Chapter – I
APPROACH TO TAX REFORM

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

The Task Force was intended as the forum to deliberate upon and correct many of the existing anomalies in the Indian direct tax system. Towards fulfilling this mandate, an attempt has been made to outline steps required for initiating and expediting a requisite *process transformation*; this Report contains its considered judgement, melded from views culled from a diverse section of stakeholders.

The approach of the Task Force has been influenced by the recognition that in the recent past economies have increased their tax revenue-to-GDP ratio not by increasing tax rates but by simplifying tax structures, widening the tax base and improving tax administration. The Task Force has examined best tax practices in the world, deliberated on ways to reduce costs of tax administration and extensively debated means of empowering Central Board of Direct Taxes (CBDT) to fulfill its function effectively.

The dynamic nature of economic activity in India is sure to impact upon the taxpayer profile, with changes in the relative share of industry, services and agriculture-value added being particularly important. Therefore, the recommendations of the Report are embedded in a forward-looking approach to taxation by imparting a sector-neutral flavour. The Task Force has endeavored to ensure that the recommendations pertaining to the direct tax codes are congruent with generally accepted principles of taxation. The three principles relate to efficiency (minimising distortions in resource allocation), equity (progressiveness of effective tax rates) and effectiveness (of tax administration). One of the principal outcomes sought of this Report is an alignment of the objectives of the tax authorities with obligations of taxpayers; in other words, enhance the incentive compatibility of the two groups.

There is a widespread perception that (frequent) changes in the tax code in the last decade or so have (unintentionally) been akin to substituting the erstwhile “license raj” with an “exemptions raj”. Tax policy and tax administration is inter-linked: complex tax policy leads to complex tax legislation, which inevitably leads to cumbersome administration through a cascading effect on filings, compliance procedures and enforcement measures. The series of *ad hoc* exemptions and other tinkering has only served to clutter the culture of compliance. Apart from its effects in distorting incentives, a weak and porous system has evolved, which by increasing transaction costs of participation dissuades potential taxpayers. Over the years a number of perverse incentives have crept in: taxpaying is often punished (by harassment) and tax evasion is not sufficiently deterred. It is noteworthy that this undesirable outcome has occurred against the backdrop of considerable efforts in recent years by the tax authorities to fulfill its functions.

Evaluation of tax policies has emerged as a concern of critical importance. The tax policy must be outcome oriented rather than input aligned; for instance, many tax incentives reward higher usage of particular factors of production (inputs) or provide tax breaks for specific savings instruments. These incentives need to be re-engineered so that outcomes, viz., higher productivity of income tax-payers and increased profitability of corporations is encouraged. This is the case with the most dynamic countries among the emerging markets.

Optimal tax policy should be pursued in the general interest of the economy rather than for catering to sectional interests. Every exemption has a constituency and democratic systems tend to respond to constituencies – a tax break to one constituency inevitably spawns similar demand by others. Hitherto, tax policy, including exemptions, has been used in instances where other instruments at the disposal of the government are *prima facie* more suited to achieve stated objectives. Confusion in allocating instruments to objectives result in an inefficient allocation of resources and often defeat stated aims. Clearly demarcated distinctions among objectives to be achieved and increasing transparency in the use of expenditure and tax instruments for these objectives can be expected to yield better results. An explicit separation of the two broad classes of instruments will have the secondary effect of reducing ambiguities in justification of expenditures and also impart greater effectiveness to parliamentary oversight of the government’s fiscal decisions.

Communication about taxes and tax policies is extremely important – taxpayer rights and obligations need to be clearly specified. The best tax systems in the world deal with taxpayers in a professional customer-relationship environment, which requires the system to be transparent, responsive and nondiscriminatory. Furthermore, by increasing accountability of tax authorities, a durable welfare-improving social contract is established between taxpayers and tax administration.

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

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

A change in attitudes has distinctly and perceptibly emerged in a previously largely adversarial relationship between the tax collector and taxpayer, when neither was inclined to believe the other's integrity. Younger taxpayers are more willing to pay their dues to society. Simultaneously, this willingness is conditional; based on their experience as customers for commercial services, they have come to expect a professional interaction with service providers. The Task Force reiterates that all possible measures are instituted to prevent an alienation of this increasingly important demographic segment and an attendant reversion to the tax cynicism of earlier generations.

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