**Public Finance Unit: - 5**

**Indian Tax System**

**Class: - 5th**

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Reforms in the Indirect Tax Structure: Goods and Service Tax.

The philosophy of tax reform has undergone significant changes over the years in keeping with the changing perception of the role of the state. With the change in the development strategy in favour of market determined resource allocation, the traditional approach of raising revenues to finance a large public sector without much regard to economic effects has been given up. The recent approaches to reform lay emphasis on minimizing distortions in tax policy to keep the economy competitive. Minimizing distortions implies reducing the marginal rates of both direct and indirect taxes. This also calls for reducing differentiation in tax rates to reduce unintended distortions in relative prices. To achieve this, the approach suggests broadening of the tax bases. Thus, over the years, emphasis has shifted from vertical equity in which both direct and indirect taxes are subject to high marginal rates with minute differentiation in rates, to horizontal equity in which, the taxes are broad-based, simple and transparent, and subject to low and less differentiated rates. Equity in general, is taken to mean improving the living conditions of the poor. This has to be achieved mainly through expenditure policy and human resource development rather than reducing the incomes of the rich as was envisaged in the 1950s and 1960s

Indirect taxes have played an increasingly important role in the Indian economy. Indirect tax was first introduced in India in 1944 in the form of excise duty on Indian products as a measure of protection for goods imported from the UK. In the course of time, it became a well-established tax to shore up government finances. The need for reform in indirect taxes was felt soon after Independence, and several committees were appointed for this purpose. From there, the process of reforms of indirect taxes in India went through ups and downs till the introduction of the Goods and Services Tax (GST) in 2017. Indirect Tax Reform in India: 1947 to GST and beyond maps these developments in detail and analyses the political economy behind it. It also deals with the current problems, the conceptual infirmities and the reforms needed urgently to restrict the disruption it has caused in the economy so far.

The trends in tax revenues presented in table 1 present three distinct phases. In the first, right from the 1970s to mid-1980s, there has been a steady increase in the tax-GDP ratio in keeping with the buoyant economic conditions and acceleration in the growth rate of the economy. The tax ratio, which was about 11 per cent in 1970-71, increased steadily to 14.6 per cent in 1980-81 (table 1). The ratio continued to increase steadily during the early 1980s. In addition to the economy attaining a higher growth path, the buoyancy in tax revenues was fuelled by the progressive substitution of quantitative restrictions with tariffs following initial attempts at economic liberalization in the 1980s. The economic recession following the severe drought of 1987 resulted in stagnation in revenues in the second phase until 1992-93. Following the economic crisis of 1991 and the subsequent reforms in the tax system, particularly reduction in tariffs, actually caused a decline in the tax ratio. Overall, it is seen that the tax ratio which reached the peak of about 17 per cent in 1987-88, declined thereafter to 13.9 per cent in 1993-94 and gradually recovered to 14.6 per cent in 1997-98. Overall, the level of tax revenues, although reasonable as compared to the average tax level in developing countries, is clearly inadequate from the viewpoint of resource requirements of the economy. In terms of composition of tax revenue, there has been a steady decline in the share of direct taxes from 21 per cent in 1970-71 to about 14 per cent in 1990-91. After the introduction of tax reforms in 1992, the revenue from direct taxes has grown faster than revenue from other taxes as well as GDP and consequently, the share of direct taxes increased by almost ten percentage points to 24 per cent on 1997-98. An increase was seen in both corporate income and individual income taxes though, taxes on agricultural land and incomes have continued to decline. In fact, although the agricultural sector contributes over 30 per cent of GDP, its contribution to tax revenues is just about half a per cent.

Table: - 1 Level and composition of taxes in India (per cent)

|  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- |
| Tax | 1970-71 | 1980-81 | 1990-91 | 1995-96 | 1996-97 | 1997-98 |
| Direct tax of which:  Corporation tax  Personal Income tax  Agricultural tax  Others | 21.3  7.8  10.0  2.8  0.7 | 16.4  6.6  7.6  1.0  1.2 | 14.0  6.1  6.1  0.9  0.9 | 20.4  9.4  8.9  0.8  1.3 | 20.5  9.3  9.1  0.6  1.5 | 23.6  9.4  12.6  0.6  1.0 |
| Indirect tax of which:  Customs  Union Excise duties  Sales tax  State Excise duties  Others | 78.7  11.0  37.0  16.6  4.1  10.0 | 83.6  17.2  32.8  20.3  4.2  9.1 | 86.0  23.5  27.9  20.8  5.7  8.1 | 79.6  20.4  22.9  20.4  4.9  10.9 | 79.5  21.4  22.5  21.1  4.5  10.0 | 76.4  18.0  20.9  21.2  5.0  11.3 |
| Total tax revenue | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 |
| Tax-GDP percentage | 11.0 | 14.6 | 16.4 | 14.4 | 14.2 | 14.6 |

There have been a number of attempts at improving the tax system since independence. The principal objective of these attempts has been to enhance revenue productivity to finance large development plans. Although the various tax reform committees considered economic efficiency as one of the objectives, the recommendations do not bear much testimony to this aspect. The recommendations were in keeping with the philosophy of the times. Further, even when the committees did recommend certain measures on efficiency considerations, this was not acted upon if it involved loss of revenues. The first comprehensive attempt at reforming the tax system was by the Tax Reform Committee in 1953. This provided the backdrop for the generation of resources for the Second Five Year Plan (1956-60), and was required to fulfill a variety of objectives such as raising the level of savings and investment, effecting resource transfer from the private to the public sector and achieving a desired state of redistribution.

Since then, there have been a number of attempts, most of them partial, to remedy various aspects of the tax system. The expenditure tax levied on the recommendation of the Kaldor Committee in 1957-58 had to be withdrawn after three years as it did not generate the expected revenues. The attempt to achieve the desired state of redistribution caused the policy makers to design the income tax system with confiscatory marginal rates. The consequent moral hazard problems led the Direct Taxes Enquiry Committee in 1971 to recommend a significant reduction in marginal tax rates. On the indirect taxes side, a major simplification exercise was attempted by the Indirect Taxes Enquiry Committee in 1972. At the state and local level, there were a number of tax reform committees in different states that went into the issue of rationalization and simplification of the tax system. The motivation for almost all these committees was to raise more revenues to finance ever-increasing public consumption and investment requirements. As mentioned earlier, although the effect of the rationalization has been to reduce the marginal tax rates, the prevailing philosophy still dictated keeping the rates very high. It may be noted that in the early 1970s the marginal tax rate including the surcharge was as high as 93.5 per cent. Combined with the highest marginal wealth tax rate of 8 per cent tax on wealth, the tax system produced enormous incentives for evasion and avoidance of the tax. On the recommendation of the Direct Taxes Enquiry Committee, the marginal tax rate was brought down to 77 per cent in 1974-75 and further to 66 per cent in 1976. Similarly, the highest wealth tax rate was reduced to 2.5 per cent. On the indirect taxes front, the most important reform before 1991 was the conversion of the union excise duties into a modified value added tax (MODVAT) in 1986. The MODVAT was introduced in a limited manner on a few commodities and the coverage was gradually extended over the years. It was an income type VAT applicable only to a few manufactured goods. Also, there was an attempt to substitute ad valorem taxes to specific levies though quite a few commodities are subject to specific tax even today. There were attempts to simplify and rationalize the structures, but these cannot be considered comprehensive.

Tax reform since 1991 was initiated as a part of the structural reform process, following the economic crisis of 1991. In keeping with the best practice approaches, the TRC adopted an approach of combining economic principles with conventional wisdom in recommending comprehensive tax system reforms.

GST is a comprehensive indirect tax levied on manufacture, sale and consumption of goods as well as services at the national level. It has replaced all indirect taxes levied on goods and services by the Central and State Governments.

GST regime was implemented from 1st July 2017, and India has adopted the dual GST model in which both the Centre and States levy taxes:

**Major taxation related reforms introduced in recent times**

* **Indirect taxes reforms:**The integration of State and Central indirect taxes in the GST led to the abolition of entry tax and the Central Sales Tax (CST). This has had important spillover effects on the economy. The abolition of the entry tax has reduced trip times on the major road corridors leading to cost benefits for the manufacturers. GST stands for Goods and Services Tax. It is an Indirect tax which introduced to replace a host of other Indirect taxes such as VAT service tax, purchase tax, excise duty, and so on. GST levied on the supply of certain goods and services in India. It is one tax that is applicable all over India.
* **Reduction in the corporate tax rate for all existing domestic companies:** In order to promote growth and investment, the Government has brought in a historic tax reform through the Taxation Laws (Amendment) Ordinance 2019 which provided a concessional tax regime of 22% for all existing domestic companies from FY 2019-20 if they do not avail any specified exemption or incentive. Further, such companies have also been exempted from payment of Minimum Alternate Tax (MAT).
* **The incentive for new manufacturing domestic companies:**In order to attract investment in the manufacturing sector, the Taxation Laws (Amendment) Ordinance 2019 has drastically reduced the tax rate to 15% for new manufacturing domestic companies if such company does not avail any specified exemption or incentive. These companies have also been exempted from payment of Minimum Alternate Tax (MAT).
* **Reduction in MAT rate:**In order to provide relief to the companies which continue to avail exemption/deduction and pay tax under MAT, the rate of MAT has also been reduced from 18.5% to 15%.
* **Exemption from income-tax to individuals earning income up to Rs. 5 lakh and increase in standard deduction:**Further, to provide complete relief from payment of income-tax to individuals earning taxable income up to Rs. 5 lakh, the Finance Act, 2019 exempted an individual taxpayer with taxable income up to Rs. 5 lakh by providing 100% tax rebate. Also, to provide relief to the salaried taxpayers, the Finance Act, 2019 enhanced the standard deduction from Rs. 40,000 to Rs. 50,000.

The Government is committed to providing a hassle-free direct tax environment with moderate tax rates and ease of compliance to the taxpayers and also to stimulate growth by reforming the direct taxes system. Some of the recent steps taken in this direction, apart from those discussed above, are as under:

* **Personal Income Tax –**In order to reform Personal Income Tax, the Finance Act, 2020 has provided an option to individuals and co-operatives for paying income tax at concessional rates if they do not avail of specified exemption and incentive.
* **Abolition of Dividend Distribution Tax (DDT) –**In order to increase the attractiveness of the Indian Equity Market and to provide relief to a large class of investors in whose case dividend income is taxable at the rate lower than the rate of DDT, the Finance Act, 2020 removed the Dividend Distribution Tax under which the companies are not required to pay DDT with effect from 01.04.2020. The dividend income shall be taxed only in the hands of the recipients at their applicable rate.
* **Vivad se Vishwas –**In the current times, a large number of disputes related to direct taxes are pending at various levels of adjudication from Commissioner (Appeals) level to Supreme Court. These tax disputes consume a large part of resources both on the part of the Government as well as taxpayers and also deprive the Government of the timely collection of revenue. With these facts in mind, an urgent need was felt to provide for the resolution of pending tax disputes which will not only benefit the Government by generating timely revenue but also the taxpayers as it will bring down mounting litigation costs and efforts can be better utilized for expanding business activities. Direct Tax Vivad se Vishwas Act, 2020 was enacted on 17th March 2020 under which the declarations for settling disputes are currently being filed.
* **Faceless E-assessment Scheme –**The E-assessment Scheme, 2019 has been notified on 12th September 2019 which provides for a new scheme for making assessments by eliminating the interface between the Assessing Officer and the assessee, optimizing the use of resources through functional specialization, and introducing the team-based assessment.
* **Faceless appeals –**In order to take the reforms to the next level and to eliminate human interface, the Finance Act, 2020 empowered the Central Government to notify the Faceless Appeal Scheme in the appellate function of the department between the appellant and the Commissioner of Income-tax (Appeals).
* **Document Identification Number (DIN) –**In order to bring efficiency and transparency in the functioning of the Income Tax Department, every communication of the Department whether it is related to assessment, appeals, investigation, penalty, and rectification, among other things, issued from 1st October 2019 onwards are mandatorily having a computer-generated unique document identification number (DIN).
* **Pre-filling of Income-tax Returns –**In order to make tax compliance more convenient, pre-filled Income Tax Returns (ITR) have been provided to individual taxpayers. The ITR form now contains pre-filled details of certain incomes such as salary income. The scope of information for pre-filling is being continuously expanded by pre-filling more transactions in the ITR.
* **Encouraging digital transactions –**In order to facilitate the digitalization of the economy and reduce unaccounted transactions, various measures have been taken which include reduction in the rate of presumptive profit on digital turnover, removal of MDR charges on prescribed modes of transactions, reducing the threshold for cash transactions, prohibition of certain cash transactions, etc.
* **Simplification of compliance norms for Start-ups –**Start-ups have been provided a hassle-free tax environment which includes simplification of the assessment procedure, exemptions from Angel-tax, the constitution of dedicated start-up cells, etc.
* **Relaxation in the norms for Prosecution:**The threshold for launching prosecution has been substantially increased. A system of the collegium of senior officers for sanction of prosecution has been introduced. The norms for compounding have also been relaxed.
* **Raising of monetary limit for filing of appeal –**To effectively reduce taxpayer grievances/ litigation and help the Income Tax Department focus on litigation involving complex legal issues and high tax effects, the monetary thresholds for filing of departmental appeals have been raised from Rs. 20 lakh to Rs. 50 lakh for appeal before ITAT, from Rs. 50 lakh to Rs. 1 crore for appeal before the High Court and from Rs. 1 crore to Rs. 2 crores for appeal before the Supreme Court.

**Expansion of scope of TDS/TCS –**For widening the tax base, several new transactions were brought into the ambit of Tax Deduction at Source (TDS) and Tax Collection at Source (TCS). These transactions include huge cash withdrawals, foreign remittances, purchases of a luxury cars, e-commerce participants, sales of goods, acquisition of immovable property, etc.

**Note**: The GST is applicable on all goods other than the following:

• Alcoholic liquor for human consumption

• Five petroleum products (Petroleum crude, high-speed diesel, motor spirit, natural gas and aviation turbine fuel). GST on these to be levied post notification about the effective date.