# CHAPTER 2

## APPROACH TO TAX REFORM

2.1 The Government of India is emphasising, *inter alia*, enhanced fiscal transparency to improve budgetary management, which the impending passage of the Fiscal Responsibility and Budget Management Act will further reinforce. In this regard, the Government is convinced that rationalising and simplifying direct tax laws and redesigning procedures to bring them at par with practices of other dynamic economies is *sine qua non*. Accordingly, the Task Force was assigned the following Terms of Reference: (i) Rationalisation and simplification of the direct taxes with a view to minimising exemptions, removing anomalies and improving equity; (ii) Improvement in tax-payer services so as to reduce compliance cost, impart transparency and facilitate voluntary compliance; (iii) Redesigning procedures for strengthening enforcement so as to improve compliance of direct tax laws; and (iv) Any other matter related to the above points.

2.2 The Task Force was intended as the forum to deliberate upon and correct many of the existing anomalies in the Indian direct tax system. Towards fulfilling this mandate, an attempt has been made to outline steps required for initiating and expediting a requisite change in the *fiscal paradigm* of the country by way of a *process transformation* on the direct tax side. The Task Force deliberated on ways to reduce costs of tax administration, examined best tax practices in the world and extensively debated means of empowering Central Board of Direct Taxes (CBDT) to fulfill its function effectively. The approach of the Task Force has been influenced by the recognition that in the recent past, economies have increased their tax revenue-to-GDP ratio not by increasing tax rates but by simplifying tax structures, widening the tax base and improving tax administration. This Report contains the Task Force's considered judgement, melded from views culled from a diverse section of stakeholders. In conjunction with the reduction in the incidence of commodity taxes – which are by definition regressive – recommended by the Task Force on Indirect Taxes, the tax structure of the Indian fiscal system is sought to be made more progressive and to improve the functioning of markets.

2.3 Hitherto, tax policy, including exemptions, has been used in instances where other instruments at the disposal of the government are *prima facie* more suited to achieve stated objectives. There is a widespread perception that (frequent) changes in the tax code in the last decade or so have (unintentionally) been akin to substituting the erstwhile "license raj" with an "exemptions raj". Confusion in assigning instruments to objectives result in an inefficient allocation of resources and often defeat stated aims. Clearly demarcated distinctions among objectives to be achieved and increasing transparency in the use of expenditure and tax instruments for these objectives can be expected to yield better results. Old-age social security and pensions, for instance, can be better provided through transfers funded by *explicit* social security taxes (as is done elsewhere). A definitive separation of the two broad classes of instruments will have the secondary effect of reducing ambiguities in justification of expenditures and also impart greater effectiveness to parliamentary oversight of the government's fiscal decisions.

2.4 The Task Force has endeavored to ensure that the recommendations pertaining to the direct tax codes are congruent with generally accepted principles of taxation. The three principles relate to efficiency (minimising distortions in resource allocation), equity (which *inter alia* includes progressiveness of effective tax rates) and effectiveness (of tax administration). The Task Force recognized that the best means of advancing the three principles – thereby being one of the principal outcomes that was set of this Report – is an alignment of the objectives of the tax authorities with obligations of taxpayers; in other words, enhance the incentive compatibility of the two groups. The effects of most changes overlap all three principles; it is impossible (and artificial) to ascribe any particular desired principle as the sole motivator of a recommended change.

2.5 The design of tax policies has emerged as a concern of critical importance. The tax policy must be outcome oriented rather than input specific; for instance, many tax incentives reward higher usage of particular factors of production (inputs) or provide tax breaks for specific savings instruments. These incentives need to be re-engineered so that desired outcomes – viz., higher productivity of income taxpayers and increased returns to shareholders – are encouraged. This is the case with the most dynamic countries among the emerging markets. Additionally, in conformity with recent initiatives in other parts of the world, transparency & corporate governance has sought to be enhanced (by, among other things, aligning book and taxable profits).

2.6 An equitable treatment of tax incidence is critical to the acceptability – and thereby the success – of any tax structure. Equity – both horizontal (similar tax treatment for similar classes of taxpayers) and vertical (progressive nature of tax incidence) – is consciously sought to be enhanced. The regime of a multitude of exemptions has been detrimental not only to tax efficiency but also equity by enabling a vocal (often rich and powerful) minority to enjoy rents arising from the resultant distortions (complexity) in the system, consequently undermining the postulate of equitable incidence (and thereby foster a regressive tax structure).

2.7 Optimal tax policy should be pursued in the general interest of the economy rather than for catering to sectional interests. Every exemption has a constituency and democratic systems tend to respond to constituencies – a tax break to one constituency inevitably spawns similar demand by others. The dynamic nature of economic activity in India, with changes in the relative share of industry, services and agriculture-value added, is moreover sure to continually shift the taxpayer profile. The recommendations of the Report are embedded in a forward-looking approach to taxation by imparting a sector-neutral flavour (including fiscal impartiality between those who produce for the domestic market and those catering to external markets). Therefore, it is recommended that income from all sources and asset classes – skilled and unskilled labour, human capital, physical capital and financial (risk) capital – should have equal tax incidence.

2.8 Often, the exemptions looked to be rational at the micro level, but were irrational at the macro level. For instance, tax breaks on specific savings/investment products did help in resource mobilisation of particular financial instruments with associated high rates of return to subscribers of these instruments. Selective exemptions did not only engender dichotomy of real returns on various instruments, they also helped to increase the cost of borrowing for everyone with debilitating consequences for investment and growth for the whole economy – in other words, the strategy was harmful at the macro level. If this wasn't bad enough, to make investments in specific assets affordable – given the high cost of borrowing brought about, in part, by the aforementioned tax breaks – tax incentives were conferred! Removal of tax breaks on specific savings vehicles will impart downward flexibility to the (implicit) floor on rates of return on these instruments and contribute towards further lowering the cost of debt capital. Furthermore, by the elimination of taxation on dividend and capital gains (on equity of listed companies), shareholders are taxed only once, and therefore the cost of (equity) risk capital also comes down. A *systemic* beneficial outcome will be a reduction in the cost of capital, thereby helping to boost investment and growth.

2.9 As a macroeconomic coda to these arguments, it should also be pointed out that that cross-section and inter-temporal evidence points overwhelmingly towards *simultaneity* in savings and growth behaviour of economies rather than causality from the former to the latter[10]. In other words, there is little evidence that high savings have actually caused high growth; the two normally move together. Encouraging savings as an objective *per se*, with little regard for the damage it might cause by raising the cost of funds, is likely to defeat the purpose of growth. The Task Force does recognize, though, that long-term savings might need to be encouraged and explicitly does this by rewarding the fruits of such savings, at the time they mature.

2.10 In addition to enhancing horizontal equity, vertical equity will, moreover, also be served. The specific tax proposals outlined in subsequent chapters – if accepted as an integrated package – will constitute the most progressive tax changes in India in the last two decades.

2.11 The Task Force would like to explicitly point out that elimination of various (corporate level) tax holidays, concomitantly with removal of dividend and capital gains tax (on listed equity), will bring down a shareholder's *ex ante* tax liability from about 50 percent at present to 30 percent. On that account, viewed from the unexceptionable perspective of a shareholder, the government is not going back on its moral commitment regarding corporate level tax breaks that have already been granted (and availed of).

2.12 The series of *ad hoc* exemptions and other tinkering, in addition to distorting economic incentives, has also served to clutter the culture of compliance. Tax policy and tax administration is inter-linked: complex tax policy leads to complex tax legislation, which inevitably leads to cumbersome administration through a cascading effect on filings,

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[10] See Report of the Expert Group to Review Existing Fiscal Incentives for Savings (Chairman: P. Shome) for a review of evidence in this regard.

compliance procedures and enforcement measures. Unsurprisingly, a weak and porous system has evolved, which by increasing transaction costs of participation dissuades potential taxpayers. Over the years, a number of perverse incentives have crept in: taxpaying is often punished (by harassment) and tax evasion is not sufficiently deterred. The recommendations are designed to change the economics of tax compliance, viz., reduce transaction costs of tax paying and increase the price of evasion. One of the tax department's biggest challenges will be to bring the "missing middle"– mainly urban, self-employed service sector professionals who, advertently or unwittingly, have dropped out of the tax base – into compliance, through the right mix of communication, education and enforcement. Presently, the compliance rate in percentage terms of this category of taxpayer is in the single digit. It is noteworthy that this undesirable outcome has occurred against the backdrop of considerable efforts in recent years by the tax authorities to fulfil its functions.

2.13 Just as the Task Force recommends that greater effort be expended on enlarging the taxpayer base, so must it emphasise that the quality of services extended to the taxpayer be improved. The tax department is no different than most businesses: world-class customer service is critical. Communication about taxes and tax policies is extremely important – taxpayer rights and obligations need to be clearly specified. The best tax systems in the world deal with taxpayers in a professional customer-relationship environment, which requires the system to be transparent, responsive and non-discriminatory. Furthermore, by increasing accountability of tax authorities, a durable welfare-improving social contract is established between taxpayers and tax administration.

2.14 A change in attitudes has distinctly and perceptibly emerged in a previously largely adversarial relationship between the tax collector and taxpayer, when neither was inclined to believe the other's integrity. Younger taxpayers are more willing to pay their dues to society. This bracket of young taxpayers, in line with global trends, constitutes the most dynamic and productive segment of India's population. Not only will they be the engine for higher growth, their contribution to the tax coffers will increase. At the same time, this willingness is conditional; based on their experience as customers for commercial services, they have come to expect a professional interaction with service providers.

Leveraging this segment for both higher growth and tax revenues will consequently have to tread the fine line between incentivising effort and enterprise while simultaneously co-opting them into the tax base. The Task Force reiterates that all possible measures are instituted to prevent an alienation of this increasingly important demographic segment and an attendant reversion to the tax cynicism of earlier generations.

2.15 The Task Force cannot over-emphasise that effective tax reform must harness Information Technology (IT). The CBDT has to be commended for the effort it has expended and the actions it has initiated for computerisation of taxpayer records. However, business processes, systems and facilities have not kept pace with the growing demands on tax administration. Simple and transparent business processes are at the core of any service organisation and this is also true for a tax administration. Raising the resources required for the targets envisaged by the Tenth Plan involves much more than adjusting rates and rationalizing exemptions – a fundamental process change which empowers the tax department in more effectively fulfilling its functions is needed. Apart from facilitating increased efficiency, IT can contribute to aligning the incentive compatibility of the department and taxpayers by its potential of enhancing transparency thereby contributing to mitigating rent seeking. The mandatory web-based logging of details & parameters of taxpayer complaints and action taken on these complaints is an example of the use of IT facilitation in this context.

2.16 Availability of IT expertise and the presence of world class (common carrier) network systems developed by the National Stock Depository Limited (NSDL) can be relatively quickly deployed to make a *systemic* improvement in processes to reduce transaction costs (for both CBDT and the taxpayer). Establishment of a Tax Information Network (TIN) can facilitate transactions, akin to securities markets, and establish *secure and seamless logistics of tax collection* through integration of primary information, record keeping, retrieval and enforcement. Centralised processing of TDS certificates, for example, has the potential to increase compliance and reduce fraud – false certificates result in increased costs of cross-checking and verification. Reciprocally, not only is there reduced potential for discretion and concomitant harassment, but it can also help to expedite refunds. Some of these activities, as well as systems for process automation, can be out-sourced in conformity with procedures adopted by the best international tax administrations, thereby permitting the CBDT to pursue more effectively its core functions.

2.17 These broad recommendations are elaborated in subsequent chapters. In closing, however, the Task Force would like to strongly urge that these recommendations be adopted as a package. Deep organisational reform in the private sector occurs following the failure of discrete changes from preventing a threat to the viability of the enterprise; the same is true of the framework for direct taxes. The efficacy of the recommendations is likely to be seriously vitiated if individual components are selectively accepted or rejected and reforms continue in a piece-meal manner; success of tax reform efforts depends on their implementation as an integrated package.