Chapter No. 04:

Tax Policies, Reforms and their impacts.

- Introduction.
- Taxation Policy.
- Simplified Tax Policy.
- Tax Policy in India.
- Tax Reforms in India.
- Direct Tax Reform in India.
- Reforms since 1991.
- Recent Changes in the Indian Taxation System.
- Summary of India’s Tax Reforms.
- Tax Rebate & Relief.
- Tax Incentives in India.
- Need of Tax Reforms.
- Direct Tax Code.
- Tax System Reforms in India Challenges Ahead.
- A good tax system.
- Characteristics of good tax system.
Introduction:

World over, tax systems have undergone significant changes during the last 20 years as many countries across different ideological spectrum and varying levels of development have undertaken reforms. The wave of tax reforms across the world that began in the mid 1980s actually accelerated in the 1990s motivated by a number of factors. In many developing countries, pressing fiscal imbalance was the driving force. Tax policy was employed as a principal instrument to correct severe budgetary pressures. In others, the transition from plan to market necessitated wide ranging tax reforms. Besides efficiency considerations, these tax reforms had to address the issue of replacing public enterprise profits with taxes as a principal source of revenue and aligning tax policy to change the development strategy. Another motivation was provided by the internationalization of economic activities arising from increasing globalization. While the hand, this has entailed significant reduction in tariffs and replacement had to be found for this important and relatively easily administered revenue source, on the other, globalization emphasized the need to minimize both efficiency and compliance costs of the tax system.¹

The evolution of Indian tax system was motivated by similar concerns and yet, in some ways, it is different and even unique. Unlike most developing countries, which were guided in their tax reforms by multilateral agencies, Indian tax reform attempts have largely borne a domestic brand. They have been calibrated in response to changes in the development strategy over time while keeping in tune with the institutional arrangements in the country. Thus, even when the government sought assistance from
multilateral financial institutions, the recommendations of these institutions did not directly translate into an agenda for tax reform. Despite this, the tax system reforms were broadly in conformity with international trends and advice proffered by expert groups and was in tune with international best practices.

Inevitably, tax policy has evolved in the country in response to changing development strategy over the years. In the initial years, the tax policy was guided by a large number of demands placed on the government. They can be summarized into the need to increase the level of savings and investment in the economy and hence stimulate growth and the need to ensure a fair distribution of incomes. These meant an effort to raise taxes from those with ability to pay, with little regard for the efficiency implications of the chosen instruments for the purpose.

The role of history and institutions was also important in shaping the tax system in the country. Indeed, the nature of federal polity, assignment of tax powers and tax sharing arrangements have impacted on the incentives for revenue mobilization and the structure and administration of the taxes in both central and state governments. The overlapping tax systems have made it difficult to have encompassing, comprehensive and co-ordinate tax system reforms. Another legacy of planning is selectivity and discretion both in designing the structure and in implementation of the tax system. These contributed to erosion of the tax base, created powerful special interest groups, and introduced ‘negotiated settlement’ to the tax system.
The Indian tax reform experience can provide useful lessons for many countries due to the largeness of the country with multilevel fiscal framework, uniqueness of the reform experience and difficulties in calibrating reforms due to institutional constraints. These, by themselves, are important enough reasons for a detailed analysis of the tax system in India. Unfortunately, unlike in many developed countries where major tax reform initiatives were followed by detailed analysis of their impact, there are no serious studies analyzing the economic impact of tax reforms in India.

**Taxation Policy:**

Taxation is a key tool of fiscal policy. In a developing economy like India, taxation policy has a crucial role in the overall policy scheme of the government. Tax occupies a position of strategic importance in the overall development of the country due to its significant contribution to the national exchequer, which is ultimately spent on the overall development of different sectors of the economy, such as defense, infrastructure, education, health, food security, etc. The main functions that an effective taxation system is supposed to perform are: to ensure collective savings for the purpose of public investment and at the same time to provide incentives for boosting private investment. Taxation is considered to be the most important for ensuring social justice both in equitably distributing the burden of development, and also for reducing inequality of incomes. The main objectives of tax policies in a developing country like India should be:

1. Raising resources for productive investment in public sector;
2. Stimulating the growth forces in the private sector;
3. Maintaining a reasonable stability by controlling the inflationary pressure in the country; and
4. Reduction of extreme inequalities in distribution of income and wealth.

To meet the above objectives, in every budget of the government, the emphasis is always given to the stability of tax rates, rationalization of tax structure, widening of tax base for better compliance, simplification of tax laws and procedures, providing incentives for infrastructure development and promotion of the financial market, measures to curb tax evasion, revamping of the administrative set up of the tax department for improving efficiency, and correction of structural imbalances in order to make the tax system more elastic, equitable, vibrant and buoyant.

**Simplified Tax Policy:**

Rationalizing and simplifying direct and indirect tax laws and bringing them in line with the current needs of a liberalizing and competitive global economy is an urgent though uphill task especially considering the mindset of the people involved in tax administration at different levels. Accordingly, in the areas of tax reforms, the liberal budget would continue to be guided by the following broad principles:

1. Any increase in tax revenue would not be by way of increase in tax rates, but by increasing the tax base to be achieved by humane, fair, efficient, transparent and accountable tax administration on the one hand and rationalization and reasonable simplification of the tax laws on the other;
2. Tax reforms would be through the creation of an atmosphere in tax administration resulting in voluntary compliance with tax laws by taxpayers;

3. Tax reforms would be through the creation of a simplified tax policy with rational and globally competitive tax rates;

4. Tax reforms should also be aimed at providing a fair, speedy and efficient mechanism to resolve genuine disputes in the interpretation and administration of tax laws;

5. Tax reforms should also be aimed at providing a speedy and efficient mechanism to severely punish habitual tax evaders and corrupt officials on the one hand, and give a fair deal to those tax payers who sometimes become victims of complex tax laws which are difficult to simplify beyond a point considering their basic nature. Likewise, such mechanism should also provide an opportunity for forthright officials to get a fair deal in the event of their becoming victims of the present system of tax administration;

6. Tax policy should aim at offering a lighter burden on earned income as compared to unearned income, by making proper and appropriate adjustments in the tax structure and tax rates; and

7. Tax reforms should also be aimed at achieving a minimum number of tax rates even for individuals/ HUFs by adopting not more than two rates of taxes, with appropriate
adjustments in the level at which the second rate of tax should apply.

8. Tax reforms should ensure minimum cost of compliance to the taxpayers.

For the purpose of raising tax revenues, it is necessary to widen the tax base rather than increase the tax burden of existing taxpayers. This is the only way to achieve real growth in tax revenue. The main hurdle in increasing the tax base is the perception of the people at large about tax administration. Unless this changes, it is unlikely that the tax base will increase in real terms. This can be achieved only by gaining the confidence of the citizens in the tax administration. For this, some permanent statutory provisions should be made whereby the small assessee can be asked to pay a fixed amount of tax in absolute terms up to a certain level of income with the assurance that their declaration of income will be accepted at face value without further enquiries except in cases where the Revenue Department has concrete evidence in its possession about the incorrectness of the declaration made by an assessee. For this, a simple scheme can be worked out in the Act itself to provide safeguards against the abuse of such a scheme.
Tax Policy in India:

Conventionally, the criteria of a good tax system have been classified in terms of equity, efficiency and simplicity.⁴

Equity:

Whilst everyone agrees that a taxation system should be equitable or fair, there has been much debate over what constitutes equity in the distribution of the taxation burden. The most commonly accepted principle of taxation equity is the "ability-to-pay" principle. This principle states that the distribution of the burden of taxation should be commensurate with taxpayers' ability to pay tax. Those who are more able to pay tax should pay more tax. Ability to pay is normally measured by a taxpayers' annual income. The ability-to-pay principle was originally framed in terms of the sacrifice approach to taxation. The view was taken that the burden of taxation should be equal in some sense.

There were three interpretations of equal sacrifice, namely: equal absolute sacrifice, equal proportional sacrifice, and equal marginal sacrifice. An attempt was made to deduce conclusions about the rate structure (progressive, proportional, regressive) of personal income taxation from these principles. Unfortunately, this requires information about the shape of the marginal utility of income function for each taxpayer, as well as the ability to make interpersonal comparisons of income. For example, if the marginal utility of income decreases (as income rises) at a percentage rate greater than the percentage rate of fall in average utility, then progressive taxation is justified according to the equal proportional sacrifice version of the theory. Yet, despite an inability to derive
firm conclusions about the rate structure of taxation from the equal-sacrifice approach to the ability-to-pay principle, a progressive rate structure for personal taxation has been adopted in most countries in an attempt to reduce the proportionate inequality in the distribution of income. There are two other principles of taxation equity that are less accepted than the ability-to-pay principle: the benefit principle and the expenditure principle.

The benefit principle claims that a fair tax system is one in which individuals are taxed pro rata to the benefits that they receive from the existence of government. Supporters of this equity principle include and other adherents to the voluntary exchange approach to the analysis of the public sector. With this approach, taxes are regarded as prices that individuals pay in exchange for public goods provided by governments and the tax-prices they pay should be commensurate with the benefits that they receive from public goods. There are at least two major problems with the benefit principle. First, it is incompatible with any form of welfare payment, since according to this principle any individual receiving Ids or her entire income from the government would have to pay high taxes (since they receive significant benefits from the government). Second, it is very difficult to measure the benefits that individuals receive from government-provided goods and services, and any attempt to do so would encounter the free-rider problem that bedevils private-sector provision of public goods. So the benefit principle cannot be operationalised without policy-makers or researchers making some very strong assumptions about the particular benefits gained from public goods.
Efficiency:

Another important criterion of a good tax system is efficiency. The taxation regime should promote an efficient allocation of the economy's scarce resources. In the absence of externalities and other types of market failure, this is normally achieved by the tax system having the minimum possible distortionary effect on individual choices and allowing the invisible hand of market forces to achieve Pareto optimality. The choices referred to here include the choices between work and leisure, consumption and savings, the patterns of consumption, and so on. Of particular interest here is the choice between consumption and savings, or between present and future consumption. In this regard, the taxation of consumption expenditure (either via a broad-based indirect tax or by a personal expenditure tax) is to be preferred over the taxation of income, since the latter distorts the proper allocation of resources between consumption and savings through the double taxation of savings.

An appealing feature of any change in the tax mix away from the taxation of income towards the taxation of consumption is that it encourages savings. In the presence of shortsightedness in intertemporal choice at the individual level, resulting in an aggregate savings/consumption ratio below that held to be socially desirable; any change in the tax mix that encourages savings is to be applauded. A revenue-neutral change in the tax mix away from the taxation of income towards the taxation of consumption (whether through a broad-based indirect tax on consumption or a personal consumption expenditure tax) does just that.
Simplicity:

Compliance costs and administration costs are the two aspects of a tax's simplicity. Obviously, these two types of cost should be minimized. International studies have found that both administrative costs and compliance costs are higher for personal income tax than for broad-based consumption taxes. In this era of globalization, taxation policy needs to take into account the fact that any economy is part of the global economy. With globalisation, the economies of the world are more closely related and the tax reforms of large open economies, like the US and Japan, affect small open economies, such as India. Tax policy in many countries in the 1990s aimed at reducing the rates of personal and corporate income tax and liaising the tax threshold to promote savings and capital formation. A series of tax reforms emerged in response to intellectual, historical and political debates of the 1970s. High marginal tax rates and differential tax treatment imposed on economically similar activities resulted in distortions and large-scale tax evasion during this period. The 1970s was also a decade with relatively high inflation (caused by oil crisis), which artificially increased the tax burden for the middle class. The outcome was the diversion of productive resources into unproductive investment and tax shelters (Boskin 1990). However, the globalization of the world economy put pressure on small open economies to respond to the tax reforms of large open economies.
**Tax Reforms in India:**

In the era of pro-market reforms in India started since 1991, a number of reforms have dealt with the country’s tax system; many of these have been based on the Dr. Raja Chelliah Committee Report. According to such thinking, in the early 1990s, the tax rates were very high and taxable entities were much less. Due to higher tax rates, the tendency of tax evasion was higher leading to loss of revenue. Hence, it was felt that rates should be reduced and the number of taxable units increased. The Chelliah panel’s major recommendations are as follows:

- Rationalization of entire tax structure.
- Increasing the amount of taxable entities (i.e., increasing the tax base).
- Lowering tax rates.
- Value Added Tax; and
- Simplification of tax laws.

Over the years, most of its recommendations have been implemented, at least at the Central level. Notwithstanding the reduction in marginal tax rates, revenues from personal and corporate income taxes increased after the reforms were initiated. Thus, the share of revenue from direct taxes as a proportion of GDP showed a substantial increase (from less than 14 percent in 1990-91 to 24 percent in 1997-98). According to some proponents, the increase in tax revenue was partly due to the Voluntary Disclosure of Income Scheme (VDIS), introduced in 1997-98 to provide an opportunity to individuals, companies and NRIs to declare concealed incomes and assets. There were reductions in the
Wealth Tax rate and a basic exemption given to Gift Tax (from Rs.20,000 to Rs.30,000).

Moreover, both average and peak tariff rates were drastically reduced while Union excise duties were simplified and rationalized – the number of rates was reduced. A tax on specific services (telephones, non-life insurance and stock brokerage) was introduced in 1994-95 and subsequently extended to cover a large number of services. The Centre set up a Task Force on Tax Reforms in September 2002, and subsequently, a Task Force on Implementation of the Fiscal Responsibility and Budget (FRBM) Act, 2003 – both of which were headed by Dr Vijay Kelkar. The Kelkar Committee report on taxation made a broad list of recommendations.

**Direct Tax Reform in India:**

India’s direct taxes consist mainly of a personal income tax, a corporate income tax, a wealth tax, and a gift tax. Income tax is levied on individuals, firms, and corporations and includes tax on capital gains. Residents are taxed on worldwide income, while non-residents are taxed only on income received in India or which accrues or is deemed to accrue in India. Non-residents pay withholding tax on dividends, interests, royalties and fees for technical services. Like many other developing countries, India makes wide use of tax policies to alter investment decisions. It has used tax incentives, such as a significant cut in corporate and personal income tax rates, tax holidays, rapid depreciation and other means to promote investment.5
Rates of Personal Income Tax and Corporate Tax:

It is generally believed that a good personal income tax rate structure should ensure smoothness in progression and a more equitable treatment of assessee with different levels of income. The number of tax brackets should not be too few or too many. To ensure smoothness of progression, the size of the steps is to be evenly graduated and unnecessary sudden jumps need to be avoided. The drawback of having too many brackets is that it results in complexity and encourages tax evasion and avoidance. The Chelliah committee recommended in its interim report, "as a first step towards the rationalization of the rate structure of personal income tax, a three-slab rate schedule should be introduced which should be replaced finally by a two-rate schedule." It suggested that except those who are very rich, others must be subject to the same rate of tax. Moreover, in a country like India, where there is a large-scale evasion of income tax, it is necessary to convince assessee that with a moderate tax rate they should voluntarily disclose their income.6

In India, there have been frequent changes in the rate structure during the past 50 years. There have been changes in the rate structure during every budget or every alternate budget. The reasons for the frequent changes have been differences in the views of Finance Ministers, and there have been times when the same Finance Minister has changed his opinion over the rate structure within a span of two years. It is argued that the rate structure can be devised to ensure growth with equity if there is stability and no change in the rate structure at least for a period ranging from three to five years.
During the 1990s, the Indian government attempted to simplify not only the personal income tax structure, but also the corporate income tax structure. The base for corporate income tax is arrived at after deducting expenses and tax concessions either partially or totally from the company's profits. The domestic company tax rate, in which the public is substantially interested, declined from 55 percent in 1984-85 to 45 percent in 1994-95. A similar trend is seen in the period 1995-96 to 1999-2000. The corporate tax rate for all domestic companies was reduced further from 40 percent to 35 percent and on foreign firms from 50 percent to 48 percent during the period 1995-96 to 1999-2000.

**Reforms since 1991:**

The government accepted the recommendations of the Tax Reforms Committee (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 number of tax rates has 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 is necessarily required to file a tax return.7

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 to tax defaulters by paying the necessary tax was introduced in 1997-98. 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.
**No need to file income tax returns salary income is less than Rs 5 lakh:**

Salaried employees earning up to Rs 5 lakh a year need not file income tax returns from the year 2012-13. The exemption from filing I-T returns is applicable only if "the total income of the employee does not exceed Rs 5 lakh and the annual interest earned from savings bank account is less than Rs 10,000" for assessment year 2012-13. Filing I-T returns is, however, necessary to claim refunds. There are about 85 lakh salaried persons in the country whose yearly income, including earnings from other sources like bank deposits, does not exceed Rs 5 lakh. The exemption will be permitted only if the assessee has received a certificate of tax deduction in Form 16 from the employer. The employees have to report income from interest on savings bank account to the employer to become eligible for exemptions. Earlier, it was obligatory for all salaried persons to file income tax returns under the Income Tax Act, 1961.⁸

**Recent Changes in the Indian Taxation System:**

Over a period of 10 years to 15 years, the tax system in the nation has undergone some significant changes. The entire system has been tremendously reformed. The slabs for the imposition of taxes have been modified. Besides that, the rates at which any particular tax is being levied have been restructured as well as the various laws that govern the levying of taxes were being simplified. All of these reformations have resulted in the following:

- Better compliance
- Better enforcement
- Easy payment of the levied taxes
The date of 1st April of the year 2005 is marked as the date of the implementation of the V. A. T. or the Value Added Tax by almost all the State Governments as a replacement of the earlier Sales Tax. Some of the states in the Indian Republic, where V. A. T. has not been implemented yet, still levy Sales Tax though. Apart from these, the process of rationalization of the tax laws is still in progress.  

Summary of India’s Tax Reforms:  

Direct taxes:  

- **Income tax:** In 1973-74, there were 11 income tax slabs, ranging from 10 per cent to 85 per cent. Factoring in a 15 per cent surcharge, those earning over Rs 200,000 would pay a marginal tax rate of 97.5 per cent; including wealth tax, this would rise to 107 per cent. Thus, there were large disincentives to declare one's real income and this helped create a dishonest society. Major reforms in 1985-86 reduced the number of tax rates from 8 to 4, and brought the marginal tax rate down from 60 per cent to 50 per cent. Further, the wealth tax rates were reduced. Additional reforms took place in 1991-92 and 1996-97 and today, there are just 3 tax rates, with a 10 per cent surcharge for those earning above Rs 1 million per annum. Still, such issues as the Fringe Benefits Tax and certain exemptions, remain to be resolved.  

- **Corporate tax:** Until about a decade ago, there were several different rates for different types of companies (e.g. closely-held and widely-held) - ranging from 45 per cent to
65 per cent - and widespread tax preferences existed. Tax rates were gradually reduced to 40 per cent, and further, to 35 per cent in 1997-98. Moreover, the distinction between widely-held and closely-held companies was dropped, and the rates unified. Despite these reforms, however, there has been much back-and-forth on the dividend tax, and the system of Minimum Alternative Tax (MAT) continues to be controversial.

**Indirect taxes:**

- **Excise duties:** The existing excise tax system is complex, discretionary and cascading, with 24 rates and a mix of ad valorem and specific duties. It is currently difficult to estimate effective rates. Services are taxed selectively. Going forward, a unification of rates - through the CENVAT - will be an important step, as will the reduction or removal of exemptions, such as to small-scale industries (SSIs).

- **Customs duty:** Until the mid-1980s, India had a high, differentiated and complex customs duty structure, in addition to quantitative restrictions on imports. Tax rates varied according to the stage of processing. Beginning in 1985-86 and accelerating in 1991-92, reforms were put in place, bringing down customs rates steeply. Peak rates were reduced to 30 per cent in 2002-03, 25 per cent in 2003-04, 12.5 per cent in 2005-06, and to 10 per cent in 2007-08. A further simplification and lowering of rates, however, will need to be implemented in the coming years.
Tax Rebate & Relief:

The total income of an assessee is determined after deductions from the gross total income. It is on this total income that the tax payable is computed at the rates in force. The Income Tax Act further provides for rebate from the tax payable as computed above, if certain investments or payments are made. Rebate provided u/s 88 of the Act. While the latter reduces the gross total income, rebate is a reduction from the tax payable. The Finance Act, 2002 introduced some changes in the above which came into effect from A.Y. 2003-2004. The rate of rebate has been kept at 20% in case the gross total income, before giving effect to the deductions under chapter VIA, is below Rs. 1.5 lacs while the rate would be 15% if gross total income is higher than Rs. 1.5 lacs but lower than Rs. 5 lacs. On the other hand, if the gross total income exceeds Rs. 5 lacs, no rebate under this chapter would be available.¹¹

It has also been provided that an individual whose income under the head ‘Salaries’ is below Rs. 1 lakh during the previous year and constitutes at least 90% of his gross total income, shall be entitled to rebate @ 30% on the investments/ payments specified in Section 88. The maximum amount of investment qualifying for rebate u/s 88 has been enhanced to Rs.70,000, however, additional rebate on investment upto Rs. 30,000 is available in respect of subscription to specified infrastructure equity share/debentures. Investment qualifying for rebate u/s 88 must be out of income chargeable to tax in the relevant previous year. The above requirement has, however, been deleted by the Finance Act 2002 w.e.f. A.Y. 2003-2004. With effect from assessment year
2001-2002 onwards a new section 88C has been inserted. It provides that in case of assesseee being a woman resident in India and below 65 years of age, tax rebate of an amount of Rs. 5,000 or 100% of tax, whichever is less, shall be available. The above rebate is to be allowed from the amount of Income Tax computed before allowing for tax rebate u/s 88 in respect of various investments expenditures.\textsuperscript{12}

**Tax Incentives in India:**

The India Government offers tax incentives that are subject to some specified conditions. Such incentives are provided for the following:

- Allowance for accelerated depreciation
- Corporate profit
- Certain expense deduction on the basis of some particular conditions

A tax incentive is available for any fresh investment in any of the below mentioned sectors:

- Companies involved in Research and Development
- Development of housing projects
- Development by undertakings
- Food processing industry
- Infrastructure
- Mineral oil production and refining
- Operating industrial places
- Organizations handling food grains
- Power distribution
- Hospitals located in the rural areas
- Specialized economic zones
• Telecom services (For some specified services)

Undertakings based in some specified hill states

**Need of Tax Reforms:**

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. 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 fulfils 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. The systematic reform in India’s tax system is seen after 1990’s. Many changes have been seen in Indirect tax like VAT as well as in Direct tax.¹³

Today, the maximum marginal rate is 30% for individuals above an annual income of Rs.5,00,000. Up to Rs. 1,60,000 there is no tax. On income between Rs.1,60,000 to 3,00,000 the tax rate is 10% and up to Rs. 5,00,000 it is 20%. One can get a deduction of up to Rs1,00,000 on saving in particular assets. Long term capital gains are taxed at a lower rate in case of residents. For long term capital gains and dividends from equity shares traded on the stock exchange, there is no tax. The falling tax rates during the last
decade has been one of the major reforms in Indian economy and ironically has lead to booming revenue collections, which have risen from being 25% a decade back to now over 50% of total tax revenues generated. Alongside, there have also been major reforms in tax administration, and gradually the Indian tax system is moving towards one of the better functioning parts of the Government.

**Direct Tax Code:**

The Direct Tax Code (DTC) is governed by the Direct Tax Code Bill 2010. It is a direct amendment to the current law, Income-Tax Act 1961. The DTC has proposed more than 5,000 amendments to the current five-decade-old Act. The first draft of DTC, governed by the then Direct Tax Code Bill 2009, was introduced in August 2009 with the following objectives:14

- Making the whole process simpler
- Minimizing litigation
- Broadening tax base
- Eliminating tax exemptions

DTC proposes reduction in tax rate to 30 per cent (originally proposed at 25%), which would reduce the tax burden on the corporate world in a big way. But it also takes away many current tax exemptions. Other major changes are discontinuing incentives for area-based incentives, for example, setting up of plants in the backward-areas or northeast of the country and adding investment-linked incentives like infrastructure, power, oil, and so on. Moreover, tax holiday will cease to exist and will equal all the revenue and capital expenditures with exception to land, goodwill, and debt. In other words, DTC has proposed to shift substitute the
current profit-based incentives with expenditure-based incentives. Moreover, SEZs will no longer enjoy the exemptions from Dividend Distribution Tax and Minimum Alternate Tax Liability. However, the current proposal of introducing the DTC from 1st April 2012 comes as a major relief for everybody. Mostly, it has stalled the worry of a rush of transition among many corporate houses.

**New recommendations of the Code:**
- 10 per cent tax rate should apply to an annual income of Rs. 1.6-10 lakh per annum (*Now 10 per cent is levied on incomes of Rs. 1.6-3 lakh, 20 per cent on Rs. 3-5 lakh and 30 per cent above Rs. 5 lakh*).
- 20 per cent rate should apply to an annual income to Rs. 10-25 lakh per annum.
- The maximum rate of 30 per cent should apply to income above Rs. 25 lakh per annum.
- Perquisites given to employees should be included in salary income.
- Tax rates for companies should be reduced to 25 per cent for both domestic and overseas companies. Currently, domestic companies are taxed at 30 per cent with surcharge and cess coming later.
- Foreign companies should pay an additional tax of 15 per cent as branch profit tax.
- Abolition of the controversial STT (*the Code also suggests reintroduction of tax on long term capital gains on securities trading*).
Tax System Reforms in India Challenges Ahead:

In a globalizing environment, tax reforms can serve a multitude of needs. They can help enhance revenue productivity, reduce economic distortions, and help create a stable and predictable market environment. Given the growing mobility of capital and skilled labour which raises new tax issues continual reforms also serve, simply, to keep the country up-to-date with changing conditions. Furthermore, tax reforms can help address equity concerns. However, unlike in the past, equity in tax policy should not involve reducing the incomes of the rich, but raising those of the poor. Hence, there needs to be a paradigm shift, away from a socialistic focus on vertical equity and towards horizontal equity. Until very recently, this preoccupation with vertical equity in the Indian tax system created enormous incentives for tax avoidance. While this is starting to change, many reforms remain unfinished.15

In response to its changing developmental strategy, India’s tax system, too, has been undergoing profound changes. Within the framework of a closed and heavily planned economy, the tax system was based on multiple objectives: raising government revenues, generating employment, increasing equity, and fostering investments in ‘backward’ regions. This gave rise to enormous complications and created channels for tax evasion and avoidance. Further, given its discretionary nature, the system had built-in incentives for firms to lobby for industry-specific concessions - which added even further to its complexity.
While this system may have been sustainable within a closed economy in today’s globalizing world, it is more critical than ever to put in place an efficient tax system. A competitive tax environment means that a country’s tax policy must be calibrated on three levels: architecture, engineering, and management. Paradoxically, an open economy presents bigger challenges in setting tax rates - since there are fewer ‘degrees of freedom’ available to policymakers. In such an environment, not only do tax rates impact foreign investment, but they can also shift the incidence of taxation in unexpected ways. (For instance, studies find that, in a small open economy, a tax on capital can effectively become a tax on labour.) Hence, being a large and complex economy, India needs to learn from worldwide best practices, but apply them judiciously to meet its specific needs.

In this regard, although the erstwhile emphasis on revenues over efficiency is shifting a planning ‘hangover’ remains. This is reflected, for instance, in the creation of three new taxes in recent years - the Securities Transaction Tax, the Cash Withdrawal Tax and the Fringe Benefits Tax. From an economic point of view, these taxes are sub-optimal: while they purport to solve specific problems (e.g. money laundering), in actuality, they serve only to raise revenues, while creating enormous difficulties for businesses.

**A Good Tax System:**

A good tax system is characterized by a high responsiveness of tax revenue to changes in income of public bodies or national income; the technique of measuring this response is *tax elasticity* and *tax buoyancy*. Tax policy forms an important part of
development process in a developing economy. The total tax revenue is dependent upon three variables viz., tax rate, tax base and national income. Out of these three the functional relationship between tax revenue and national income is used to determine the responsiveness of taxation. In this case tax revenue is taken as dependent variable while national income is taken as independent variable. The Tax buoyancy is defined as actual changes in tax yield, with respect to changes in national income. There are discretionary changes that take place in the tax structure each year which impact the revenue yield of tax. Tax buoyancy attempts to estimate the responsiveness of taxation resulting from the discretionary measures in taxation.\textsuperscript{16}

**Characteristics Of Good Tax System:**

A good tax system should adhere to certain principle that becomes the characteristics of good tax system. These principles are called canons of taxation.\textsuperscript{17}

1. **Equality:** Canon of equality states that persons should be allowed to pay their taxes as per their ability to pay. Equality, however does not mean equal amount of tax but the burden of tax should be fair and just. Equality of tax burden can be achieved if the rich people are taxed more than the poor people not only in terms of tax but also in the terms of tax rate. This canon tries to achieve the objectives of economic justice.

2. **Certainty:** Many a times, it is seen that the rates of taxes keep on fluctuating and the tax-payers are absolutely uninformed about it. They pay the regular rates and then, the
government officials keep on harassing them. They have to spend most of their time in the public offices explaining the reasons why did they pay less. Some are even unaware of the place where they need to pay the taxes that results in the delay in the payments. They have to submit several documents of which most of the tax-payers are uninformed. They need to visit their house again and again to get those documents. Thus, the canon of certainty implies that the tax-payer should be informed about every detail relating to the payment of each and every kind of taxes.

3. **Economy**: Every tax has a system of cost of collection which is the administrative cost of collection. The canon of economy should be such that the cost of collection should be minimum. It will be useless to impose a tax that involves huge expenditure in its collection.

4. **Productivity**: All taxes should be productive. The canon of productivity implies two things. In the first place, the tax system should be able to generate enough revenue to meet the required expenditure. If a tax yields poor revenue, it cannot be considered as productive revenue. Secondly, taxes should be imposed in such a way as not to obstruct and discourage production.

5. **Elasticity**: The canon of elasticity implies that the taxes should be levied that the yields of the taxes can be easily increased or decreased as per the need of the government.
6. **Diversity:** The canon of diversity requires that the tax system should be such that the government depends on the number of the taxes so that every class of citizen may be called upon to contribute something towards the state revenue.

7. **Simplicity:** The tax system should be easy and simple so that the tax payer can easily understand its implication, the basis and the method of calculation etc. without the costly help of the experts. A complex and complicated method of taxation will make it costly for the tax payers since he will have to seek the help of the experts in order to understand its implications.

8. **Convenience:** Every tax ought to be levied at the time, or in a manner in which it is most likely to be convenient for the contributor to pay it.

9. **Fiscal Objectives:** The tax structure should facilitate the use of fiscal policy for stabilization and growth of objectives.
References:


