INTERIM REPORT OF THE ADVISORY GROUP

ON

TAX POLICY AND TAX ADMINISTRATION REFORM

FOR THE TENTH PLAN

Constituted by the Planning Commission,
Government of India

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New Delhi
December 31,2000

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Preface

The Advisory Group has attempted to address the terms of reference given to it, comprising an examination of the contribution of various taxes at the level of both the Centre and states, an analysis of the present tax structure and aspects of tax administration leading to appropriate recommendations, and providing an international perspective where relevant. The Group coopted two advisers from the Revenue Department to familiarise itself fully with current tax policy and administration concerns from the viewpoint of the Department.

The Group was addressed in the initial stages by Shri Montek Singh Ahluwalia, Member, Planning Commission, who informed the Group of the expectations that would be attached to its recommendations not only in the context of mobilising resources for the Tenth Plan but also for carrying out fundamental tax reform. Thereafter, the Group met eleven times at an average interval of a fortnight with the twelfth meeting culminating in the submission of the Interim Report to Shri K.C. Pant, Deputy Chairman, Planning Commission. In the process, the Group also met Shri S. Narayanan, Revenue Secretary, as well as Dr. Shankar Acharya, Chief Economic Advisor, Ministry of Finance.

After the initial meetings, it was decided to submit the report in two stages, an Interim Report at the end of 2000 and a Final Report by mid-2001. While the Interim Report would define the macro-economic perspective and focus mainly on taxes at the Central level, the Final Report would include state taxes in greater detail as well as other issues not included in the Interim Report. The Group has made sure to submit its Interim Report at year-end to allow for some of its recommendations to be considered for incorporation in the Union Budget of 2001-02, as needed.

The Group conducted field level dialogue with regard to tax policy and administration issues, both under direct and indirect taxes at the Central level. Accordingly, visits to Chennai and Calcutta were organised. In Chennai the Group visited the Income Tax computer unit and Custom House including the port. The Group also visited the Income Tax office in Calcutta followed by a visit to Hindustan Lever factory to examine excise procedures.

In order to make the best possible use of the Chennai and Calcutta visits, the Group also held meetings with State Government officials—including the Finance Secretary, Secretary and Commissioner of Commercial Taxes as well as of other taxes, together with other related secretaries and officers of both states—and representatives of leading chambers of commerce and industry. The Group thus obtained an overview of state level taxes even though the latter is scheduled for greater focus in the Final Report. In this context, the Group invited Dr. Indira Rajaraman, Senior Fellow, NIPFP, to speak on the agricultural income tax. As such, the Interim Report includes a chapter on state taxes, which flags some of the issues that the Group would be elaborating in its Final Report.

Abstract

The necessary stance of the authorities in the area of tax policy and tax administration for the Tenth Plan comprises many facets. For central taxes, the potential of corporation and personal income taxes—that have demonstrated the highest revenue buoyancy—has to be tapped further. Measures include improvements in the tax structure as well as in tax administration. The former issue has to focus on minimising exemptions and incentives and improving the base of the minimum alternate tax (MAT). The latter issue should include increasing the number of assessees while reducing taxpayer burden to improve compliance, and introducing comprehensive and meaningful computerisation for major functional areas of administration.

Indirect taxes have demonstrated low buoyancy which is likely to continue given anticipated structural changes in indirect tax structure. A composite reduction of customs tariffs to internationally comparable levels for increased competition and global integration should be kept apace. This is reflected in the projected customs revenue being allowed to decline marginally in terms of GDP during the Tenth Plan period even in light of exemptions under the customs being streamlined.

A comprehensive central value added tax (CENVAT) that allows full credit for all inputs including capital goods and minimises the number of rates is also likely to have a short term negative revenue impact. But this has to be done to eliminate distortions affecting industry adversely. If multiple and complex exemptions are removed, robust revenue improvement could nevertheless be realised from Union excises. Base expansion to include the consumption of services comprehensively should be carried out forthwith. It would also support the objective of improved revenue productivity.

States should reform their sales taxes and introduce a broad based VAT by April 2002 as has been agreed. Equally importantly, they have to address the issue of taxation of interstate trade under a state level VAT. Without that, the VAT—currently focussed only on intra-state trade--would remain distortionary. Allowing taxation of services also by states should be considered by the Centre as a solution for compensating states that would loose when the VAT includes interstate trade in its base. The ultimate goal should be to have a harmonised VAT comprising both the Centre and states. State excises have to be rationalised further and its revenue potential fully realised.

At the local level, property taxation has to be elevated to its full potential to relieve the states somewhat from their heavy responsibility of meeting the revenue needs of local bodies per the 73rd and 74th Amendments to the Constitution. Available examples of selected local bodies that are attempting to use improved methods to tap their revenue potential more fully, for example, in the form of self assessment in Bangalore should be explored in a national effort.

Main Recommendations

- In an analysis of the trends of tax revenue in terms of GDP and future prospects, it was concluded that the tax/GDP ratio should reach 17.8 percent in 2006-07, which is 3.7 percentage points above that of 1999-2000. This has to happen if a 15 percent nominal rate of growth is to be achieved during the Tenth Plan, reflecting the Prime Minister's indication that a 9 percent real rate of growth be realised.

Reform of Direct Taxes

- It is recommended that the maximum marginal rate of personal income tax be retained at 30 percent and the surcharge should be removed. Also, correction must be made to remove bracket creep from the structure by broadbasing the various brackets/slabs, even though it may lead to some revenue loss at existing levels of compliance. However, this should be done pari passu with streamlining base erosion.

- It is recommended that, ideally, tax incentives under Sections 80CCC, 88, 80L and 10 (15) of the Income Tax Act be abolished, at least in phases; that tax concessions under Sections 80D, 80DD, 80DDB and 80E be given in the form of tax credit rather than as deduction from income (to improve equity); and the rollover provision relating to capital gains under Sections 54, 54B, 54D, 54EA and 54EB be removed. This reform should eventually enable further reduction in the overall tax rate structure that should enable improved savings behaviour by all tax payers.

- It is recommended that the exemption for interest on foreign borrowings be withdrawn.

- It is recommended that the income of the Funds should be subjected to tax at the lowest marginal rate of personal income tax, i.e., at 10 percent.

- It is recommended that the provisions of Sections 10(8), 10(8A), 10(8B) and 10(9) be deleted.

- It is recommended that the provisions of Sections 10A and 10B be phased out.

- It is recommended that the provisions of Sections 80IA and 80IB be deleted.

- It is recommended that the standard deduction be reduced to 10 percent of the salaries subject to a maximum of Rs. 5000.

- It is recommended that the present provision for allowing of interest deduction on borrowed capital for construction of a self-occupied house property be discontinued.

- It is recommended that, first, the income-based deduction for donations under Sections 80G and 80GGA be converted to a tax credit at the lowest marginal tax rate of 10 percent—for equity reasons—without any limit as a fraction of gross income as set under Section 80G. Second, the exemptions under Sections 10 and 11 to 13 of the Income Tax Act in respect of income of charitable trusts and institutions of various categories be restricted only to donative NPOs, to be defined as those in which 90 percent of the receipts are through donations. Third, the non-distribution constraint should be made explicit and universal.

- It is recommended that the present corporate tax rate of 38.5 percent be lowered to 30 percent in case the top personal income tax rate is integrated at the latter rate. Or, if the prevailing personal income tax rate structure continues, the corporate income tax rate should be brought down to 34.5 percent.

- It is recommended that the prevailing 20 percent dividend tax be abolished. Instead, the MAT should be reconstituted as a tax equal to the aggregate of 0.75 percent of adjusted net worth at the end of the year plus 10 percent of the dividend distributed. It would allow carry forward for setoff against future tax liability in excess of the MAT as provided in Section 115JAA.

- The following immediate reform measures in direct tax administration are recommended:

  (1) extending the pilot voice message system of Calcutta to other centres;
  (2) making available forms and returns on floppy diskettes;
  (3) allowing the tax administration to print forms in private presses;
  (4) developing a long term plan for non-discretionary information gathering;
  (5) notifying the categories of transactions for which the Permanent Account Number (PAN) must be quoted;
  (6) refusing to accept taxpayer forms by the administration without the PAN;
  (7) replacing the income tax clearance certificate by simply quoting of the PAN;
  (8) removing the deficiencies from the Taxpayer Master File to enable identification and notification of stopfilers;
  (9) writing off arrears in cases where the identity of the taxpayer is not established beyond doubt;
  (10) while reducing corruption in cases of scrutiny (detailed audit), maintaining a credible minimum deterrence level—by ensuring that a certain minimum percentage of taxpayers is scrutinised annually through a selection pattern that is secret and fair;
  (11) decentralising selected expenditures to local offices that are currently consolidated at the cost of efficiency at the Finance Department level;
  (12) identifying areas on which resources could be saved with the advent of IT;
  (13) requiring banks to furnish information regarding collection of taxes on magnetic media;
  (14) providing computers to the staff members;
  (15) setting up an inter-Ministerial Committee to oversee the time bound programme for networking of all income tax offices across the country; and
  (16) clearly specifying the rights and obligations of all parties and supporting institutions for greater accountability in the proposed MOU between Government and the CBDT.

Reform of Union Excises

- It is recommended that a two-rate structure of 16 percent together with a higher rate be introduced. An increasing number of items are to be converged to fall under the 16 percent rate to minimise classification problems. This would be economically desirable and administratively simple. The rates would have to be adjusted for inclusion of services in the CENVAT.

- There should be a single levy under the Central Excise Act.

- It is recommended that the definition of manufacture be widened to include the chain of value addition by or on behalf of the manufacturer (undertaken before marketing the product) and to be charged to duty.

- It is recommended that both capital goods and raw material “used in the factory of the manufacturer” be allowed CENVAT credit.

- Input tax credit on capital goods should be immediately restored by giving the credit in the year of purchase itself.

- An intensive effort is necessary to rationalise exemptions on the same subject through abolition and merger. Conditions for exemptions must be minimised. When an item is covered under the SSI exemption scheme, there should not be any separate exemption except for some very valid reasons. SSI exemption should be extended to textiles also by replacing the individual exemptions.

- SSI units below a turnover of Rs. 3 crore should pay a duty of 85-90 percent of the normal rate if they opt for CENVAT credit. At least, the unutilised credit should lapse once the Rs. 1 crore exemption limit is reached. The 3 crore turnover calculation should not exclude exports and exempted goods produced by a SSI unit. SSI units must maintain all records and give a declaration. Only really small units with a turnover of Rs. 15-20 lakhs should be exempted from declaration/maintenance of records.

- It is important to integrate services as early as possible with the CENVAT to arrive at a full fledged VAT at the Centre, perhaps as early as in the Budget of 2002-03.

- The depots or other places of removal should be made into duty paying agencies, with accounts-based checks and audits at regular intervals.

- Fortnightly payment should be replaced by monthly payment to enhance the liquidity of units and to reduce excessively stringent accounting needs.

- Reentry should be allowed on accounts based self declaration or simple intimation to the Department.

- Resale should be allowed on the basis of maintenance of accounts and penalty imposed in case of misuse. On the whole, therefore, excise administration should complete its movement towards financial control from physical control based methods.

Reform of Customs Duties

- The basic tariff rate should be reduced from 25 percent to 20 percent.

- Countervailing duty (CVD) of 16 percent should be levied uniformly. Exemptions from the 4 percent special additional duty (SAD) should be removed.

- Transaction value should be adopted since international prices vary from transaction to transaction.

- There are many schemes for export promotion, remission, exemption and entitlement, including Duty Free Replenishment Certificate (DFRC), DEEC, Export Promotion Capital Goods (EPCG), export under bond, drawback, and special scheme for gem/jewellery/diamonds, Export Processing Zone etc.. There is no need for so many export promotion schemes. They need to be rationalised by combining them and removing the overlapping.

- Computerisation in customs administration is progressing and improvement is an ongoing process. Much remains to be accomplished, however, and speeding up is essential.

- Only targeted goods should be checked on the basis of intelligence. Thus the intelligence collection machinery should be strengthened, while selective post audit should be based on computerised information.

- The CBEC should be allowed to give advance rulings. Advance rulings should be made available to all and not be restricted to NRIs.