Taxation Reforms

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Introduction

The 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 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 in the 1950s and 1960s. The best practice approach has attempted to make the tax systems comprehensive, simple and transparent. As mentioned earlier, the general pattern of these reforms has been to broaden the base of taxes, reduce the tax rates and lower the rate differentiation both in direct and indirect taxes. A broader base requires lower rates to be levied to generate a given amount of revenues.

Lower marginal rates not only reduce disincentives to work, save and invest, but also help to improve tax compliance. More importantly, broadening the tax base helps to ensure horizontal equity, is desirable from the political economy point of view as it reduces the influence of special interest groups on tax policy, and reduces administrative costs. In the case of indirect taxation, the reform agenda includes the levy of a broad- based VAT with minimal exemptions and supplemented by a few luxury excises.

As regards import duties, quantitative restrictions should be replaced by tariffs, export taxes eliminated, and dispersion in tariffs should be minimized. Personal income tax too is to be levied on all but a small number of persons with income levels less than twice the per capita income of the country. Much of the direct taxes should be collected by withholding, but for the “Hard- to-Tax” groups, presumptive taxation is to be applied. Emphasis on horizontal equity also implies emphasis on strengthening the administration and enforcement of the tax and the development of proper information systems and automation.

Objective of the Research Paper

1. To assesses the introduction of new forms of direct and indirect taxes, their revenue and equity implications and the successes achieved in their implementation in the context of Indian Economy in 21st Century.

2. To Understand the evolution of tax system reforms, alternative paradigms employed in reform exercises in different countries and the best practice approaches to reform are described to provide a framework for analysing

the Indian tax reform experience until the comprehensive tax reform exercise were taken up in 1991.

3. To list of measures Suggested for the comprehensive growth in developing the tax system in India.

Research Methodology

The research methodology used for this study is both exploratory and descriptive. The Secondary Data was collected from Various Reports, Articles and the Books which had the Aspect of "Tax Reform in India."

India Tax System prior 1991

The trends in tax revenues show 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% in 1970-71, increased steadily to 14.6 % in 1980-81.

The ratio continued to increase steadily during the early 1980sIn 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 until1992-93.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 % in 1987-88, declined thereafter to 13.9 per cent in 1993-94 and gradually recovered to 14.6% 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% in 1970-71 to about 14 % 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 % 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 % of GDP, its contribution to tax revenues is just about half a per cent. The fastest growth of revenues was in respect of customs during the period from 1970 until 1992-93, when import duties were significantly reduced. Some observers attribute this lopsided development of the tax system to the perverse incentives arising from the constitutional arrangement of devolving revenue from personal income tax and union excise duties to states. It is also seen that even after reforms were initiated in 1992-93, although the share of revenue from import duties has declined due to reduction in tariffs, the decline in the share of revenue from union excise duties has been much faster.

In the Indian federal polity, both central and state governments exercise revenue powers and the latter raise about 37 % of total revenues. The Seventh Schedule to the Constitution specifies revenue sources of the centre and the states respectively in the union and state lists.

Impact of Reform since 1991

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. There are three parts in the report. In the first interim report, the Committee set out the guiding principles of tax reform and applied them to important taxes namely, taxes on income and wealth, tariffs and taxes on domestic consumption. The first part of the final report was concerned mainly with the much- neglected aspect of reforms in administration and enforcement of both direct and indirect taxes.

The second part of the report dealt with restructuring the tariff structure. In keeping with the structural adjustment of the economy, the basic principles taken in the recommendations were to broaden the base, lower marginal tax rates, reduce rate differentiation, and undertake measures to make the administration and enforcement of the tax system more effective. The reforms were to be calibrated to bring about revenue neutrality in the short term and to enhance revenue productivity of the tax system in the medium and long term. The overall thrust of the TRC was to (i) decrease the share of trade taxes in total tax revenue; (ii) increase the share of domestic consumption taxes by transforming the domestic excises into VAT and (iii) increase the relative contribution of direct taxes. The important proposals put forward by the TRC included reduction in the rates of all major taxes, viz. customs, individual and corporate income taxes and excises to reasonable levels, maintain progressively but not such as to induce evasion.

Implementation of Reform since 1991(Tax Reform Committee) TRC

The government accepted the recommendations of the TRC and has implemented them in phases. Although it did not entirely follow the recommendations and is yet to implement many of the measures to strengthen the administration and enforcement machinery, most of the recommendations have been implemented. It must also be noted that the pace and content of reforms have not been exactly true to TRC recommendations. As regards the personal income taxes, the most drastic and visible changes have been seen in the reduction in personal and corporate income tax rates. In the case of personal income taxes, besides exemption, the number of tax rates has been reduced to three and the tax rates were drastically reduced to 10%, 20% and 30 %. At the same time, the exemption limit was raised in stages to Rs 50,000. Combined with the standard deduction, a salaried taxpayer up to an income of Rs 75,000 need not pay any tax. In addition, saving incentives were given by exempting investment in small savings and provident funds up to a specified limit.

Attempts have also been made to bring in the self-employed income earners into the tax net. Every individual living in large cities covered under any of the specified conditions (ownership of house, cars, membership of a club, ownership of credit card, foreign travel) is necessarily required to file a tax return. Empirical evidence shows that this drastic reduction in the marginal tax rates has improved the compliance index significantly. Thus, revenues from personal and corporate income taxes have shown appreciable increases after the reforms were initiated in spite of the fact that the rates of tax have been reduced significantly. Voluntary disclosure scheme to allow a one time amnesty to tax defaulters by paying the necessary tax was introduced in 1997-98.

In the case of corporate income taxes, the rates were progressively reduced on both domestic and foreign companies to 35 per cent and 48 per cent respectively.The dividend tax at the individual income tax level has been abolished. However, very little has been done in terms of broadening the base of corporation tax. In fact, besides depreciation allowances and exemptions for the exporters, generous tax holidays and preferences are given for investment in various activities (housing, medical equipment, tourism, infrastructure, oil refining, free trade zones, software development, telecommunication, sports etc.). Consequently, the tax base has not grown in proportion to the growth of corporate profits. As many corporate entities took generous advantage of all these tax preferences, there were a number of “zero-tax” companies.

To ensure minimum tax payments by them, a Minimum Alternative Tax (MAT) was introduced in 1997-98.In the case of tariffs, there has been a drastic reduction in both the average and peak tariff rates. In 1990-91, the unweighted average nominal tariff was 125 % cent and peak rate was 355 per cent. These were progressively reduced over the years. The peak rate of import duty in 1997-98 was 40 % and the average rate of tariff is just about 25 per cent. It is proposed to reduce the tariffs further to the levels prevailing in the South-East Asian countries in the next five years. In terms of rate differentiation, the number of tax rates continues to remain high. While in the initial years, there was an attempt to reduce the rate differentiation, in more recent years, the variations have, in fact, increased. Again, the pattern of tariffs with the rates varying with the stage of processing has resulted in very high incentives given to the assembly of consumer durables and luxury items of consumption.

There has been a considerable simplification and rationalization of union excise duties as well. Besides reduction in the number of rates, the tax has been progressively converted from a specific into *ad valorem* levy in respect of the majority of commodities. The facility of providing credit on input taxes under the MODVAT too has been progressively extended to a larger number of commodities. As of now almost 80 per cent of the goods covered under excise duties are provided with the MODVAT facility. The base of the tax was broadened by removing the exemptions and levying excise duty at the lowest rate 8%.

There has also been a simplification of the tax on the small-scale sector. As the government realized that there was considerable misuse, availability of MODVAT credit was reduced to 95% instead of 100 %. Another important change that has been brought about since 1991 is the introduction of a selective tax on services.
The constitution does not assign this tax base specifically either to the centre or the states. However, the central government by invoking residuary powers has introduced a tax on services since 1994-95. Beginning with three services (telephones, non-life insurance and stock brokerage), the base of the tax has been broadened to cover a large number of services such as transporters, car rentals, air travel agents, architects, interior designers, management consultants, chartered accountants, cost accountants, company secretaries, credit rating agencies, market research agencies, underwriters, private security /detectives, real estate agencies and mechanized slaughter houses. There have been significant attempts to improve the administration and enforcement of the tax as well, though progress in actual implementation has not been commensurate. Besides amnesties given from time to time, efforts have been made to reduce arrears by introducing simplified assessment procedures. A large number of pending cases in courts have been decided through out of court settlements. There have also been attempts to establish special tax courts to deal exclusively with tax disputes. With the assistance of the Canadian International Development Agency (CIDA), the government has started an ambitious programme of computerising tax returns and building a management information system.

Some Quantitative and institutional features of Main Taxes
India has a tax structure with a three-tier federal structure (the union government, the state governments and the urban/rural local bodies). The power to levy taxes and duties is distributed between the union government and the state governments in accordance with the provisions of the Indian Constitution. The state government may delegate any of its fiscal powers to local authorities that do not have any constitutionally reserved powers of taxation. The main taxes/duties that the union government is empowered to levy are: income tax (except tax on agricultural income, which the state governments can levy), customs duties, excise duties (except on alcoholic liquors or narcotics), sales tax and service tax.

The principal taxes levied by the state governments are sales tax (tax on intra-state sale of goods), stamp duty (duty on transfer of property), state excise (duty on manufacture of alcohol), land revenue (levy on land used for agricultural/non-agricultural purposes), duty on entertainment and tax on professions & callings. The local bodies are empowered to levy tax on properties (buildings, etc.), Octroi (tax on entry of goods for use/consumption within areas of the local bodies), tax on markets and tax/user charges for utilities like water supply, drainage, etc.

1. **Direct Taxes**

Income Tax

Income tax is charged under the Indian Income Tax Act, 1961. It is an annual tax on income of both individuals and companies5 levied by the union government.
Every person (individuals, Hindu undivided families, companies, firms, association of persons or bodies of individuals and all other artificial juridical persons), whose total income exceeds the maximum exemption limit, is chargeable to the income tax at the rates prescribed in the Finance Act passed each year by the parliament. The income tax is paid on the total income of an individual, determined on the basis of her/his residential status in

India. The tax is charged in respect of the income of the previous year - that is the financial year, beginning on 1st April and ending on 31st March -and the same is chargeable in the assessment year - that is the next financial year. In the taxable income are included the following heads: salaries; income from house property (determined by reference to the annual value of property); profits and gains of business or profession; capital gains; income from other sources (included interest). The basis of taxation is the gross receipts after deducting the related expenses incurred in connection with earning such receipts. Such deductions, determined according to rules varying from head to head of income, are allowed from the aggregate of income and are in the nature of incentive provisions of different kinds.

The main deductions are the following:-

- Standard deduction – available to certain taxpayers receiving salary or pension.
- Entertainment allowance – provided to government employees that may claim a deduction up to 20 percent of their salaries or 5,000 rupees, whichever is lower, for certain entertainment allowances granted by the employer.
- Tax – for any sum paid by an employee on account of state or municipal tax on employment.
- Annuity and insurance payment – up to 10,000 rupees per annum for payments made in respect of an annuity contract in order to receive a pension.
- Repayment of loan – deduction of up to 40,000 rupees per annum for the repayment, interest, of loans used to finance higher education (available for eight assessment years); deduction of up to 150,000 rupees in respect of interest on capital borrowed to purchase or construct owner-occupied residential property;
- Donation – to charities approved for tax purposes up to the limit prescribed by the tax.
- Investment income – up to 9,000 rupees per annum in respect of interest received from certain specified investment, including dividends from cooperative societies and interest on bank deposits; up to 3,000 per annum for interest received from government securities.
- Permanent physical disability – up to 40,000 rupees for a permanent physical disability (occurred in the previous year) certified by a competent person. Other deductions are granted as tax incentives: for example, new export-oriented undertakings are entitled to an exemption from income tax; new industrial undertakings that fulfill certain conditions are entitled to a deduction (25 percent or 30 percent) of the profits for a period of 10 consecutive assessment years (or 12 for a co-operative society); a deduction of 50 percent of profits is available to hotels in hilly/rural areas. Centers (except Calcutta, Madras, Delhi and Mumbai), and so forth. After reducing the gross total income by the amount of deductions, what is left is the total income that is the basis for taxation. If the total income is below the basic exemption limit, no tax is chargeable. All receipts having the character of income are taxable unless they are specifically exempt from taxation.

2. Wealth Tax

Wealth tax is charged under the Indian Wealth Tax Act, 1957 and the union government levies it. The tax is charged on individuals, Hindu Undivided Families (HUF) and companies respect of the net wealth held by them during the assessment year. Indian citizens, resident companies and HUF are charged in respect of their worldwide assets, whereas non-resident is charged in respect of assets located in India. Net wealth is the aggregate of the assets owned by the taxpayer10, less the debts owned by her/him relative to the taxable assets. From the computation of net wealth some assets excluded (for example, the value of one house or plot of land for an individual or a HUF). Among the assets subject to wealth tax there are, for example: buildings, or land belonging with them, used for residential or commercial purposes or as a guest house or farm house, within 25 km of the local limits or cantonment board; motor cars (other than those used in a business car-hire or which are stock-in-trade); jewels or precious metals (unless they are stock-in-trade); yachts, boats and aircraft (unless used for commercial purposes); urban land (with some exclusion); cash in hand in excess of Rs. 50,000.

3. Other taxes on capital and property

Other taxes on capital and property are levied by the states and the local authorities. The states impose: - a land

tax on the value of land (the methods of valuation and the rates vary from states to states); - a tax on motor vehicles, whose yield is used for the development and the maintenance of state roads.
The local authorities impose: - land cesses in the form of a surcharge on land revenue; - a tax on land and buildings, generally based on the annual rental value; - betterment taxes, based on increases of land value caused by town planning and town improvement; - taxes on the transfer of immovable property, based on the value of the property and in addition to state stamp duty.

4. Expenditure Tax

The expenditure tax is charged under the Indian Expenditure-tax Act, 198711 and it is by the union government. The tax is charged at the rate of 10 percent on any chargeable expenditure incurred in a hotel wherein the room charges12 for any unit of residential accommodation are three thousand rupees or more per day. The expenditure tax is collected by the person who carries on the business of such hotel. The tax collected during any calendar month is paid to the credit of the union government by the 10th of the month immediately following the said calendar month. Any person responsible for collecting the expenditure tax who fails to collect it shall pay, in addition to paying the tax, a sum equal to the amount of tax that s/he failed to collect. From the 1st October, 1991 to the 31st May, 1992 a tax at the rate of 15 percent of the chargeable expenditure incurred in a restaurant was levied.

Indirect Taxes

1. Customs Duties

The Constitution has given to the union the right to legislate and collect duties on goods imported into or exported from India. The Customs Act, 1962 is the basic Statute, effective from 1st February 1963. The categories of items and the rates of duties which are leviable have been specified in two schedules to the Customs Tariff Act, 1975. The first schedule specifies the various categories of import items, in accordance with an international scheme of classifications of internationally traded goods (Harmonized System of Nomenclature (HSN), established by the World Customs Organization). All goods are classified into categories, called “Headings” and “subheadings”; for each sub-heading, a specific rate of duty is prescribed. The duties are levied both on specific and *ad-valorem* basis, while there are few cases where at times specific-cum-*ad valorem* duties are also collected on imported items. Where *advalorem* duties are collected, the value of the goods has to be determined for customs duty purposes according to WTO Valuation Agreement.

Under the Custom Tariff Act, 1975 and other laws, there are the following types of duties that are leviable:-
• *Basic Customs Duty* - that is duty specified against each heading or sub-heading in the first schedule. There are different rates of duty for different commodities and there are preferential rates for goods imported from certain countries in accordance with bilateral agreements with such countries. The duty may be *ad valorem* or specific.
• *Surcharge* - that is levied at the rate of 10% of the Basic Customs Duty on imported goods, unless exempted by a notification.
• *Additional duty of customs* - equivalent to the excise duty leviable on goods produced manufactured in India. Generally it is on *ad valorem* basis, though specific rates are prescribed for some items. For imported goods to be used as inputs for manufacture of other goods, it is generally eligible for a credit (called CENVAT credit) equal to the additional duty of customs paid on the imported goods. This credit can be used for paying central excise duties.
• *Special additional duty* – whose amount is computed by applying the specified rate13 on the total of the assessable value, the basic customs duty and the additional duty of customs described above.
There are also additional levies on particular items and other levies which are specific to the country of origin. Among the later there are *anti-dumping duty*, on specified goods imported from specified countries to protect indigenous industry, and *safeguard duty*, applicable on certain goods for specified periods in order to check their excessive imports which may damage the Indian industry. The rates vary and are based on official notification.

The custom duty on exports is levied on items listed in the second schedule to Customs Tariff Act, 1975. Currently, the rates vary from 10 to 60 percent and they are either *ad valorem*, specific or a combination of both. Very few items are subject to customs duties on their export. In order to make the exports more competitive, it is provided a duty exemption scheme for registered exporters so that they may import the inputs required for export production at international prices and free from duty. Imported items that are exempt from customs duty are raw materials, components and consumables.

2. Central Excise Duties

Central excise duties are charged under the Central Excise Act, 1944 at the rates specified in the schedules to the Central Excise Tariff Act, 1985. They are an indirect tax levied on goods produced or manufactured in India, excluding those produced or manufactured in special economic zones. There are several types of duties which become payable at the time of clearance of such goods.

These duties are:-

• *Basic excise duty* (specified against each sub-heading in the First Schedule to the Central Excise Tariff Act, 1985) actually called the "Central Value Added Tax (CENVAT)

• *Special excise duty* (leviable only on a few items, in addition to CENVAT, at the rate specified under the Second Schedule to the Central Excise Tariff Act, 1985).

• *Additional duties of excise* (leviable on various commodities, as specified textiles and textile articles, or on sugar, tobacco products in lieu of sales tax).

Service Tax

Service tax was introduced in India for the first time in 1994. It extends to whole of India except the state of Jammu and Kashmir. It is levied, collected and appropriated by the union Government. Service tax is levied on specified taxable services and the responsibility of payment of the tax is cast on the service provider. The Finance Act 2001 introduced self assessment for service tax returns, which are expected to be filled half yearly and by the 25th of the month following the half-year15. This is in replacement of the monthly/quarterly returns prescribed earlier.

Initially the service tax was imposed on the following services: telephone, stockbroker, general insurance. Over the years it was extended to other services, as advertising agencies and courier agencies. At present the total number of services on which service tax is levied has gone up to 58, despite withdrawal of certain services from the tax net or grant of exemptions.

In the budget 2003-04 more services16 have been added to the tax net and the levy of service tax on these services is effective from July 1st, 2003. Service tax is levied on the gross or aggregate amount charged by the service provider on the receiver; only in particular cases the tax is permitted to be paid on the value received.

To reduce the cascading impact of tax on tax and to help restoring competitiveness of service sector, a credit of the service tax paid on the input-service is allowed since 2002. At present the assesses can avail of input credit in respect of any of the categories of the services and utilize the said service tax credit for payment of service tax on any of the output services.

Sales Tax

Sales tax is charged under the Central Sales Tax Act, 1956. It is levied on the sale or purchase of goods. There are two kinds of sales tax: 1) Central Sales Tax (CST), imposed by the union government; 2) Sales tax, imposed by each state. Central sales tax is generally payable on the sale of all goods by a dealer in the course of inter-state trade and commerce and it is levied in the state where the movement of goods commences. Although the tax is imposed by the central government, the revenue is administered by the state in which it is levied.

Analysis Strength and Economic Impact on Tax System

In this section, the observed trends in different central and state taxes are explained in greater detail and the possible efficiency and equity implications of different taxes are analyzed. Specifically, the analysis seeks to answer a number of questions. Has tax compliance improved over the years in response to reductions in marginal tax rates? What other factors influence revenue productivity of the tax system? What are the efficiency and equity implications of the tax system? The increase in revenue productivity of the personal income tax is attributed to the improvement in tax compliance arising from the sharp reduction in marginal tax rates in 1991–92 and 1996–97. This is also the period when the growth of GDP itself had decelerated. The apparent stimulus of declining marginal tax rates is reflected in the negative correlation between effective tax rates and the ratio of income tax collections to GDP, While it is clearly difficult to attribute the increase in revenue productivity solely or even mainly to reduction in marginal tax rates, To draw a tentative but important conclusion capturing improvement in overall performance of the tax system. Similarly, analyzes sixteen different structural, administrative, and institutional indicators, and concludes that the performance of the tax system has shown improvement: tax compliance indeed improved with the reduction in marginal tax rates. In a more recent analysis, Economist Bhalla estimates the aggregate revenue elasticity at –1.43 percent and concludes that the 1996–97 tax cut was a huge success in increasing revenues.Bhalla provides an estimate of compliance by comparing the data published by the income tax department, the coverage of which itself is narrow, with those from other sources, particularly the National Council of Applied Economic Research to establish that the number of people recording incomes within any given bracket for income tax purposes, is significantly lower than the numbers recorded by other surveys. This approach has problems, however, especially for proprietary firms and individual businesses where it can be hard to distinguish between expenditures of the firm and expenditures of the individual for personal needs.

Nevertheless, the paper helps to focus on the need for some informed debate and analysis in area. The important point is that improvement in revenue productivity of the personal income since 1996–97 cannot be attributed solely or even mainly to reduction in the marginal rate. The information shows that the main reason for the increase in revenues is the administrative arrangement extending the scope of tax deductions at source— an arrangement whereby the employer withholds the tax due on the income paid to the employees and directly remits the same to the government exchequer. The proportion of tax deducted at source (TDS) to total revenue collections actually declined from 42 percent in 1990–91 to 22 percent in 1994–95. It increased to 50 percent following the expansion in the scope of TDS in 1996–97 and to 67 percent in 2001–02 before declining marginally to 64 percent in 2003–04. As a proportion of GDP, the ratio of collections from TDS increased by 0.67 percentage points over the period considered. When compared with the increase of 0.56 percentage points in the ratio of personal income tax collections to GDP, the improved compliance appears to result largely if not solely from improved coverage or greater effectiveness of TDS as a tool for collecting taxes.

Interestingly, although it is tempting to attribute this observed trend to extension of TDS to interest, dividends, payments to contractors, and insurance commissions, the increase has come about mainly in TDS in salaries. The TDS in salaries in 1992–93 constituted only 25 percent of total TDS, increased to 50 percent in 1999–2000 and thereafter declined to 41 percent, as TDS from payments to nonresidents and others and payments to contractors increased substantially. Even after the refunds are adjusted, the share of TDS in total receipts continues to remain high and increasing. This implies that the contribution of TDS to incremental revenue is increasing as well. The increase in the tax revenue thus has more to do with the rapid growth of the organized sector, expansion in the interaction of the financial sector with the rest of the economy, and administrative measures extending the TDS than with improved compliance arising from the reduction in marginal rates of tax.

The extension of permanent account numbers to cover a larger number of potential taxpayers and the expansion of the tax information system (TIN) are expected to advance this cause further, by generating an The increase in the number of taxpayers indicates improvement in horizontal equity since more people with similar incomes now possibly pay the tax, and the fact that a larger proportion of incomes are now subject to tax represents improvement in Vertical equity as well.

Suggestion / Recommendations

To create excellent systems of government, it is important that certain high standard principles are established and adhered to. Such principles should be used as solid guidelines for creating systems of taxation as well. Not very much attention has been paid in any country to establish such important guidelines for taxation and the result has been that no excellent systems of taxation exist in India or any other country.

The following 10 sound principles are largely ignored by all systems of Taxation in existence and also by most tax reform proposals.

The first 4 principles of taxation are by Adam Smith (1776 Wealth of Nations). Adam Smith can be regarded as the "Godfather" of economics. The additional 6 principles of taxation are by Alf Temme (author of Automatic-Tax 2005 and other economics related topics such as www.Universal Demand Law.com1975)

1. The subjects of every state ought to contribute towards the support of the government, as nearly as possible, in proportion to their respective abilities; that is, in proportion to the revenue which they respectively enjoy under the protection of the state.
2. The tax which each individual is bound to pay ought to be certain, and not arbitrary.
3. Every tax ought to be levied at the time, or in the manner, in which it is most likely to be convenient for the contributor to pay it.
4. Every tax ought to be so contrived as both to take out and to keep out of the pockets of the people as little as possible over and above what it brings into the public treasury of the state.
5. A tax should not be used to give favorable tax treatment to different people or businesses for any reason or purpose no matter how well intentioned. Any reduction in taxes to some will necessarily increase the rate of taxation to all other taxpayers. There has been always great sentimental debate and implementation of lower or no taxes for people on the lowest rungs of the socio economic ladder. This is, and always has been one of the greatest mistakes and it most often amounts only to shameless vote buying by politicians. The fact is that the paying of taxes by "the poor" gives them the equal dignity of all other taxpayers who contribute equally to the running of their government. The equal paying of taxes does not create the class strife that has been created by the politicians who pretend to care for the poor and the under-classes they are identifying in their election campaigns and whose votes they endeavor to "buy" with money they "steal" from all the rest of the taxpayers by indirectly increasing their tax rates in the process.
   The "poor" do not benefit from favorable tax treatment because the ironic reality is that their "take home" wages gradually decline by the amount they otherwise would have paid in taxes.
6. A tax should be as broad based as possible, resulting in a low percentage rate that offers little incentive for tax evasion and tax avoidance and all the unproductive activities people engage in to lower their taxes.
7. A tax code must be formulated in simple language easily understood by all who are subject to it and not be a document of 65,000 pages (like the shameful United States income tax code) that cannot possibly be known and understood by the average tax payer and will be subject to many interpretations.
8. To keep a tax system as simple and clear as possible, it must have as few as possible exemptions or special provisions. Instead of exemptions or special provisions in the tax code, a government can have refund provisions or bestow grants rather than use favorable tax treatment as a political tool or for social engineering.
9. An optimum tax replacement must be able to be phased in very incrementally to create as little economic and political disruption as possible. People and their politicians are very risk adverse and will not easily accept a proposal that will create sudden drastic economic and political changes over a short span of time.
10. The optimum tax replacement proposal must be attractive enough to be accepted as optimal by multiple countries. The fact that all major countries have totally different tax systems serves as proof that none of them as yet has found or implemented an excellent tax system that many other countries would like to copy.

Conclusion

As we embark upon the year 2011, the country is expectantly looking at the largest and most radical reform in Tax Systems. The industry expects that it would be a much simpler regime, where hopefully taxes will not impact the business decisions.

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