‘The important thing about tax reform is you make the tax code less complicated, easier for people to understand.’

Grover Norquist

5.1 Tax Reform

Tax reform is the process of changing the way taxes are collected or managed by the government. Tax reformers have different goals. Some seek to reduce the level of taxation of all people by the government. Some seek to make the tax system more progressive or less progressive. Others seek to simplify the tax system and make the system more understandable or more accountable.

Different countries have made several changes in their tax system. These changes were either due to their development strategy or different economics policies. In developing economies the tax system is generally changed to increase the revenue to meet the increasing fiscal deficit. It has been said that fiscal crisis has been mother of tax revenues.\(^\text{100}\)

In recent times it has been observed that globalization is also one of the reasons of change in tax system. Now such tax system is required which is broad base, simple and transparent as well as which fulfills the international needs. In India there is transition from licensed industrial regime to open market system. The market system indicated that there should be change in the recent tax system to adjust with the needs of a market economy to ensure international competitiveness.

Numerous organizations have been set up to reform tax systems worldwide, often with the intent to reform income taxes or value added taxes into something considered more economically liberal. Other reforms propose tax

\(^{100}\) Bird Rechard, “Taxation and Decentralization”, 38 World Bank 1-5 (2010)
systems that attempt to deal with externalities. Georgism claims that various forms of land tax can both deal with externalities and improve productivity.

There have been major changes in tax systems of countries with a wide variety of economic systems and levels of development during the last two decades. The motivation for these reforms has varied from one country to another and the thrust of reforms has differed from time to time depending on the development strategy and philosophy of the times. In many developing countries, the immediate reason for tax reforms has been the need to enhance revenues to meet impending fiscal crises. As Bird states, “…fiscal crisis has been proven to be the mother of tax reform”. Such reforms, however, are often ad hoc and are done to meet immediate exigencies of revenue. In most cases, such reforms are not in the nature of systemic improvements to enhance the long run productivity of the tax system.

5.1.1. Philosophy of Tax Reform

The philosophy of tax reforms has undergone change with the change in economic policies. The objectives of economic planning are moving from social perspective to market oriented policies. Therefore, the reforms in tax system lead to reduction in tax rate both direct and indirect taxes. This approach lays emphasis on minimizing tax distortions to keep economy competitiveness. The tax base has been broadened and emphasis has been shifted from vertical equity to horizontal equity. This has led to broad based, simple and transparent tax. Equity, in general, is taken to man improving the living conditions of the poor. This has to be achieved mainly through expenditure policy and human resource development rather than reducing the incomes of rich as it has done in 1950’s and 1960’s Thus, three different models of reforms have been evolved to bring changes in the tax system.\(^{101}\)

The Optimal Tax Model (Ahmed and Stern 1991) theoretically sounds very good but it is very difficult to implement. It has taken into consideration

tradeoffs between efficiency and equity. It needs too much information as well as administrative costs.

The Harberger Tax Model is like Optimal Tax Model but it has more practical approach which will minimize the tax distortions as well as politically acceptable. The basic reform Harberger Tax Package for developing countries that are price takers in the international market consists of uniform tariffs and a broad based VAT.

The third model is supply sides tax model. It reduces the role of state. Public expenditure should be reduced by reducing direct tax rate. If direct tax rates are reduced than it will give incentive to work, save and investment.

The recent reform in Indian tax system are based on the combination of all the above given models of reforms. The thrust of these reforms is to enhance the revenue and minimize the relative price distortions. With this view a big reform has been put forward in Direct tax.

5.1.2. Tax Reform Analysis: A Necessity

One of the most important reasons for recent tax reforms in many developing and transitional economies has been to evolve a tax system to meet the requirements of international competition. The transition from a predominantly centrally planned development strategy to market based resource allocation has changed the perspective of the role of the state in development. The transition from a public sector based, heavy industry dominated, import substituting industrialization strategy to one of allocating resources according to market signals has necessitated systemic changes in the tax system. In an export-led open economy, the tax system should not only raise the necessary revenues to provide the social and physical infrastructure but also minimize distortions. Thus, the tax system has to adjust to the requirements of a market economy to ensure international competitiveness.

As in other countries, the systemic reforms in the tax system in India in the 1990s were the product of crisis but the reforms were calibrated on the
basis of detailed analysis. It is necessary to analyze the evolution of the India tax system with special reference to the systemic reforms in the design and implementation of the structure and operation of the taxes in Indian federal polity.\footnote{M. Govinda Rao and R. Kavita Rao, “Trends and Issues in Tax Policy and Reforms in India”. National Institute of Public Finance and Policy, (2011)}

5.2. Tax Reforms Attempts Until 1990

There have been a number of attempts at improving the tax system since independence. The principal objective of these attempts has been to enhance revenue productivity to finance large development plans. Although the various tax reform committees considered economic efficiency as one of the objectives, the recommendations do not bear much testimony to this aspect. The recommendations were in keeping with the philosophy of the times. Further, even when the committees did recommend certain measures on efficiency considerations, this was not acted upon if it involved loss of revenues.

The first comprehensive attempt at reforming the tax system was by the Tax Reform Committee in 1953. This provided the backdrop for the generation of resources for the Second Five Year Plan (1956-60), and was required to fulfil a variety of objectives such as raising the level of savings and investment, effecting resource transfer from the private to the public sector and achieving a desired state of redistribution.

Since then, there have been a number of attempts, most of them partial, to remedy various aspects of the tax system. The expenditure tax levied on the recommendation of the Kaldor Committee in 1957-58 had to be withdrawn after three years as it did not generate the expected revenues. The attempt to achieve the desired state of redistribution caused the policy makers to design the income tax system with confiscatory marginal rates. The consequent moral hazard problems led the Direct Taxes Enquiry Committee in 1971 to recommend a significant reduction in marginal tax rates. On the indirect taxes side, a major simplification exercise was attempted by the Indirect Taxes
Enquiry Committee in 1972. At the state and local level, there were a number of tax reform committees in different states that went into the issue of rationalization and simplification of the tax system. The motivation for almost all these committees was to raise more revenues to finance ever-increasing public consumption and investment requirements.

As mentioned earlier, although the effect of the rationalization has been to reduce the marginal tax rates, the prevailing philosophy still dictated keeping the rates very high. It may be noted that in the early 1970s the marginal tax rate including the surcharge was as high as 93.5 per cent. Combined with the highest marginal wealth tax rate of 8 per cent tax on wealth, the tax system produced enormous incentives for evasion and avoidance of the tax. On the recommendation of the Direct Taxes Enquiry Committee, the marginal tax rate was brought down to 77 per cent in 1974-75 and further to 66 per cent in 1976. Similarly, the highest wealth tax rate was reduced to 2.5 per cent. On the indirect taxes front, the most important reform before 1991 was the conversion of the union excise duties into a modified value added tax (MODVAT) in 1986. The MODVAT was introduced in a limited manner on a few commodities and the coverage was gradually extended over the years. It was an income type VAT applicable only to a few manufactured goods. Also, there was an attempt to substitute ad valorem taxes to specific levies though quite a few commodities are subject to specific tax even today. There were attempts to simplify and rationalize the structures, but these cannot be considered comprehensive.¹⁰³

5.2.1. Report of Tax Reform Committee

Tax reform since 1991 was initiated as a part of the structural reform process, following the economic crisis of 1991. In keeping with the best practice approaches, the Tax Reform Committee (TRC) adopted an approach of combining economic principles with conventional wisdom in recommending comprehensive tax system reforms. There are three parts in the report. In the

¹⁰³ Dr. Sneha Despande, “Indian Tax Reforms and Issues of Direct Tax Code”, All India Commerce Conference, Goa (October, 2010)
first interim report, the Committee set out the guiding principles of tax reform and applied them to important taxes namely, taxes on income and wealth, tariffs and taxes on domestic consumption. The first part of the final report was concerned mainly with the much-neglected aspect of reforms in administration and enforcement of both direct and indirect taxes. The second part of the report dealt with restructuring the tariff structure. In keeping with the structural adjustment of the economy, the basic principles taken in the recommendations were to broaden the base, lower marginal tax rates, reduce rate differentiation, and undertake measures to make the administration and enforcement of the tax system more effective. The reforms were to be calibrated to bring about revenue neutrality in the short term and to enhance revenue productivity of the tax system in the medium and long term. The overall thrust of the TRC was to (i) decrease the share of trade taxes in total tax revenue; (ii) increase the share of domestic consumption taxes by transforming the domestic excises into VAT and (iii) increase the relative contribution of direct taxes.

The important proposals put forward by the TRC included reduction in the rates of all major taxes, viz. customs, individual and corporate income taxes and excises to reasonable levels, maintain progressivity but not such as to induce evasion. The TRC recommended a number of measures to broaden the base of all taxes by minimizing exemptions and concessions, drastic simplification of laws and procedures, building a proper information system and computerization of tax returns, and a thorough revamping and modernization of the administrative and enforcement machinery. It also recommended that the taxes on domestic production should be fully converted into a value added tax, and this should be extended to the wholesale level in agreement with the states, with additional revenues beyond the post-manufacturing stage passed on to the state governments.\footnote{Ravindra Dholakia, “Spatial Dimension of the Acceleration of Economic Growth in India”, Economic & Political Weekly Vol. 29 No.35.}

In the case of customs, the TRC recommendations were the weakest. The TRC recommended tariff rates of 5, 10, 15, 20, 25, 30 and 50 to be achieved by 1997-98. The tariff rate was to vary directly with the stage of
processing of commodities, and among final consumer goods, with the income elasticity of demand (higher rates on luxuries). Excessive rate differentiation (seven rates) and according varying degrees of protection depending on the stage of processing has been severely criticized by Joshi and little when they state, “...this is a totally unprincipled principle, for it has no foundation in economic principles”. In addition to continued complexity, the proposed tariff structure creates very high differences in effective rates and provides a higher degree of protection to inessential commodities.

The TRC recommendation also falls much short of developing a co-ordinate domestic trade tax system in the country. This, in a sense, is understandable, as it had no mandate to go into the state level taxes. However, the Committee was aware of the serious problems of avoidance and evasion in respect of sales taxes levied by the states predominantly at the manufacturing stage. Therefore, it did recommend the extension of the central VAT to the wholesale stage with the revenues from the extended levy assigned to the states.

5.2.1.1. Implementation of Reforms

The government accepted the recommendations of the TRC and has implemented them in phases. Although it did not entirely follow the recommendations and is yet to implement many of the measures to strengthen the administration and enforcement machinery, most of the recommendations have been implemented. It must also be noted that the pace and content of reforms have not been exactly true to TRC recommendations.

As regards the personal income taxes, the most drastic and visible changes have been seen in the reduction in personal and corporate income tax rates. In the case of personal income taxes, besides exemption, the numbers of tax rates have been reduced to three and the tax rates were drastically reduced to 10, 20 and 30 per cent. At the same time, the exemption limit was raised in stages to Rs 50,000. Combined with the standard deduction, a salaried taxpayer up to an income of Rs 75,000 need not pay any tax. In addition,
saving incentives were given by exempting investment in small savings and provident funds up to a specified limit. Attempts have also been made to bring in the self-employed income earners into the tax net. Every individual living in large cities covered under any of the specified conditions (ownership of house, cars, membership of a club, ownership of credit card, foreign travel) is necessarily required to file a tax return. Empirical evidence shows that this drastic reduction in the marginal tax rates has improved the compliance index significantly. Thus, revenues from personal and corporate income taxes have shown appreciable increases after the reforms were initiated in spite of the fact that the rates of tax have been reduced significantly. Voluntary disclosure scheme to allow a onetime amnesty to tax defaulters by paying the necessary tax was introduced in 1997-98.\textsuperscript{105}

In the case of corporate income taxes, the rates were progressively reduced on both domestic and foreign companies to 35 per cent and 48 per cent respectively. The dividend tax at the individual income tax level has been abolished. However, very little has been done in terms of broadening the base of corporation tax. In fact, besides depreciation allowances and exemptions for exporters, generous tax holidays and preferences are given for investment in various activities (housing, medical equipment, tourism, infrastructure, oil refining, free trade zones, software development, telecommunication, sports etc.). Consequently, the tax base has not grown in proportion to the growth of corporate profits. As many corporate entities took generous advantage of all these tax preferences, there were a number of “zero-tax” companies. To ensure minimum tax payments by them, a Minimum Alternative Tax (MAT) was introduced in 1997-98.

In the case of tariffs, there has been a drastic reduction in both the average and peak tariff rates. In 1990-91, the unweighted average nominal tariff was 125 per cent and peak rate was 355 per cent. These were progressively reduced over the years. The peak rate of import duty in 1997-98 was 40 per cent and the average rate of tariff is just about 25 per cent. It is proposed to reduce the tariffs further to the levels prevailing in the South-East Asian

countries in the next five years. In terms of rate differentiation, the number of tax rates continues to remain high. While in the initial years, there was an attempt to reduce the rate differentiation, in more recent years, the variations have, in fact, increased. Again, the pattern of tariffs with the rates varying with the stage of processing has resulted in very high incentives given to the assembly of consumer durables and luxury items of consumption.¹⁰⁶

There has been a considerable simplification and rationalization of union excise duties as well. Besides reduction in the number of rates, the tax has been progressively converted from a specific into *ad valorem* levy in respect of the majority of commodities. The facility of providing credit on input taxes under the MODVAT too has been progressively extended to a larger number of commodities. As of now almost 80 per cent of the goods covered under excise duties are provided with the MODVAT facility. The base of the tax was broadened by removing the exemptions and levying excise duty at the lowest rate (8 per cent). There has also been a simplification of the tax on the small-scale sector. As the government realized that there was considerable misuse, availability of MODVAT credit was reduced to 95 per cent instead of 100 per cent.

Another important change that has been brought about since 1991 is the introduction of a selective tax on services. The constitution does not assign this tax base specifically either to the centre or the states. However, the central government by invoking residuary powers has introduced a tax on services since 1994-95. Beginning with three services (telephones, non-life insurance and stock brokerage), the base of the tax has been broadened to cover a large number of services such as transporters, car rentals, air travel agents, architects, interior designers, management consultants, chartered accountants, cost accountants, company secretaries, credit rating agencies, market research agencies, underwriters, private security/detectives, real estate agencies and mechanized slaughter houses.

There have been significant attempts to improve the administration and enforcement of the tax as well, though progress in actual implementation has not been commensurate. Besides amnesties given from time to time, efforts have been made to reduce arrears by introducing simplified assessment procedures. A large number of pending cases in courts have been decided through out of court settlements. There have also been attempts to establish special tax courts to deal exclusively with tax disputes. With the assistance of the Canadian International Development Agency (CIDA), the government has started an ambitious programme of computerizing tax returns and building a management information system.¹⁰⁷

5.3. Revenue Implications of Reforms

The economic crisis of 1991 resulted in a significant decline in revenues. Although the tax reforms were intended to be a revenue neutral exercise, the natural consequence of a significant decline in tax rates was to reduce revenues. As there was no commensurate increase in the tax base, the revenue naturally showed a declining trend. Thus, the tax-GDP ratio, which was over 16 per cent in 1990-91, declined sharply to less than 14 per cent in 1993-94. Although thereafter there has been some improvement, it still remains less than 15 per cent and this remains a matter for concern (India 1994). Thus, the reforms in the Indian context have in fact, caused an immediate loss of revenues, though in the next few years, they are likely to reach pre-reform levels.

Interestingly, in spite of significant reductions in the rates of both individual and corporate income taxes, the revenues have shown a significant increase. The share of revenue from direct taxes showed a significant increase as a proportion of GDP as well as total tax revenue. The contribution of revenue from direct taxes, which was less than 14 per cent in 1990-91, increased sharply to 24 per cent in 1997-98. However, it is not clear to what extent the increase in revenue productivity is due to increase in public sector wages

¹⁰⁷ Dr. Sneha Despande, “Indian Tax Reforms and Issues of Direct Tax Code”, All India Commerce Conference, Goa (October, 2010)
following the implementation of pay commission recommendations, how much of this is attributable to better compliance arising from lower marginal tax rates and how much due to administrative measures.

The decline in the tax-GDP ratio since the reforms were initiated has to be attributed to lower yield of indirect taxes. Naturally, some reduction in customs revenue was only to be expected as the prevailing tariffs were extremely high and had to be drastically reduced. For the same reason, the reforms in excise duties were to be calibrated to compensate revenue loss from import duties. This, however, did not happen and in fact, the revenue from union excise duties showed a drastic decline. Analysis shows that the revenue from import duties as a ratio of GDP declined by 1.3 percentage points from 3.9 per cent in 1990-91 to 2.6 per cent in 1997-98. However, decline in the revenue from excise duties was faster, by 1.5 percentage points from 4.6 per cent to 3.1 per cent during the same period. Consequently, the share of excise duties in total revenue declined by about 7 percentage points (from 28 to 21 per cent) as compared to a 6 percentage point decline in the share of customs (from 24 to 18 per cent). Significant improvements in the tax ratio, therefore, have to come from improvement in the revenue productivity of domestic indirect taxes.\(^{108}\)

The continued heavy reliance on import duties as a source of revenue rather than as an instrument of protection is an issue that merits some discussion. It has been pointed out that the central government does not have the incentive to raise revenues from the taxes that are shared with the states. According to the existing intergovernmental fiscal arrangement, the central government should share 87.5 per cent of the net collections from personal income tax and 47.5 per cent of gross revenues from union excise duties with the states. This is alleged to have created a moral hazard problem and it is stated that the central government concentrates on those taxes which are not shared. Consequently, while the shares of revenues from the taxes that are shared with the states have declined, the revenues from the sources that are not shared have shown a steady

increase. Therefore, Joshi and Little state, “...there is no doubt that this
cockeyed growth of the tax system has harmed the development of the
whole economy.”\textsuperscript{109}

5.4. Shortcomings and Challenges

After so many years of tax reform, as already mentioned, a number of
disquieting features in the tax system still remain. Improving the productivity of
the tax system continues to be a major challenge in India. The tax ratio is yet
to reach the pre-reform levels. Although the coverage under income tax has
shown significant improvement, much remains to be done to reach the hard to
tax groups. The ratio of domestic trade taxes in particular has continued to
decline and this has posed a major constraint in reducing tariffs which is
necessary to achieve allocated efficiency. Designing of tariffs itself needs to
be re-examined to ensure lower tariffs as well as a low level of dispersion to
ensure that effective rates of protection are as intended. Reforms in Goods
and Services Tax have not reached the stage of conscience VAT. Much
remains to be done to simplify and rationalise the state and local consumption
and service taxes. Concerted efforts are necessary to create a proper
management information system and automating tax returns. Above all, tax
reforms should become systemic, a continuous process to keep the economy
competitive instead of being sporadic and crisis-driven.\textsuperscript{110}

In the case of direct taxes, as already mentioned, the revenue ratio has
shown an upward trend. Marked decline in tax rates seems to have improved
tax compliance, though much of the increase seems to have come about due
to increases in public sector wages. Yet, the revenues realized are nowhere
near the potential and much remains to be done to improve the horizontal
equity of the tax system by extending the tax net to hard-to-tax groups. The
criteria stipulated for filing tax returns has increased the number of tax returns
from less than half a per cent of population to more than 2 per cent. But this
has not brought about a corresponding increase in revenues. Inability to bring

\textsuperscript{109} Joshi Vijay and Ian Little, 96 (India's Economic Reforms) (2001)
\textsuperscript{110} Monsingh, “The Structure and Reference in Direct Taxation”, 212 (Ashish Publishing
House), 2010
in the hard-to-tax groups into the net has continued to exert pressure to increase the standard exemption limit deductions. There is also scope for rationalizing savings incentives. Perquisites continue to receive favorable tax treatment and the coverage of tax deduction at source needs to be expanded before long.

In the case of corporate income taxes, too, it is necessary to broaden the tax base by minimizing tax concessions and preferences. Rather than minimizing them, the recent coalition governments have gone about proliferating tax incentives to complicate the tax system and to create a wide wedge between the nominal and effective corporate tax rates. As the companies started using the provisions, for revenue reasons, the government started levying the minimum alternative tax (MAT). Thus one imperfection was sought to be remedied through another. This has complicated the tax system further.

As already mentioned, complete rethinking is necessary in designing tariffs. The TRC recommendation of having seven tax rate categories, the rates varying according to the stage of production, would create large dispersal in the effective rate of protection. Levying lower rates on necessities and higher rates on consumer durable and luxury items of consumption enormously increases protection to these products. It is essential that the highest tariff rate should be brought down to 15-20 per cent and there should be no more than three rate categories. Unless this is done, it would not be possible for Indian manufacturing to achieve international competitiveness in the medium term.

The most important challenge in restructuring the tax system in the country is to evolve a co-ordinated consumption tax system. Although tax assignment between different levels of government follows the principle of separation, as these separate taxes levied by the centre (excise duties), states (sales taxes, state excise duties, taxes on motor vehicles, goods and passengers), and local governments (octroi) fall on the same tax base, we end up in a chaotic situation with tax on tax and mark up on the tax. Besides cascading and relative price distortions, this results in a totally non-transparent tax system. Development of GST; a manufacturing stage tax by the centre and a consumption type destination based retailed stage tax by the states is a
solution, which needs to be progressively applied. However, neither the centre nor the states have made appreciable progress in this regard. To achieve this, in the case of the centre, the excise duties should be levied entirely as *ad valorem* levies. The rates should be rationalised into a maximum of two and tax credit should be provided on a systematic basis. For this, developing a proper information system is imperative. At the state level, transforming the state taxes into GST has to be calibrated even more carefully. Rate rationalization, systematic provision of tax credit on inputs and those paid on previous stages, removal of competing tax incentives and concessions, zero rating the tax on interstate sales; all these have to be done in phases.\(^{111}\)

A major difficulty in evolving a destination based retail stage GST at the state level arises from the fact that the states do not have the power to levy tax on services. As mentioned earlier, the states can levy sales taxation of only goods. Taxation of services is not assigned to either the centre or the state, but the former levies taxes on selected services based on power to levy taxes on residual items. Proper levy of goods and services tax would, therefore, require an amendment of the Constitution. The central government can use this as a leverage to persuade the states to reduce and eventually eliminate the taxation on interstate sales so that a levy of GST becomes a reality.\(^{112}\)

5.5. Role of State and Economic Reforms

From 1955 to 1991, India as a nation followed the ideology of socialism and interventionist policy of direct state participation and control and regulation of economic activities in the economy. The process of shift in the ideology from state intervention to market orientation initiated and speeded up since 1991 in India implies restoration of functioning of market forces in all markets by:

a) removing or reducing quantity restrictions on supply;

b) removing price controls or other distortions; and

\(^{111}\) Shankar Acharya, “Thirty years of Tax Reforms in India”, Economic and Political Weekly (May 14): 2061-2069

c) reducing unjustified or unnecessary market interventions by the government.

Liberalisation is a process of relaxing or reducing the direct restrictions, regulations and controls on and participation in the economic activities by the government. Such direct interventions existing prior to liberalisation are conceptually similar to the quantitative restrictions. As against this, the government can also control and regulate the economic activities by imposing tariffs, charging fees, levying taxes, etc. These are conceptually similar to the price-based interventions. In a federal structure, the price-based reforms in excise and customs duties, exchange rate and interest rate structure, or administrative price mechanism typically fall under the jurisdiction of the Central Government. State governments can exercise control only in matters pertaining to sales tax, minor taxes and user charges and fees on services provided by them. While State Governments largely provide approvals and registration to smaller enterprises, restricting entry and exit of enterprises through licensing, reservation and specific legislations is largely under the control of the Central Government. The role of a State Government to achieve faster economic growth under the existing federal structure is limited to what is feasible at the state level in terms of liberalisation and economic policy reforms on one hand, and the effective resource base and the socio-cultural environment of the state in relation to the rest of the country on the other hand. It can be argued that the latter also depend on the policies of the state government vis-à-vis other states over a long period of time. The process of economic policy reforms and liberalisation at the state level, therefore, assumes special significance in providing a conducive environment for attracting and promoting private sector activities in the state. The dimension of interstate competition in this regard makes the issue more complicated.¹¹³

Generally, economic reforms are linked to the restoration of the functioning of the market forces in (a) goods markets, (b) services markets, and (c) factor markets that is likely to promote the growth of private sector by encouraging it (i) to expand its existing activities in terms of scale and scope, and (ii) to

participate in newer activities. These reforms usually apply uniformly to the existing and the new participants. However, competition among states often compels the states to discriminate between these two sets of participants over varying periods of time. As a result, these measures do not represent policy reforms. Very often they actually contradict or negate the reforms. Prudence of ensuring sufficient revenue generation to be able to afford offering of various sops to attract industry into the state is often sacrificed with disastrous fiscal consequences in several states. These are not very uncommon outcomes in the framework of non cooperative games.

Keeping this context in view, we can review the efforts made by Gujarat government during the nineties to promote the private sector in the state. Like several Indian states, Gujarat also used the following three instruments: (1) providing tax and cost related incentives; (2) provision of infrastructure and input supplies; and (3) granting various approvals and clearances particularly to the small-scale, cottage and tiny sector units (since these sectors are effectively under the State control). For Gujarat, we may also add the fourth district instrument, viz.; (4) restoring the market forces in the land market in the state. These instruments are reviewed briefly in the following four sections.114

5.5.1. Tax and Cost Related Incentives

In the industrial policy of Gujarat State during the nineties, the major instrument used by the state until recently was reduction, exemption or deferment of sales tax by the new business and industry to encourage them to locate in the state. Such measures had the effect of reducing the sales tax revenue collection by the state. It was estimated that during 1991-95, on an average Rs. 2.10 billion per annum were lost to Gujarat government on account of such incentives. The amount increased to Rs. 13.43 billion during 1997-98 and further to about Rs. 20 billion during 1998-99. Such sales tax related incentives were thought to be very powerful and all the states entered into the race of offering greater incentives to attract the private sector units to

locate in their territory. This was a harmful competition for the states to attract industry and business in their territory because sales tax has been the single most important source of tax revenue for almost all the states in India, and such incentives very adversely affected its buoyancy over time. Moreover, there have been serious doubts raised about the efficacy of such tax-related incentives to attract the private sector activities in the state.\textsuperscript{115}

External intervention to foster co-operation among states became necessary. In the forum of the Finance Ministers and Finance Secretaries of all the states, it was decided through consensus to implement sales tax reforms simplifying the rate structure by reducing the number of slabs, accepting uniform floor rates and allowing no exemptions from January 2000. This was specifically intended to remove unhealthy and harmful competition to attract industries in a state from another state.\textsuperscript{1} Gujarat was the first state to implement the floor rates and remove all exemptions. However, if other states do not follow such a co-operative decision, the leaders would be forced to bear the cost. Since several other states found excuses to delay the implementation of the decision, Gujarat was almost forced to re-look at its industrial policy in terms of increasing several cost reduction incentives or subsidies to the private sector. Thus, subsidies substituted the tax exemption and tax reduction. However, the major advantage of shifting from the tax related incentives to the cost related incentives is that the budgetary process becomes more transparent. Previously, the subsidies were hidden and would not appear in the state budget, whereas now, they are explicit in the state budget. Other than this, there are hardly any significant benefits of such a shift in the policy.\textsuperscript{116}

Gujarat’s Industrial and Agro Industries Policies, 2000 have attempted to provide cost related incentives to the private sector by increasing subsidies in various forms to attract them to Gujarat and “to make the industries globally competitive”. Some of these measures are listed as an illustration in the Box.

5.6. Evolving Coordinated Consumption Tax System

One of the most important reforms needed in indirect tax system is to evolve a coordinated consumption tax system for the country. This is necessary to ensure fair distribution of the burden of taxation between different sectors and between goods and services, improve the revenue productivity, minimise relative price distortions and above all, ensure a common market in the country without placing any impediments on the movement of factors and products.

The above involves co-ordinated reforms at central, state, and local levels. At the centre, as mentioned above, the first step is to evolve a manufacturing stage VAT on goods and services. At the state level, the reform initiated in April, 2005, of introducing the VAT has to be completed. The most important step involved in this is, the extension of input tax credit mechanism not only to intrastate trade but also interstate trade by introducing appropriate zero rating mechanism. This would require building up a proper information system on interstate transactions, which has been initiated. This will have to be adopted by all the states and union territories. Also, appropriate mechanisms will have to be found for enabling the states to levy the tax on services and integrating it with the VAT on goods, so as to arrive at a comprehensive VAT. An important problem in this regard is devising a system for taxation of services with an interstate coverage, which would depend closely on the mechanism chosen for zero rating interstate trade.

An important aspect from the viewpoint of efficiency in resource allocation is the continued cascading of the tax on petroleum products. These are kept outside the CenVAT system. They are also not a part of the VAT system in states. These contribute to over 40 percent of the revenues of both the taxes. Considering the use of these items for intermediate consumption, the extent of cascading and relative price distortion will continue to be high.

In terms of the burden distribution, extending the scope of service tax to all services and then unifying it with CenVAT in a revenue neutral manner would help bring down the CenVAT rate approximately by about three percentage points. This would enable the centre to reduce the VAT rate to about 12
percent and for reasons of equity and revenue, a special excise of an additional 6 percent could be levied on items of luxury consumption (Acharya, 2005). The tax rate of 12 percent at manufacturing stage would be equivalent to 8 percent at retail stage assuming that value added beyond the stage of manufacturing amounts to a third of the retail value of the commodity. KTF on indirect taxes assumed that the overall consumption tax burden should not exceed 20 percent, and in such a case, a 12 percent manufacturing stage VAT would leave a tax room of about 12 percent to the states for the levy of VAT at the retail stage. Along with the levy of VAT at the state level, it is important to integrate many of the existing taxes, such as entertainment tax, electricity duty, passengers and goods tax and luxury tax on hotels. Also there is no case for turnover taxes, surcharges, and additional taxes.

The local level indirect tax reform relates to the abolition of octroi. There is no place for octroi in any modern tax system. The problem, however, is of finding an alternative source of revenue. In every country, property tax is a mainstay of local body finances and reform in this area should help in raising revenue productivity. Yet, this may not suffice. In this situation, a better option is to allow the local bodies to piggyback on the VAT collections in urban local body jurisdictions. This will avoid cascading of the tax and minimise tax spill over by the urban local bodies to non-residents.

5.7. Reform in Tax Administration

In India, until recently the focus of tax reform attempts was on “what to do” and much less on “how to do”. The administrative dimension has been in the periphery rather than the centre of tax reform (Bird, 1989). The TRC did emphasise the need to reform tax administration to some extent but it is the KTF on Direct and Indirect taxes that has brought the administrative dimension to the centre of reform process.117

Not surprisingly, the poor state of tax administration has been a major reason for low levels of compliance and high compliance cost. A major aspect of poor

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tax administration is the virtual absence of data on both direct and indirect taxes even at the central level. Not only that this rendered proper analysis of taxes to provide adequate analytical background to calibrate changes in tax structure, but also it made proper enforcement of the tax difficult. Thus the changes in the tax structure had to be made in an ad hoc manner. Given the complexity in the tax structure and poor information system, the tax system often, acquired the character of negotiated payments. The consequence of this has been a high compliance cost. The only estimate of compliance cost by Das-Gupta of both personal income and corporation tax shows that in the case of personal income tax it is as high as 49 percent of personal income tax collections and in the case of corporate tax, between 6 and 15 percent of the tax paid, with the bulk being legal costs of compliance. While these estimates should be taken with a note of caution as the author himself has reservations on the adequacy and quality of the sample analysed, the important point to note is that the compliance cost in Indian income taxes is extremely high.

High compliance cost combined with poor state of computerisation and information system has led to continued interface of taxpayers and tax officials, negotiated payment of taxes, corruption and rent seeking and low levels of tax compliance. An important indication of the poor state of information system is seen by the fact that even as the coverage of TDS was extended over the years, there was virtually no information system to check whether those deducting the tax at source file the returns and pay the tax. As the CAG report for 2003-04 states, of the 626 thousand returns to be filed by TDS assesses, only 499 thousand returns were filed. In other words, more than 20 percent of the TDS assesses did not file the returns. Even this is a vast improvement from the previous year when almost 80 percent of the TDS assesses did not file the returns.\textsuperscript{118}

The fact that tax administration was the soft underbelly of the tax system and is a critical element in improving tax policy and revenue productivity has been underlined for long. The Chelliah Committee (India, 1993) devoted

considerable attention to this issue and the ideas of building a tax information network go back to the recommendation of this committee. The Kelkar Task Force on Direct and Indirect Taxes rightly brought these issues to the fore with greater emphasis once again.

Recent initiatives on building the computerised information system in direct taxes follow from the recommendations of the KTF. The Central Board of Direct Taxes (CBDT) outsourced the function of issuing PAN which in turn has facilitated the compiling of information on all taxpayers. Furthermore, the Tax Information Network has been established by the National Securities Depository Limited (NSDL). The initial phase was focused on ensuring that TDS assesses do in fact file the returns, besides matching and cross checking the information from banks and financial institutions to ensure that the taxes paid according to the returns are actually credited into government accounts. The Online Tax Accounting System (OLTAS) was operational in July, 2004. This has helped to expedite the number of refunds from 2.6 million in 2002-03 to 5.6 million in 2003-04. The PANs issued increased to 36 million by late 2004. Large companies such as Infosys Ltd could now upload one diskette for filing the TDS of their employees instead of filing separate TDS returns for each employee. In short, in the last four years, the direct taxes have shown annual growth rate of over 20 percent per year and the contribution of improved information system in this has not been insignificant.

Similar initiatives have been taken in regard to indirect taxes as well. The customs e-commerce gateway (ICEGATE), Customs Electronic Data Interchange System (ICES) have helped to improve the information system and speed up the clearance processes. In 2003-04, ICES handled about 4 million declarations in automated customs locations which constituted about 75 percent of India’s international trade. The technical assistance from Canadian International Development Agency (CIDA) has helped the excise department to establish and build capacity in modern audit systems and computerise risk assessment for detailed audit. This is a step-up in building up expertise in areas requiring significant technical of expertise. Both the direct and indirect tax departments could gain from building up expertise
through functional specialisation in such identified areas which require technical and focused expertise.

These initial steps in building computerised information system are the basic requirement for tax administration. The second phase of the TIN has been initiated and when completed, this should help not only in better administration and enforcement of the tax but also in planning the policy changes in regard to the tax system. Computerised information system will help to put together data from a variety of relevant sources, ensure better administration and enforcement of the tax, and thus improve tax compliance. It will also help in significantly reducing the compliance cost as it will avoid the need to interact with tax officials. An important constraint for this is the fact that many of the senior officers are not initiated to computers and there is natural hesitancy and often unwillingness on their part to adapt to new technology. Orientation workshops can go a long way in managing this change well.

Another critical element in tax administration is the networking of the information from various sources. As mentioned earlier, systems have to be evolved to put together information received from various sources to quantify the possible tax implications from them in a legally acceptable manner to improve tax enforcement. In the first instance, the information networking should get the data from various sources such as banks and financial institutions for various assesses. In the second, CBDT and CBEC should exchange information to ensure a measure of consistency between the returns filed by the two departments. In the third, it is necessary to exchange information between central and state taxes. It is only through a well organised and computerised information system of returns, will it be possible to enforce the tax and improve tax compliance.

5.7.1. Scope of Improvement in Tax Administration

The foregoing analysis shows that there has been significant progress in tax reforms particularly in tax administration in recent years that has helped in the recovery of tax-GDP ratio close to the levels that prevailed prior to significant
reduction in customs. This, however, is only the beginning, and considerable distance in reforming the tax system is yet to be covered. In other words, the tax system reform including reform in administration is a continuous exercise for improving the revenue productivity, minimise distortions and improve equity.

It is important to note that the reforms should be undertaken at central, state as well as local levels. A major objective should be to minimise distortions and compliance cost. In fact, the sub-national tax system should be evolved such that the principles of common market are not violated. It is also necessary that domestic trade taxes on goods and services should be calibrated in a coordinated manner in the spirit of cooperative federalism. Coordinated calibration of domestic and external trade taxes to ensure the desired degree of protection to domestic industry and the desired burden of consumption taxes to the community is also necessary.

Broadening the base of both central and state taxes and keeping the tax structures simple within the administrative capacity of the governments is an important international lesson that has to be taken note of in calibrating further reforms. Phasing out small scale industry exemptions, minimising exemptions and concession to industries in the services sector, minimising discretion and selectivity in tax policy and administration are all important not only for the soundness of the tax system but to enhance its acceptability and credibility.

Although the customs duties have been significantly reduced, India is still one of the highly protected economies. Further reduction in tariffs as also further unification and rationalisation is necessary. This would certainly entail loss of revenue and there has to be corresponding improvement in the revenue productivity in all the taxes. The reforms in converting the prevailing sales taxes into a destination based consumption type VAT by the states initiated in April, 2005, will have to be carried out with vigour and completed within the next few years.
5.7.2. Tax Indicators

We will now look at some other financial indicators relating to tax collections and underline its implications. Better tax collections will lead to higher revenue and provide freedom with respect to revenue management.

<table>
<thead>
<tr>
<th>Year</th>
<th>OTR/GSDP (%)</th>
<th>TRR/GSDP (%)</th>
<th>Debt/TRR (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>2002-03</td>
<td>6.7</td>
<td>12.6</td>
<td>308.6</td>
</tr>
<tr>
<td>2003-04</td>
<td>6.6</td>
<td>10.8</td>
<td>341.4</td>
</tr>
<tr>
<td>2004-05</td>
<td>6.8</td>
<td>10.7</td>
<td>352.0</td>
</tr>
<tr>
<td>2005-06</td>
<td>6.9</td>
<td>12.5</td>
<td>291.9</td>
</tr>
<tr>
<td>2006-07</td>
<td>7.0</td>
<td>12.8</td>
<td>293.3</td>
</tr>
<tr>
<td>2007-08</td>
<td>7.2</td>
<td>11.7</td>
<td>281.1</td>
</tr>
<tr>
<td>2008-09</td>
<td>6.9</td>
<td>11.4</td>
<td>281.1</td>
</tr>
<tr>
<td>2009-10</td>
<td>6.7</td>
<td>11.0</td>
<td>288.7</td>
</tr>
</tbody>
</table>

OTR- Own Tax Revenue, TRR-Total Revenue Receipt, GSDP-Gross State Domestic Product.
(Source: Planning Commission Data)

Own Tax Revenue (OTR) is the tax revenue generated by the state government. As can be seen from (Table 3), Own Tax Revenue/GSDP ratio has hovered between 6% and 7% and the highest was in 2007-08 at 7.2%. Post 2007-08, the ratio has fallen below 7%, hitting a low of 6.7% in 2009-10.

In 2009-10, the OTR/GSDP ratio was 9.8% for Andhra Pradesh, 10.1% for Tamil Nadu and 10.9% for Karnataka. Out of 28 states, Gujarat was right in the middle – ranked 14th – in 2009-10.

Let us now look at Total Revenue Receipt/GSDP, and we reach a similar conclusion. Besides own tax revenues, total revenue receipt includes non-tax revenues, share in central taxes and grants from the central government.

The TRR/GSDP ratio has hovered between 11% and 13%. A high of 12.8% was reached in 2006-07. In 2009-10, the figure was 11.0%. In the same year, the ratio was 19.2% for Andhra Pradesh, 15.3 % for Tamil Nadu and 16.2 % for Karnataka. Out of 28 states, Gujarat was ranked 25th on this ratio.
The Debt/TRR ratio gives us a measure of debt servicing capability of the state. Higher the ratio, larger is the amount required to service the debt, leaving lesser funds for other expenditure. The Debt/TRR ratio of Gujarat has remained close to 300% in all the years. In 2009-10, the ratio was 288.7%. It was worse than all states except West Bengal that had a ratio of 398.6%.

So, many financial concerns of the Modi government (like high revenue deficit and fiscal deficit) can be addressed with tax reforms that can push up the Own Tax Revenue/GSDP ratio. This happened in Budget 2011-12 when value added tax (VAT) was increased on tobacco products and mobile phones. This led to a revenue surplus of Rs 1,920 crore. The Modi government has provided many tax reliefs in Budget 2012-13 (Read India Spend’s report here) too. Despite these reliefs, the state government expects revenue surplus to go up to Rs 3,615 crore.

While basic infrastructure issues like water and electricity are likely to play out more than the state’s finances in the forthcoming elections, the numbers are useful to understand a state’s (in this case Gujarat) capability in investing ahead for its citizens.119

5.8. Tax Reforms in Gujarat

In a multilevel federal democracy a state often represents a middle level between the central government and the local bodies. Gujarat had all these 3 layers of government efficiently functioning ever since its inception in 1960. The constitution of India provides reasonably clear division of the rights and duties of different layers of the governments for achieving overall development of the country. Within these broad constraints, different state governments in India have been following their own specific development strategies (see Dholakia, 1994). During the process of economic policy reforms and liberalisation, the constraints and regulation on economic activities by the centre in different segments of the economy got relaxed. The states found more freedom and flexibility to pursue their own socio-economic agenda. It is not surprising that different states took advantage of this

increased flexibility according to their physical capabilities, economic environment and ability to evaluate opportunities and risks involved. States were required to respond dynamically and compete with each other to attract the private sector activities by providing the most conducive economic environment. During the initial phase of the economic reforms, i.e., 1991-92 to 1997-98, Gujarat outperformed all other states in the country in terms of economic growth according to the then member, Planning Commission (see, Ahluwalia, 2000). It is, therefore, interesting to examine in detail the case of Gujarat, particularly the economic reforms and the development strategy it has followed during the nineties.

Development strategy in Gujarat State has been very clear and unambiguous ever since its inception in 1960 in according a high priority to industrialisation as can be seen from various state plans documents and the socio-economic reviews carried out annually. The state had made a clear choice of encouraging the secondary sector activities over the primary and tertiary sectors’ activities (see, Dholakia, 1994). It is a well-known fact that Gujarat lags behind several states in the country in terms of human capital and related indices. Between the human capital and physical capital related government expenditures also, the Gujarat government had consistently accorded higher priority to the latter (see, Archana Dholakia, 1990). Thus, the development strategy of the Gujarat State for industrialisation has been unbalanced growth with emphasis on directly productive activity (DPA) rather than on creating social overhead capital (SOC). While this has its own limitation for the overall development of the state, it has advantages in terms of clarity and consistency of objectives. Since Gujarat is well connected to other states in the nation, it has an access to the highly skilled technical and professional manpower, financial capital and physical infrastructure like ports, airports and means of communications from the other states. Gujarat has followed “an open door” policy with regard to the factor mobility; particularly the labour mobility in and out of the state irrespective of the political party in power. The endeavour of the Gujarat government has all along been to provide as far as possible the most conducive environment to promote business and industry in the state irrespective of who provide and
own them. In this sense, Gujarat did not have to make any major shift in its basic strategy in the wake of liberalisation and policy reforms at the central level.¹²⁰

5.8.1. Process of Economic Reforms in Gujarat

Gujarat being a leading state in terms of economic development in the country is watchful on the internal and external environment governing any change and accordingly, wherever required implements the reforms quickly. As a result, the state has earned the distinction of being the first state to advance the reform process in the country.

When the economic regime in India was under protective environment and most of the activities were under the Government control, Gujarat first time in the country had stepped in the direction of privatization. Today when the Union Government and other state Governments have initiated the process of privatisation, Gujarat has already started enjoying the sweet fruits of it.

In the decade of 80s, a large number of industrial enterprises were set up in the joint sector in Gujarat. In spite of the Government partnerships in these ventures, most of them turned out to be blue chip companies. As and when these ventures turned viable, the Government withdrew its investment from them.

Thus, Government of Gujarat had played a role of financial promoter and facilitator to remove other bottlenecks in establishment of these projects. The responsibilities of day to day operations of these ventures were assigned to the private sector partner. Today most of these ventures are under the management of private sector companies. Similarly, Government of Gujarat for the first time in the country had enacted Gujarat Infrastructure Development Act which not only facilitated but accelerated the process of setting up infrastructure projects with the help of private sector investment. Disaster Management Act is yet another example through which the state is now capable of facing the challenges of any type of disaster.

The state Government has also initiated the process of reforms in power sector and as a result in the coming years, the consumers of electricity will certainly be benefited. On implementation of provisions of the Gujarat Gas Act enacted again for the first time in the country, the economy of the state is slated to be transformed into a gas-based economy. Labour reforms will also become an important attraction for investment in the state in the coming years and other states will be inspired to emulate the same. In the recent times, Government has promulgated ordinances to facilitate speedy establishment of Special Economic Zones and Industrial Parks. These SEZs will prove to be ideal destinations for industrial investment on account of the flexibility in terms of the provisions of labour laws associated with them. Gujarat has brought about important and revolutionary reforms in its taxation regime for the first time in the country, which had landed simplification, transparency and harmony in the taxation system for the taxpayers. Some of the reforms have resulted in the reduction of tax for the taxpayers. Government of India sometime back had constituted a committee to explore the possibilities of linkages of river waters, but in Gujarat the process of linkage has already been initiated by transferring waters of Narmada in the rivers of Mahi and Sabarmati through canal network. Thus, any developmental reforms considered by Gujarat today are followed by other states in the country later. Like a leader in any other sector, Gujarat is way ahead of other states in India in the reform process too.\textsuperscript{121}

5.8.2. Gujarat Economy Scenario

Gujarat has managed to register good growth in industry and agriculture, even though, as we argued in a previous article, the agriculture sector has not been as consistent.

India should now looks at the general financial health of the state government to understand the cost of the progress

Let us first look at the finances of the state government.

\textsuperscript{121} Dholakia Archana, "Fixed Imbalance in Gujarat – Non-Tax Revenues and Subsidies", Economic and Political Weekly, Vol.35 PP3217-27 (August 2006)
Table 5.2: Revenue and Fiscal Deficits

<table>
<thead>
<tr>
<th>Year</th>
<th>Revenue deficit (-) or surplus (+)</th>
<th>Fiscal deficit (-) or surplus (+)</th>
</tr>
</thead>
<tbody>
<tr>
<td>2002-03</td>
<td>-3,564</td>
<td>-6,028</td>
</tr>
<tr>
<td>2003-04</td>
<td>-3,706</td>
<td>-9,143</td>
</tr>
<tr>
<td>2004-05</td>
<td>-4,036</td>
<td>-8,690</td>
</tr>
<tr>
<td>2005-06</td>
<td>-398</td>
<td>-6,269</td>
</tr>
<tr>
<td>2006-07</td>
<td>+1,770</td>
<td>-5,648</td>
</tr>
<tr>
<td>2007-08</td>
<td>+2,150</td>
<td>-4,770</td>
</tr>
<tr>
<td>2008-09</td>
<td>-65</td>
<td>-10,437</td>
</tr>
<tr>
<td>2009-10</td>
<td>-6,965</td>
<td>-15,153</td>
</tr>
<tr>
<td>2010-11</td>
<td>-5,076</td>
<td>-15,073</td>
</tr>
<tr>
<td>2011-12</td>
<td>+3215</td>
<td>-17,831</td>
</tr>
</tbody>
</table>

Source: Gujarat Socio-Economic Review 2012-13)

The revenue account involves general spending like payments of salaries, pension and interest. The receipt side includes tax and non-tax revenue. A high revenue deficit in general could be considered unhealthy as finances meant for productive investments, such as building infrastructure, have to be re-directed to meet the deficit.

As we can see from (Table 5.2), in 2002-03, the revenue deficit was very high at Rs 3,564 crore. The years 2006-07 and 2007-08 were a golden period of sorts; reporting revenue surpluses to the extent of Rs 1,770 crore and Rs 2,150 crore, respectively.

Matters worsened later due to the effects of the global slowdown, which required higher government expenditure to boost the economy. In 2010-11, the revenue deficit stood at Rs 5,076 crore.

The good news is that the state recorded a revenue surplus of Rs 1,920 crore in 2011-12 (as per the revised estimates of the government). And the surplus is expected to go up to Rs 3,615 crore in 2012-13, according to the Budget Estimates.
5.8.2.1. Analyzing the Fiscal Indicators

The fiscal deficit is a combination of revenue and capital deficits. As expected, the fiscal deficit also went haywire after 2008-09. In 2010-11, the fiscal deficit stood at Rs 15,073 crore. Given this broad overview of the finances, we can move on to look at some fiscal indicators.

<table>
<thead>
<tr>
<th>Year</th>
<th>RD*/GSDP*** (%)</th>
<th>FD**/GSDP (%)</th>
<th>Debt/GSDP (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>2002-03</td>
<td>-2.5</td>
<td>-4.2</td>
<td>38.9</td>
</tr>
<tr>
<td>2003-04</td>
<td>-2.2</td>
<td>-5.4</td>
<td>37.0</td>
</tr>
<tr>
<td>2004-05</td>
<td>-2.1</td>
<td>-4.6</td>
<td>37.7</td>
</tr>
<tr>
<td>2005-06</td>
<td>-0.1</td>
<td>-2.7</td>
<td>36.5</td>
</tr>
<tr>
<td>2006-07</td>
<td>0.6</td>
<td>-2.1</td>
<td>34.6</td>
</tr>
<tr>
<td>2007-08</td>
<td>0.7</td>
<td>-1.5</td>
<td>33.0</td>
</tr>
<tr>
<td>2008-09</td>
<td>0</td>
<td>-3.1</td>
<td>32.2</td>
</tr>
<tr>
<td>2009-10</td>
<td>-1.6</td>
<td>-3.2</td>
<td>31.7</td>
</tr>
<tr>
<td>2010-11</td>
<td>-1.0</td>
<td>-2.9</td>
<td>NA</td>
</tr>
</tbody>
</table>

*RD – Revenue Deficit (-)/Surplus (+),
**FD – Fiscal Deficit,
***GSDP-Gross State Domestic Product

Data for the last row is taken from Gujarat Budget 2012-13
Source: Planning Commission Data

As can be seen, the figures in (Table 5.3) mirror (Table 5.2). The RD/GSDP ratio is a simple indicator of the size of overspending (on factors like salaries, interest payments etc) relative to the total income of the economy. The RD/GSDP ratio was controlled well post 2002-03 but things went wrong post 2007-08. Recovery kicked in after 2011-12.

The FD/GSDP ratio was also controlled till 2007-08 when it reached 1.5%. Since then, the figure has shot up to over 3% and stayed over that mark till 2009-10. In 2010-11, it was brought marginally below 3% and stood at 2.9%. The Debt/GSDP ratio, however, has shown a steady decline from 38.9% in 2002-03 to 31.7% in 2009-10.
Let us step back for a moment. In 2009-10, of the states for which data is available, 14 had revenue deficits and Gujarat was one of them. Only states like Kerala, West Bengal, Punjab and Haryana had worse figures.

In 2009-10, Gujarat was ranked 9th on the Debt/GSDP ratio with a figure of 31.7% but a Debt/GSDP ratio of over 30% is not a comfortable number. Higher Debt/GSDP ratio implies larger liabilities in terms of debt servicing.

The best performer was Haryana with a Debt/GSDP ratio of 19.2%. The worst were states like West Bengal and Uttar Pradesh with ratios of 43.3% and 45%, respectively.

5.8.3. Gujarat committed to Tax Reforms

The State Government is committed to bring about reforms in the regime of taxation and in fact, had already initiated an agenda in this direction. In order to have the right perspective, the details of the reforms agenda and results thereof are given briefly hereunder.

(i) Tax reforms with emphasis on rationalization, simplification, transparency and harmonization in rate structure.

(ii) Reform in tax structure;
    • Reduction in input taxation under the State Sales Tax regime.
    • Element of turnover tax subsumed in basic rate of sales tax.
    • Numbers of sales tax (main) slabs have been reduced from 17% to 6%.
    • Levy of additional tax (surcharge) has been abolished from 1st March 03. Industries have benefited by 10% reduction in their tax burden.
    • Input taxation and prohibited list: In respect of 73 commodities set off of the tax paid on the purchase was not available prior to April 1997. This resulted in cascading of tax for industries. Number of such commodities in the list of prohibited goods has been reduced to sixteen by April 2002. Out of these 16 commodities, four commodities carry the rate of sales tax at 4%, which is the
rate of purchase tax/input tax in most other states. Barring these 16 commodities, input taxation on other commodities is just 2% as against the average rate of input tax of 4% in other states.

(iii) Removal of cascading and multiplicity of commodity taxes.

(iv) During last six years, conscious effort has been made to ensure that resource mobilization does not result in unbearable burden on industry. To the extent possible, tax burden on industry has been reduced. Consequently, weighted average rate of sales tax in Gujarat is now 12% as against higher rates in other states. Barring 16 commodities, input taxation in Gujarat is 2% as against the rate of input taxation of 3-4%.

(v) Consistency in the approach based on the above policy -

- has been appreciated by local trade and industry,
- has provided stability to rate regime as against unpredictability of tax burden in many other states,
- has enabled the state to understand revenue trends, and
- has resulted in the decline in the overall burden of taxation on industrial sector.

(vi) Another tax-related measure the state government has taken during the nineties is to abolish the turnover tax in 1997. Similarly, Octroi is a major issue in the State. Octroi is an effective barrier on the movement of goods and creates additional burden on goods produced outside the city limits but consumed in the city. This leads to adverse effects on resource allocation, efficiency and consumption. Moreover, it involves delays and inconvenience to the private sector ultimately giving rise to corruption. Gujarat Government has also abolished Octroi from 143 towns and 14,000 villages effective from May 2001. These municipalities, nagar panchayats and village panchayats collected Rs.2.08 billion from Octroi during 2000-01. This amount is now raised through surcharge on the sales tax on petroleum products. The major proportion of Octroi revenue (above 80%), however, accrues not from these 143 towns and 14000 villages, but from the 6 major municipal
corporations in the state. Octroi has so far not been abolished from these 6 corporations in absence of any viable alternative yielding stable income. States of Karnataka and Rajasthan had to revert back to Octroi after abolishing it because the alternative means could not generate the same amount of stable income for the local governments. The State Public Finance Reform Committee (SPFRC) for Gujarat (2000) had strongly recommended immediate abolition of Octroi and suggested as alternative the revisions and realistic rates for water-tax, property-tax, health-tax, education- cess and user fees for various municipal facilities and services. The Gujarat Government has, however, not shown enough determination to abolish Octroi from the 6 municipal corporations in the state nor force them to revise their local taxes and user fees as per the recommendation of SPFRC (2000). On 15th November, 2007 the octroi was abolished in all the Municipal Corporations and the State has decided to grant from state’s kitty.

(vii) Reforms in sales tax structure so far carried out are in tune and harmony with Value Added Tax (VAT). Most other states have been taken steps, which are not in tune with VAT. The State of Gujarat had taken necessary preparatory steps for introduction of VAT. In true spirit value added Tax is implemented in Gujarat since 2006.

(viii) Ad valorem rates of Stamp Duty applicable for commercial transactions and industrial activities are subjected to maximum amount on concessional basis. In respect of industrial loans, maximum stamp duty payable is only Rs. 2 lakh irrespective of the loan amount. In respect of documents relating to amalgamations and merger, securitisation, pledge and hypothecation, etc., maximum amount of Stamp Duty is subject to suitable ceiling limits. Survey conducted by Researcher also supports the suggested reform.\footnote{Annexure-I, Survey Report, Majority Responses, Item No. 2.}

(ix) At present Gujarat is preparing a sound platform for Goods and Services Act.
It is important to offer a level playing field in the matter of taxation to the industries in Gujarat to become globally competitive. The Government therefore will strive to reform the tax regime further by rationalizing the structure in the times ahead. This would help promoting scale of manufacturing, which ultimately leads to the development of technological and marketing capabilities in our manufacturing companies in their efforts to becoming global Indian Multi National Companies.