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   REVIEW OF LITERATURE

   NEED/IMPORTANCE OF THE STUDY

   STATEMENT OF THE PROBLEM

   OBJECTIVES

   HYPOTHESES

   RESEARCH METHODOLOGY

   RESULTS & DISCUSSION

   FINDINGS

   RECOMMENDATIONS/SUGGESTIONS

   CONCLUSIONS

   SCOPE FOR FURTHER RESEARCH

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   REFERENCES

   APPENDIX/ANNEXURE

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- Garg, Bhavet (2011): Towards a New Natural Gas Policy, Political Weekly, Viewed on January 01, 2012 http://epw.in/user/viewabstract.jsp

INDIAN TAX POLICIES: HOW FAR RATIONAL

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ABSTRACT

The tax reforms of recent years in India are based on Chelliah and Kelkar's recommendations of simple broad-based taxes with a moderate and limited number of rates. The reduction in direct tax rates in the economy has not only increased revenue collection but also accelerated economic growth. This article aims to investigate the effect of India's tax policy on private capital formation. The major problem facing the Indian direct tax system is evasion of income taxes. The article concludes that an expenditure tax is a powerful tool to combat evasion.

KEYWORDS

Direct Tax, Indirect Tax, Evasion, Maximum Marginal Rate.

INTRODUCTION

The tax policy as enunciated in the Budget of 2012-13 does not meet the general expectations of taxpayers who always feel the pinch on one or other account. It is like win some lose more.

Economic growth relies heavily on raising the rate of savings and the level of investment. Taxation reforms in low-income, developing economies like India have yielded beneficial results in terms of reductions in the marginal rates of personal income tax and corporate income tax and the abolition of taxation on income from interest. It is argued that heavy taxation on productive income is detrimental to private capital formation. Several studies (eg, Jenkins 1989; Marsden 1990; Trela & Whalley 1992; Tanzi & Zee 2000) have shown that tax policy and tax mix strategies have made an important contribution to economic growth in developing economies. If there is a discernible influence of taxation policy on capital accumulation and economic growth, then there may be lessons to be learnt for India from its own past experience.

A tax policy pertains to

- Level of taxation i.e. tax-GDP ratio
- Composition of tax-revenue
- Use of tax incentives and
- Tax yield

Taxation is a potent instrument to shape and influence the socio economic policies of a country. It is, of course, difficult to formulate a set of universally acceptable goals of tax policy because of different socio economic and political environment and stages of economic development of different countries. Likewise, objectives of economic policies differ from country to country. Further, priorities and objectives of economic policy keep on changing with the changing economic, social and political environment of the country.

An effective tax policy should aim resource allocation based on the judicious mix, resource allocation based on distributive economic justice and stabilization with the reference to price level. Thus a tax policy emerges out of the interaction between economic rationale and political judgment. The process of compromises and trade off is influenced by the political expediency and economic logic.

In fact, the political requirements and economic thinking change with time, giving a new direction to tax policy. According to Richard Bird, "Tax reform is a never ending process, not "something that can be brought-about once and for all and then forgotten."

REVIEW OF LITERATURE

There are no universal laws that can be discovered concerning the influence of tax policies on a country's economic growth and development. Nevertheless, there are several studies and results that can be draw on to reach some conclusions about the influence of taxation on savings and capital formation and thus of growth. Some of these are described here. Jenkins (1989) and Marsden (1990) argue that lower taxes stimulate growth by increasing the incentive to save and invest. Jenkins (1989) compared the tax system of Sri Lanka prior to 1977 with the system after 1977. The Sri Lankan tax system prior to 1977 was highly regulated. The tax rates were quite high, but were ineffective in raising adequate revenue. The change in government in 1977 saw a number of changes in the tax structure that shifted the bias in the fiscal system from direct taxes to indirect taxes. The tax changes of the 1990s gradually transformed the tax system into one conducive to capital accumulation and growth. An empirical study by Marsden (1990), based on a cross-section analysis of 20 countries, has thrown some light on the effect of tax on the growth rate of the economy. Keeping per capita income constant, the selected countries were compared on the basis of lower and higher levels of taxation and their influence on growth rates over the period 1980-89. In all cases, the countries that imposed a lower effective average tax burden on their populations achieved substantially higher rates of GDP growth than did their more highly taxed counterparts. The average annual rate of growth of GDP was 7.3 percent in the low tax group and 1.1 percent in the high tax group. Moreover, fiscal incentives provided by low tax countries shifted resources from less productive to more productive sectors, thus raising the overall efficiency of resource utilization.

Recent studies by Peter and Kerr (2004) and Kerr and Monsingh (2001a, 2001b) also reveal an inverse relationship between direct taxes and private savings and capital formation. Peter and Kerr (2004) show that a 1 percent change in direct tax per capita (average direct tax per person) in India led to a -0.4 percent change in savings per capita (average savings per person) and thus adversely affected the growth of the economy. The present study uses a private capital formation ratio, an income variable, and direct tax variables to examine the effect of tax policies on the private capital formation ratio.

Major Reforms - A Review: The Indian tax structure has undergone major changes in recent years especially after 1991 in the wake of liberalization and globalization policies initiated by the Government. The tax reforms are part of the package to open up the economy. In August, 1991, the Government of India constituted a Tax Reform Committee to recommend a comprehensive tax reforms of both direct and indirect taxes.

TABLE-1: SHOWING TOTAL TAX REVENUE (DIRECT & INDIRECT) AND DIRECT TAXES WITH PERCENTAGE SHARE (Rs. in crores)

Year	Total Taxes	Direct Taxes	% of Direct Taxes to Total Taxes
1990-91	87722	12260	14.0
1994-95	147849	28878	19.5
1996-97	199840	47294	23.7
1998-99	233069	57404	24.6
2000-01	305630	80947	26.5
2002-03	358943	101236	28.2
2003-04	415582	125613	30.2
2004-05	494047	156804	31.7
2006-07	686903	240728	34.9
2008-09	865802	300456	36.2
2010-11	1095906	408000	40.11

Source: Indian Finance Statistics - Ministry of Finance, GO1**.**

TABLE-2: SHOWING TRENDS IN MAXIMUM MARGINAL RATE (%)

Financial Year	MMR (%)	Surcharge, if any (%)	Rate including surcharged (%)
1990-91	50	12	56
1992-93	40	12	44.8
1994-95	40	Nil	40
1996-97	40	Nil	40
1998-99	30	Nil	30
2000-01	30	17	35.1
2002-03	30	2	30.6
2004-05	30	10+2**	33.66
2006-07	30	10+3**	33.99
2008-10	30	10+3**	33.99
2010-11	30	10+3**	33.99

From financial year 2009-10, surcharge has been waived off. **Education Cess

Source: Finance Acts of Various years

TABLE-3: EXHIBITING MMR OF SELECTED COUNTRIES

Rank	Country	MMR (%)
1	Brazil	27.5
2	Malaysia	28
3	Canada	29
4	Mexico	30
5	India	30.0(33.99%)
6	US	35
7	Argentina	35
8	Japan	37
9	South Korea	38.5
10	UK	40
11	France	40
12	South Asia	40
13	Germany	42
14	Italy	43
15	Spain	45
16	Australia	45
17	China	45
18	Israel	49

Source: Compiled from relevant website. In India MMR is 30% and Education Cess is 3%. However, Surcharge is abolished from the financial year 2009-2010.

TABLE -4: CORPORATE TAX IN INDIA

Financial year	Tax Rate %	Surcharge %	Effective Tax Rate
1990-91	40	15	46
1992-93	45	15	51.75
1994-95	40	15	46
1996-97	40	7.5	43
1998-99	35	Nil	35
2000-01	35	13	39.55
2002-03	35	2	35.7
2004-05	35	2.5+2**	36.59
2006-07	30	10+3**	33.99
2008-09	30	10+3**	33.99
2010-11	30	10+3**	33.99

Source: Finance Acts of Relevant Years ** Education Cess

TABLE NO. 5: GLOBAL INCOME TAX RATES

Rank	Country	Rate (%)
1	Cyprus	10
2	Ireland	12.5
3	Mauritius	12
4	Hong Kong	17.5
5	Poland	19
6	Singapore	20
7	Portugal	27.5
8	Malaysia	28
9	Thailand	30
10	UK	30
11	India	33.99
12	Philippines	35
13	Spain	35
14	Italy	37.25
15	Germany	38.38
16	US	40
17	Japan	40.7

Source: Compiled from relevant website.

The committee made recommendation for restructuring and rationalization of personal income tax, corporate tax, wealth tax, excise duties, import tariff, tax administration and enforcement machinery. Based on the overall direction and recommendations of committee, tax reforms are geared to build a structure which is simple, relies on moderate tax rates but with a wider base and better environment. Tax Reforms for the period 1991 onwards have not only halted but reversed the declining trend in the share of direct taxes. The share of direct taxes has increased from 14% in 1990-91 to 23.7% in 1996-97 and 34.9% in 2008-09. The budget estimate for the year 2010-11 is estimated at 40 %.

MAXIMUM MARGINAL RATE & TAX

REVENUE

An analysis of the table-1 in relation to table-2 discloses the relationship of direct tax collection to maximum marginal rate (tax rate structure). The Indian tax structure had been afflicted by high rates and narrow tax base. Some reforms have helped to improve the direct tax collection. There seems to be an inverse relation between maximum marginal rate of taxation and tax collection. Over the years the maximum marginal rate has travelled down from 85% (97.7% with surcharge) in 1973-74 to 30% in 1997-98 and continue to remains the same till now in 2009-10 with changing rate of surcharge, whereas direct tax collection went up from Rs. 1552 crore in 1973-74 to Rs.408000 crore in 2010-11 (budget estimate). Even after taking cost inflation index into account there has been manifold increase in the direct tax collection - more than 32 times. This enormous increase can well be attributed to major tax reforms and tax payers willingness (tax compliance) to pay tax honestly due to lower tax rate (MMR). This gives the tax payers a sense of pride and satisfaction for being honest and law abiding citizens of the country. Thus, they save themselves of being humiliated at the hands of tax officials if caught in the process of searches and seizure.

The trend can be noticed very evidently from the following table. Even the F.M. realized the impact of lowering maximum marginal rate. In an annual economic indicators conference held on November 08, 2009 the Finance Minister hinted that the maximum marginal rate could fall further. He said, "I am happy to note that the attitude of assessees towards taxes seems to have undergone a remarkable change. Both corporate and individuals seems to have imbibed the principle that honesty is the best policy. This attitudinal change is the result of moderate and stable tax rates. He pointed out that there has been a 30.6% rise in income tax collection including fringe benefit tax and 47.88% rise in corporate tax collections in 2010-11. There is scope for further moderation, however, this will depend upon greater tax compliance, the F.M. said

GLOBAL SCENARIO

PERSONAL INCOME TAX

Considering the buoyancy in the direct tax collection over the years under the impact of rate cut and other measures there was an indication of further rate cut both in personal income tax and corporate tax. With the Government having indicated that there is a case for moderation of tax rates; expectations were a little higher this time. It is this context that a look at the tax regime for individual and corporate in select economies would help put the issue in perspective. Though in view of different level of income, standard of living and employment level of different countries, the tax rate structure of various (selected) countries can not be compared with Indian tax structure, yet a glance at the maximum marginal rate personal income tax rate and corporate rate will certainly provide an insight to make our tax structure at par with other nations. Considering the Asian countries like Japan. China, South Korea, and Malaysia, the maximum marginal income tax is 37%,45%,38.5% and 28% respectively as compared to India (33.99% including surcharge of 10% and Education cess of 3%) whereas American countries like Argentina, Brazil, Canada, Maxico and US have 35%, 27.5%, 29%, 30% and 35% as peak rates (MMR) respectively. The European economies like UK, Italy, French, Germany and Spain levy at 40%, 43%,40%, 42% and 45% respectively as the highest slab rate. This way India is the 5th country charging lowest maximum marginal rate of tax in the ascending order as shown in **table 3.**

CORPORATE INCOME TAX

Corporate tax in India is levied at flat rate on the profit earned by the company. During the last more than two and a half decades the corporate tax rate to underwent changes in quick succession showing a downward trend **(table 4).** In the beginning of 1980s, the effective tax rates were around 60% and by the end

of the decade, it came down to 46%. However, during the period 1991-92 to 93-94 the effective tax rate increased to 51.75% and again reduced to 46% in 1994-95. In 1997, the Finance Minister abolished the surcharge on corporate income tax and reduced the tax rate from 40% to 35% on the income of domestic companies. The surcharge was further introduced in 1999-2000 @ 10% and increase to 13% in 2000-0 1. However, during 2004-05, the finance minister imposed Education Cess of 2% along with surcharge of 2.5%. For the financial year 2005-06, it was 30% plus 10% Surcharge and 2% Education cess. For the current year 2007-08, the rate remains at 30%, surcharge @10% and 3% Education cess making an effective rate of 33.99% for domestic companies other than SMEs (Entities having total income of less than l crore). For Foreign companies the rate is up from 41.82% to 42.23%. For MAT paying companies it is now 11.33% as compared to 11.22% (*There is no surcharge for SMEs). Further, the company has to bear another pinch on account of dividend distribution tax which has been hiked from 12.5% to 15% making an effective rate of 16.995% as compared to earlier effective rate of 14.025%. From the financial year 2009-10, the surcharge has been waived off.

Thus India is placed in tenth position in order of lower corporate tax rate. Given a choice between a reduction in the corporate tax rate and other reforms, foreign investors would rather opt for lower rate of tax and stability in the tax regime and transparency in the tax administration which in turn would trigger growth and enlarge the tax base. Most countries across the globe have consistently been clipping the corporate tax rate to woo the foreign investors. The tax rate cut was initiated by the U K who with 52% corporate tax rate in eighties slashed the rate to 30%. Other European Countries have also followed the suit. The reduction in corporate rate should be accompanied by the gradual withdrawal or phasing out of all exemptions and concessions. Because steep cut in rate without pruning exemptions would result in significant loss of revenue.

The actual impact of lowering MMR would be judged only when the exemptions are fully phased out. However, the incentives aimed towards development of infra-structure, backward area or other priority sectors should continue. Hence our direct tax policy should have a judicious mix of reforms i.e. trade off between rate cut and phasing out exemptions.

The lower rate will definitely eliminate the fear psychosis of being taxed at a higher rate. It will help boost the tax collection in a big way by broadening the tax base. Tax policy reforms should act as stimulus to economic growth and should aim to achieve the objectives of simplification, certainty, equity and justice.

An ET survey of 1368 companies grouped under 45 industries found that their aggregate provision for corporate taxes have risen by an annual compound rate of 16.2% in the last five years between 2005-06 and 2010-11 whereas their turnover during the same period has grown by 14% annually. This is significant since the rise in the share of taxes despite the rate cut indicates a rise in the tax compliance rate. Interestingly, India Incorporation seems to have given greater priority to tax payments than to service to shareholders.

Thus, it is established that moderate taxes hold the key to improve tax compliance. It is quite evident that voluntary tax compliance improves the tax collection. Tax reforms have to be viewed as an integral part of over-all economic reforms without which the process will be incomplete. The simplified procedure will eliminate the unnecessary cost of' compliance & litigation.

SUGGESTED APPROACH

Revenue buoyancy has given the Finance Minister enough strength to undertake further tax reforms in future. Tax buoyancy and fiscal challenges can be met if the tax policy deals with the following items in the suggested way.

1. Exemptions are essentially subsidy payments to preferred taxpayers. In public finance parlance these are called tax-expenditures and should be treated as such. In fact, the Kelkar Committee had recommended the phasing out of exemptions on the ground that these tend to create pressure group and as such there are chances that these may be misused. Despite the moderation of tax rates, the Indian tax structure is still replete with exemptions of numerous types. Past experience shows that it is not an easy task to away with all exemptions and deductions, though in a phased manner. However, some of these can continue in priority areas and should be replaced by a more transparent method of ensuring relief of the target group only.

2. Lower maximum marginal rate is 20% for non corporate assessees and 25% tax rate for corporate assessees or introduce a flat rate of 15% in lieu thereof to break the psychological barrier of higher rate of taxation which compels the assesses to conceal their actual income and evade tax.

TABLE 6: VALUE OF ASSETS SEIZED

Year	Value of Assets
	Rs. (in crores)
2003-04	1012.36
2004-05	1308.33
2005-06	1620.87
2006-07	2031.37
2008-09	2262.28
2010-11	3351.69

Source: India – 2012, p.132

This will broaden the tax base and bring the tax buoyancy in tax collections. As the past experience shows that there has been a marked increase in tax collection with every cut in the MMR. Further, this simplification will reduce the cost of administration, tax collection and compliance.

3. Levy of tax on agricultural incomes of those with large holdings, exemption to continue for small land owners. This levy is long overdue. It will help in checking parallel black economy. Agricultural incomes have been used as a tool to convert black money into white. However, it will require great deal of political persuasion to evolve a consensus. The political opponents will try to thwart every attempt to levy tax on agricultural income.

4. The next possible areas for broadening the tax base are religious, charitable and educational institutions who receive donations which should be subject to scrutiny and tax. This will put a check on flow of black money. Further, private educational institutions and nursing homes are no more non-profit making entities.

5. One of the biggest drawbacks of the Indian tax system is the ongoing litigation that it breeds. To reduce unnecessary litigation, there is a need to introduce advance rulings for resident taxpayers as a transparent mechanism to settle tax disputes.

6. Strict penal provisions and prosecution proceedings for tax evasion offences. These may take the form of higher rate of tax on the income concealed along with the penalty which may exceed up to the normal (actual) tax liability. These provisions should be applied to all offenders irrespective of the status of the offender whether he is a politician, bureaucrat or a celebrity.

7. Searches, seizures and raids to be conducted on suspected assessees owning assets disproportionate to their known sources of income. The unexplained money, unexplained investment, gold or jewellery or any other unexplained asset be confiscated whereas on unexplained expenditure the tax liability should be calculated at a higher rate. And finally rationalization and simplification administrative procedure. The key to tax reform is to bring certainty in administration of the tax department and uniformity in interpretation of tax laws. If this is achieved the people in general, will not have any hesitation in filing tax returns and taxes. It will eliminate the role of middlemen and as such reduce the tax compliance cost. Thus the problem that taxpayers face will be largely addressed. Thus, these measures along with the transparent and simplified procedure will ensure tax buoyancy. However, tax reform is an ongoing process and will continue with the passage of time, economy's requirements, level of growth achieved, the degree of compliance and overall tax administration. Past experience shows that some of the exemptions withdrawn have been brought back. As the saying goes when an economy is stagnant, subsidize it and it is growing tax it. Since our economy is fast growing there is a need to tax it in a way that the people feel the minimum pinch. It is possible only when general exemption and deductions are scrapped and tax rate is lowered. For this, there is a need for strong political will on the part of Government to go ahead with the most challenging and daring task, only when the economic objectives of' the National Common Minimum Programme such as maintaining high growth rate, providing universal access to

quality basic education and health, generating gainful employment in agriculture, manufacturing and services and promoting investments, assuring 100 days employment to the bread winners in each family at the minimum wage, focusing on agriculture and infrastructure, accelerating fiscal consolidation and reform and ensuring higher and more efficient fiscal devolution can he achieved.

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