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TAX SYSTEM AND TAX REFORMS IN INDIA

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Abstract

This paper is part of a wider research on South-East Asia countries' taxation carried on under the supervision of V. Tanzi. India is a federal republic and a big, highly populated and poor country, which however since some years has entered the catching up stage of development and shows impressive rates of GDP growth. General Government budget is structurally imbalanced and public debt stays high. Public spending (about 25 percent of GDP) is mainly devoted to general services, defense, and the support of economic activities, rather than to public health and welfare programs. Total fiscal pressure (about 17 percent of GDP) is in line with per capita GDP and is shared evenly enough between central and states governments. The structure of the tax system is not much beyond the Musgravian "early stage". A complex structure of taxes on goods and services is largely the main heading of the tax system and it is difficultly moving towards a VAT-kind structure. Direct taxes still are in an infant state, both as weight as well as structure. Import duties remain at not negligible levels. Social contributions are entirely lacking. A tax system of a country like India unavoidably raises more than one problem: foremost among these problems appear to be a too large dominance of a complex and obsolete indirect taxation and the fiscal relations among government layers. The road to updating and improving the Indian tax system has been entered since the early 1990s, but the reform is still largely to be accomplished. Introducing VAT – so successfully adopted in other developing countries – is the most striking but not the only example.

JEL Classification numbers: H20, H24, H25, H29

Key words: Taxation, Tax Reforms, India

1. Introduction, contents and main conclusions

India is a federal republic with an area of 3,287,590 sq. km and the population in 2002 stood at about one billion and 52 million persons and the population density (people per square kilometer) was 320. At the turn of the century, GDP totals about US\$ 440 billion. This aggregate figure stays at the world's fourth place, but its per capita counterpart is less than US\$ 450. Poverty remains an enormous problem: according to World Bank, India has some 433 million people living on less than US\$ 1 a day, 36 percent of the total number of poor in the world. Also non-income poverty represents a huge problem and many social indicators are going bad. This notwithstanding, India's economic performance has been impressive over the last two decades. Total GDP grew yearly at about 6 percent, per capita GDP at about 4 percent.

During the 1990s the average gross fiscal deficit level was 7.2 percent of GDP, while during latest years gross fiscal deficit went up to the 9-10 percent of GDP range. The general government debt fell from 72.5 percent of GDP in 1990-91 to 65.1 percent at the middle of 1990s, but then rose to 79.8 percent in 2001-2002. At the late 1990s Indian general government public expenditure totaled near 25 percent of GDP. This figure is not low with respect to the Indian per capita income. However the joint share of education and health is poor and that of social security is still poorer.

Around the turn of the century, about 80 percent of public expenditure is financed by means of taxes, whose total pressure stays around 15 percent of GDP. Central government collects more than half of tax revenue, but about a quarter is transferred to the states. Taxes on goods and services are definitively the dominant item (60 percent of total taxes). Direct taxes' revenue is far lower and barely reaches 20 percent of total taxes. On the contrary, import duties are still a not negligible share (about 12 percent) of total taxation's yield. Finally, social contributions are wholly lacking.

Beginning with the early 1990s Indian tax system entered a way of reforms. Until now the accomplishments were of some relevance but neither radical nor fast coming. They largely are still under way or planned for the incoming years (see below). Obviously one must be aware that the economic structure as well as administrative difficulties severely constrains tax system's features in developing countries. Anyway in India the change over to the typical "modern" system (PIT+CIT+VAT+ few large excise duties) has not been accomplished yet and it is still expected to be take place and being completed in the near future.

India has a tax structure with a three-tier federal structure (the union government, the state governments and the urban/rural local bodies). The main taxes/duties that the union government is empowered to levy are: income tax, customs duties, excise duties, sales tax and service tax. It is worthwhile to notice some peculiar features of this tax bundle. Income tax is a single tax that is levied on a comprehensive basis both on persons and companies. The structure of custom duties is particularly intricate and the burden hits almost entirely the import side of international trade. Also internal indirect taxes are a complicated matter: they are separately levied on goods, services and intra-states' sales. During the time excise duties and service tax had benefited of a credit system compensating paid tax on inputs and capital goods that has grown to avoid cascading effects and to approximate a VAT-type structure.

The main taxes levied by the state governments are sales tax, stamp duty, state excise, land revenue, duty on entertainment and tax on professions & callings. The local bodies are empowered to levy tax on properties, octroi, tax on markets and tax/user charges for utilities.

Indian tax system is still too largely made up of a big, complex and obsolete bundle of excises and sales taxes. The room of the direct taxation, both on individuals and companies, is very smaller. Consequently a number of issues arise. The share of the personal income tax is more limited than in countries where the value of the per capita income is not far from the Indian one. This may be aimed to preserve poverty income from taxation, but unavoidably the poor are then hit by regressive consumption taxes. Furthermore, the argument that the collection costs are higher for the direct than for the indirect taxes does not seem well demonstrated. Finally, some traditional argument of economic theory - *i.e.* that the income tax is not adequately saving preserving and might induce supply disincentives - is not consistent with the situation of Indian economy. Relative to the companies' taxation, its basis should be broadened through the reduction of a large number of multifaceted incentives. To conclude on this point, a great deal of rationalization is still mandatory to avoid cascading effects - between national excises and states' sales tax -, random 'all in' rates charged on final goods, and high costs of collection. Since few years the long-term strategy moves towards a double VAT system (union and states), leaving to survive just some excises on specific goods.

As we have already noticed, India is a federal republic (union and states) with a complex structure of local authorities. The assignment of tax powers is based on the principle of tax separation and the consequence is a vertical fiscal imbalance. The inadequacy of the states

to meet expenditure from their own resources is recognized by the Constitution, which provides for grant-in-aid both purposed-based and need-based.

Since the last two decades impressive catching-growth is going on in the Indian economy. In 2003-04 real GDP at factor cost has been estimated to have grown by 8.2 percent and was accompanied by a relative stability of prices.

The fiscal deficit of the central government, in GDP terms, after declining from 6.6 percent in 1990-91 to 4.1 percent in 1996-97, started rising to 5.3 percent in 2002-03. The combined fiscal deficit of the centre and the states increased from a level of 9.4 percent of GDP in 1990-91 to a level of 10.1 percent of GDP in the revised estimates for 2002-03.

In 1991, in reaction to a severe macroeconomic crisis involving high fiscal deficits, India carried out a series of economic reforms, among which a tax reform. The main proposals comprised: *a)* the reduction in the rates of the most important taxes; *b)* the enlargement of all taxes' bases; *c)* the transformation of the taxes on domestic production into something similar to a value added tax; *d)* the simplification of laws and administrative procedures. Most of the recommendations have been implemented over the years, at least at the central level. In the case of the states the reforms of their tax systems did not proceed.

In September 2002 the Government set up a new Task Force on tax reforms headed by V. Kelkar. The Kelkar committees suggested sweeping reforms including: *a)* raising the limits of income tax exemption and two-tier brackets; *b)* cut in corporate tax rate; *c)* three-rate basic customs duty structure; *d)* service tax levied in a comprehensive manner; *e)* repeal of wealth tax; *f)* removal of tax exemptions, rationalization of incentives for savings and simplification of procedures; *g)* gradual moving over the destination based, consumption type value added taxes at the state level.

The introduction of VAT was repeatedly postponed, mainly because of the lack of administrative preparation and of disagreements between union government and some states. In July 2004 a Task Force on Implementation of Fiscal Responsibility and Budget Act, also headed by V. Kelkar, has come up with a proposal for an integrated VAT on goods and services to be levied by the central government and the states in parallel, removing all cascading taxes. Of course dismantling and deeply reforming about 60 percent of taxation will be an operation neither easy nor without the risk of loosing yield.

2. A broad view of tax system and its developments since the late 1980s

2.1 A short reminder of the Indian economy and a public sector outline

India was a British colony and it earned its independence on the 15th August 1947. It is a republic with a federal constitution, consisting of 28 states and seven union territories. India has an area of around 3.3 million sq. km., and it is the seventh largest country in the world. The population rose by 184.4 percent between 1951 and 2001 and on 1st March 2001 stood at about one billion and 27 million persons. Notwithstanding an infant mortality rate of 6.4 percent in 2002, population is still rapidly increasing (2.4 percent in 2002 and 1.44 percent estimated in 2004).

The country is characterized by striking contrasts, with huge linguistic, religious and cultural diversity. Poverty remains an enormous problem: according to World Bank figures, India has some 433 million people living on less than US\$ 1 a day, 36 percent of the total number of poor in the world. Also non-income poverty represents a big problem: about 25 percent of world's maternal deaths, about 23 percent of the world's under-five child deaths every year and about 20 percent of the world's children (aged 6-14) out of school are estimated to be in India. The general UN index of human development stays at the 111th place in the world, with a value equal to 0.590 in 2001; endemic diseases are widely diffused.

This notwithstanding, India's economic performance has been impressive over the last two decades, while in the previous period its rate of economic growth appears ordinary (see Table 1).

Tab. 1 - Indian yearly percent rates of economic growth

	<i>1950-1980</i>	<i>1980-1990</i>	<i>1990-2000</i>
Total real GDP	3.7	5.9	6.2
Per capita GDP	1.5	3.8	4.4

Source: IMF data quoted in DeLong (2001).

In the mid-1980s and in the 1990s India has been one of the fastest growing economies in the world, with a doubling time for average GDP per capita of only sixteen years. A large share of GDP originated in the services sector that accompanied the relative decline in the share of agriculture (Table 2).

Tab. 2 Percent shares of Indian GDP

	1980	1990	2000
Agriculture	38.6	31.3	24.9
Industry	24.2	27.6	26.9
Services	37.2	41.1	48.2

Source: World Bank data quoted in Panagariya (2004)

While the conventional wisdom imputes the growth acceleration to neo-liberal economic reforms of the 1990s, according to DeLong (2001) the sources of that acceleration have to be found in some relatively minor reforms undertaken by Rajiv Gandhi's government. Other scholars attribute the acceleration in growth in the 1980s to liberalization of trade and industry (see, for example, Pursell 1992 and Desai 1999).

During the 1980s growth was also driven by fiscal expansion financed by borrowing abroad and at home. But this was unsustainable and led to a crisis in 1991. General government's (centre plus states consolidates) gross fiscal deficit averaged 9 percent of GDP in the second half of 1980s. The period 1992/93-1996/97 (Eighth Plan) has been one of high growth (the average real GDP growth rate was 7.1 percent yearly) and of fiscal restraint (the average gross fiscal deficit level was 7.2 percent of GDP against 9.3 percent in 1990-91). In the same period, the average revenue deficit (current spending minus revenues) was 3.6 percent of GDP (4 percent in 1990/91) and the average primary deficit (fiscal deficit minus interest payments) was 2.1 percent of GDP (4.8 percent in 1990/91).

During the Ninth Plan period (1997/98-2001/02) gross fiscal deficit returned to the 9-10 percent of GDP range, the level of the mid-1980s; the revenue deficit and the primary deficit rose, respectively, to 6.1 and 3.5 percent of GDP. The general government debt fell from 72.5 percent of GDP in 1990/91 to 65.1 percent at the end of the Eighth Plan period, but then rose to 79.8 percent at the end of the Ninth Plan period.

In 1998 (GFSY 2001: last data available), Indian general government public expenditure totaled near 25 percent of GDP, net from intra-national transfers. The shares of central (11.9 percent) and states government (the remaining 13.1 percent) were rather even. However the two layers' specific items were rather different. The central government was engaged mainly in defense, economic affairs & services (agriculture, transports, communications and

so forth) and to pay a huge amount of interests (4.1 percent of GDP) on public debt. States governments devoted their resources mainly to education (3.5 percent of GDP), quite less to health (0.5 percent) and, on the contrary, somewhat more to economic services, especially agriculture (1.4 percent).

Surprisingly enough, social security and welfare programs were virtually absent at the central level, and small also at the states' tier (0.6 percent of GDP).¹ On the contrary, general administration, law & order and defense all together reach more than 7 percent of GDP, i.e. near a third of total spending.

A comparison with the whole of developing countries (Burgess and Stern 1993) shows that total spending is not low in India, especially with respect to the per capita income, nor that of general administration and defense stays far from the average of these countries. However the share of joint education and health is poor and it is still poorer that of social security - also taking into account the caveat reported on the reliability of the data. This happens in a country where many social indicators are going badly, as we have already seen.

2.2 The tax system broad structure and its development

Tables 3, 4 and 5 show the broad quantitative structure of the Indian tax system and its developments since the late 1980s until the first years of the current century. Data are shown for consolidated general, central and states' governments.² At the turn of the century, tax revenue amounts to about 80 percent of total general government revenue (Table 3). The remaining 20 percent is a not-homogeneous item, made up of tariffs, foreign grants, interest and so forth. Its level is anyway not negligible, higher than it is usually experienced in more advanced countries.

By considering the average values among those of the years shown by the Table 3, total tax pressure is something less than 15 percent of GDP. Taxes on goods and services -almost entirely by excise duties- are definitively the dominant item (near 10 percent of GDP and 60

¹ The figures in the text however may be under reported. Some welfare spending could in fact be hidden inside certain agricultural or other economic activities' support. Furthermore, welfare services are largely supplied by local authorities whose accounts are largely defective.

² The main source is IMF *GFSY* (2000, 2001). It has been integrated especially with the aid of Baird and Ferro (2003); Imf (2003); India Union Budget (1995-2002). General government account is an own estimate, this account being not available in official data sources. We cleaned central government accounts from states' share taxes and highlighted states' grants revenue from the union. These data are mainly drawn from Baird and Ferro (2003), from whom the GDP series is drawn too. Pay the due care to the fact that these sources are not perfectly homogeneous and that there is some evidence that last years' data are better than those of the older ones.

percent of total taxes). Direct taxes' revenue is far lower and barely reaches less than 3 percent of GDP and not more than 20 percent of total taxes. One may calculate that this figure can be split almost evenly between individuals and corporations, also if they are both subject to the same single personal tax³. Property taxes are very narrow, especially by considering that they include also capital transactions' tax yield. On the contrary, import duties accounted on average for a not negligible share (about 20 percent) of total taxation. Finally, social contributions are entirely lacking, like it is common in developing countries and as one could suspect from the low level of social services & welfare programs we have already spoken about.

A comparison between the Indian tax structure and its counterparts prevailing in other developing countries (e.g. Burgess and Stern 1993; Tanzi, 1994) relatively shows a somewhat outdated picture. The total Indian fiscal pressure is just slightly lower than the figure prevailing in those countries where per-capita income is near to the Indian value. However Indian direct taxes appear comparatively very low, while indirect ones stay quite high and the share of import duties is relatively low.

The development of general government tax structure does not show striking changes since the late 1980s to the turn of the century, but just some -also relevant- ups and downs and some increasing/decreasing trends as to certain tax items. The total fiscal pressure went down since the beginning of the 1990s. A recovery emerged at the end of the decade but it has been not confirmed during last years. This movement is explained almost at all by the analogous one of excise duties and it was due to the rates' reductions that were adopted at that time (see below). Personal taxes gained one point of GDP -i.e. 50 percent of the starting value- while the share of import duties more than halved itself.

Notwithstanding this somewhat static picture, a lot of reforms were introduced into Indian tax system during the 1990s, on the wave of the proposals the Tax Reforms Committee, chaired by R. J. Chelliah in 1991 (Shome 1997; Rao 2000; Sarma and Gupta 2002). Broadening the bases, reducing tax rates, simplifying the system, making it more supply friendly and attractive for FDI were the main aims of the suggested reforms. But the accomplishments

³ A Kaldor-type expenditure tax was levied in 1956-57, but it was repealed three years later because of its revenue shortage (Rao 2000).

Tab. 3 - Structure and developments of consolidated General Government revenue - 1989-2002 - Percentage of GDP

	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002
<i>Total revenue and Grants</i>	19.9	17.1	17.9	19.3	18.2	17.7	18.4	18.0	17.3	17.4	18.4	19.6	17.4	18.3
Non-tax revenue and grants	3.9	2.9	3.5	4.0	4.0	4.0	3.9	3.5	3.5	3.9	3.2	3.1	3.6	3.8
<i>Tax Revenue</i>	16.0	14.2	14.5	15.3	14.2	13.7	14.6	14.5	13.8	13.4	15.2	16.5	13.8	14.6
Income and profits, of which:	2.1	2.0	2.4	2.4	2.4	2.2	2.8	2.8	2.5	2.6	3.0	3.3	3.0	3.2
Individual (Income tax and other)	1.1	1.0	1.1	1.1	1.1	1.0	1.3	1.3	1.1	1.2	1.4	1.5	1.4	1.4
Corporate	1.0	1.0	1.2	1.2	1.2	1.2	1.4	1.4	1.3	1.4	1.5	1.7	1.6	1.8
Property & capital transaction	0.6	0.5	0.5	0.6	0.6	0.6	0.6	0.6	0.6	0.5	0.6	0.7	0.6	0.7
Goods and services, of which:	9.4	8.0	8.1	9.0	8.6	8.5	8.1	8.0	8.0	7.9	9.1	10.3	8.4	8.9
Excises	9.2	7.8	7.9	8.8	8.4	8.4	8.0	7.8	7.9	7.8	9.0	10.2	8.3	8.8
International trade, of which:	3.8	3.8	3.5	3.3	2.7	2.3	3.0	3.1	2.6	2.3	2.5	2.3	1.8	1.8
Import duties	3.8	3.8	3.5	3.2	2.6	2.2	3.0	3.1	2.6	2.3	2.5	2.2	1.7	1.7

Sources: Own calculations (see text) according to: Imf, Government Finance Statistical Yearbook, 2000 and 2001; Baird and Ferro (World Bank, 2003); Imf (2003: India Selected Issues); Ministry of Finance of India (Union Budget: various years).

Notes: Preliminary data for 2002. Fiscal year starting on April, 1.

Tab.4 - Structure and development of consolidated Central Government revenue - 1989-2002 - Percentage of GDP

	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002
<i>Total current revenue and Grants</i>	9.0	10.7	11.6	11.1	9.6	10.3	10.2	10.1	9.3	9.1	9.9	9.8	9.4	9.6
Non-tax revenue	0.8	2.8	3.6	3.4	3.3	3.1	3.3	3.2	3.1	3.1	3.3	3.2	3.5	3.4
Gross Tax Revenue	11.0	10.5	10.7	10.6	9.0	7.8	9.4	9.4	9.1	8.3	8.9	9.0	8.1	8.4
Income and profits, of which:	2.1	2.0	2.4	2.4	2.4	2.2	2.8	2.8	2.5	2.6	3.0	3.3	3.0	3.2
Individual (Income tax and other)	1.1	1.0	1.1	1.1	1.1	1.0	1.3	1.3	0.0	1.2	1.4	1.5	1.4	1.4
Corporate	1.0	1.0	1.2	1.2	1.2	1.2	1.4	1.4	1.3	1.4	1.5	1.7	1.6	1.8
Goods and services, of which:	5.0	4.7	4.7	4.5	3.9	3.2	3.5	3.4	3.3	3.2	3.3	3.4	3.3	3.4
Excises	4.8	4.5	4.5	4.3	3.7	3.1	3.4	3.3	3.2	3.1	3.2	3.3	3.2	3.2
International trade, of which:	3.8	3.8	3.5	3.3	2.7	2.3	3.0	3.1	2.6	2.3	2.5	2.3	1.8	1.8
Import duties	3.8	3.8	3.5	3.2	2.6	2.2	3.0	3.1	2.6	2.3	2.5	2.2	1.7	1.7
Less States' Share	2.8	2.6	2.7	2.8	2.7	2.1	2.4	2.6	2.9	2.2	2.2	2.5	2.3	2.2
<i>Net Tax Revenue</i>	8.2	7.9	8.0	7.7	6.3	6.7	6.9	6.9	6.3	6.0	6.6	6.5	5.9	6.3

Sources: Own calculations (see text) according to: Imf, Government Finance Statistical Yearbook, 2000 and 2001; Baird and Ferro (World Bank, 2003); Imf (2003: India Selected Issues); Ministry of Finance of India (Union Budget: various years).

Notes: Preliminary data for 2002. Fiscal year starting on April, 1.

Tab. 5 - Structure and developments of states government revenue - 1989-2002 - Percentage of GDP

	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002
<i>Total current revenue and grants</i>	11.2	11.6	11.9	12.1	11.8	11.5	10.6	10.5	10.5	9.8	9.9	10.6	10.6	11.3
Non-tax revenue	1.2	1.3	1.4	1.3	1.3	1.3	1.2	1.1	1.0	0.9	1.0	1.1	1.1	1.1
Grants from National Government	1.8	2.3	2.4	2.5	2.5	2.4	2.0	1.7	1.6	1.5	1.5	1.7	1.6	1.8
Tax Revenue of which:	8.1	8.0	8.1	8.2	8.1	7.9	7.4	7.6	7.9	7.4	7.4	7.8	7.8	8.3
State shares in central taxes	2.8	2.6	2.7	2.8	2.6	2.5	2.4	2.5	2.6	2.3	2.2	2.4	2.4	2.5
<i>Own taxes of which:</i>	5.3	5.4	5.4	5.4	5.4	5.4	5.1	5.1	5.3	5.1	5.2	5.4	5.5	5.8
Goods and services	4.7	4.8	4.8	4.8	4.8	4.8	4.5	4.5	4.7	4.5	4.6	4.8	4.9	5.1
Property & capital transaction	0.6	0.5	0.6	0.6	0.6	0.6	0.6	0.6	0.6	0.6	0.6	0.6	0.6	0.7

Sources: Own calculations (see text) according to: Imf, Government Finance Statistical Yearbook, 2000 and 2001; Baird and Ferro (World Bank, 2003); Imf (2003: India Selected Issues); Ministry of Finance of India (Union Budget: various years).

Notes: Preliminary data for 2002. Fiscal year starting on April, 1.

were somewhat more limited than the initial challenging design, as we will see at the end of this chapter.

During the 1990s the central government collected near two third of consolidated tax revenue, but about a quarter was transferred to the states, so that the net tax revenue was almost evenly distributed between the two main government layers. The tax mix of central government was far more balanced than it was at general government's level. The union budget appropriates all direct taxes and import duties, and about half of total excise duties. The relative weight of these three items is about the same. During the 1990s, excise duties went down, as also import duties did. Notwithstanding the increase in direct taxes, central government total tax pressure showed an overall decreasing trend, albeit with ups and downs.

A more flat level of total tax revenue is on the contrary showed by states' accounts, with the exception of some decrease during the second half of the 1990s. The two main headings of tax financing –both quite stable during the decade- are the shares in central taxes (about one third) and states' own taxes. The latter are also almost all excise duties so that this is the dominant item also in tax financing of the states. Finally it is worthwhile to notice that the share of taxes is just a half of states' total revenue, once that the former is cleaned from the contribution of central government's taxes.

To sum up, the Indian tax system seems to slowly moving from the traditional features of the Musgrave's "early stage" (Musgrave 1969). Obviously the economic structure and administrative capabilities severely constrain tax system's features in developing countries. The large share of agriculture and the prevailing small scale of early manufacturing prevent the determination of business income. Therefore income tax could be effectively applied just to wage income of the civil servants and to the employees of large firms. Retail or multiple-stage sales taxation is difficult to be effectively implemented. However in India the changeover to the typical "modern" system (PIT+CIT+VAT + few large excise duties) has not been accomplished yet or just it is in the starting stage.

3. Some quantitative and institutional features of main taxes

India has a tax structure with a three-tier federal structure (the union government, the state governments and the urban/rural local bodies). The power to levy taxes and duties is distributed between the union government and the state governments in accordance with the provi-

sions of the Indian Constitution⁴. The state government may delegate any of its fiscal powers to local authorities that do not have any constitutionally reserved powers of taxation. The main taxes/duties that the union government is empowered to levy are: income tax (except tax on agricultural income, which the state governments can levy), customs duties, excise duties (except on alcoholic liquors or narcotics), sales tax and service tax. The principal taxes levied by the state governments are sales tax (tax on intra-state sale of goods), stamp duty (duty on transfer of property), state excise (duty on manufacture of alcohol), land revenue (levy on land used for agricultural/non-agricultural purposes), duty on entertainment and tax on professions & callings. The local bodies are empowered to levy tax on properties (buildings, etc.), octroi (tax on entry of goods for use/consumption within areas of the local bodies), tax on markets and tax/user charges for utilities like water supply, drainage, etc.

3.1 Direct Taxes

3.1.1 Income Tax

Income tax is charged under the Indian Income Tax Act, 1961. It is an annual tax on income of both individuals and companies⁵ levied by the union government.

Every person (individuals, Hindu undivided families, companies, firms, association of persons or bodies of individuals and all other artificial juridical persons), whose total income exceeds the maximum exemption limit, is chargeable to the income tax at the rates prescribed in the Finance Act passed each year by the parliament. The income tax is paid on the total income of an individual, determined on the basis of her/his residential status in India⁶.

The tax is charged in respect of the income of the previous year - that is the financial year, beginning on 1st April and ending on 31st March -and the same is chargeable in the assessment year - that is the next financial year.

⁴ The Constitution points out three lists of legislative fields: 1) the union list (in which the central government has exclusive jurisdiction); 2) the state list (in which the state governments have exclusive jurisdiction); 3) the concurrent list (in which the union government and the state governments have concurrent jurisdiction, subject to the power of the union government).

⁵ In the statistics income tax payable by corporates goes under the head "corporation tax".

⁶ An individual is considered a 'resident' if s/he stays for the prescribed period during a fiscal year either for 182 days or more, or 60 days or more (182 days or more for non-resident) and has been in India in aggregate for 365 days or more in the previous four years. Any person who does not satisfy these norms is considered as a 'non-resident'.

In the taxable income are included the following heads: salaries; income from house property (determined by reference to the annual value of property); profits and gains of business or profession; capital gains; income from other sources (included interest⁷). The basis of taxation is the gross receipts after deducting the related expenses incurred in connection with earning such receipts. Such deductions, determined according to rules varying from head to head of income, are allowed from the aggregate of income and are in the nature of incentive provisions of different kinds.

The main deductions are the following:

- Standard deduction – available to certain taxpayers receiving salary or pension⁸;
- Entertainment allowance – provided to government employees that may claim a deduction up to 20 percent of their salaries or 5,000 rupees, whichever is lower, for certain entertainment allowances granted by the employer;
- Tax – for any sum paid by an employee on account of state or municipal tax on employment;
- Annuity and insurance payment – up to 10,000 rupees per annum for payments made in respect of an annuity contract in order to receive a pension;
- Repayment of loan – deduction of up to 40,000 rupees per annum for the repayment, including interest, of loans used to finance higher education (available for eight assessment years); deduction of up to 150,000 rupees in respect of interest on capital borrowed to purchase or construct owner-occupied residential property;
- Donation – to charities approved for tax purposes up to the limit prescribed by the tax authorities,
- Investment income – up to 9,000 rupees per annum in respect of interest received from certain specified investment, including dividends from cooperative societies and interest on bank deposits; up to 3,000 per annum for interest received from government securities;
- Permanent physical disability – up to 40,000 rupees for a permanent physical disability (occurred in the previous year) certified by a competent person.

⁷ However, interest derived in the course of a business is taxed as business profits under the head “profits and gains of business or profession”.

⁸ From the assessment year 2001/02 the standard deduction is equal to: 33.33 per cent of salary up to 150,000 rupees or 30,000 rupees, whichever is lower; 25,000 rupees for salary ranging from 150,001 and 300,000 rupees; 20,000 rupees for salary ranging from 300,001 and 500,000 rupees; no deduction for salary over 500,000 rupees.

Other deductions are granted as tax incentives: for example, new export-oriented undertakings are entitled to an exemption from income tax; new industrial undertakings that fulfill certain conditions are entitled to a deduction (25 percent or 30 percent in the case of a company) of the profits for a period of 10 consecutive assessment years (or 12 for a co-operative society); a deduction of 50 percent of profits is available to hotels in hilly/rural areas and pilgrimage centers (except Calcutta, Madras, Delhi and Mumbai), and so forth.

After reducing the gross total income by the amount of deductions, what is left is the total income that is the basis for taxation⁹. If the total income is below the basic exemption limit, no tax is chargeable. All receipts having the character of income are taxable unless they are specifically exempt from taxation.

For tax purposes spouses are treated separately and generally their income is not clubbed. On the contrary, income of all minors, except handicapped ones, is clubbed with the income of their parents, unless the income is derived from manual work or an activity involving skill, specialized knowledge and experience.

The tax rates for the assessment year 2004-2005 are listed in Table 6.

Different types of assessments are provided:

- a) self-assessment (the taxpayer is required to make a self- assessment and pay the tax on the basis of the returns furnished);
- b) regular assessment (on the basis of the return of income chargeable to tax furnished by the taxpayer an intimation is sent to her/him informing about the tax or interest payable or refundable);
- c) best judgment assessment (the assessing officer bases the assessment on her/his best judgment).

⁹ In certain cases (for example, interest, winnings from lotteries, horse races, card games and other games of any sort), income tax is deducted at source at the rates in force. For the assessment year 2004-2005 the tax rate for interest is 10 percent, whereas for the other above items is 30 percent, in the case of a person (other than a company) that is resident in India.

Table 6- Tax rates, assessment year 2004-2005 (Finance Bill)

a) **Individual***

<i>Net income range (Rs.)</i>	<i>Rate**</i>
Up to 50,000	nil
50,001 - 60,000	10 percent of the amount exceeding Rs. 50,000
60,001 – 150,000	Rs. 1,000 plus 20 percent of the amount exceeding Rs. 60,000
150,001 and above	Rs. 19,000 plus 30 percent of the amount exceeding Rs. 150,000

* The tax rates applicable to individuals are also applicable to Hindu Undivided Family (HUF), Association of Persons (AOP) and Body of Individuals (BOI).

**A surcharge of 10 percent of the income tax is levied (except by non resident) where taxable income exceeds Rs. 85,000.

b) **Co-operative society**

<i>Net income range (Rs.)</i>	<i>Rate*</i>
Up to 10,000	10 percent of total income
10,001 - 20,000	Rs. 1,000 plus 20 percent of the amount exceeding 10,000
Above 20,000	Rs. 3,000 plus 30 percent of the amount exceeding Rs. 20,000

* A surcharge of 2.5 percent of the income tax is levied.

c) **Firm and domestic company:** 35 percent of the total income plus a surcharge of 2.5 percent of the income tax

d) **Local authority:** 30 percent of the total income plus a surcharge of 2.5 percent of the income tax

3.1.2 Wealth Tax

Wealth tax is charged under the Indian Wealth Tax Act, 1957 and the union government levies it. The tax is charged on individuals, Hindu Undivided Families (HUF) and companies in respect of the net wealth held by them during the assessment year. Indian citizens, resident companies and HUF are charged in respect of their worldwide assets, whereas non-resident is charged in respect of assets located in India.

Net wealth is the aggregate of the assets owned by the taxpayer¹⁰, less the debts owned by her/him relative to the taxable assets. From the computation of net wealth some assets are excluded (for example, the value of one house or plot of land for an individual or a HUF).

Among the assets subject to wealth tax there are, for example: buildings, or land belonging with them, used for residential or commercial purposes or as a guest house or farm house, within 25 km of the local limits or cantonment board; motor cars (other than those used in a business car-hire or which are stock-in-trade); jewels or precious metals (unless they are stock-in-trade); yachts, boats and aircraft (unless used for commercial purposes); urban land (with some exclusion); cash in hand in excess of Rs. 50,000.

Among the entities that are exempt from the wealth tax there are: any social club; any political party; any cooperative society; any company whose object is the promotion of art, science, religion, charity, commerce, etc... The rate is 1 percent on net wealth exceeding Rs. 1.5 million. It is provided a self-assessment scheme.

3.1.3 Other taxes on capital and property

Other taxes on capital and property are levied by the states and the local authorities.

The states impose: - a land tax on the value of land (the methods of valuation and the rates vary from states to states); - a tax on motor vehicles, whose yield is used for the development and the maintenance of state roads.

The local authorities impose: - land cesses in the form of a surcharge on land revenue; - a tax on land and buildings, generally based on the annual rental value; - betterment taxes,

¹⁰ The net wealth computation of an individual must include assets transferred to a spouse or minor child.

based on increases of land value caused by town planning and town improvement; - taxes on the transfer of immovable property, based on the value of the property and in addition to state stamp duty.

3.1.4 Expenditure Tax

The expenditure tax is charged under the Indian Expenditure-tax Act, 1987¹¹ and it is imposed by the union government. The tax is charged at the rate of 10 percent on any chargeable expenditure incurred in a hotel wherein the room charges¹² for any unit of residential accommodation are three thousand rupees or more per day. The expenditure tax is collected by the person who carries on the business of such hotel. The tax collected during any calendar month is paid to the credit of the union government by the 10th of the month immediately following the said calendar month. Any person responsible for collecting the expenditure tax who fails to collect it shall pay, in addition to paying the tax, a sum equal to the amount of tax that s/he failed to collect.

From the 1st October, 1991 to the 31st May, 1992 a tax at the rate of 15 percent of the chargeable expenditure incurred in a restaurant was levied.

3.2 Indirect Taxes

3.2.1 Customs Duties

The Constitution has given to the union the right to legislate and collect duties on goods imported into or exported from India. The Customs Act, 1962 is the basic Statute, effective from 1st February 1963. The categories of items and the rates of duties which are leviable have been specified in two schedules to the Customs Tariff Act, 1975. The first schedule specifies the various categories of import items, in accordance with an international scheme of classifi-

¹¹ The Act extends to the whole of India except the State of Jammu and Kashmir.

¹² In the case where a composite charge is payable in respect of residential accommodation and food, the room charges included therein shall be determined by deducting from the composite charge, the charges for food in the following manner: (i) where the composite charge includes the charge for breakfast: 10 per cent of the composite charge; (ii) where the composite charge includes the charge for breakfast and one meal: 25 per cent of the composite charge; (iii) where the composite charge includes the charge for breakfast and two meals: 40 per cent of the composite charge. As of 1st June 2002 the definition of "chargeable expenditure" excludes payments made to the hotel in respect of food, drinks or any other services.

cation of internationally traded goods (Harmonized System of Nomenclature (HSN), established by the World Customs Organization). All goods are classified into categories, called "headings" and "subheadings"; for each sub-heading, a specific rate of duty is prescribed. The duties are levied both on specific and *ad-valorem* basis, while there are few cases where at times specific-cum-*ad valorem* duties are also collected on imported items. Where *ad-valorem* duties are collected, the value of the goods has to be determined for customs duty purposes according to WTO Valuation Agreement.

Under the Custom Tariff Act, 1975 and other laws, there are the following types of duties that are leviable:

- *Basic Customs Duty* - that is duty specified against each heading or sub-heading in the first schedule. There are different rates of duty for different commodities and there are preferential rates for goods imported from certain countries in accordance with bilateral agreements with such countries. The duty may be *ad valorem* or specific.
- *Surcharge* - that is levied at the rate of 10% of the Basic Customs Duty on imported goods, unless exempted by a notification.
- *Additional duty of customs* - equivalent to the excise duty leviable on goods produced or manufactured in India. Generally it is on *ad valorem* basis, though specific rates are prescribed for some items. For imported goods to be used as inputs for manufacture of other goods, it is generally eligible for a credit (called CENVAT credit) equal to the additional duty of customs paid on the imported goods. This credit can be used for paying central excise duties.
- *Special additional duty* – whose amount is computed by applying the specified rate¹³ on the total of the assessable value, the basic customs duty and the additional duty of customs described above.

There are also additional levies on particular items and other levies which are specific to the country of origin. Among the later there are *anti-dumping duty*, on specified goods imported from specified countries to protect indigenous industry, and *safeguard duty*, applicable on certain goods for specified periods in order to check their excessive imports which may damage the Indian industry. The rates vary and are based on official notification.

¹³ The maximum rate permissible is 8 per cent. Currently there are various rates, with the maximum rate being 4 per cent.

The custom duty on exports is levied on items listed in the second schedule to Customs Tariff Act, 1975. Currently, the rates vary from 10 to 60 percent and they are either *ad valorem*, specific or a combination of both. Very few items are subject to customs duties on their export.

In order to make the exports more competitive, it is provided a duty exemption scheme for registered exporters so that they may import the inputs required for export production at international prices and free from duty. Imported items that are exempt from customs duty are raw materials, components and consumables.

3.2.2 Central Excise Duties

Central excise duties are charged under the Central Excise Act, 1944 at the rates specified in the schedules to the Central Excise Tariff Act, 1985. They are an indirect tax levied on goods produced or manufactured in India, excluding those produced or manufactured in special economic zones.

There are several types of duties which become payable at the time of clearance of such goods. These duties are:

- *Basic excise duty* (specified against each sub-heading in the First Schedule to the Central Excise Tariff Act, 1985) actually called the "Central Value Added Tax (CENVAT)¹⁴.
- *Special excise duty* (leviable only on a few items, in addition to CENVAT, at the rate specified under the Second Schedule to the Central Excise Tariff Act, 1985).
- *Additional duties of excise* (leviable on various commodities, as specified textiles and textile articles, or on sugar, tobacco products in lieu of sales tax).
- *Cess* (on different items - for example, spices, agriculture and processed food products, coffee, marine products which are exported - through special enactment).

The duty is payable by the manufacturer at the time of removal of goods from the factory premises or warehouse; the taxable base is the wholesale price of the goods manufactured. However, to achieve particular objectives - for example, to promote exports, to avoid multiple taxation, to promote educational and research activities, or to encourage the use of specified

¹⁴ The duty paid on specified inputs and capital goods used in relation to the manufacture of specified final products can be claimed, under specific conditions, as a credit (CENVAT credit).

raw material - it is in the power of the central government to exempt certain excisable goods from the whole or any part of the duty leviable on such goods.

The general rate of the basic excise duty in 2002/2003 is 16 percent, but there are a number of items that are subject to either a “nil” or *ad valorem* rate. In the same fiscal year the special excise duty is levied at a rate of 16 percent, although there are a number of items subject to a rate of 8 percent; additional duties of excise are imposed at rates ranging from 5 percent to 18 percent, or at *ad valorem* rates. Cess is applied at varying rates (for example, 0.5 percent on spices and agriculture and processed food products, Rs. 25.00 per quintal on coffee).

Unless the assessee is a cigarette manufacturer (in which case the assessment is carried out by the authorities), a self-assessment procedure is provided.

3.2.3 Service Tax

Service tax was introduced in India for the first time in 1994. It extends to whole of India except the state of Jammu and Kashmir. It is levied, collected and appropriated by the union government. Service tax is levied on specified taxable services and the responsibility of payment of the tax is cast on the service provider. The Finance Act 2001 introduced self-assessment for service tax returns, which are expected to be filled half yearly and by the 25th of the month following the half-year¹⁵. This is in replacement of the monthly/quarterly returns prescribed earlier.

Initially the service tax was imposed on the following services: telephone, stockbroker, general insurance. Over the years it was extended to other services, as advertising agencies and courier agencies. At present the total number of services on which service tax is levied has gone up to 58, despite withdrawal of certain services from the tax net or grant of exemptions. In the budget 2003-04 more services¹⁶ have been added to the tax net and the levy of service tax on these services is effective from July 1st, 2003.

¹⁵ The individual assesseees are required to pay the levy only once in a quarter.

¹⁶ The services are the following: a) commercial vocational institute, coaching centres and private tutorials; b) technical testing and analysis (excluding health and diagnostic testing) technical inspection and certification service; c) maintenance and repair services; d) commission and installation services; e) business auxiliary services, namely business promotion and support services (excluding on information technology services); f) internet café; g) franchise services; h) foreign exchange broking services; i) maxi cab repair services; l) minor ports (other than major ports).

Service tax is levied on the gross or aggregate amount charged by the service provider on the receiver; only in particular cases the tax is permitted to be paid on the value received. Since the 14th May 2003 it is collected at a rate of 8 percent, while the previous rate was 5 percent.

To reduce the cascading impact of tax on tax and to help restoring competitiveness of service sector, a credit of the service tax paid on the input-service is allowed since 2002. At present the assessee can avail of input credit in respect of any of the categories of the services and utilize the said service tax credit for payment of service tax on any of the output services.

3.2.4 Sales Tax

Sales tax is charged under the Central Sales Tax Act, 1956. It is levied on the sale or purchase of goods. There are two kinds of sales tax: 1) central sales tax (CST), imposed by the union government; 2) sales tax, imposed by each state.

Central sales tax is generally payable on the sale of all goods by a dealer in the course of inter-state trade and commerce and it is levied in the state where the movement of goods commences. Although the tax is imposed by the central government, the revenue is administered by the state in which it is levied.

The taxable base is determined by applying the appropriate rate, depending on the type of transaction, to the dealer's turnover¹⁷.

Sales tax on intra-state sale or purchase of goods (other than newspapers) may only be imposed by the state in which the sale or purchase takes place. Nearly all the states impose sales taxes at rates that range from 4 to 15 percent.

4. Some critical issues of the Indian tax system

4.1 The large prevalence of a complex system of indirect taxes

¹⁷ The turnover is defined as the aggregate of the sale prices received by a dealer net of sale tax less the sale price of goods returned within six months of the date of delivery.

We have already noticed that the Indian tax system is still largely made up of a big, complex and entangled bundle of excises and sales taxes. The room of direct taxation, both on individuals and companies, is very smaller. Formal rates are not particularly low, especially for corporations (see par. 3 above) but the wideness of the bases is just so. Such a system -we have already reminded- is not just a consequence of free tax policy choices, but mainly draws its model from the severe constraints - economic, social and administrative in nature -, which limit the room of manoeuvre to build the tax system of developing countries (Musgrave 1969; Burgess and Stern 1993; Tanzi 1994). The large prevalence of a complex system of indirect taxes however raises a number of critical issues that require some discussion.

i. The limited share of direct taxes on individuals – The per capita income is not the only explaining factor of the total fiscal pressure¹⁸, as well as of the level of a particular tax. Anyway, it is a key factor and a starting point to compare different countries' tax levels, not to be disregarded. Put the issue in that way, the current level of personal income tax in India stays about one third below the figure computed by the prevailing literature (*e.g.* Burgess and Stern 1994)¹⁹ with reference to the bracket that encompasses the Indian per capita income. Why not a bigger amount of PIT? Why just 32 million of taxpayers file income's tax return, over a population of more than 1 billion and sixty five million people?²⁰

A first argument to limit the room of income tax could be the need to preserve poverty incomes from taxation. Otherwise avoiding any taxation of the poor' consumption is virtually impossible. It is also commonly recognized that consumption taxes tend to be regressive, especially in developing countries, if they are not coupled with commanding and administratively costly measures of prices' subsidies, in kind rations and transfers. Furthermore the rates should be scheduled according to a steeply -revenue reducing- increasing tax rates' profile (*e.g.* Burgess and Stern 1994). Might well be that a proper behaved structure of larger income taxation could cooperate to do a better redistributive job. Of course also agriculture incomes should be taxed at a non-negligible level, but without burdening poor peasant households. Land tax may be a good solution in terms of both efficiency and equity (Burgess and Stern 1994).

¹⁸ Tanzi's (1994) equation adds the weight of agriculture sector (-), the ratio of imports (+) to GDP, the level of public debt (+). Musgrave (1969) and Burgess and Stern (1993) furthermore add qualitative factors of the same kind. Remind from the previous sections that agriculture' share is declining since some decades relatively to other economy's sectors, while Debt/GDP ratio stays high in India.

¹⁹ 2.53 GDP points as to the bracket [360-750] US\$ inside a sample of 82 developing countries. The average figure for all Asian and all African countries results to be about the same.

It also is often assumed that the costs of administration and compliance are higher for direct than for indirect taxes, especially inside the informal setting of developing countries' economies. Here the true difficulty is more specific but common to the two kinds of taxation: the need to improve the capabilities of both the tax administration and of the taxpayers. In this connection, it has been demonstrated that simple reforms of personnel policy inside the Indian income tax administration can imply significant enforcement and compliance gains (Das-Gupta, Gosh and Mookherejee 2004) so that to reduce the cost of collection per unit of yield. Furthermore, when one looks at the complexity system of the Indian indirect taxes, the unavoidable suspicion arises of not having to cope with an inexpensive system of tax collection.

Finally, according to standard economic theory, consumption taxes would be more saving preserving and income taxes could induce supply disincentives, especially as steeper is their rates' schedule. Notice however that these arguments mainly apply to countries where the per capita income is already higher than it is today in India. On the contrary, we may infer that the taxation has little to do with the savings in a still so poor country and with the labor supply in a country where the employed workers are not more than 24 percent of the total population.²¹

ii) Broadening companies' tax base – The native literature unambiguously recognizes (e.g. Kwatra 1997) that the corporate backward effective rates are far lower than the legal ones. This is mainly due to tax holidays for new small undertakings and venture capitals, to incentives to exports, to a lot of allowances for FDI, to deductions for particular sectors (e.g. power plants, infrastructures, industrial research). This happens when it is well recognized by a general authoritative opinion (rooted especially inside the international organizations - OECD/WB/IMF-) that playing the field and reducing the standard rate is more incentives inducing than the sector allowances, in transition and developing economies too (e.g. Owens 2004).

iii) Rationalizing indirect taxes – We have already noticed that the present large system of indirect taxes is quite complicated and confused. A state sales tax is added to the national excise duties. The national excises hit goods at the production stage, while the services are subject to a different separate tax. Furthermore, the national excises are organized in a multi-classes structure (basic, special, additional excises and cess), according to various types of goods. In its turn, the sales tax (anyway payable to the state) is set by the central government

²⁰ The ratio tax payers / population is then around 3 per cent.

for the inter-states trade and by the states themselves for the intra-states trade. This system unavoidably raises cascading effects (although partially mitigated by widespread deductions of the taxes paid on inputs and capital goods in the case of the national excises and services taxes) and may result in random ‘all in’ rates charged on final goods and services. Many recent government’s reports (e.g. Government of India 2002) underline the need to deeply rationalize the structure of the indirect taxation and to improve the tax administration and the tax-payers compliance, also to reduce the costs of collection. Since some years the long-term strategy is in the direction of a double Vat system (at the central level on manufactured goods and at the state level on retail sales). Just some excise duties on particular goods (tobacco, alcoholic beverages, energy) should survive. Unambiguously the literature favors this move (e.g.: Shome 1997; Rao 2000) whose current steps are reported below. Anyway, the setting of rates will not be easy: the unavoidable trade-off between equity and efficiency (and yield) clearly emerged in a seminal paper devoted just to India (Ahmad and Stern 1984). Finally a deep reform of what accounts for about 60 percent of total taxation will not be easy neither without risk of an, at least temporary, revenue’s losses. All this would make unsustainable the Indian budget position, already suffering a high level deficit (see section 5 below).

4.2 Intergovernmental fiscal relations

As already noted, India is a federal republic²² and its government consists of a central (union) government, 28 state governments and 7 union territories. Many states have autonomous regions with regional councils and in different states there are three tiers of local bodies²³. There also are 602 districts administered by their respective state/UT government. The Indian federal system is quite centralized. Indian Constitution makers divided the government

²¹ U.N. data for the late 1990s: 33 percent of active population and 9 percent of total unemployment.

²² India has a federal structure with unitary features. The two essential features of Indian federalism are: a) Indian federalism is not the result of an agreement by the units; b) the component units have no freedom to secede. For a brief description of the evolution of financial relations from 1858 up to the coming into force of the Constitution in 1950 see Vithal and Sastry, 2001.

²³ There are two types of local government: urban local government and rural local government. Until 1992, municipal corporations, municipal councils, town area committees and notified area committees formed urban local government. However, the Seventy-Fourth Constitution Amendment Act adopted in 1992 proposes to form a uniform structure of municipal corporations, municipal councils and *Nagar Panchayats* in transitional areas. Rural local government operates through *Zilla Panchayats (Parishads)*, *Taluka Panchayats* and *Village Panchayats*. That amendment granted local self-governments a constitutional status and safeguarded their continued existence. Local government bodies are covered in the state list and are governed by the state statutes or, in the case of union territories, by the union parliament. (<http://www.unescap.org>).

functions in three lists: federal, state and concurrent. Under the Seventh Schedule of the Indian Constitution, the central government has exclusive powers on foreign policy, defence, communications, currency, taxation on corporations and non-agricultural income, and railroads; while state governments have the exclusive power to legislate on such subjects as law and order, public health and sanitation, local government, betting and gambling, and taxation on agricultural income, entertainment, and alcoholic beverages. On some issues both the central government and state governments may legislate, though a union law generally takes precedence. Among these areas are criminal law, marriage and divorce, contracts, economic and social planning, population control and family planning, trade unions, social security, and education. All residuary issues lie within the exclusive domain of the central government. An exceedingly important power of the central government is that of creating new states, combining states, changing state boundaries, and terminating a state's existence. The central government may also create and dissolve any of the union territories, which have more limited powers than those of the states. Although the states exercise either exclusive or joint control over a substantial range of issues, the Constitution establishes a more dominant role for the union government.

The assignment of tax powers is based on the principle of separation; most broad based taxes are assigned to the centre, whereas in practice the states have a narrower tax base and the consequence is a vertical fiscal imbalance. In 2002-03 the states on average raised about 38 percent of central revenues, but incurred about 58 percent of expenditures. The capacity of the states to finance their current expenditures from their own sources of revenues has declined from 69 percent in 1955-56 to 52 percent in 2002-03. Transfers from the centre made up the balance (Singh 2004, p. 7-8).

The inadequacy of the states to meet expenditures from their own resources is recognized by the Constitution of India at Articles 275 and 282. Grants-in-aid under Article 275 are need-based, on the recommendations of the Finance Commission, while grants under Article 282 are purpose-based, in the sense that the central government has the power to make discretionary grants to the states. The Finance Commission is appointed by the President of India every five years or earlier if needed²⁴ and it is the mechanism provided by the Constitution to regulate the flow of transfers from the central government to the states and their allocation among different states.

Generally, the Finance Commission makes recommendations on the following matters:

a) the distribution between the union and the states of the net proceeds of taxes which are to be divided between them under Chapter I Part XII of the Constitution²⁵ and the allocation among the states of the respective shares of such proceeds²⁶;

b) the principles which should govern the grants-in-aid of the revenues of the states out of the consolidated Fund of India²⁷ and the sums to be paid to the states which are in need of assistance by way of grants-in-aid of their revenues under article 275 of the Constitution²⁸;

c) the measures needed to augment the consolidated Fund of a state to supplement the resources of the panchayats and municipalities in the state on the basis of the recommendations made by the Finance Commission of the state²⁹.

Moreover, the Commission reviews the financial situation of the union and the states and suggests a plan by which the governments, collectively and severally, may bring about a restructuring of the public finances restoring budgetary balance, achieving macro-economic stability and debt reduction along with equitable growth.

Over the last fifty years the Finance Commissions have elaborated a sophisticated methodology to deal with horizontal and vertical fiscal imbalances. To distribute horizontally the two major taxes that are shared between the centre and the states the Finance Commissions

²⁴ The last Finance Commission appointed is the twelfth and its report must cover a period of five years commencing on the 1st April 2005.

²⁵ Before the Eightieth Amendment Act, 2000, the Constitution provided for sharing of two taxes, income tax and union excise duties, with the states. The relevant ratios determining the vertical allocation in tax devolution have remained for many years at 85 percent in the case of income tax and at 45 percent for union excise duties. The Tenth Finance Commission proposed a system of vertical resource sharing in which central taxes are pooled and a proportion of 29 percent of gross proceeds devolved to the states (26 percent to all states and three percent to those where sales tax on sugar, textiles and tobacco was not levied). That recommendation brought forth an amendment to the Constitution (Eightieth Amendment Act 2000). The Eleventh Finance Commission recommended the devolution of 29.5 percent (28 percent to all states and 1.5 percent to those which did not levy sales tax on sugar, textile and tobacco) of net proceeds of all shareable taxes. (Government of India 2000). About 20 per cent of the revenue collected by the union is transferred under tax sharing mechanism (Chaubey 2003).

²⁶ For example, the Eighth and Ninth Commissions determined the respective shares of states in the devolution of income tax and union excise duties on the basis of three allocative criteria: a) population; b) distance (measured by the term $(y_n - y_i)$ where y_n is the highest per capita income among all the states); c) inverse of income.

²⁷ The consolidate Fund of India is a part of the government accounts in which are credited all revenues received by government by way of taxation and other receipts flowing to government in connection with the conduct of government business, like receipts from railways, posts, transport etc. (non-tax revenues). Similarly, all loans raised by government by issue of public notifications, internal and external debt and all moneys received by government in repayment of loans and interest thereon is also credited into this fund. All expenditure incurred by the government for the conduct of its business including repayment of internal and external debt and release of loans to states/union territory governments for various purposes is debited against this fund.

²⁸ For example, the Eleventh Finance Commission suggested giving grants-in-aid to the states equal to the amount of the deficits as estimated for each of the years during 1995-96 to 1999-2000. Under this head only 3-4 percent of the total revenue receipts of the union are transferred (Chaubey 2003).

used a large number of criteria, among which: population, tax effort, collection assessment, income distance, income adjusted total population, indices of social and economic backwardness, territorial area, post-devolution deficits, poverty, revenue equalization, etc. (Singh 2003). The Eleventh Finance Commission set a new benchmark in the centre-state fiscal relations: it reduced weight of population from 20-30 percent in the recent past to 10 percent, maintained weight of income distance criterion at 62.5 percent and chose to allocate 27.5 percent of states' share of pooled proceeds according to area, infrastructure, tax effort and fiscal discipline (Chaubey 2003).

The central government also distributes substantial grants to the states through its development plans as elaborated by the Planning Commission³⁰. While the Finance Commission decides on tax shares and makes grants-in-aid, the Planning Commission makes grants and loans to implement development plans. It is worth to notice the problem of coordination between the two independent commissions that arises. The loan-grant composition of the assistance given to special category states is 10:90 while that to other states is 70:30. Before 1969, plan transfers were project-based; since then, the distribution has been done on the basis of a formula that takes into account population, per capita income, fiscal performance (tax effort, fiscal management, national objectives) and special problems (Singh, 2004). Plan revenue grants make about 7-8 percent of the total revenue receipts of the union (Chaubey 2003).

5. Tax reforms

5.1 A quick glance at macro economic and budget outlook³¹

Over the last two decades the Indian economy made significant improvements at an annual average growth rate rising from 2.9 percent in the 1970s to 5.8 percent in the 1990s. Notwithstanding this improvement, the per capita income remains very low in comparison with other East Asian countries, particularly China, which had the same level of per capita income as In-

²⁹ For a brief description of the main recommendations with respect to local government see, for example, Rao and Sing, 2004.

³⁰ The Planning Commission was not conceived in the Constitution but through a resolution of the cabinet, after 50 days of promulgation of the Constitution.

³¹ The contents of this section are mainly based on Government of India, *Union Budget*, various years. and *Economic Survey*, various years.

dia in the 1970s³². The progress in growth was accompanied by structural changes quite different from those experienced in other developing countries, where a decline in the share of agriculture in GDP was coupled by a remarkable expansion of industry. In India between the 1970s and 2003-04, the share of agriculture and allied sectors in GDP declined from an average of 42.8 percent to 22.1 percent, while that of services rose from an average of 34.5 percent to 51.0 percent. The share of industry showed a little increase from an average of 22.8 percent to 26.9 percent. In 2002-03 the GDP growth decelerated from 5.8 percent of the previous year to 4.0 percent, mainly because of a heavy decline of 5.2 percent in the agriculture and allied sectors, due to a severe drought (the industrial sector growth was 6.4 percent, whereas the services sector growth was 7.1 percent). In 2003-04 real GDP at factor cost has been estimated to have grown by 8.2 percent, sustained by a growth of 9.1 percent in agriculture and allied sectors (aided by an abundant monsoon), 6.7 percent in industry sector and 8.7 percent in the services sector. The growth recovery in 2003-04 was accompanied by a relative stability of prices; inflation, as measured by the wholesale price index (WPI), was 5.5 percent on average, while retail price inflation, as measured by the consumer price index for industrial workers (CPI-IW), declined from 5.1 percent in April 2003 to 2.2 percent in April 2004. Higher growth rates are needed for the rapid elimination of poverty, in spite of the fact that there already was a significant decline in the poverty ratio from 36 percent in 1993-94 to 25 percent in 2001-02. In recent years domestic demand was the main driver of growth; during the period 1998-99 to 2002-03, on average, the contributions of private final consumption expenditure and investment to growth of GDP at current market prices were 64.2 percent and 21.0 percent respectively.

Since 2001-02 the current account of India's balance of payments recorded a surplus, indicating that the rest of the world has contributed to support aggregate demand; moreover, a strong balance of payments position in recent years resulted in a steady accumulation of foreign exchange reserves.

Public finances, which have been under pressure since 1997-98 on account of the pay revision of government employees and the economic slowdown, showed a further deterioration. The fiscal deficit of the central government, in GDP terms, after declining from 6.6 percent in 1990-91 to 4.1 percent in 1996-97, started rising to 5.3 percent in 2002-03. The deterioration in revenue deficit was sharper: in 1990-91 it reached 3.3 percent of GDP, then de-

³² According to the estimates of CIA, *The World Factbook*, in 2003 the GDP per capita in India and in China was

clined to 2.4 percent in 1996-97 and started rising to 4.4 percent in 2002-03. The main factors that have contributed to this deterioration have been rising expenditure on salaries, interest payments (higher fiscal deficits have resulted in higher government borrowings), unfounded pensions, improperly targeted subsidies and stagnation in the tax-GDP ratio that continue to remain at a lower level even as compared with the pre-reform year of 1990-91.

The tax-GDP ratio for the central government declined from 10.1 percent in 1990-91 to 8.8 percent in 2002-03 and the decline was entirely due to the sharp decrease in the ratio of indirect taxes to GDP (7.9 percent in 1990-91; 5.3 percent in 2002-03). That decrease was mainly imputable to the reduction of customs duty provided by the tax reforms to improve both resource allocation and efficiency and to make Indian manufacturing competitive. The total expenditure-GDP ratio of the central government, after declining from 17.3 percent in 1990-91 to 13.9 percent in 1996-97, started rising from 14.2 percent in 1997-98 to 16.2 percent in 2002-03. The fiscal situation improved in 2003-04: in the revised estimate, the fiscal deficit and the revenue deficit came down, respectively, to 4.8 and 3.6 percent of GDP.

The deterioration in the fiscal situation of the states was even sharper. The fiscal deficit increased from 3.3 percent of GDP in 1990-91 to 4.7 percent in the revised estimates for 2002-03. In the same period the revenue deficit deteriorated from 0.9 percent to 2.5 percent of GDP on account of the growing burden of interest payments, pension liabilities and administrative expenditure. Losses of state owned public enterprises, inappropriate user charges and deceleration in central transfers finished the job of deteriorating revenue deficit.

The combined fiscal deficit of the center and the states increased from a level of 9.4 percent of GDP in 1990-91 to a level of 10.1 percent of GDP in the revised estimates for 2002-03, whereas the combined revenue deficit as a proportion of GDP was 4.2 percent and 6.7 percent in the same years.

5.2 Tax reforms of last years, under way and planned

In 1991, in reaction to a severe macroeconomic crisis involving high fiscal deficits, India carried out a series of economic reforms³³, among which a tax reform. Tax reform strategy

\$ 2,900 and \$ 5,000, respectively.

³³ Those reforms included liberalized foreign investment and exchange regimes, significant reductions in tariffs and other trade barriers, reform and modernization of the financial sector, and significant adjustments in government monetary and fiscal policies.

was largely based on the Raja Chelliah Committee Report. The main proposals put forth by the Committee comprised: *a)* the reduction in the rates of the most important taxes - namely individual and corporate income taxes, excises, customs – still maintaining the progressivity of the system but not such as to induce evasion; *b)* the enlargement of the tax base of all taxes by reducing exemptions and concessions; *c)* the transformation of the taxes on domestic production into a value added tax; *d)* the simplification of laws and procedures to make the administration and enforcement of the tax system more effective. Most of the Committee's recommendations have been implemented over the years, at least at the central level.

Relative to personal income tax, to try to decrease tax evasion there have been a strong reduction of tax rates, both in the number (to three) and in the value (10, 20 and 30³⁴ percent), the tax threshold was raised from Rs 40,000 to Rs. 50,000³⁵, and the number of brackets was reduced from seven to three.

Also the rates of corporate income tax were reduced (from 40 to 35 percent for domestic companies and from 50 to 48 percent for foreign companies) but there was not a wide broadening of the corporation tax's base, mainly due to tax holidays and rapid depreciation given to investments in many activities.

Notwithstanding the reduction in the marginal tax rates, the revenues from personal and corporate income taxes increased after the reforms and therefore the share of revenue from direct taxes as a proportion of GDP showed a significant increase (from less than 14 percent in 1990-91 to 24 percent in 1997-98). A not-unimportant share of that increase was due to the voluntary disclosure scheme (VDIS)³⁶ that was introduced in 1997-98 to provide an opportunity for individuals, companies and non-resident Indians to declare their concealed income and assets by paying 30 percent tax.

There also were reductions in the wealth tax rate (only one rate equal to 1 percent of the amount by which net wealth exceeded Rs 1,500,000 = about 30,000 EU€) and in the basic exemption of the gift tax (from Rs 20,000 to Rs 30,000).

³⁴ During the year 1999-2000 a surcharge of 10 percent was levied on income above Rs 60,000 and in 2000-2001 that surcharge was further increased to 15 percent on income above Rs 150,000; consequently the tax rates increased.

³⁵ About 1,000 EU€ or 1,300 US\$.

³⁶ The scheme was very successful and the amount collected (Rs 100,500 million) exceeded the expected one (Rs 70,000 million).

As regards the tariffs, both the average and peak tariff rates were drastically reduced, whereas in terms of rate differentiation the number of tax rates remained high and in more recent years has even increased.

In the case of union excise duties there was an important simplification and rationalization: the number of rates was reduced and, in respect of the majority of commodities, the tax was progressively transformed from a specific into *ad valorem* levy. Exemptions and the lowest rate (8 percent) were removed thus broadening the tax base.

A tax on specific services (telephones, non-life insurance and stock brokerage) was introduced in 1994-95 and successively that tax was extended to a large number of services.

The reforms' effect on revenue was to reduce it: the improvement in direct tax revenue only partly compensated the decline in indirect tax revenue, mainly due to the reduction in import duty rates and in excise duty rates for items of mass consumption.

While the reform of the central government's tax system has been implemented during the 1990's, although not completely, in the case of the states the reforms of their tax systems did not proceed, notwithstanding the recommendations of the study group appointed by the Government of India to rationalize and harmonize the states tax systems themselves.

In September 2002 the Government set up a new Task Force on tax reforms and successively a Task Force on Implementation of Fiscal Responsibility and Budget Act, 2003 (FRBM Act), both headed by Vijay Kelkar³⁷. The Kelkar committees had suggested sweeping reforms including: *a*) raising income tax exemption limit to Rs 100,000 and two-tier rate structure (20 percent for income of Rs 100,001-400,000 and 30 percent for income above Rs 400,000); *b*) cut in corporate tax rate from 35.875 percent to 30 percent for domestic companies - to remove the gap between the peak rate for personal income tax and the corporate tax rate - and cut in depreciation rate for plant and machinery to 15 percent from 25 percent; *c*) three-rate basic customs duty structure (raw materials 5 percent, intermediate goods 8 percent and finished goods 10 percent); *d*) service tax levied in a comprehensive manner³⁸, leaving out only few services (public utilities and social services) to be included in a negative list; *e*) abolition of wealth tax; *f*) merging of tax on expenditure in hotels with service tax; *g*) abolition of the concessional treatment of long-term capital gains through a reduced scheduler tax rate; *h*) re-

³⁷ The Kelkar task force on FRBM has fine-tuned the previous reports of the Kelkar task force on tax reforms, particularly on indirect taxes (see Government of India 2004).

³⁸ Service tax is currently levied on 51 services only.

removal of tax exemptions, rationalization of incentives for savings³⁹ and simplification of procedures; *i*) gradual moving over the destination based, consumption type value added taxes at the state level.

The decision to introduce VAT was discussed first at a conference of state chief ministers and finance ministers in 1999 and the deadline of April 2002 was decided to bring in the tax. However the introduction of VAT was postponed to April 2003 and successively to April 2005, mainly because of the lack of administrative preparation of some states. Moreover, there was not an agreement between the central government and the states on the system of compensating the states that incur revenue loss on account of VAT's implementation. Only on 2 November 2004 that agreement has been reached after all states, except three, declared they were ready with the necessary legislation. Therefore, sales taxes of the states are going to be replaced with a harmonized VAT from April 2005, based on a blueprint finalized by the empowered committee of state finance ministers⁴⁰.

Meanwhile in July 2004 the above quoted Task Force on Implementation of the FRBM Act has come up with a proposal for an integrated VAT on goods and services to be levied by the central government and the states in parallel, removing all cascading taxes, such as, for example, octroi, central sales tax, state level sales taxes etc.. The Task Force proposed a "grand bargain" whereby the states would have the power to tax all services currently with the center⁴¹, and therefore both central and state government would exercise concurrent but independent jurisdiction over common tax bases extending over all goods and services. The new goods and services tax (GST) would have three *ad valorem* rates, in addition to the zero rate. The proposed rate structure considers a floor rate, equal to 6 percent for the centre and 4 percent for the states, a standard rate, equal to 12 percent for the center (to replace the CENVAT

³⁹ The savings incentives should be rationalized into a single "EET" (exempt during collection, exempt during accumulation and tax during withdrawal) system, where savings up to Rs 100,000 a year would be eligible for this deduction.

⁴⁰ On January 17, 2005, a white paper on value-added tax was released by the Empowered Committee of State Finance Ministers. The white paper on VAT, which would replace the sales tax regime in states, was drawn up after all states except Uttar Pradesh were prepared to implement VAT from April 1, 2005. The white paper lays down a roadmap for levy of a uniform state-level tax on over 500 items, exempts 46 local and social items (comprising of natural and unprocessed products in unorganised sector) and gives states an option to exempt food grains for a year. Under the VAT system there will be only two basic VAT rates of 4 per cent and 12.5 per cent, plus a special VAT rate of 1 per cent for gold and silver ornaments (see Ministry of Finance January 17, 2005).

⁴¹ Within the limits of the existing taxation of goods and services the tax base is fragmented between the centre (that levies tax on goods at the manufacturing level and tax on services) and the states (that levy tax on goods at the point of sale).

of 16 percent⁴²) and 8 percent for the states, and a higher rate, equal to 20 percent for the centre and 14 percent for the states. Under this proposal, the total tax burden on most goods and services would work out to 20 percent, comparable with the standard VAT rates in OECD countries. Moreover, the treatment of imports and exports should be fully integrated with the dual-GST system. In particular, for imports a two-part levy should replace the countervailing duty (CVD) proposed with the first part reflecting the central GST and the second reflecting state-level GST. All imports should be charged to the central and state GST at the same rate applicable to domestic goods. According to this proposal, the states would obtain revenues from taxation of services and from access to GST on imports, but, in our opinion, their fiscal autonomy should be undermined owing to the uniform rates across the states.

According to the Task Force, the reforms proposed would have great positive implications for India's outlook and would make the most of tax system, as part of efforts to cancel revenue deficit and lower fiscal deficit to less than 3.0 percent of GDP by 2009. Moreover, the implementation of the proposed fiscal reforms should reduce both tax evasion and costs of compliance, and should eliminate most of the distorted behavior coming from tax avoidance.

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⁴² The reduction would be possible as a consequence of the broadening of the tax base.

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