8 percent, showing an average buoyancy of over 2 during this period. Similarly, service tax revenues grew at an average annual rate of 63 percent due to the steady expansion in the base with the inclusion of more and more services in the tax net. Although total indirect taxes registered an average annual growth of 17 percent, the share of excise duty in the total revenue as well as the ratio to GDP continued to decline during

TABLE 2. Trends in Tax–GDP Ratio: Union Government (percent)

Year	*Corporate Tax*	*Personal Income Tax*	*Total Direct Taxes*	*Customs Duty*	*Excise Duty*	*Service Tax*	*Total Indirect Taxes*	*Total tax-Union*
1991–92	1.17	1.00	2.26	3.30	4.17	0.00	7.55	10.00
1995–96	1.34	1.27	2.74	2.91	3.28	0.07	6.31	9.07
2001–02	1.55	1.36	2.94	1.71	3.08	0.14	4.98	7.94
2005–06	2.74	1.55	4.30	1.76	3.01	0.62	5.62	9.95
2006–07	3.36	1.97	5.34	2.01	2.74	0.88	5.88	11.03
2007–08	3.87	2.17	6.05	2.09	2.48	1.03	5.93	11.89
2008–09	3.79	1.88	5.68	1.77	1.93	0.55	4.51	10.75
2009–10	3.78	1.89	5.68	1.29	1.59	0.90	3.94	9.64
2010–11	3.84	1.79	5.63	1.74	1.77	0.91	4.53	10.19
2011–12	3.58	1.83	5.42	1.66	1.61	1.09	4.43	9.87
2012–13	3.52	1.94	5.48	1.63	1.74	1.31	4.74	10.25
2013–14	3.45	2.08	5.54	1.51	1.48	1.35	4.39	9.96
2014–15	3.37	2.15	5.53	1.49	1.46	1.33	4.33	9.89
2015–16	3.34	2.27	5.61	1.48	1.62	1.49	4.64	10.27
Growth rate: 1990–91 to 2001–02	19.58	18.57	19.29	10.06	10.47	33.07	10.62	12.74
Growth rate: 2002–03 to 2007–08	31.80	21.29	27.76	17.23	9.40	63.25	17.00	21.26
Growth rate: 2007–08 to 2014–15	12.13	17.46	14.00	13.54	10.65	31.42	15.23	13.91

Source: Budget Documents, Ministry of Finance, Government of India.

Note: 1. Total direct taxes include revenue from other minor taxes such as estate duty and wealth tax.

2. Total taxes also include Union Territory taxes.

this phase, registering a growth rate of 9.4 percent per year, which works out to a buoyancy of 0.7.

The spectacular increase in revenue from income taxes is attributed in the main to the application of technology in tax administration. In particular, following the Comptroller and Auditor General's comment that a large proportion of those who were required to deduct tax at source were not submitting their returns to the tax department, the tax identification number (TIN) was introduced for tracking tax deduction at source and matching it with actual payments to banks in cities that were increasingly covered from 2003–04 to 2007–08. This progressively resulted in improving tax revenue as efficient networks, and information systems helped improve compliance in tax payments. Thus, until 2007–08, there was a spectacular increase in both personal and corporate income tax revenues. The steady expansion in the service tax base by including more and more services increased service tax revenue. However, revenue from Union excise duties in spite of buoyant economic conditions and high growth of the manufacturing sector continued to be low. The revenue from Union excise duties grew only at 9.4 percent even when the nominal growth of GDP during this period was 14.5 percent.

Revenue trends in the third phase are marked by a decline in the revenue–GDP ratio, partly due to the reduction in excise and service tax rates by two percentage points in the 2009–10 budget as a part of the stimulus given in the wake of the global financial crisis. The CENVAT rate was reduced from 10 percent to 8 percent and the service tax rate was reduced from 12 percent to 10 percent. The lowering of these tax rates, along with a decelerating manufacturing sector, caused a decline in the Union Government's tax revenues relative to GDP from 11.9 percent in 2007–08 to 9.6 percent in 2009–10. The largest decline in the ratio was in the case of excise duties by 0.9 percentage points, followed by customs duty (0.8 percentage points). The revenue from income tax remained static following the completion of TIN coverage. In subsequent years, even as the stimulus provided by reduced tax rates was withdrawn, the revenue–GDP ratio remained stagnant.

3.4. Trends in State Tax Revenue

In contrast to the Union tax revenues, revenues from State taxes relative to GDP showed an increase from 6.3 percent in 2000–01 to 7 percent in 2005–06, mainly on the strength of an increase in revenue from sales tax and stamps and registration. However, subsequently, the ratio declined to 6.5 percent in 2009–10 before recovering to 7.6 percent in 2012–13. The trend is broadly the same in the case of non-special category States.

The tax–GDP ratio increased from 6.3 percent in 2000–01 to 7.2 percent in 2006–07, then declined to 6.6 percent in 2009–10, before recovering to 7.7 percent in 2012–13. Interestingly, the growth of revenues in the special category States was faster—increasing by one percentage point from 4.1 percent in 2000–01 to 5.1 percent in 2005–06 and eventually increasing to 6 percent in 2012–13 (Table 3).

An important feature of state-level taxation is the wide variations in revenue among the States, which cannot be explained by taxable capacity alone even when general and special category States are considered separately. Analysis by the Fourteenth Finance Commission (Government of India 2015) showed that among general category States, the tax ratio in 2013–14 (RE) varied from 11.2 percent in Tamil Nadu to 10.2 percent in Karnataka and 5.5 percent in West Bengal.[7] The per capita GSDPs of Gujarat, Haryana, Maharashtra, and Punjab were higher than those of Karnataka and Tamil Nadu, but their tax–GSDP ratios were at least two percentage points lower at 7.8, 6.8, 7.2, and 8.3, respectively. Similarly, Chhattisgarh, Madhya Pradesh, Uttar Pradesh, and Bihar had tax–GSDP ratios at 8.9 percent, 7.5 percent, 8.1 percent, and 6.7 percent, respectively, which were much higher than that of West Bengal at 5.5 percent. The tax–GSDP ratios of Bihar and Haryana were similar. These comparisons showed that there were significant differences in tax effort among the States.

Table 4 presents the analysis of the growth of the individual state's own tax revenues and sales tax revenue for the period 1991–92 to 2012–13. The growth rates were estimated for the periods 1991–92 to 2004–05 and 2005–06 to 2012–13 to assess whether the replacement of cascading sales taxes based on multiple rates with a value-added tax on goods with two rates accelerated the growth of tax revenue in States. As Table 4 shows, growth rates during the second period were generally higher at 16.5 percent as compared to 13.7 percent. Similarly, sales tax revenue growth for all States was higher at 16.7 percent as compared to 14.3 percent in the earlier period. Broadly, a similar trend was seen in the case of the general category States. In the case of special category States, the acceleration was even higher.

The analysis presented for individual States suggests that acceleration in the average annual growth of tax revenue as well as in sales tax revenue was substantially higher in the case of some of the poorest States. In Bihar, for example, the growth of tax revenues accelerated from 11.9 percent

7. In Annex 4.34 in Volume 2 of the Report, the data on the tax–GSDP ratio are presented for the period 2004–05 to 2014–15 (BE). Since generally, the budget estimates are more in the nature of targets than actual realizations, the revised estimates of 2013–14 are analyzed here.

TABLE 3. Trends in Tax–GDP Ratio in States (percent)

Year	*Tax on Land and Agri. Incomes*	*Stamp and Registration*	*State Excise Duties*	*Sales Tax/ VAT*	*Taxes on Transport*	*Other Taxes*	*Total- States' Own Tax*
			I. Non-Special Category States				
1991–92	0.13	0.48	0.96	3.72	0.53	0.34	6.31
1995–96	0.14	0.55	0.76	3.19	0.48	0.52	5.79
2001–02	0.09	0.57	0.84	3.80	0.57	0.18	6.31
2005–06	0.09	0.84	0.83	4.26	0.61	0.19	7.04
2006–07	0.10	0.94	0.83	4.33	0.57	0.18	7.15
2007–08	0.11	0.93	0.83	4.20	0.53	0.16	6.97
2008–09	0.11	0.78	0.87	4.16	0.52	0.15	6.78
2009–10	0.10	0.75	0.89	4.03	0.52	0.16	6.66
2010–11	0.13	0.83	0.91	4.26	0.54	0.19	7.07
2011–12	0.12	0.89	0.97	4.60	0.54	0.16	7.47
2012–13	0.12	0.92	0.98	4.76	0.58	0.19	7.75
			II. Special Category States				
1991–92	0.47	0.09	0.59	1.49	0.24	0.12	3.47
1995–96	0.18	0.09	0.63	1.49	0.28	0.13	3.10
2001–02	0.13	0.18	0.76	2.23	0.46	0.24	4.12
2005–06	0.06	0.32	0.65	3.28	0.47	0.18	5.13
2006–07	0.06	0.40	0.64	3.42	0.45	0.14	5.31
2007–08	0.06	0.31	0.64	3.49	0.40	0.18	5.29
2008–09	0.09	0.24	0.61	3.37	0.47	0.19	5.16
2009–10	0.08	0.23	0.64	3.29	0.52	0.14	5.06
2010–11	0.10	0.22	0.63	3.49	0.48	0.15	5.21
2011–12	0.07	0.25	0.68	3.93	0.52	0.24	5.90
2012–13	0.09	0.28	0.73	4.01	0.47	0.23	5.99

(Table 3 Contd)

(Table 3 Contd)

Year	*Tax on Land and Agri. Incomes*	*Stamp and Registration*	*State Excise Duties*	*Sales Tax/ VAT*	*Taxes on Transport*	*Other Taxes*	*Total- States' Own Tax*
				III. All States			
1991–92	0.33	0.15	0.46	0.94	3.60	0.52	6.15
1995–96	0.50	0.14	0.53	0.75	3.10	0.47	5.66
2001–02	0.18	0.09	0.55	0.83	3.70	0.56	6.18
2005–06	0.19	0.09	0.81	0.82	4.20	0.60	6.93
2006–07	0.18	0.10	0.91	0.82	4.28	0.56	7.05
2007–08	0.16	0.10	0.89	0.82	4.16	0.52	6.88
2008–09	0.15	0.11	0.75	0.85	4.12	0.52	6.69
2009–10	0.16	0.10	0.72	0.88	3.99	0.52	6.57
2010–11	0.19	0.13	0.80	0.89	4.22	0.54	6.96
2011–12	0.17	0.12	0.85	0.95	4.56	0.54	7.38
2012–13	0.19	0.12	0.88	0.97	4.71	0.58	7.65

Source: Finance Accounts of different States.

TABLE 4. Growth Rates of States' Own Tax Revenues (percent)

	Sales Tax/ VAT			*Total States' Own Tax Revenues*		
	1991–2012	*1991–2004*	*2005–2012*	*1991–2012*	*1991–2004*	*2005–12*
Andhra Pradesh	15.99	18.13	17.01	15.56	15.23	17.06
Bihar	9.20	11.90	17.51	11.11	11.87	19.10
Chhattisgarh		23.29	19.99		21.70	18.54
Goa	14.74	17.95	14.55	15.74	17.43	16.52
Gujarat	9.70	0.00	17.37	13.50	13.36	17.65
Haryana	18.21	18.70	27.05	14.97	13.61	14.74
Jharkhand		18.05	15.87		18.24	15.86
Karnataka	13.90	14.26	16.77	14.69	13.53	16.85
Kerala	14.18	16.64	15.33	13.71	15.22	15.46
Madhya Pradesh	13.04	13.25	17.50	12.47	12.86	17.99
Maharashtra	13.40	13.32	15.35	13.89	14.13	15.79
Odisha	16.27	14.34	19.27	16.36	13.18	18.14
Punjab	14.43	13.10	15.59	12.76	11.96	14.32
Rajasthan	15.71	14.66	17.81	14.66	14.81	16.30
Tamil Nadu	13.68	14.20	15.24	14.13	14.44	16.44
Uttar Pradesh	14.98	14.30	17.78	14.09	13.54	16.90
West Bengal	12.00	11.22	15.34	12.01	10.01	14.63
All General Category States	14.36	14.26	16.60	14.21	13.74	16.46
Arunachal Pradesh	45.00	11.80	28.65	25.13	19.93	25.44
Assam	16.40	12.12	15.83	14.80	11.92	15.75
Himachal Pradesh	19.70	17.61	22.08	15.96	16.19	17.12
Jammu and Kashmir	23.36	19.57	22.64	18.69	17.35	18.44
Manipur	18.87	16.12	23.40	16.24	14.01	19.77
Meghalaya	18.98	15.39	20.76	15.24	12.32	18.03
Mizoram	32.89	25.73	26.98	23.03	16.00	23.30
Nagaland	18.23	12.72	20.19	16.19	13.79	18.37
Sikkim	22.02	23.08	16.79	19.10	16.42	19.09
Tripura	20.72	20.10	19.09	18.41	17.63	17.73
Uttarakhand			22.79			19.65
All Special Category States	20.63	15.21	19.77	17.54	14.09	17.82
All States	14.56	14.29	16.73	14.33	13.75	16.52

Source: Author's estimates from States' Finance Accounts data.

during 1991–2004 to 19.1 percent during 2005–13. There was an increase of at least 3.5 percentage points in growth rates in the other low-income States of Odisha, Madhya Pradesh, Rajasthan, and Uttar Pradesh. In contrast, the acceleration was not very high in the case of the more affluent States of Kerala (from 15.2 percent to 15.5 percent), Haryana (13.6 percent to 14.7 percent), and Punjab (12 percent to 14.3 percent). During 2005–13, despite the acceleration, the growth of tax revenues in the States of Haryana

(14.7 percent), Punjab (14.3 percent), and West Bengal (14.6 percent) were only marginally higher than the growth of GSDP in these States. While tax revenues in the three States during 2005–13 grew at 14.7 percent, 14.3 percent, and 14.6 percent, respectively, their growth rates in GSDP were 16.9 percent, 13.3 percent, and 13.4 percent, respectively, indicating a buoyancy of less than 1 in the case of Haryana and marginally more than 1 in the case of the other two States.

Although the periods above for analyzing revenue growth were chosen with a view to examining the structural break due to the introduction of VAT in 2005–06, it would be misleading to attribute the acceleration entirely to policy reform since during the second period, the economy was also buoyant and commodity prices were high. The economy registered a 14.9 percent nominal growth rate as compared to 12.6 percent during the previous period. With revenue from petroleum products constituting 30–35 percent of the ad valorem sales tax revenue in the States, an important reason for the acceleration in the growth of tax revenues during the second period was the sharp increase in the price of petroleum products after 2008–09.

To examine whether the introduction of VAT by itself led to an acceleration in revenues, sales tax revenues in each of the States for the period 1991–92 to 2013–14 were regressed on the per capita GSDP, the proportion of GSDP from the non-agricultural sector, the wholesale price index of petroleum products, and the VAT dummy after 2005–06 in a log-linear model.[8] The regression estimates are summarized in Table 5. The analysis shows that in all the States, per capita GSDP was a significant determinant of sales tax revenues. In 10 out of the 25 States, the proportion of non-agricultural income was significant with the correct sign. Similarly, in 10 States, the wholesale price index of petroleum products was significant. The VAT dummy was significant only in Gujarat and Manipur. Thus, while the introduction of VAT could have substantially rationalized the tax system, it would be unrealistic to claim that it led to a significant increase in revenues. The major reasons for the increase in revenues must be attributed to acceleration in the growth rate of GSDP and sharp increase in the prices of petroleum products, particularly after 2008–09.

8. Thanks are due to Ms Suranjali Tandon of NIPFP for estimating these equations.

TABLE 5. Impact of VAT Reform in Indian States

State	*Log GSDP per capita*	*Petrol Price Index*	*Non-Agricultural GDP share*	*VAT dummy*	*Constant*	*Adjusted R-Square*
Andhra Pradesh	1.082***	−2.9E-05	0.0105**	−0.067**	−2.42***	0.9921
Arunachal Pradesh	3.611*	−0.0026	0.054*	0.512	−17.201**	0.7998
Assam	0.75**	0.0012	0.0219***	−0.0208	−2.032**	0.9860
Bihar	1.07**	0.0012	−0.018**	−0.098	−0.715	0.8557
Goa	0.91***	−0.0005	−0.01	0.0469	0.109	0.9851
Gujarat	0.485***	0.003***	0.0014	0.049*	0.547	0.9927
Haryana	0.605***	0.0079	0.0187***	0.0025	−0.957**	0.9925
Himachal Pradesh	1.214***	0.0005	0.0003	0.05	−2.667***	0.9948
J&K	1.89***	−0.0021	0.01	−0.034	−5.91***	0.9772
Karnataka	0.807***	0.001***	−0.0005	0.007	−0.544*	0.9963
Kerala	0.951***	0.0013*	−0.00007	−0.089***	−1.093***	0.9927
Madhya Pradesh	0.705***	0.0024***	0.0036	−0.0039	−0.696	0.9909
Maharashtra	0.898***	0.001	0.003	−0.059*	−1.28**	0.9896
Manipur	1.216***	0.0026	−0.017	0.138*	−1.92*	0.9638
Meghalaya	1.17***	0.0015	−0.004	0.0038	−2.55***	0.9903
Mizoram	2.26***	−0.003	0.038**	0.153	−10.37***	0.9654
Nagaland	1.067***	0.002**	−0.0019	0.052	−2.4***	0.9928
Odisha	0.73***	0.0017**	0.008**	−0.019	−1.088**	0.9904
Punjab	1.106***	0.0001	0.008	−0.063	−2.43**	0.9696
Rajasthan	0.82***	0.002***	0.0095***	−0.0039	−1.56***	0.9975
Sikkim	−0.0116	0.0042	0.036***	−0.0019	−0.433	0.9088
Tamil Nadu	0.6***	0.0022***	0.0097***	−0.011	−0.495*	0.9967
Tripura	1.015***	0.0018**	0.016**	−0.02	−3.17***	0.9942
Uttar Pradesh	1.4***	0.00005	−0.002	−0.047	−2.98***	0.99
West Bengal	0.636***	0.0023***	−0.0027	0.027	−0.009	0.9864

Sources: 1. Finance Accounts of the States, Comptroller and Auditor General, Government of India (for data on VAT revenues); 2. Ministry of Petroleum and Natural Gas, Government of India. (Price index of petroleum products); 3. Central Statistical Organization, Ministry of Statistics and Programme Implementation, Government of India (for data on non-agricultural GSDFP share).

Note: Estimated Equation: log(*sales tax per capita*) $= \alpha + \beta_1$ log(*GSDP per capita*) $+ \beta_2$ *Petrol price index* $+ \beta_3$ *Share of non-agricultutral GDP* $+ \beta_4$ *VAT dummy*

*Significant at 10 percent; **significant at 5 percent; *** significant at 1 percent.

4. Successful Reform Initiatives in India's Tax System

The analysis of Indian tax policy suggests remarkable successes as well as important failures. Understanding successes is important in order to replicate them wherever possible, and the analysis of failures provides lessons for the future to devise strategies to avoid them.

The most important success story in Indian tax policy is the simplification of the personal income tax in terms of reducing the number of brackets and marginal tax rates. The number of brackets was reduced from 12 in the early 1970s to 3 in 1997 and the marginal tax rate was reduced from 97.75 percent to 30 percent during the same period. There is considerable anecdotal evidence to show that the reduction in marginal rates led to a significant improvement in tax compliance. The impact on revenues could have been even higher had the reduction in the marginal rate of tax been accompanied by administrative reforms.

The second important success story of the Indian tax system is the application of technology to improve revenue productivity. The introduction of the TIN in 2003–04 led to an increase in income tax revenues relative to GDP by almost 2.7 percentage points in just four years from 3.3 percent in 2002–03 to 6 percent in 2007–08, registering a growth rate of close to 30 percent per year during the period. The use of technology was simply to ensure that those who were required to deduct tax at source paid tax and filed the returns. The TIN has also generated a vast amount of data on the sources of income of individuals and could be usefully mined to get much more information to improve compliance. It is also hoped that when GST is introduced, the seeding of PAN numbers in GST numbers can lead to enormous information on small businesses and self-employed traders and service providers, and this could substantially improve tax compliance.

The third most successful tax reform in the Indian context is the introduction of the value-added tax at the State level in 2005. This was truly a major reform involving all the States and Union Territories in which cascading sales taxes with 14–16 rates were replaced with a value-added tax with broadly two rates (excluding a low rate on bullion and specie and precious metals, and a high rate on motor spirit and high-speed diesel). Besides, being revenue-neutral, this reform seems to have substantially improved the competitiveness of Indian manufacturing and has led the way for a further reform of implementing the GST.

The fourth important reform initiative that has helped to broaden the base and balance tax burden is the introduction of service tax. The tax, first introduced in 2004 on three services, was progressively expanded into other services and finally, in 2012, coverage was extended to all services excluding those specified in the negative list. There is still scope for pruning the negative list and doing away with exemptions, but expansion in the coverage of the tax is no mean achievement. In fact, in the Indian context, this has helped to offset the revenue loss from customs duty undertaken to open up the economy and to ensure a measure of balance in the tax burden between commodities and services.

Another important initiative that has helped to improve the ease of doing businesses is the creation of large taxpayers units (LTUs). Beginning with

Bangalore in 2009, the LTUs have been set up in Chennai and Mumbai. Taxpayers with a turnover of more than ₹5 crores in service tax or excise duty, or those paying an advance tax of more than ₹10 crore, are eligible to be served by the LTUs. They function as a one-stop shop for all central taxes and, hence, enable a coordinated approach to taxpayer services. However, joining an LTU is optional for eligible taxpayers. Reducing eligibility thresholds, making participation mandatory, providing fast services, and facilitating payments could go a long way in improving taxpayer services.

5. What Ails the Indian Tax System?

In contrast to the few successful initiatives, the failures of the Indian tax system are many and there is much to be done to evolve a broad-based, simple, productive and less distorting tax system. As discussed in Section 2, the tax system is supposed to raise required revenues by minimizing collection, compliance, and distortion costs, that is, have high revenue productivity, low cost of paying tax, and few adverse impacts on resource allocation.

The low revenue productivity of the Indian tax system has been a matter of concern, and despite several rounds of reform, the tax–GDP ratio has remained stubbornly low. The highest tax–GDP ratio of 17.5 percent was reached in 2007–08, and after declining to 15.5 percent due to reductions in the rates of excise and service taxation, revenues recovered only marginally and hovered around 16.5 percent of GDP, mainly due to a marginal increase in the tax–GDP ratio of the States. The ratio of Union tax revenue to GDP in 2014–15 is estimated to be less than 10 percent, a clear two percentage points lower than in 2007–08.

5.1. Constitutional Assignment and Narrow Base

The most important reason for the low productivity of the Indian tax system is its narrow tax base. The base is narrow for a number of reasons: the fragmented Constitutional assignment of revenues, wide-ranging exemptions, concessions and deductions, complications and ambiguities in tax laws due to a multiplicity of objectives assigned to tax policy, large and increasing tax arrears held in disputes, base erosion and profit shifting (BEPS) by multinationals, organizational shortcomings and the poor capacity of tax administrations, and less than full use of information systems to administer and enforce tax compliance.

The difficulty of levying a comprehensive income tax in India lies in part in the Constitutional assignment itself. The assignment of income tax on agriculture to the States means that the Union Government can levy tax only on non-agricultural incomes. The States do not levy agricultural income tax except on income from plantation crops. Even corporates earning income from agriculture do not pay tax. A recent study by Rao and Sengupta (2012) for 2008–09 estimates the potential loss from not taxing agriculture at 0.6 percent of GDP. Exempting agricultural income provides an easy avenue for the evasion and avoidance of tax.

5.2. Tax Exemptions and Preferences

The second important reason for India's narrow tax base is the plethora of exemptions, concessions, and deductions in direct and indirect taxes, all justified in one way or the other by the multiple objectives of the tax system. Besides raising revenue, the tax system is expected to incentivize savings, promote exports, achieve balanced regional development, promote investments in infrastructure, expand employment, promote scientific research and development, and encourage cooperatives and charitable activities. Similarly, excise duty is used to provide preferential treatment to small-scale industries by keeping the threshold high and to promote backward area development. The resulting exemptions, concessions, and deductions create enormous opportunities for tax evasion and avoidance. No one can be sure how far these objectives are being achieved, if at all. What is worse, having given these concessions, when companies take advantage of them to reduce tax liability, the government comes up with a minimum alternative tax.

Since 2006, the Government of India has been publishing estimates of revenue foregone from tax concessions in its annual budget. For 2014–15, the government estimates revenue foregone at a staggering ₹5,89,285 crore, ₹3,01,688 crore from customs, and ₹1,84,764 crore from excise. These may appear to be over-estimates to some due to the methodology employed. The difference between rates specified in the tariff schedule and the actual rate applied on imports is taken as the basis for revenue foregone in the case of customs duty. However, when an "essential" commodity is imported due to domestic shortages, the government applies lower tariff rates in the public interest. There is the basic question of the right level of customs duty used for such calculations because the duty is simply protection given to domestic producers: all import duties are taxes imposed on citizens to provide subsidies to domestic producers. Similarly, customs revenue lost due to exemptions given to imports used in re-exports could be left out since the exemptions are provided to help the competitiveness of domestic exporters. The same logic might hold when excise rates are lowered for commodities to control prices during periods of shortages of essential goods. These arguments have led to the concept of tax expenditures.

Whatever be the logic, the tax-expenditure estimates bring out glaring shortcomings in the tax system that constrain revenue productivity. The revenue lost on account of concessions for special economic zones (SEZs) for 2014–15 is estimated at ₹20,376 crore from corporate tax alone. The rationale for tax concessions for companies in SEZs is that they need to be compensated for the overall infrastructure deficit to help their competitiveness. But exporters located in non-SEZ areas do not get the benefit and yet face perhaps even worse disadvantages due to poor infrastructure and governance. Not surprisingly, companies prefer to locate in these enclaves. The Union Commerce Ministry showcases this as additional investment and argues for the continuation of tax benefits. The revenue cost of area-based incentives for 2014–15 is estimated at ₹17,284 crore from excise duty and almost ₹8,000 crore in the case of corporate tax. The revenue foregone on account of tax concessions to infrastructure industries works out to ₹22,230 crore. There are also customs duty reductions in the case of items like fertilizers. A closer scrutiny and weeding out of these tax preferences could easily result in enhancing the ratio of tax to GDP by at least 1 percent, helping to contain the revenue and fiscal deficits and augment much-needed education, health, and capital expenditures.

5.3. Lopsided Revenue Concentration

Revenue from Union excise duties has declined steadily from 4.2 percent of GDP in 1990–91 to 1.5 percent in 2014–15 (Revised Estimate, RE). Even during 2001–02 to 2007–08, when the economy was in its high growth phase, excise revenue grew at an average rate of 9.4 percent, actually lower than the average growth rate of about 10 percent in the following years. The low growth of excise duty has been a major constraint in improving the revenue–GDP ratio. The detailed commodity composition of excise revenue shows that a large part of the tax is derived from petroleum products and basic metals. In 1990–91, tax revenue from petroleum products constituted about 13.9 percent of the total, increasing steadily to 41 percent in 2003–04 and then declining to 26 percent in 2009–10 (Table 6) due to a shift to specific tax rates following high international oil prices after 2008–09. Similarly, revenue from basic metals, which was just about 9.6 percent in 1991–92 rose to 19 percent in 2009–10. In contrast, the shares of revenue from textiles,

TABLE 6. Commodity-wise Collection of Union Excise Duties (Percent in Total)

	1990–91	*2000–01*	*2003–04*	*2009–10*
Food Products	4.0	4.5	3.2	1.7
Tobacco Products	8.3	6.7	5.6	5.0
Minerals and Ores	8.4	6.2	6.2	4.2
Petroleum Products	13.9	32.9	41.0	26.1
Chemicals	11.1	10.2	9.3	8.3
Plastics and articles thereof	2.5	2.3	2.4	4.1
Rubber Products	4.9	2.2	1.3	1.3
Leather and Wood Products	0.6	0.2	0.1	0.9
Textiles and Garments	10.8	4.8	3.7	2.9
Basic Metals	9.6	10.4	11.2	19.0
Electrical and Electronic Goods	16.1	8.8	7.8	11.2
Transport Vehicles	8.4	8.9	6.6	12.3
Miscellaneous	1.3	1.8	1.7	3.1
Total	100.0	100.0	100.0	100.0

Source: CBEC, Ministry of Finance, Government of India.

minerals, chemicals and electrical goods all showed declines, reflecting the changing pattern of industrialization and its impact on revenue productivity. To improve the revenue productivity, it is vitally important to broaden the excise duty base by introducing a properly designed GST.

5.4. Low Productivity of the Property Tax

One of the major shortcomings of the Indian tax system is the low productivity of real property taxes. In most multilevel fiscal systems, property tax plays an important role in financing local services. It is also a preferred means of financing local services because it is relatively immobile and, therefore, less distorting, transparent, and simple and easy to administer at the local level. This is an important instrument to link revenue–expenditure decisions at the local level because it is largely a benefit tax and, for that reason, should evoke greater compliance. It is also argued that fiscal differentials at the local level get capitalized into property values (Oates 1969).

Despite its transparency, localized nature, direct link to the beneficiaries of local public services, and progressivity, the tax on immovable properties has not been successful in India. In contrast to the OECD countries which, on average raise about 2 percent of GDP from property taxes, and developing and transitional countries where the average is about 0.6 to 0.7 percent, property taxes in India are negligible. The available estimate based on sample surveys of municipalities for the Thirteenth Finance

Commission for 2006–07 showed that revenue from property tax ranged from a mere 0.16 percent to 0.24 percent of GDP and has remained stagnant over the years.

The most important reason for this disappointing performance is poor coverage and collection efficiency. Poor coverage is due to (a) wide-ranging exemptions; (b) poor information systems and the absence of up-to-date registries of land and properties with municipal bodies; and (c) vacant properties. Exemptions vary from state to state, and from one municipal body to another, but there are some common exemptions. Article 285 of the Constitution provides exemption to all properties belonging to the Union Government. Many metros have large unauthorized buildings, and properties that are not included in the municipal register and as a result do not pay any property tax. Other important exemptions include places of religious worship, educational institutions, charitable institutions, ancient and historical monuments, burial and cremation grounds, government land and buildings set apart for free recreational purposes, offices of trade union associations, buildings and lands of urban development authorities constituted under respective State government acts, institutions providing free medical relief and education, properties owned by ex-servicemen and their families, and certain types of vacant lands and buildings.

Poor information on properties with urban local bodies, lack of clarity on property ownership or tenancy rights and the absence of a cadaster that uniquely identifies properties and their owners, and the inability to adopt market-based valuation all constrain property taxes. Most municipal bodies have not yet sought to update their records relating to property ownership and tenancies, and nor do they coordinate with their own registration departments to obtain information on properties transferred and their values. The Administrative Reforms Commission has noted that only about 60–70 percent of properties in urban areas are actually assessed. The Commission recommended using satellite imagery and geographical information systems to identify properties that are not paying tax.

The problem of low coverage is compounded by poor collection. The assessed values of properties are significantly lower than their market values and do not capture either the increase in value due to improvements or general market conditions. Often assessed values are as low as 8–10 percent of market values; they were found to be on average about 30 percent of market value in the 36 largest municipal corporations in India (Rao 2012). Given these huge gaps, attempts to increase these values are likely to meet with severe opposition.

5.5. Tax Avoidance by Multinational Corporations

The fifth important area needing reform has to do with multinational companies avoiding taxes in a variety of ways— base erosion and profit shifting (BEPS) by such companies is a worldwide phenomenon. Shifting profits to subsidiaries created in low-tax jurisdictions, taking advantage of tax treaties, and manipulating prices in related party transactions through transfer pricing have been commonly used to avoid taxes. Although there are "arm's length pricing rules" to deal with transfer pricing, it is difficult to apply these in practice when intangible assets such as trade names, goodwill, brand recognition and intellectual properties such as patents, copyrights, brands and trademarks, and business methodologies are involved. Multinational companies also act as intermediaries in product sales and distribution, make loans and interest payments to one another, and charge fees from one another for activities such as management services, treasury services, and investment services to reduce tax liability.

Evidence of this, even in developed countries like the United States, United Kingdom, and the European Union, has led the OECD and, in more recent times, the G-20 countries, to seek reforms in the international corporate tax system, which has led to the BEPS Action Plan initiated by OECD in September 2013. The BEPS Plan was approved as a G-20 project and organized through the OECD for delivery by December 2015. In the meantime, the International Commission for the Reform of International Corporate Taxation has made a number of recommendations to deal with this pernicious practice (ICRICT 2015).

In the Indian context, there is considerable anecdotal evidence to show that multinational companies have been indulging in tax avoidance practices. Patnaik and Shah (2011) in their study showed that the effective corporate tax rate on multinational companies was significantly lower than on domestic companies. Rao and Sengupta (2014) in their more detailed study using the Prowess database show that during the period 2006–11, the effective interest rate paid by multinational companies was higher and the amount of tax paid per unit of borrowing was lower. The paper also shows that from 2008 to 2011, while royalty payments by top 25 multinationals doubled, dividend payments increased by just 30 percent. The paper cites specific instances of multinational companies indulging in willful tax avoidance.

The problem is compounded by the fact that while multinational companies have access to resources that they use in hiring the best accountants and lawyers, tax administrations in most developing countries are hamstrung by low resources as well as administrative capacity. It is not surprising that the Ministry of Finance, after putting out the General Anti-avoidance Rules (GAAR), has continuously postponed implementing them.

There is a view that the issue really is more about the poor capacity and incompetence of policy makers and legal drafters than the behavior of multinational companies. While it is legitimate for countries to demand a fair share of taxes, they need to draft their laws better, have more competent staff, and apply laws more evenly. Information exchange among countries may help, but the countries need to have the capability and intentions to use the information better to enforce laws. Given the pressure to meet tax revenue targets, tax departments in India have taken aggressive postures to recover tax from multinational companies, but this has only earned them bad publicity with overseas investors. In India, cases like Vodafone clearly belong to a grey area as transactions were made through subsidiaries located in tax havens, resulting in the Supreme Court in January 2012 overturning the decision of the Bombay High Court and striking down the capital gains tax claims of the Central Board of Direct Taxes (CBDT) from Vodafone.[9] All this, however, does not justify the arbitrary actions of the government in resorting to retrospective changes in tax law purely for revenue reasons.

5.6. Low Capacity of Tax Administrations

Tax administration is a critical element of any tax system. de Jantscher (1990, p. 179) declares that in developing countries "tax administration is tax policy." According to Richard Bird (2004), "The best tax policy is worth little if it cannot be implemented effectively." However, the issue of tax administration is not just about its effective implementation. It has to do with the ability to enforce tax compliance through the complex dealings of taxpayers, the attitude of tax administrations towards taxpayers, the taxpayers' confidence and trust in the tax administration, and clarity in laws to avoid discretion in the hands of tax administrators.

By all accounts, the Indian tax administration does not evoke the confidence and trust that a modern tax administration requires for greater voluntary tax compliance. There have been a number of reports on the reform of tax administration beginning with the report of the Tax Reforms Commission (1991). The careful studies by Das-Gupta and Mookherjee (1998), Bagchi et al. (1995), and more recently, the reports of the Tax Administration Reforms Commission (Government of India

9. Vodafone International Holding B.V. versus the Union of India & ANR; case No: I.A. No. 19 in Civil Appeal No. 733 of 2012.

2014; 2015) have dealt in detail with various aspects of the reform of tax administration. Implementing these reforms requires political will.

Tax administration in India suffers as a result of (a) lack of autonomy; (b) low morale of tax administrators due to their organizational structure, low prospects of career progression, and their subservience to general administrators; (c) the separation, independent functioning, and lack of coordination between direct and indirect tax administration split into the CBDT and the Central Board of Excise and Customs (CBEC); (d) area-based offices rather than functional divisions and poor functional specialization, including on tax intelligence; (e) poor information systems and delayed use of technology for tax administration; (f) perverse incentives for tax administrators by judging performance based on their fulfilment of tax collection targets; (g) poor capacity to forecast revenues and its adverse impact on expenditure management at both Union and State levels; (h) lack of clarity in tax laws, wide discretion to tax officials, and a huge build-up of tax arrears; and (i) tax administrators who see taxpayers as tax evaders and adversaries.

One way in which unclear tax laws and poor administration have manifested themselves is in the buildup of huge tax arrears. At the end of 2013–14, the amount of tax arrears from various taxes amounted to over ₹5.83 lakh crore or 5.1 percent of GDP. Almost 86 percent of this amount is held up in disputes; about 47 percent in disputes of up to 2 years old; and about 76 percent in disputes of up to 5 years old (Table 7).

Another way to see the impact of poor tax administration is the number of non-corporate assessees, which in 2012–13 numbered just about 3.7 million, less than 3.4 percent of the population. Over 75 percent of them had taxable incomes of less than ₹2 lakh.[10] Assessees with an income of more than

TABLE 7. Tax Arrears in 2013–14

	Held in Disputes Rs crore	*Not under Dispute Rs crore*	*Total Rs crore*	*Percent of Total*
Corporate Tax	150,802	41,211	192,013	32.92
Non-corporate Income Tax	259,721	23,985	283,706	48.63
Taxes on Income and Expenditure	410,523	65,196	475,719	81.55
Customs	9,758	4,686	14,444	2.48
Union Excise Duties	41,817	7,978	49,795	8.54
Service Tax	41,245	2,143	43,388	7.44
Total Taxes on Commodities and	97,821	14,807	112,628	19.31
Total	503,344	80,003	583,347	100.00

Source: Report of the Comptroller and Auditor General—Revenue 2013–14.

10. Report No. 10 of 2014 (Direct Taxes), Comptroller and Auditor General, Government of India.

₹10 lakh numbered just about 660 thousand, and those with a reported income of more than ₹1 crore numbered just about 42,800, implying incredibly poor coverage of the income tax in India.

While the problems with both the organizational setup and the functioning of the tax administration are well known, there have been few attempts to address them. An important innovation has been the creation of LTUs, which have helped coordinate the functioning of the CBDT and CBEC and reduce compliance costs for large taxpayers. Another important reform has been the requirement for electronic filing of returns and payment of refunds directly to taxpayer accounts. These are important but small initiatives, and by and large tax administrations have not yet gained the trust and confidence of taxpayers enough to improve voluntary tax compliance, a goal all tax administrations must strive for.

6. The Way Forward: The Need for Urgent Reforms

This analysis of the Indian tax system underlines the need for urgent reform of both direct and indirect taxes at the Union and State levels. An increase in revenue productivity in the least distortionary manner requires expansion in the tax base, rationalization of rates to reasonable levels, simplifying the tax system, and reforming tax administration. Some of these reforms can be taken up immediately, whereas others are medium and long term. While some are not difficult, others are very difficult, and some are formidable in their challenge.

The government will have to evolve a clear strategy of carrying out those reforms in a phased manner, building on the easier ones and progressing to the more difficult ones. The quote from Johnson and Myles (2011) that started this paper goes on to say that "There is always a tension between what is economically desirable and what is politically practical." The major precondition for successful tax reforms is the political appetite for such reforms.

The most formidable task in implementing a comprehensive income tax in India is dealing with the fractured assignment system. While it may not be easy to integrate income from agricultural and non-agricultural sources, the practical solution may be to enter into an agreement with the States and levy income tax according to applicable rates on income declared as agricultural income after allowing deductions for crop insurance premiums, and distributing the proceeds to the States from where the income originates. This will not be easy to do and would still face political opposition, but should nevertheless be in the medium-term reform agenda.

The first discussion paper on the DTC was a well thought-out document, and many of the suggestions contained in it, particularly those relating to grandfathering exemptions and concessions, merit consideration to broaden the base, increase revenue productivity and reduce unintended distortions in resource allocation. It is also important to work on a time-bound plan to effectively apply the general tax anti-avoidance rules on multinational companies and to develop the capacity to administer them. Indeed, there is a need to overhaul the administrative framework to enable functional specialization and coordination among various tax departments including sharing of information. The transition is not likely to be easy and in the short term it would be advisable to create specialized agencies, like the one for administering GAAR, and finally create proper administrative divisions into various functionally specialized groups from the prevailing region-based divisions. Although the Union Finance Minister in his Budget speech stated that the DTC will not be on the reform agenda, there is need to simplify the Income Tax Act of 1961, broaden the base, and reduce compliance costs.

The biggest item in the current reform agenda is of course the introduction of GST at the Union and State levels. The government has shown keenness to implement the reform and has brought in the 122nd Constitution Amendment Bill to hasten the process. The Finance Minister has, on a number of occasions, characterized this reform as a "game changer" and the "reform of the century", and taken several initiatives to persuade State governments to embrace it. The empowered Committee of State Finance Ministers is in broad agreement that the reform is desirable, and has been seeking to arrive at a consensus on a number of issues necessary for its implementation.

The original proposal for the introduction of GST was made in 2008, with implementation planned by April 2010. This has been postponed more than once since then. The Finance Minister in his Budget Speech of 2015–16 had set the date as April 2016, now of course missed. A realistic assessment also shows that the structure and operational details of GST emerging from the compromise agreement reached in the GST Council will be far from being flawless. There is no doubt that the GST replacing a plethora of Union and State indirect taxes is an important reform. This is expected to improve the ease of doing business, enhance efficiency in the supply chain by obviating the need to have branch offices (created to avoid the inter-states sales tax), reduce transaction costs by ensuring seamless trade in commodities and services across the country, and improve export competitiveness by providing comprehensive relief from domestic taxes. The extent to which these objectives can be accomplished will depend upon the ultimate structure and operational details that will emerge. Given the nature of the Indian polity and the fact that the interests of the Union and States, on the one hand, and those of the producing and consuming States, on the other, do not coincide, the consensus solution should be seen only as the next stage of consumption tax reform.

A closer examination of the 122nd Constitution Amendment Bill shows that the GST structure envisaged will not be flawless. First, the Bill provides only a minimalist framework for the levy. The details of the structure and operation of the tax, including exemptions, the rate structure, and thresholds, will be determined through negotiations in the GST Council. Second, keeping petroleum products and natural gas out of the GST chain will not only cause relative price distortions due to cascading, but also create administrative complexities. Both the Union and the State governments want to continue with the high tax rates on petroleum products prevailing at present. Third, the most undesirable compromise is the decision to levy a 1 percent tax on the inter-state supply of goods and services. While the present inter-state sales tax is only on goods, the new levy will be a tax not merely on the sales but also on the supply and not only on goods but on services as well. This will negate a major expected gain from the GST by making the tax partly origin-based, violating the federal principle of providing seamless tax credit, and continuing with the cascading element in the tax by denying input tax credit on this part.

The GST Bill has been stalled in the Rajya Sabha mainly due to differences between the ruling party and the opposition on the structure of the proposed levy, particularly in regard to the levy of 1 percent tax on the inter-state supply of goods, the exclusion of some taxes in the GST, and of the provision for a dispute resolution mechanism. Although the Select Committee of the Rajya Sabha, in its report, diluted the scope of 1 percent tax by confining it to the inter-state sale of goods, the opposition (particularly the Indian National Congress) has demanded dropping of the provision to levy 1 percent tax, fixing the maximum tax rate at 18 percent, and providing for a dispute resolution mechanism. The committee appointed by the Union Government with the Chief Economic Adviser as the Chairman to determine the rate structure of the tax at both the Union and State levels too has recommended that the 1 percent tax on inter-state transactions be dropped from the Bill. It has recommended that with a lower rate of 12 percent and sumptuary items and luxury goods taxed at 40 percent, the general rate of tax should not exceed 18 percent. It, however, suggested that the rate structure should not be a part of the Bill. With political issues taking precedence resulting in the logjam in the Parliament, the Rajya Sabha has not found time to debate and pass the Bill so far. The reform is likely to take time and is not likely to be implemented before 2017. After the Bill is passed, it has to be ratified by one half of the States. Once the amendment comes into effect, the GST Council will have to be formed, which will deliberate and decide on the thresholds, exemption limit, rate structure, special arrangements for the north-eastern States, application of place of supply rule for inter-state sale of services, mechanisms to deal with special arrangements such as works contracts and SEZs, and a dispute resolution mechanism. In addition, tax collectors will have to be trained and technology platforms will have to be put in place, though work is progressing on these already.

In this context, three issues must be noted. First, given the nature of the Indian polity, the GST that will be ultimately adopted will be full of compromises and it would be too ambitious to presume that the GST will be flawless. Second, for the above reason, the implementation of GST should be considered as the next stage of reform. Given the compromises on the structure and operational details, to consider GST as a game changer would be too optimistic. Nevertheless, the reform is important and it should be seen as a process rather than an event. Third, the reform should be preceded by considerable preparation to ensure a smooth transition and that includes the erection of a technology platform, capacity building of the tax administration, and educating taxpayers.

7. Concluding Remarks

The paper has attempted to analyze the Indian tax system from the perspective of the best practice approach to tax policy and reform. Tax policy matters to government, businesses and citizens alike. Governments have to collect taxes to provide public services. People are concerned about parting with their hard-earned money for the services they cannot clearly see and perceive. From the point of view of the economy, tax policy is an important factor in determining the business climate. A simple tax system with a broad base and low rates and differentiation, ease of paying taxes and transparent, non-adversarial administration can help improve the business climate in the country and would be best practice. The revenue productivity of taxes also determines the allocation of resources for providing physical and social infrastructure. Loading tax policy with too many objectives complicates the tax system. The objective of reform should be to reduce administrative, compliance and distortion costs. Thus, a major reform agenda for the government should be to phase out tax preferences to evolve a simple tax system.

The Indian tax system is characterized by low revenue productivity and stagnancy in the tax to GDP ratio. The paper identifies the reasons for low revenue productivity, going back to the Constitutional assignment of income taxes that constrains a comprehensive income tax. Although it is possible to coordinate such a tax between the Union and the States, political difficulties have prevented this. Narrow tax bases of both direct and indirect taxes are also the consequences of wide-ranging exemptions, concessions, and deductions given to pursue a variety of objectives through tax policy. The pursuit of multiple objectives has not only made their attainment difficult but has narrowed the tax base, reduced revenue productivity, and complicated the tax system, resulting in high compliance costs and distortions in resource allocation. The lack of clarity in tax laws and a huge buildup of tax arrears, an overwhelming proportion of which are stuck in tax disputes, is another problem. The paper highlights the problem of base erosion and profit shifting by multinationals and the organizational and functional problems with tax administration, as also the need to build capacity and professionalism in administering tax, including the building and application of information systems and better use of technology.

The paper underlines the need for reforming both direct and indirect tax systems not only to increase revenue productivity but also to improve the business climate in the country. The replacement of a plethora of indirect taxes with the GST is an important reform. However, its structure and operational difficulties will be decided on the basis of the compromise between the Union and the States, on the one hand, and among the States, on the other, with the resulting structure being far from flawless. It is, therefore, important to manage expectations of the GST. It is also important to realize that the Constitution Amendment Bill has some serious shortcomings that should be corrected before it is passed in the Parliament. As far as the reform of direct taxes is concerned, though the Finance Minister has indicated that the implementation of DTC will not be on the agenda, various reforms to simplify the law, phase out tax preferences to broaden the base, and the preparatory measures needed to implement the GAAR should be taken up. Reforms relating to tax administration to professionalize it and make it taxpayer-friendly also need to be pursued with vigor to improve administrative efficiency and voluntary tax compliance.

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Comments and Discussion*

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Rao's paper covers a wide canvas on what ails the Indian tax system, the theoretical dimensions of good tax policy, the practical problems of implementing good policies, and the experience of India so far. I will focus only on two issues: the question of the progressivity of personal income tax rates and the assignment issue. On the first, we have done much, and on the second, it is a lot tougher than the paper suggests.

First, Rao emphasizes that direct tax policy, in general, and highly progressive income tax rates, in particular, are blunt instruments, if not counterproductive ones, for achieving redistributive goals. He points out how high marginal tax rates can lead to high economic distortions relative to the revenue raised. Such distortions can be significant when labor supply is relatively inelastic, dampening wage rates and, thereby, defeating the very purpose of reducing inequality.

As some of us will remember, in the 1970–71 Budget speech, Prime Minister Indira Gandhi, also holding charge as the Finance Minister, said "… for the individual who derives his entire income from wealth, the combined effect of income and wealth taxation as now proposed will impose an effective ceiling on income after tax when such income reaches approximately 25,000 rupees per annum." There were 11 tax brackets at that time. We have come a long way. From 11 brackets and a highest marginal tax rate at 97.75 percent in 1973–75, we now have three brackets and the highest rate, including a surcharge of 10 percent and the education cess of 3 percent at 33.99 percent.

The paper also points out studies that highlight the undesirable effects of capital taxation and recommend taxing capital income at lower and less progressive rates, where a flat tax rate could be close to being optimal. India has done precisely that, with a flat rate dividends distribution tax

* To preserve the sense of the discussions at the IPF, these discussants' comments reflect the views expressed at the IPF and do not take into account revisions to the original conference paper in response to these and other comments, even though the IPF Volume itself contains the revised paper. The original conference version of the paper is available on "http://www.ncaer.org".

at the company level from 1997–98 onwards and tax-free dividends for final recipients. The highest marginal tax rate on personal income in India is lower than that in China (45 percent), South Korea (38 percent), Japan (50 percent), USA (45 percent), and most other OECD countries.

The question then that I would like the paper to answer is whether India has reached close enough to its optimal tax structure. There are people who feel that the highest tax rate is too low and that capital gains and dividends are not being taxed in an equitable manner. Is the taxation of capital income close to the optimum?

On my second point, the paper recommends a major overhaul of tax assignment in India, where the constitution assigns agricultural income tax to the states. We all know the two cannons of federal tax devolution assignment: Lower tiers of government are more accountable as own-source revenue increases and relatively immobile tax sources should be assigned to them. We have long followed these canons. But the states have no doubt been very coy in either raising land revenue rates or taxing agricultural income. For the sake of argument, let us consider such an amendment to change the tax assignment, as indeed Pakistan did in 1948. Both the Indian and Pakistani Constitutions were drawn up on the lines of the Government of India Act, 1935. That Act in 1935 had assigned sales tax revenue on goods to state provincial governments and, by exclusion, the sales tax on services to the center. The Pakistan Constituent Assembly changed the assignment of the Pakistan General Sales Tax Act (March 31, 1948) and reassigned it to the federal government. For this reason, among others, the federal structure of Pakistan does not find much acclaim among experts and has come under severe strain over the years. So, I would be careful in amending the constitution and changing tax assignments. I realize that what Rao suggests is not a constitutional amendment but an agreement between the centre and states that the centre will tax agricultural income and give the revenue to the states. But even this tampering may not be a simple matter.

Furthermore, it is important to note that the definition of agricultural income in the Income Tax Act in India is a very limited one. Section 2 of the Income Tax Act makes it clear that agricultural income includes rent or revenue from agricultural land that must be cultivated. It is a fairly restrictive definition. For example, poultry, livestock, dairy farming, and beekeeping are not part of agricultural income. To that extent, the revenue loss because of the tax exemption of agricultural income is not as large. For the time being, I am ignoring the loophole of non-agricultural income passing off as agricultural income. I will come to that later.

My own back-of-the-envelope calculation, based on rather heroic assumptions that I am happy to share with anyone interested in my method, also suggests that revenue loss for not having a perfectly good agricultural income tax is about ₹63,000 crores, or about 0.5 percent of GDP, very close to the 0.6 percent that Rao and Sengupta (2011) came up with.

Rao's paper rightly points out that "a tax policy is only as good as it can be administered." Trying to tax agricultural income spread over some 0.6 million villages can be challenging and may end up increasing black money in the economy. Let me suggest two alternatives to mobilize revenue and combine equity with administrative feasibility. First, the 1972 report of the Committee on Taxation of Agricultural Wealth and Income headed by Dr K. N. Raj recommended a progressive agricultural holdings tax to be levied by the states as a good substitute for an agricultural income tax imposed by the center. A land tax is likely not to be administratively more difficult than an agricultural income tax because the asset is there for all to see, though land titles would need to be cleared first, which itself is not an easy task. But it would not require a constitutional amendment and would strengthen fiscal federalism by augmenting the own-source revenue of the states, enhancing their accountability. What is needed is an all-India incentivized effort under the Center's leadership to encourage the States to introduce such a tax.

Second, agricultural income is indeed exempt from income tax, but there has been a twist post-2014. Agricultural income is considered for determining the tax rate while computing income tax liability if net agricultural income exceeds ₹5,000 and the total income, excluding net agricultural income, exceeds the basic exemption limit. There is a complicated, three-step process if an assessee's total income, excluding net agricultural income, exceeds his or her applicable basic exemption limit. It is a complex process of the partial integration of agricultural and non-agricultural incomes, with more taxable income in the higher tax slabs and the same non-agricultural income taxed at a higher rate, so I will not go into the details.

My overall argument is that because of informational problems and lacuna in tax administration, we have not been able to stop non-agricultural income being declared as agricultural income, leave alone to properly implement the partial integration that was envisaged at the beginning of the 1974–75 assessment year as recommended in 1972 by the Raj Committee. Perhaps we should first try and plug these loopholes in declaring nonagricultural income as agricultural income and implement partial integration. It has been more than 40 years since, and we still have not done it. Learning to walk before running may be a safer strategy.

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It is a pleasure to be here and I would like to thank Govinda for this excellent paper.

I want to start by saying that the first section on what makes for a sound tax system is very hard to pull off. It is a compression of a hundred years of research on optimal taxation, and, notwithstanding how capable one is, it would be hard to do justice to it. So, for example, one can always quarrel with the paper's characterization of the latest developments in optimal tax theory. I wonder if it is even necessary here, because (a) it is relatively generic and (b) I would consider staying instead with the data, which is extremely interesting and doing more with it. So, let me a give you a couple of straightforward comments and ask for more from what is already an extremely rich paper.

The first is more distillation. Sometimes, the most important points were unclear in the paper, and I will try to give my version of them. Second, the paper seems a bit depressing, and so perhaps it could highlight the success stories a little more as being instructive. Third, I think it is difficult to make the argument the paper is making without talking about India in a comparative perspective, because otherwise we run the risk of "Indian tax exceptionalism", which is a very dangerous path to traverse. Finally, I want to talk about the theory of reform, push the paper a little bit on the emphasis on revenue, discuss how an IPF paper can effectively use emerging ideas to lay out a research agenda, and suggest why the paper should list out the concrete proposals that should be implemented.

On distilling key messages, it is not entirely clear what the big lessons are, and, in particular, a lot of the problems cited, the Johnson and Myles quote, the political economy carve-outs are quite generic. One could say exactly the same thing about the US tax system. It would be nice to know what is wrong with the Indian tax system that is not so generic. In my opinion, the assignment problem—which level of government should tax what—is the original sin.

I think it would also be useful to distill some of the striking things that have gone well and organize them around the key ideas of the paper. For instance, there was a remarkable 5–6-year period in the early 2000s when revenues grew considerably. Since the paper is very worried about the level of revenues, one would want to dig into that period and understand it. A second significant, almost startling, success is the basic structure of personal income tax, the reduced numbers of brackets, and the relatively low marginal rates compared to several other countries. A third big success, which the paper underplays considerably, is corporate taxation, which has tripled as a share of the GDP over the last 20 years, has been very resilient, and is now a stable source of revenue at 3.5 percent of GDP. The fourth big success, which the paper notes, but could cover more substantially, is service tax and its growth from zero to close to 2 percent of GDP. It would be useful to know more about how and why these things happened. I think all these developments are reasons for optimism, and the paper could highlight them. In fact, the paper could have been organized around tax successes and failures, rather than focusing just on the "bads."

The big failures of the Indian tax system are covered well in the paper. The first is the coverage of personal income tax, where the paper reports two mindboggling numbers. The number of people reporting incomes of more than 10 million is only about 40,000. Taxpayers comprise only 3 percent of the population, and, even there, 75 percent of them are reporting an annual income of less than ₹2 lakh. This is a remarkable failure. The second failure, as you suggest, is a decline in the tax/GDP ratio after the 2008 global financial crisis, which I think is mainly in indirect taxes. Why did that happen? The paper could say more. My own instinct is that the tax assignment issues around agriculture are the problem. It would be useful to get a definitive picture. The final, mindboggling, failure number in the paper relates to tax arrears at 5.1 percent of GDP. Thinking a little more about that would be useful.

It is difficult to talk about these issues without country comparisons, and the paper refers to the Bird and Zolt (2003) and the IMF (2011) papers. From these, it is not entirely clear that India is so much of an outlier, not appearing to be very different from the other large emerging markets such as Turkey, Brazil, or China. These comparisons are hard to make, but I do not know how to assess failure or success without that. If we are worried about India, then there is no more powerful motivator than putting the Indian experience in relief. That way, we also avoid falling prey to Indian tax exceptionalism.

Although the paper talks about the importance of tax reforms in India, I did not quite understand its theory of reform. Tax reforms are politically difficult everywhere—winners do not pay, losers are vengeful—but it is not exactly clear why this is more difficult in India than anywhere else. The paper suggests that tax reform in India is a very slow process that gets bogged down in the details. I think that perhaps the opposite is also true, that very significant tax reforms are not really a process but sudden events that happen quickly through an alignment of significant political forces and actors. That was certainly true for the 1986 US tax reforms, and it is certainly true for VAT reforms in most countries that happened quickly as part of an IMF program.

I am deeply skeptical of the OECD initiative on base erosion and profit shifting (BEPS), which the paper talks about, though it is not a big part. I think there is a lot of hand wringing about multinational firms, which is strange because corporate tax revenues have been robust, the most robust in emerging markets, and an increasing share of overall revenues. It also does not seem particularly relevant in the Indian setting, where underinvestment in the manufacturing sector and capital investment, in general, are the first-order priority.

What is driving the state heterogeneity flagged here? Some research on that would be fascinating. Economic growth in the early 2000s and the role of IT in it is a huge question mark, and if we could demonstrate something about that through research, it would be an enormously valuable contribution.

Finally, when tax arrears get as big as over 5 percent of GDP, how does that distort the behavior of taxpayers? We do not know much about this, and research on this would be very helpful. Also, I did not get a strong sense of what the key policy proposals on this should be. May be it is time to think about amnesties and how they can be implemented if arrears get really large. Overall, personal income tax inclusion would seem to be the first-order thing to be addressed rather than pursuing BEPS or trying to alleviate poverty alleviation through the tax code. Finally, it is a great paper, and it is unfair to ask for something more of a paper as rich as this.

General Discussion

Pranab Bardhan conjectured that the unbelievably small number of high taxpayers in India could have more to do with the gaps in taxation of real estate and property. Carrying further Mihir Desai's implied argument that the inaccurate determination of real estate wealth influences the structure of capital taxation, he said that India does not adequately cover property taxation or take into account real estate wealth. He pointed out that wealth tax had been abolished very recently in India on the grounds that the amount collected was not significant enough to justify the costs (the same reason given for abolishing estate duty in 1983). This was ironical. While India is doing this, the world is sitting up and taking note of Thomas Piketty's proposal for a global system of progressive wealth taxes to reduce inequality. It is time to rethink property and wealth taxation and the estate duty in India.

Nirvikar Singh suggested that the paper could focus a little more on the effect of tax policy on growth, particularly on the tax policy designed to encourage investments, especially start-ups and early stage firms. Sudipto Mundle talked about Mihir Desai's comment on the birth defect in GST, the levy of a 1 percent tax not only on the sale but also on the interstate supply of goods, which implies that a commodity passing through four or five states would attract a levy in each state, defeating the purpose of GST. He hoped that the final version of the GST bill would not include this birth defect. On tax administration, he abhorred the prevalence of silo behavior between CBDT and CBCE and wondered if the paper could discuss the feasibility and desirability of the Parthasarathy Shome Committee's proposal recommending the consolidation of CBDT and CBEC, which had been opposed by the Revenue Service officers as jeopardizing their careers.

Karthik Muralidharan supported Bardhan's plea for more attention to property taxes, noting the core principle of property values going up sufficiently to yield a discounted cash flow of increased tax revenues that could then pay for urban infrastructure. Not having a good property tax system in place would make it difficult to generate the funds for the massive urban infrastructure that India needs.

Thomas Richardson felt that following the 2013 Tax Administration Reform Commission's report, India's tax rates are broadly fine, but what is of course shocking is the small number of taxpayers in India, only 30 million compared to, say, China's 300 million. He felt that keeping agriculture outside the tax net also contributes to this since many are allegedly only nominally engaged in agriculture with the bulk of their income coming from construction or other activities. Hence, there is a lot of scope to improve tax administration, enhance taxpayer services, and change the way in which the administration approaches and interacts with the taxpayer. Whichever way one looks at it, tax revenue of 18–19 percent of GDP is really low by emerging market standards. Tax modernization would boost not only revenues but also India's 'Ease of Doing Business' ranking.

Devesh Kapur noted that taxing agriculture is politically very contentious. Following Ashok Lahiri, he asserted that the revenue could be substantially enhanced by taxing land whose use has been converted from agricultural to non-agricultural purposes, resulting in a real windfall gain. This would be much less controversial politically since the tax would fall not on farmers but on land not being used by them. On large tax arrears, Kapur blamed it on the lack of incentives for tax officials to settle tax claims quickly out of fear of being accused of taking kickbacks. Tax cases continue for years, often reaching the Supreme Court, with major adverse implications for India's tax system.

Surjit Bhalla remarked that like Mihir, there is a success story on personal income tax that should be acknowledged. And, keeping morality out of it, we should think of tax rates that balance revenue maximization without distorting incentives. The huge unaddressed problem in personal income tax, however, is the missing middle, comprising tens of millions of Indian residents outside the top and the bottom tax brackets who do not pay taxes. While 60 percent each of those in the highest and low income tax brackets are paying taxes, 40 percent of the population in each of the two categories are not paying any taxes. This group comprises professionals, doctors, and others, whose tax compliance rate is about 20–25 percent, as opposed to 60–65 percent among the high and low income categories of urban taxpayers. Only salaried people have taxes regularly deducted at source. On corporate tax, Bhalla emphasized that although tax rates in the country are in the competitive range, the problem is that it is not the nominal rate that matters but the effective tax rate, and that India is second after Japan, globally.

Jeffrey Hammer said on tax administration capacity that what is important is to figure out the nature and frequency of information needed by the authorities and how then to put it to best use. He thought that it might be absolutely necessary to conduct cadastral surveys, though they are expensive to undertake and difficult to update. He suggested that policy makers should focus on the technology of tax administration that is needed to balance the costs and benefits of identifying specific targets for taxation. There were large declines in revenue after the 1991 reforms, mostly due to reducing tariffs that were highly distortionary but easy to reduce. There was a trade-off, and the subsequent recovery of revenue was perhaps due to the tax authorities learning to do the more difficult taxes.

Tarun Ramadorai asked whether research could be done to estimate the extent of tax evasion in India. He cited an interesting paper on Greece (Artavanis et al. 2015) that measures income tax evasion through loans to tax-evading individuals from banks that assess the individual's true income. Using microdata on household credit from a Greek bank, they replicated the bank's underwriting model to infer the bank's estimate of individuals' true income. They estimated that some 43–45 percent of self-employed income goes unreported and, thus, untaxed. For 2009, this implied foregone tax revenues of over 30 percent of the fiscal deficit. The primary tax-evading sectors were the professional services—medicine, law, engineering, education, and media. Ramadorai suggested that a similar analysis of tax evasion in India would be extremely revealing if the data were available.

Reference

Artavanis, Nikolaos T., Adair Morse, and Margarita Tsoutsoura. 2015. "Measuring Income Tax Evasion Using Bank Credit: Evidence from Greece," Chicago Booth Research Paper No. 12–25, Chicago: University of Chicago-Booth School of Business, September 25.