

Three Decades of Direct Tax Reform in India¹

By

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This presentation is based on the collaborative work-in-progress with my co-author, Shri Sobhan Kar.

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- **Economic situation in early 1970's**
- **Direct tax reform process since mid-1970's**
- **Outcome of the reform process**
- **Lessons from the Indian experience**
- **Agenda for the future**



Economic situation in the early 1970's

Economic situation in the early 1970s

- **Low GDP growth rate**
- **High inflation**
- **Low savings-investment ratio**
- **Small manufacturing and tertiary sector**
- **Low export-import levels**
- **Low levels of foreign exchange reserves**
- **Low tax-GDP ratio**
- **Administratively determined foreign exchange rate**
- **Unsustainable levels of fiscal deficit**

Tax structure in the early 1970s

(In % of GDP)

Financial Year	Centre's gross tax			States own tax revenue	Total
	Direct Taxes	Indirect Taxes	Total		
1969-70	1.93	4.67	6.60	3.22	9.82
1974-75	2.13	6.03	8.16	3.74	11.90

Direct tax structure in the early 1970s

- **Narrow tax base**
- **Extremely high tax rates**
- **Capital transfer tax**
- **Manual processes**
- **Absence of a taxpayer information system**



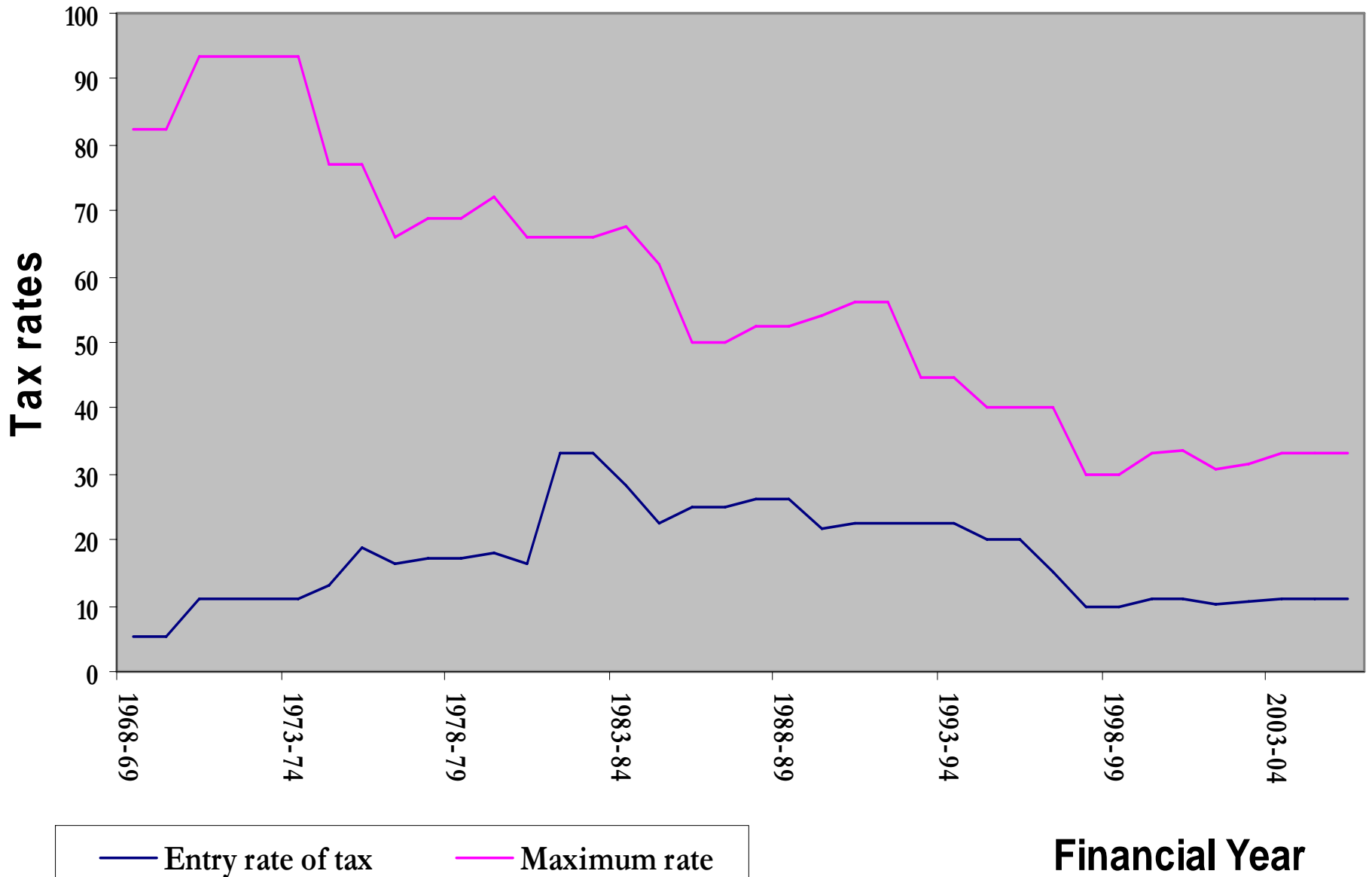
Direct tax reform process since mid-1970's

- **Episodic reduction in tax rates**
- **Flip flop on base expansion**
- **Attempts to rewrite the tax law**
- **Rationalisation of the tax system**
- **Periodic tax amnesties**
- **Anti evasion initiatives**
- **Modernization of tax administration**
 - **Process redesigning**
 - **Induction of technology**

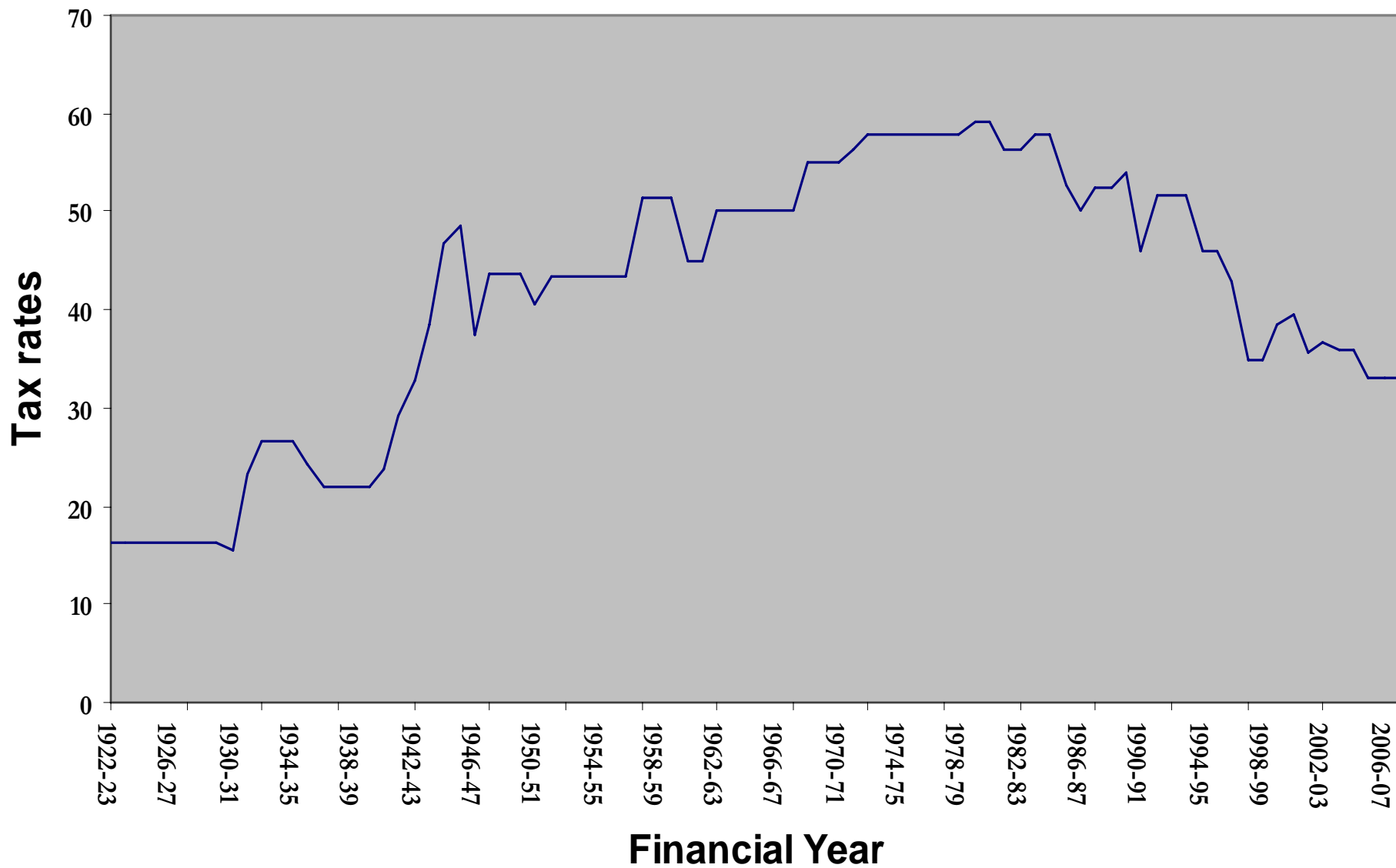


Episodic reduction in tax rates

Personal Income-tax rates



Corporate Tax Rates



Tax rate for foreign companies

Financial Year	Rate of tax (in %)
1984-85	70
1985-94	65
1994-97	55
1997-02	48
2002-07	40



Flip flop on base expansion

- **New incentives for promoting industrialization were introduced**
- **Introduction of development rebate/investment allowance**
- **Following the oil crisis in 1978 and the foreign exchange crisis in 1979-80**
 - **Foreign exchange capital flow related incentives introduced**
 - **Incentives for export of goods and services also introduced**
 - **Introduction of MAT for the first time**

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- **1985: Government announces the Long-term Fiscal Policy**
- **1987: Severe drought, political instability and FE crisis**
- **1988-89: Reversal of trend**
 - Reintroduction of capital allowances
 - Sharp increase in incentive for export earnings
- **1990: Comprehensive reforms undertaken**
 - Cut in corporate tax rates
 - Incentive for industrial undertakings, SSI units and backward area removed
 - Investment allowance withdrawn
 - MAT also withdrawn

Contd.

- **1991-99: Introduction of new incentives an annual feature**

- **2000: Positive initiatives for base expansion**
 - Four year period for phasing out FE related incentives announced
 - Sunset clause for incentive for software export announced
 - MAT was recast

- **2002:**
 - SEZ related incentives introduced
 - Attempt at eliminating/rationalizing PIT related incentives

Contd.

- **2005: Watershed in direct tax reforms**
 - Comprehensive reform undertaken; number of incentives rationalized/ withdrawn
 - Tax reform initiatives whittled down by introduction of comprehensive SEZ related higher incentives

- **2006 and 2007: Period of consolidation**
 - Number of incentives allowed to sunset
 - Scope of MAT expanded
 - Rate of MAT was increased



Rewriting of the tax law

- **Rewriting the tax law necessary to remove ambiguities**
- **First attempt initiated in 1985**
- **Report submitted in 1992 but could not be legislated**
- **Second attempt in 1996-97**
- **Report submitted in 1997 but could not be legislated**



Rationalization of the tax structure

- **Harmonisation of PIT and CT**
- **Reform of the capital gains tax**
- **Tax neutrality for business reorganization**

Harmonization of PIT and CT

- **Classical method of taxation till 1997**
- **Inter-corporate dividend exempt**
- **Dividend distribution tax introduced in 1997**
- **Dividend distributed by equity-oriented funds exempt**

Reform of the capital gains tax

- Re-designing the capital gains tax in 1992
- Inflation indexing introduced
- Scheduler rate of tax for capital gains tax
- Securities transaction tax introduced as a proxy for capital gains tax on securities

Tax amnesties

- Three amnesties before 1970
- In 1971, the Direct Taxes Enquiry Committee cautioned the Government that any more schemes will have deleterious effect on the level of compliance and on the morale of the administration.
- Frequent tax amnesties thereafter (almost every 5 years)
- Last amnesty in 1997

Anti-evasion initiatives

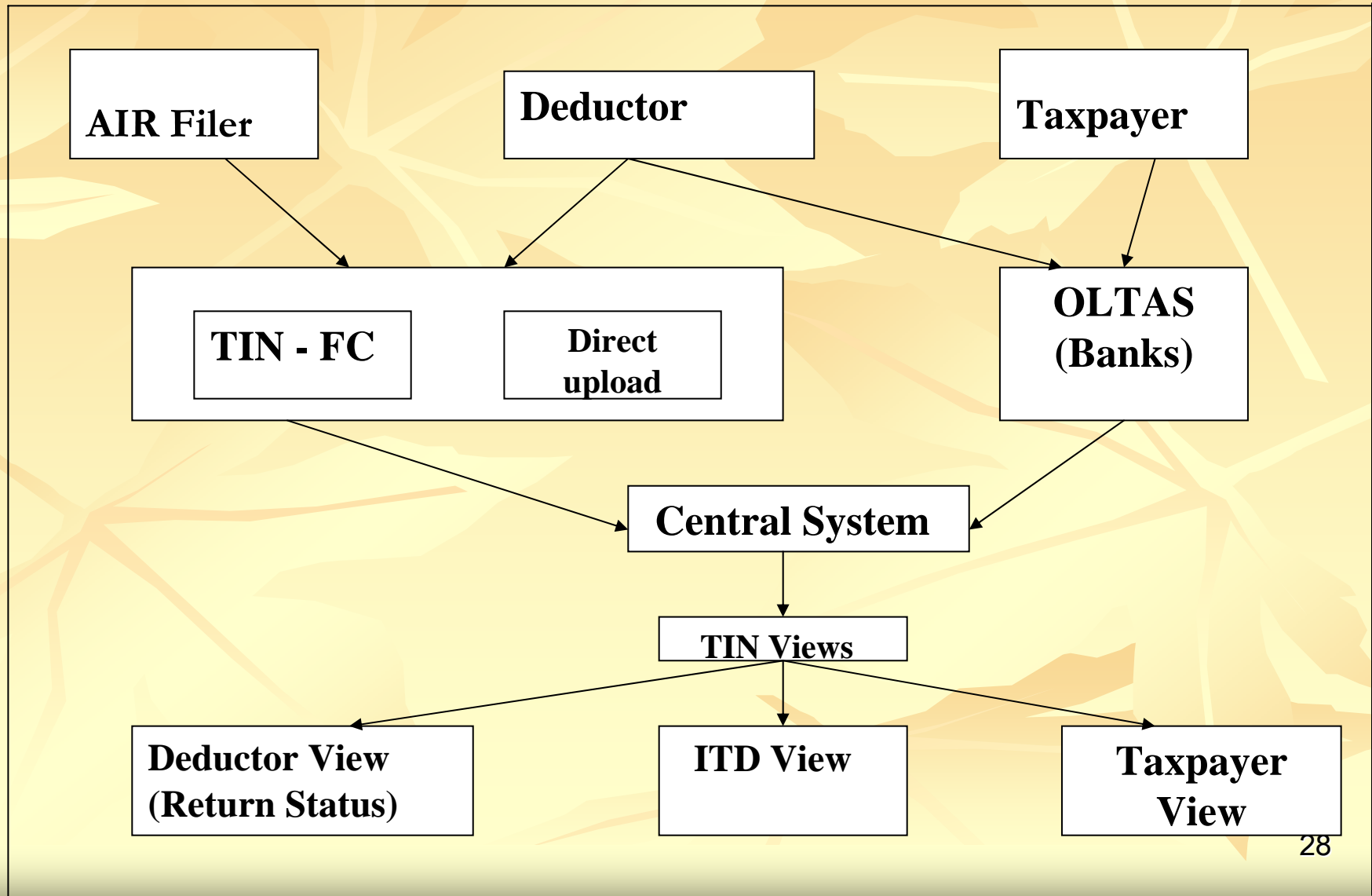
- Preemptive purchase of immovable property
- Introduction of
 - Fringe Benefit Tax
 - Banking Cash Transaction Tax
 - Presumptive taxation
 - Securities Transaction Tax
 - Transfer pricing provisions based on internationally accepted arms length prices
- Neutralization of dividend stripping benefits
- Reintroduction of Gift Tax



Modernization of tax administration

- **Payment system**
- **Reporting system**
- **Form designing**
- **Filing process**
- **Processing of returns**
- **Audit selection**
- **Refund system**
- **Taxpayers' Information Network (TIN)**
- **Administrative penalties**
- **Appeal mechanism**
- **Advance ruling**
- **Organizational restructuring**

Taxpayers' Information Network (TIN)





Outcome of the reform process

India : Tax collection trend

As percentage of GDP

Year	Centre	State	Total
1987-88	10.63	5.45	16.08
2005-06	10.37	6.10	16.47
2006-07	11.45	6.40	17.85

Changing tax composition

As percentage of GDP

Year	Direct	Indirect	Total	Share of direct taxes
1987-88	1.91	14.17	16.08	11.88
2005-06	4.68	11.79	16.47	28.42
2006-07	5.60	12.25	17.85	31.37

Outcome of the reform process

- **Structural change in tax composition**
- **Improved equity of the tax system**
- **Increase in economic efficiency**
- **Reduction in compliance gap**
- **Improved effectiveness**



Lessons from the Indian experience

- **Reduce tax rates.**
- **Expand the tax base.**
- **Initiate measures to modernize tax administration.**
- **Reform process should be participatory.**
- **Introduce transparency in governance.**
- **Minimise shock effect**
- **Timing should be politically correct**
- **Tax system no substitute for fundamental reforms**

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- **Create champions both within and outside the Government.**
- **Synchronize direct tax reform with other policy reforms.**
- **Tax reform is a process and not an event.**
- **Reforms initiatives should be simultaneous and not sequenced.**
- **Create winners and losers.**
- **Lag effect.**

The background of the slide is a warm, golden-yellow color with a subtle, repeating pattern of stylized, overlapping leaves. The leaves are rendered in a light, almost white color, creating a delicate, textured effect. The overall aesthetic is clean and modern, with a focus on natural motifs.

Agenda for the future

Tax composition: OECD countries

Percentage of GDP

Year	Direct	Indirect	Total	Share of direct taxes
2004	12.80	13.70	26.50	48.30

Structural change in tax composition

- Eleventh Plan sets a target of 20 per cent tax-GDP ratio by 2011-12
- Direct taxes-GDP ratio must reach **10 per cent.**
- Direct tax-GDP ratio expected to be 8.4 per cent.
- Indirect tax-GDP ratio expected to be 11.60 per cent.
- Introduction of GST may lead to initial losses (1.5% to 2%)
- Direct tax would be required to fill in the gap by about another 1.5% to 2% meet international standards.
- **Growth rate of direct taxes must double.**

- **Consolidating on past achievements by**
 - **Eliminating all exemptions and deductions.**
 - **Improving the equity of the direct tax structure.**
 - **Improving the effectiveness of the information system.**
 - **Facilitating tax payer compliance by reducing compliance cost.**



Thank you