

### REACTIONS TO THE CONSULTATION PAPER: RESPONSE OF THE TASK FORCE

1.1 The Consultation Paper of the Task Force on Direct Taxes was made available on the web site of the Ministry of Finance & Company Affairs (<http://finmin.nic.in>) on 2nd November 2002, inviting comments and suggestions of all concerned. The Task Force was overwhelmed by the response.

1.2 We received 1500 emails. There were more than 200 op-ed and other articles in English newspapers, and even more in regional newspapers. Almost 100 memoranda were received from various organisations. The Task Force visited major centres of trade and industry – Pune, Ludhiana, Ahmedabad, Chennai, Bangalore, New Delhi and Mumbai, thus supplementing the discussions in Mumbai, New Delhi and Kolkata which had taken place earlier.

1.3 There has been universal appreciation of the initiative by the Union Minister of Finance & Company Affairs for bringing transparency in the formulation of tax policy. The breadth and intensity of the responses clearly brought out the all-round desire to contribute to the country's Fiscal Policies.

1.4 Each one of the responses was constructive. Our discussions with trade and industry, tax professionals, income tax officials and scholars indicated considerable support to our basic proposals leading to simplification, reduction in tax burden of the salaried and non-salaried tax payers as well as of equity (risk) capital, greater usage of information technology in tax administration, outsourcing of non-core functions of the tax administration, improving services to tax payers and fundamental change in incentives and disincentives for tax compliance and against tax evasion. For instance, in a Web poll conducted by *India Today*, a majority of those who polled supported the implementation of our proposals. The support for establishing the Tax Information Network (TIN) – which will facilitate secure and seamless logistics of tax collection – was particularly enthusiastic. We also observed an interesting correlation: younger taxpayers were more likely to support our

proposals. Of course, there have been critical comments as well. Many of the reactions received contradicted each other since they offered conflicting suggestions, particularly regarding tax rates and tax exemptions. In this Chapter, we have attempted to distill the major themes that emerged from the reactions to the Consultation Paper. In addition, there are a number of individual proposals that have been addressed in the respective chapters. The Task Force wishes to express its appreciation to everyone who took time to prepare and send her or his responses and documents. We thank them all.

## Approach for reformulation

1.5 One of the most perceptive reactions received by the Task Force is that while appreciating the thrust of our tax reforms proposals, the advice is that it must have a “human face”. In other words, it must especially address the concerns of the vulnerable sections such as senior citizens. It was felt that the Consultation Paper was not sufficiently sensitive to the problems and requirements (such as housing and old age income security) of senior citizens and low-income groups. The Task Force accepts this thoughtful advice<sup>1</sup>.

1.6 Hence, in reformulating our proposals, while maintaining their essential thrust and approach, we have accepted the principle that no vulnerable class of taxpayer shall be worse off because of our proposals. Keeping this principle in view, the Task Force has modified its Consultation Paper proposals so as to, *inter alia*, (i) provide additional tax reliefs to senior citizens, (ii) maintain fiscal support to the housing needs of low income groups, and (iii) strengthen old age income security by encouraging long term savings. We would however also like to add that, in addition to the proposed tax measures, the Government will need to formulate sooner rather than later a well functioning pension system based on contributions by individuals into personal pension accounts.

## Benefits for salaried and non-salaried tax payers

1.7 A major underlying theme in the comments received was that the Task Force proposals are pro-corporate sector rather than pro-individual taxpayers. Fortunately, this perception is easy to rebut since it couldn't be further from the truth.

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<sup>1</sup> On a personal note, this was also the unanimous advice of the spouses of the Task Force members.

1.8 With the proposed personal tax rates, disposable income will be higher for every class of taxpayer, that is, the tax burden is lower for each income group as well as for senior citizens (Table-1.1). This table is based on the actual taxpayer profile, computed on the basis of average for each income group using CBDT database of 9.25 lakh taxpayers spread over assessment years 1998-99 to 2001-02. This also means that the entire “middle class” will benefit from our proposals. It is estimated that the personal tax burden for the existing taxpayers will be reduced by as much as Rs.7,900 crores per annum.

1.9 Our proposals achieve overall revenue neutrality, and enhance buoyancy by widening the personal and corporate income tax bases. This is sought to be done by reducing tax rates, pruning tax exemptions, aligning taxable profits with book profits and improving compliance. Our proposals completely eliminate the dividend tax, and long term capital gains tax on listed equities in the hands of the investors. These have been recommended with the express purpose of reducing the exorbitant cost of equity capital in our country. These gains or benefits accrue entirely to individual shareholders.

1.10 Further, we have recommended that all individuals with an annual income below Rs.1 lakh will be fully exempted from income tax. This also helps reduce the tax burden on individuals, and particularly low-income groups. Currently, with per capita income in the country at about Rs.25,000 per year, our proposal implies that an “average” family of four would not pay any income tax and thus meet their needs better.

1.11 The proposed tax reforms leave the choice of deploying a taxpayer’s income to the individual. In other words, choice regarding how much to save and in which asset is left to the individual rather than being “directed” by the tax code. Effectively, by moving away from a paternalistic tax system, the Task Force has sought to empower the individual taxpayer.

1.12 Our analysis of the existing tax framework shows that thanks to myriad, often contradictory tax exemptions, the system has become increasingly complex. In tax policy and tax administration, such complexity is inherently regressive and therefore favours the

**Table – 1.1**  
**IMPACT ON TAX INCIDENCE ACROSS INCOME GROUPS**

Income Range (in Rs)	Salaried Taxpayers			Non-Salaried Taxpayers			Senior Citizens		
	Existing Tax Liability	Proposed Tax Liability	Tax Relief (in Rs)	Existing Tax Liability	Proposed Tax Liability	Tax Relief (in Rs)	Existing Tax Liability	Proposed Tax Liability	Tax Relief (in Rs)
<b>0-40,000</b>	0	0	0	0	0	0	0	0	0
<b>40,000-50,000</b>	0	0	0	0	0	0	0	0	0
<b>50,000-60,000</b>	0	0	0	382	0	382	0	0	0
<b>60,000-80,000</b>	0	0	0	2196	0	2196	0	0	0
<b>80,000-1,00,000</b>	1587	363	1224	5452	0	5452	0	0	0
<b>1,00,000-1,50,000</b>	8901	6334	2567	10697	4057	6640	0	0	0
<b>1,50,000-2,00,000</b>	22897	15746	7151	23522	14369	9152	7772	4369	3402
<b>2,00,000-3,00,000</b>	43353	29058	14295	44830	30872	13959	29080	20872	8209
<b>3,00,000-4,00,000</b>	75600	49335	26265	76855	52576	24279	61105	42576	18529
<b>4,00,000-5,00,000</b>	106643	76662	29980	108923	82590	26334	93173	72590	20584
<b>5,00,000-10,00,000</b>	185415	140886	44528	188671	154168	34503	172921	144168	28753
<b>Above 10,00,000</b>	733666	664070	69597	1177511	1094566	82946	1161761	1084566	77196

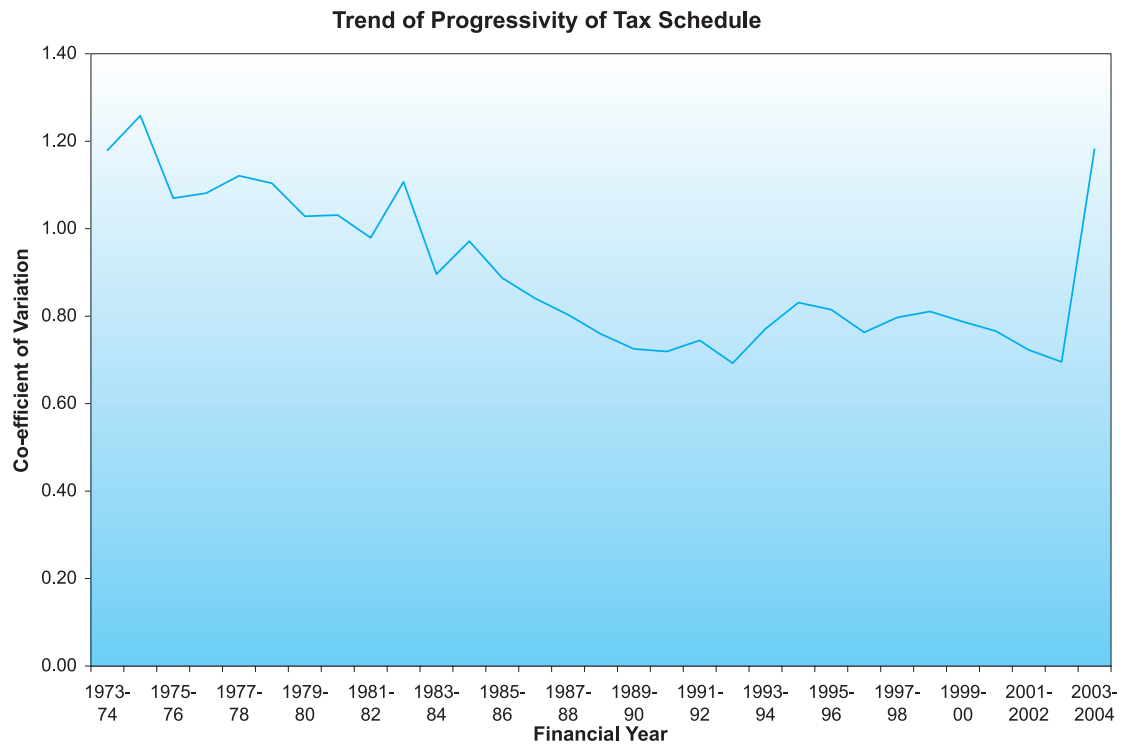
Note: This table is based on the actual taxpayer profile, computed on the basis of average for each income group using CBDT database of 9.25 lakh taxpayers spread over assessment years 1998-99 to 2001-02.

rich and the powerful<sup>2</sup>. Our proposals to simplify and enhance transparency of the tax system would thus in fact help individual taxpayers, by reducing their compliance costs, which have been estimated to be as high as **48 per cent** of taxes paid<sup>3</sup>.

1.13 Thus, our tax proposals aimed at reducing the tax burden, lowering transaction costs and promoting transparency, are individual taxpayer-friendly proposals. With the consequent downward reduction in the compliance costs by even 10 percent, individual taxpayers will have further gains of Rs.4,000 crores per annum.

1.14 In addition, we would like to emphasise that our tax proposals will make the tax system the most equitable in the last two decades as is seen in the graph below.

1.15 This feature of enhanced equity or progressivity of our proposals is important to be recognised as some analysts have mentioned that our proposals are pro-rich because we have proposed removal of dividend and long-term capital gains tax. As we have argued, with the withdrawal of exemption and alignment of taxable profits with the book profits,



<sup>2</sup> This is due to the presence of information asymmetries, and the fixed costs of reorganising economic activities in a way that avoids taxes.

<sup>3</sup>These estimates are from a NIPFP Study (2002) prepared for the Planning Commission

the corporations will bear the full burden of the corporate taxation. Richer individuals generally own corporations and therefore our proposals will effectively increase the burden of such individuals. This means that our proposals are even more progressive than what is suggested in the graph since it does not “factor in” the incidence of the corporate tax liability. We may note that we have also recognised the need to maintain the dividend tax in Option – II where the elimination of tax exemptions is spread over a three-year period.

## Treatment of housing

1.16 The Task Force received a very large number of comments with regard to our proposal for withdrawal of tax exemptions on interest payment on loans for self-occupied houses. The Task Force accepts the view that the housing sector is one of the key sectors of the Indian economy in terms of providing growth and employment and it is indeed a leading sector. However, our proposal was based essentially on the consideration of horizontal equity (equity between sectors) and vertical equity (equity amongst various income groups)<sup>4</sup>.

1.17 The extant treatment also generates a tax distortion in the investments of a household among different classes of assets. For instance, a family that invests in the professional education of its children is putting resources into building human capital which can cost as much as many a small dwelling. This investment in human capital does not get tax benefits, while buying a house and living in it does. In other words, if a family wants to send a daughter/son to a medical, engineering or other professional college which can be an investment of around Rs.5 lakhs-Rs.6 lakhs, this investment gets no tax benefit, unlike the tax benefit given for owner occupied houses. This violates horizontal equity.

1.18 Currently, up to Rs.1,50,000 of interest payments are allowed as deductibles in taxable income, which implies a subsidy of Rs.45,000 per year for individuals who are living in their own house costing Rs.20 lakhs or more. This violates vertical equity. The

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<sup>4</sup>There is a basic inconsistency in the traditional tax treatment of housing, which recognises rental income as taxable income in the hands of a homeowner who does not live in a house, while ignoring the notional rental income in the hands of a homeowner who lives in his house.

richer sections of society are being “subsidised” to purchase their own dwellings, which can hardly be justified by a fiscally constrained economy, which is aiming to reduce subsidies on food and fuel. If a housing subsidy ought to be given, then it should be directed only to low-income households. Presently, a power loom worker whose taxable income is less than Rs.80,000 receives no tax subsidy for loan repayment for his own dwelling for the simple reason that he is not a tax payer.

1.19 It is for these reasons that the Task Force had initially recommended the elimination of this tax benefit. However, we have received almost universal reaction that this facility should not be eliminated for a number of reasons. In order to protect low-income groups, we suggest an interest subsidy of 2% for housing loans up to Rs.5,00,000 to all borrowers. This will help prospective homebuilders whose income is less than Rs.1 lakh. Until such time this proposal is adopted, we also recommend the continuation of interest deduction of up to Rs.50,000. According to the data provided by the National Housing Bank this would cover about 85 percent of total borrowers and all borrowers from low income groups (Table – 1.2).

**Table 1.2: Number of Loanees and Amount Dispersed by Housing Finance Companies during 2001-02.**

Size of the Housing Loan (in Rs.)	No. of Loanees	Amount Disbursed (Rs. in crores)	Percentage		Average size of the loan (in Rs.)
			Loanees	Amount	
Up-to Rs. 5 lakh	376556	8761	85%	59%	232661
Rs. 5 lakhs to Rs. 10 lakh	48145	3442	11%	23%	714923
Above Rs. 10 lakh	16442	2608	4%	18%	1586182
<b>Total</b>	<b>441143</b>	<b>14811</b>	<b>100%</b>	<b>100%</b>	<b>335741</b>

Source : National Housing Bank.

1.20 As far as support to savings is concerned, the view of the Task Force is that the implicit costs of the present structure of tax incentives outweighs the benefits.

1.21 Firstly, the incentives are for gross savings, which has led to “round-tripping” of savings and, as pointed out by the Y.V. Reddy Committee, leads to very high implicit cost of borrowing for the exchequer. This has also been an important factor in reducing public savings. Consequently, the tax incentives for savings while changing the composition of household savings have perhaps led to a decline in total savings of the national economy.

1.22 A recent paper published in *Economic & Political Weekly* has shown how tax incentives for small savings increases the overall interest rate structure, including medium and long term rates<sup>5</sup>. In our view, this has been one of the factors that has led to a reduction in the investment, employment and growth momentum, thereby hurting the economy in the macro economic sense. In other words, showing that what may be “micro rational” for individuals has become “macro irrational” for the economy.

1.23 Our proposals will lead to lower tax outgo for all assesseees and consequently set off any perceived increase in tax liability arising from the elimination of “directed” savings in specific instruments. It is noteworthy that there is no unambiguous international evidence that the overall savings rate of an economy is influenced by tax breaks on specific savings instruments.<sup>6</sup>

1.24 Furthermore, savings incentives are available to only certain savings instruments. This implies that presently the choice to taxpayers to deploy their savings is perforce circumscribed, e.g., there is an implicit disincentive for deploying savings into the equity market. It is for this reason that the Task Force has recommended removal of exemptions. However, the (social) objective of promoting genuine long-term savings for increasing old age economic security is undoubtedly important. To promote this, in Chapter 4 we have

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<sup>5</sup> Lal, Deepak, S. Bhide and D. Vasudevan, (2001), Financial Exuberance: Savings Deposits, Fiscal Deficits and Interest Rates in India, *Economic and Political Weekly*, Vol. XXXVI, No. 44, pp. 4196-4203, November 3, 2001

<sup>6</sup> See Report of the Expert Group to Review Existing Fiscal Incentives for Savings (Chairman: P. Shome) for a review of evidence in this regard.



proposed doubling of the ceiling on contributions to the pension plan under section 80CCC to Rs. 20,000/- that will be eligible for tax relief. These pension plan schemes are presently operated by Life Insurance Corporation of India and other insurance companies.

### Enlarging the tax base

1.25 A concern has also been voiced in the comments on the Consultation Paper that by increasing the limit to Rs.1 lakh, a large number of taxpayers will escape from the tax net. These apprehensions are misplaced. For the wider goal of increasing the tax revenue-to-GDP ratio, the key question should be the total income that is being brought into the tax net, and not the number of taxpayers. Surely, a simple toll tax would bring more tax payers, but that would not give buoyancy to the tax-GDP ratio. Also, most taxpayers with incomes of up to Rs.1 lakh will continue to file returns on account of the one-by-six scheme and therefore the concern that they “drop out” of the tax net is misplaced.

1.26 Now we move to the implications of our proposals. First, by removal of the various exemptions, we are in fact enhancing transparency as well as increasing the quantum of income – corporate and personal – that will attract taxes, albeit at lower rates. Second, by reversing the trend over the last two decades of an increasing burden upon the income group between Rs.2 lakhs to Rs.5 lakhs, we would be bringing more income into the tax net due to improved compliance.

1.27 A recent study by Surjit Bhalla has shown how over time, due to increased tax rates, the tax compliance by tax payers with an income between Rs.2 lakhs-Rs.5 lakhs has steadily declined and is currently the lowest among all income groups<sup>7</sup> (in fact, the estimated compliance rate (in percentage terms) is in the single digit for this particular class) as shown in **Table-1.3** below. His study also shows that, congruent with international experience, tax compliance in India is tax rate responsive. Hence our proposals, by reducing the tax burden will capture this “missing middle” into the tax net due to greater compliance, which enlarges the tax base.

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<sup>7</sup> Surjit Bhalla, *Tax Compliance in India*, January 2002 (*mimeo*).

**Table -1.3 : Compliance Ratios**

Year	Range of Returned Income (in '000s of Rupees)							
	0-50	50-100	100-200	200-300	300-400	400-500	500-1000	above 1000
<b>1988</b>	1.2	13.2	11.1	21.6	112.6	10.2	24.1	42.9
<b>1989</b>	1.3	11.1	8.3	21.7	32.5	110.2	5.9	15.5
<b>1990</b>	1.1	17.9	4.8	10.0	39.4	136.5	5.0	22.6
<b>1991</b>	1.2	16.5	3.5	8.9	19.2	36.9	5.2	22.4
<b>1992</b>	1.3	13.1	4.8	9.2	26.9	55.5	9.2	28.4
<b>1993</b>	1.7	16.4	10.3	4.4	10.7	28.6	12.9	44.6
<b>1994</b>	1.7	12.9	9.0	3.8	7.9	20.7	26.9	17.7
<b>1995</b>	1.9	13.1	7.3	3.5	5.5	7.8	19.7	18.0
<b>1996</b>	1.7	17.2	12.0	4.5	7.0	10.2	27.2	33.4
<b>1997</b>	2.1	21.6	12.3	3.8	7.6	8.9	41.8	42.7
<b>1998</b>	2.9	28.0	14.6	4.2	5.5	8.4	32.9	35.7
<b>1999</b>	3.3	40.3	15.1	4.0	4.7	8.3	27.3	41.4
<b>2000</b>	4.4	41.4	23.2	3.7	6.7	9.0	23.7	33.6
<b>2001</b>	4.7	42.9	23.1	3.4	5.4	7.6	21.1	32.9

Source: Surjit Bhalla, *Tax Compliance in India*, January 2002 (*mimeo*).

1.28 Since the continuation of the one-by-six scheme is recommended, there would be a steady accretion to the number of tax returns filed, and with an improved tax information system, the tax base would be further enlarged.

1.29 We should also note that international comparisons regarding the minimum level of taxable income, against our proposed Rs.1 lakh, are not fair. This is because unlike other countries, Indian families with less than Rs.1 lakh in annual income pay much higher quantum of indirect taxes on the goods and services that they consume. In other words, the comparison of total tax burdens should incorporate direct *and* indirect taxes.

1.30 Regarding our proposals to tax agricultural income, there was considerable support as it promotes horizontal equity and captures agricultural income of non-agriculturists. However, a number of observers have made a point that it could result in considerable administrative difficulties and increase transaction costs for agriculturists. Given the proposed exemption level of Rs.1 lakh and other systemic reforms that have been recommended, the Task Force believes that administrative problems may not be insurmountable. However, it is entirely for State governments to consider our proposals in this area given the Constitutional provisions.

### Tax as a tool of developmental policy

1.31 One of the important points made by some commentators is that our proposals imply a reduction in the developmental role of the State. According to them, tax exemptions are aimed to meet certain development objectives, and a policy of abstaining from tax exemption is synonymous with vitiating these objectives.

1.32 Our proposals in no way dilute the role of the State. The approach of the Task Force regarding the removal of tax incentives is no different from that proposed in the Tenth Five Year Plan – which embodies the development aspirations of the State – that was recently approved by the National Development Council<sup>8</sup>. Our approach seeks to improve the role of the State by making it more efficient, transparent, better targeted and more accountable.

1.33 Tax exemptions are opaque since their incidence as well as implicit cost is non-transparent. Further, the present “exemptions raj” promotes rent-seeking behaviour, and contributes to the complexity in tax laws. In terms of administration, exemptions more often than not lead to tax leakage and tax abuse thus increasingly making the system counter productive and dysfunctional. Consequently, it has increased tax rates for tax complying sectors, thereby leading to an all-round increase in the *ex-ante* costs of “risk” (equity) capital in the economy. This adversely affects investment, growth dynamics and employment generation. Today, full tax paying corporations, including small and medium enterprises pay almost 50 per cent tax *ex ante* on risk (equity) capital since they can avail

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<sup>8</sup> Planning Commission : Tenth Five Year Plan 2002-2007, December 2002, see Box 3.1

of only few, if any, tax exemptions; on the other hand, certain classes of corporations that are privileged to “access” these exemptions pay much lower taxes. Clearly, there is cross-subsidisation. Moreover, such exemptions mean greater complexity, which burdens the tax authorities further and leads to an increasingly antagonistic relationship between the Revenue official and the taxpayer. This complexity is one of the major reasons for tax leakage and tax abuse.

1.34 Hence, the Task Force is of the view that this is not an efficient way of achieving the developmental objectives and that there are better and more efficient alternatives to achieve these goals. For instance, if we want to promote investment in economically backward regions, the government should give an up-front capital subsidy to a project in place of tax exemptions. Such an expenditure-based instrument will make the policy transparent and directly accountable – through the CAG audit – to Parliamentary oversight. More examples can be given. If the State wishes to encourage use of renewable energy, it can pay a direct subsidy of, say, 25% of the purchase price of a windmill instead of tax incentives.

1.35 One of the important objectives of our proposals is to increase the tax revenue-to-GDP ratio through better compliance, and a larger tax base. As a consequence, additional resources will become available to the State, which can be used to increase expenditures for producing public goods, particularly in the areas of health, education and other social infrastructure.

### Going back on promises?

1.36 Yet another important set of comments received, particularly from the corporate sector, related to the need to observe the doctrine of *promissory estoppel*. According to this doctrine, a Government should maintain the promises that it has given even if these are not contractual. This doctrine was particularly referred to in the context of tax exemptions relating to 80IA & 80IB and 10A & 10B. We would like to make several observations in this regard:

1. It is important to recognise that it is individuals or citizens who pay taxes, and not “corporate buildings or plant & equipment”. Promises can only be made to

individuals and our proposals do not lead to any diminution of the promises made to individual shareholders who own corporations.

In fact, our proposals improve the lot of the shareholders as for them we are eliminating not only dividend tax, but also capital gains tax. Consider what is being proposed: Currently, there are firms which pay no tax on profit, while their shareholders pay dividend tax at 30 percent and capital gains tax at 10 per cent, which are (indirectly) taxes on profits. Our proposal is to charge 30 percent tax on all corporations, and remove the dividend tax and capital gains tax (on listed equity). After all, corporations are only “vehicles” or instruments that are owned by shareholders. Therefore, there is no reduction in benefits enjoyed by shareholders if our proposals are implemented, and consequently all promises are being observed.

2. In important infrastructure sectors such as power generation and distribution, basic telephoning, major ports, toll roads etc the rate of return is regulated. This means that the tax incidence is effectively a pass through. Further, in our proposals, we have made provisions regarding the indefinite carry over of losses. This removes the financial constraints faced by the infrastructure sector, and obviates the need for complex rules relating to various sections in Chapter VIA.
3. There is also a legal perspective. A number of judgements of the Supreme Court have upheld that in the realm of tax policy, the principle of *promissory estoppel* does not hold and the State can change tax policies in the public interest.
4. An argument has been made that although our proposals imply equivalence for their shareholders, profit making firms may have transitional cash flow concerns regarding financing their investments. There are three comments in this regard: Firstly, such profit making firms will have little difficulty in financing investment as currently banks and financial institutions are looking for such opportunities. Secondly, there is adequate liquidity available to finance profit making firms and that too at declining interest rates. Hence, there shall be little transitional problems for profit making firms. Thirdly, reducing the cash flow problems of firms may aggravate the cash flow problems of shareholders as they currently have to pay dividend tax, i.e., what is really involved is the “shifting” of cash flow problems.

1.37 Regarding tax benefits available to computer software exports under section 10A, domestic as well as foreign firms with investments in India in this sector had made a detailed presentation pointing out the peculiar taxation problems faced by Indian firms on their on-site revenues and how section 10A is helpful. In light of the complexity of tax treatment for software exports, the Task Force would like to briefly flag some issues pertinent to compensating Indian software companies that provide services on-site in foreign countries (often involving the stationing of Indian employees abroad).

1.38 Exemption under sections 10A and 10B for software off-site exports (services provided from India to clients abroad) has implications for allocative efficiency and equity. From the point of view of the sector itself, the exemption is a “tax cross-subsidy” between on-site and off-site exports (the foreign tax burden on the former being mitigated by exempting from corporate-tax profits from the latter). Therefore, the exemption results in a distortion in the “relative value” signals of different activities. Equity is impacted on two grounds. First, it differentiates *between* service providers *within* the software sector: those that cater for the domestic segment and those that export. Secondly, inasmuch as the sector is treated differentially from other productive sectors of the Indian economy (including, but not limited to, exporters of both goods and non-software services). Exempting incomes of companies providing on-site software services from tax on considerations of avoiding double incidence is analogous to correcting the (price) disadvantage faced by exporters of goods arising from the imposition of customs duties by the importing country’s government. Furthermore, the need for continuing monitoring of exemptions has adverse consequences for the effectiveness of the tax administration as well. Finally, the Indian treasury loses revenue to the foreign exchequer – a case of “transfer of resources” from a developing country to a developed country.

1.39 Since the Task Force could not reach unanimity regarding the treatment of profits of computer software exports, even after discussing these issues in depth, it has suggested two possible alternatives to mitigate the tax problems faced by the software sector. The first is the elimination of exemptions under sections 10A & 10B together with retention of an amended Section 91 (to partially offset the burden). The second is retention of these

exemptions until a totalisation agreement is ratified with trading partners, simultaneously with taxes being levied on dividend distribution and long-term capital gains.

## **Towards strengthening the financial system**

1.40 There is one relatively unnoticed but important positive aspect of our proposals and this relates to the strengthening of India's financial system.

1.41 Our proposals on corporate taxes are based on real income<sup>9</sup>. This implies that with our proposals, banks that meet RBI prudential standards for NPA provisioning will get full tax credit for the same. This would encourage banks to clean their Balance Sheets, achieve improved capital adequacy ratio, and help us move towards a sound and robust banking system. Since Banks do not avail of any capital allowances the benefit from lower tax rates will increase retained profits of the financial sector, which will facilitate an increased supply of commercial credit.

1.42 There is another more profound relationship between the proposed tax rationalisation and modernisation of the financial sector, and this is from improved allocative efficiency. The decision to incur capital expenditure will now depend on return considerations rather than tax considerations. The recommendations of the report are aimed at greatly simplifying and rationalising the tax system. This will better focus investment decisions of households upon an evaluation of the underlying risk and return of alternative investment avenues, without distortions induced by tax considerations. It will hence help us obtain a system of financial market prices that reflect risk and return, as should prevail in a dynamic market economy.

## **Implementation options for corporate tax reforms**

1.43 In the Consultation Paper, we proposed two options regarding changes in Corporate Income Tax. Option I is to implement the proposals at "one go". Option II suggests a

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<sup>9</sup> Real Income here refers to commercial profit.

phased implementation. Some commentators have argued that the second option of staggered implementation appears to be superior.

1.44 Our preference is clearly for Option I. It was unanimously agreed that it is rather difficult for any government to give a credible *ex-ante* time commitment. Such commitments are rarely sustainable. Past experience shows while tax rates were reduced, successive governments failed to implement measures for strengthening the tax base eg. phased withdrawal of incentives. As a result, we have reached a point where the corporate tax rates are close to their resting points and yet the statute continues to be riddled with exemptions and deductions. Any attempt to sequence the reduction in the corporate taxes and the withdrawal of exemptions and deductions could lead to disastrous impact on revenue flows, particularly taking into account the proposed reduction in the personal income tax rates. The two must necessarily be implemented simultaneously. Phasing also gives rise to uncertainty and “hope” that reforms could be reversed. There is an additional factor in favour of Option I. Given the present weak state of the international economy, the proposed package has the potential to impart a strong counter-cyclical boost to the Indian economy by promoting domestic demand – both consumer demand as well as investment demand. A number of influential economic analysts in India have argued that our industrial economy is facing a cyclical slow down and our package would meet this challenge. In other words, the timing for the immediate launching of the proposed fiscal reforms is most opportune.

### Charitable organisations

1.45 There were also concerns expressed by a number of NGOs and charitable organisations. The concerns were regarding our proposal for the use of rating agencies. While NGOs accept the principle, they suggested that the details should be fully worked out before implementing it. We have modified our proposals in this regard, giving more time to all concerned to adapt to the new procedures.

1.46 Also, a number of organisations have argued in favour of setting up a National Charities Commission along the lines of the National Charities Commission, U.K., a body which both regulates and also helps in developing the sector. A number of States in India have the office of Charities Commissioner which regulates charity



organizations. Hence, it may be more appropriate to have, at the national level, a National Charities Board which will be an advisory and promotional organization. The Task Force recommends that the Ministry of Finance & Company Affairs may explore this in consultation with the Ministries concerned.

1.47 The Task Force fully recognises the important role played by charitable organisations and NGOs in our country in strengthening civil society. Our proposals are in fact aimed at strengthening these institutions through the provision of more efficient services by the tax authorities.

### **Taxpayer services and tax administration**

1.48 On the subject of tax administration, the Report has sought to encourage rapid improvements in both administration and accountability, in the firm belief that tax policy is only as good as its administration. The responses the Task Force received during consultations has only served to validate these concerns. The four main areas of complaints consistently perceived by taxpayers regarding tax administration related to delays in refunds, high-pitched assessments, harassment and inordinate delays in the interface process and widespread corruption. The Task Force would like to reiterate here that the measures it has recommended will help address these concerns and will put *samman* for taxpayers back into the spotlight.

1.49 A general emphasis on computerisation of the entire tax system, the cornerstone of which is the recommended Tax Information Network (TIN), is designed to streamline tax administration. A particular benefit is felt to be a reduction in the personal interface. Process improvements, such as outsourcing the non-core functions of the administration, will mitigate the high pitch of assessments by freeing up administration time for making assessments more accurate. The recommendation to route refund and tax payment transactions through banks based on PAN will both cut delays and enforce compliance, a double benefit for a move to a wide-based and efficient tax administration. Our proposals in their entirety reduce the avenues for rent seeking behavior, which *ipso facto* mitigates scope for corruption.

1.50 Accountability and oversight of the tax administration have been relentlessly emphasised in the Report. The establishment of a tax Ombudsman, on the lines of a similar body for the banking sector, has been recommended. Tax information will have to be routinely and periodically supplied by each Commissioner, enabling evaluation of the deviations of the tax administration from a set of explicit performance parameters (that have been laid out in Chapter 3).

### Combating tax evasion through more effective enforcement

1.51 A number of individuals have pointed out in their responses that the Consultation Paper has failed to evolve a comprehensive strategy for enforcement against tax evaders. This is far from reality.

1.52 The Task Force at the outset recognised the importance of evolving a strategy, which would considerably enhance the ability of the tax administration to detect and penalise non-compliance. We decided to first address various issues that impact on the effectiveness of tax administration. Tax policy issues, dealt in the later chapters, are essentially addressed to improve the core functions of the tax administration, i.e., to improve taxpayer services and to enhance deterrence against tax evasion.

1.53 The underlying philosophy of the report is to substantially alter the economics of tax evasion. The cost of compliance is proposed to be drastically reduced by simplifying the tax laws and reducing the tax rates. The emphasis on taxpayer service through extensive use of information technology will enable the department to promote voluntary compliance amongst the general class of taxpayers and identify the “hard core” tax evaders. Similarly, the cost of non-compliance is intended to be increased substantially by establishing the Tax Information Network (TIN) which will enhance the probability of identification of tax evaders as well as help in the detection of income evaded. It will also substantially improve the quality of evidence against tax evaders and enable successful prosecution. As a corollary, the current tendency of high pitched assessment based on presumptions and conjectures will be a thing of the past. In effect, the present Block Assessment policy operates as an “Amnesty Scheme” for tax evaders detected as a result of search. The proposal

of the Task Force to do away with Block Assessment in cases of search and seizure will provide further deterrence against tax evasion by levy of interest, penalty and prosecution of persons found guilty of tax evasion.

## Concluding Remarks

1.54 A number of commentators have made the point that although the thrust of the Consultation Paper was broadly acceptable, the Paper could be criticised on two grounds:

1. There were drafting issues. For instance, the Consultation Paper should have made it clear that while deleting section 36(iii) all the relevant benefits would continue under section 37 and this fully takes into account the borrowing costs of the entrepreneur in determining the tax liability.
2. The Consultation Paper did not present adequate data. Consequently, commentators made their own assumptions and, in some cases, this led to incorrect conclusions.

1.55 We accept these shortcomings and, in this Report, we have endeavored to make our proposals as clear as possible and to provide necessary tables to support the recommendations. Further, we recommend that the Central Board of Direct Taxes should regularly make available data on CD-ROMs to scholars and analysts. This will help in encouraging in-depth research and analysis of the tax data and other economic trends. Such research will be of vital importance for improving our tax policies.

1.56 Penultimately, we would like to point out that our proposals should be seen as a continuum of the reform process which began in 1991. Various eminent committees, viz., the Chelliah Committee, the Y.V. Reddy Committee and the Parthasarathi Shome Committee have recommended an open, transparent tax system with low tax rates, minimal exemptions and effective tax administration. Since 1991, our fiscal policy has substantially reduced the corporate tax rate, from 51.75 per cent in 1991-92 to 36.75 per cent in 2002-03 and now proposed to be further reduced to 30 per cent in 2003-04. Similarly, the maximum

income tax rates have also been substantially reduced from 56 per cent to 31.5 per cent in 2002-03 and now proposed to be further reduced to 30 per cent in 2003-04. However, such reductions have been effected without reducing (indeed, enhancing) exemptions. This has adversely impacted potential tax revenues, and failed to impart the necessary buoyancy. In turn, this has constrained the ability of the economy to invest in the social sector and in physical infrastructure. Our proposals are aimed to correct this distortion by increasing the buoyancy of taxes and enhancing resources for investment and, hopefully, play a role in boosting economic growth to 8%, the target growth rate of the Tenth Five Year Plan.

1.57 Finally, our proposals should be seen as an integral part of the second generation of reforms, aimed to meet India's strategic needs, i.e., to accelerate the growth rate while meeting the challenges of globalisation. To achieve this, our fiscal policy should promote transparency, reward efficiency, provide economic security to employees, protect economic rights of shareholders and discourage rent seeking and crony capitalism. We believe that the proposals laid out in this Report will enable our country to reach this worthy objective.