

## CHAPTER 1

### MACRO-PERSPECTIVE AND APPROACH TO REFORMS

#### 1. Macro perspective

1.1 Our economy is at a critical juncture in its efforts to accelerate growth and employment in order to rapidly reduce poverty. Towards this, one of the key components of the strategy will have to be to exploit the opportunities afforded by more rapid globalisation. While our economy has succeeded in maintaining one of the highest GDP growth rates in the world in the last decade with very low inflation, there are several areas where immediate improvements are required to sustain the growth momentum. The two principal concerns are the deteriorating public finances, with the consolidated public sector deficit estimated to be over 11 percent of GDP, and relatively weak performance of exports and FDI, the two pillars of trade and financial sector integration. On the fiscal side, while the government needs to focus on expenditure rationalization, a more critical area which needs immediate attention is to raise the declining tax to GDP ratio. On the external front, India's success in integrating into the world economy critically hinges upon raising the share of its exports in world trade closer to its pre-independence level of over 2 percent from the current level of 0.6 percent, and increasing the inflow of FDI to at least \$ 10 billion annually in the current plan period (China receives close to \$ 46 billion) from the current dismal level of \$ 2 billion.

1.2 The stated objective of the Ministry of Finance and Company Affairs in setting up this Task Force on Indirect Taxes is "to take advantage of information technology and bring the indirect tax systems and procedures at par with the best international practices and thus, encourage compliance and reduce transaction costs". This mandated the review of the extant indirect tax laws and procedures - Customs, Central Excise and Service Tax - with an eye toward removing complexities and facilitating voluntary compliance. The bottom line is to set in place a user friendly and transparent tax administration in tune with the best international practices. The understanding is that such measures would improve voluntary tax compliance and reduce the transaction costs and, thus arrest the trend of falling tax to GDP ratio.

1.3 The most direct way to raise tax to GDP ratio is to remove most of the plethora of exemptions granted on import and excise taxes for a variety of reasons, mostly for non economic

considerations; widen the net by expanding the service tax base; and to improve taxpayers compliance. Recent research in tax policy suggests that, in general, indirect tax incentives are very prone to abuse, as qualified purchases can easily be diverted to buyers not intended to receive incentives. Thus they are difficult to justify on policy grounds. Their use should, therefore, be limited to removing import duties on inputs used in the direct production of exports. Granting indirect tax incentives to export-oriented industries is a prevalent practice worldwide. Conceptually, relieving inputs used in the direct production of exports from the burden of indirect taxes is clearly justifiable on the principle of destination-based taxation, and should, in general, be supported. Such measures will also revive growth and stimulate investment, the tax system in general is in conformity with international norm, supported by suitable macroeconomic, structural, legal, and regulatory environments.

1.4 To boost exports and FDI, the government must sharply reduce the transaction costs associated with trade and doing business with India. Apart from maintaining a realistic market-driven exchange rate, and liberalization of imports, this will involve changes in policies and procedures involving improvements in trade logistics to allow exporters to compete in today's time-dependent markets. This will require a change in mindset away from controls rigidly administered, towards a more liberal policy environment in line with international standards. Trade facilitation revolves around the reduction of all the transaction costs associated with the enforcement of legislation, regulation, and administration of trade policies. It involves several agencies such as customs, airport authority, port authority, central bank, trade ministry etc. The main objective is to reduce the cost of doing business for all parties by eliminating unnecessary administrative burdens associated with bringing goods and services across borders. The means to achieve this objective are the modernization and automation of clearance procedures to established international standards. There is a dire need to streamline trade administration so that exports and imports are cleared in line with international norms. It takes days in major ports/airports to clear goods as against hours in most successful globalized countries. This is a key step to stimulate a rapid export drive and to attract a sizeable FDI. In this context, the Task Force would like to recommend the Government to take a more proactive stance towards trade facilitation in the coming WTO round. The Government is in dire need to streamline trade administration so that exports and imports are cleared in line with international norms. This is a key step to stimulate a rapid export drive and attract a sizeable FDI. A positive stance by India in WTO on trade facilitation would serve two purposes. We could use it to get some concessions

from the developed countries who are championing this idea. Secondly, this would improve our international image as a committed reformer.

1.5 It is important to note that once Universal Green Channel and EDI in all major ports/airports are in place, transaction costs will be substantially reduced. This will sharply bring down the anti-export bias in the economy. According to a recent EXIM Bank study (October 2002) - "Transaction cost of Indian exports : an update", transaction cost which has come down in the last four years, continues to be high. For example, dynamic sectors of textile and garments and pharmaceuticals such costs are 10% and 8%, respectively. With the proposed reforms, it is estimated that the reduction in the transaction costs could be as much as 50%, the potential gains to the economy would be Rs.4000-5000 crores per annum i.e. this large benefit would accrue to the economy every year. In a dynamic sense, in terms of exports foregone on account of high transaction costs, the reduction in costs will be several times higher. Reducing transaction costs and costs of doing business is important not only for boosting exports and FDI but even for creating an appropriate framework for vibrant domestic business.

1.6 What ails the indirect tax administration beleaguered by low collections, revenue leakages and high cost of compliance has been the subject matter of intense debate over the years. Whereas recent initiatives are directed at a more transparent and rule bound system, there is an increasing realisation that whatever has been done has neither been sufficient nor effective. As a result, it becomes evident that the present system does not lead to confidence building in the tax payer, which has grave implications such as the falling tax to GDP ratio. Accordingly, it is imperative to go to the root of the problems and arrive at long terms solutions.

## **2. Approach to reforms**

2.1 In this background, as a part of its work programme, the Task Force undertook studies and analysed the different aspects of indirect tax laws and administration. It initiated dialogue with a large number of stakeholders from the trade, industry and department and also examined the best international practices in the critical areas of indirect tax administration. A close look was also had at important reports of Expert Committees and Groups which had examined the indirect tax system in the recent past - The Advisory Group on Tax Policy and Tax Administration for the Tenth plan (Chaired by Shri Parthasarathi Shome), Committee on Review of Central Excise Collection System (Chaired by Shri S. V. Iyer), Expert Group on Taxation of Services (Chaired by

Dr. M. Govinda Rao) and Inter-Ministerial Working Group on Customs Tariff (Chaired by Shri Arvind Virmani). All these reports have contributed significantly in shaping the final views of this Task Force.

2.2 The finding was that in the recent past Government has initiated a number of steps to improve the indirect tax administration. To list a few such measures, transaction value concept has been introduced for excise duty assessment; MRP based levy introduced on 92 categories of consumer goods; central excise procedures have been substantially simplified such as dispensation of most pre-clearance requirements, fortnightly payment of duty, introduced alongwith dispensation of statutory records etc. Similar positive steps have been taken on the customs side, particularly relating to EDI based assessment and clearance of import and export cargo. However, it is the perception that much more needs to be done. All in all the common refrain which emerged out of the aforeslated exercise was that despite all what has been done, the indirect tax system in the country suffers from the following drawbacks :

- (i) Lack of confidence in the tax administration on account of too much discretion, absence of accountability and a pro-revenue bias in all matters, especially quasi-judicial.
- (ii) Alienation from tax administration, which manifests into corrupt practices and low compliance.
- (iii) Uncertainty about tax policy, administration and absence of time bound decision making all of which affects business decisions.
- (iv) Complexities of laws and procedures on account of lack of codification which is exploited for private gain by the unscrupulous tax payer and the tax collector.
- (v) Too many laws and procedures which create an environment of confusion and mistrust.
- (vi) Too many conditions attached to each exemption and procedure delay decision making and increase transaction costs.

- (vii) Absence of transparency in tax planning.
- (viii) Customer orientation is missing in the tax collectors who view all tax payers with suspicion.

2.3 Inspite of these problems, a modern, transparent and efficient tax system encompassing the best international practices is certainly possible to implement in the short run. In fact, a review of the indirect tax law and procedures reveals that simplification has also been carried out in the past few years. One has to recognize a discernible move towards reducing departmental interface with the tax payer, increased reliance upon automation, particularly in customs, reducing complexities in tariffs and procedures etc. There can be no two views that these changes have largely been beneficial to the trade and industry. However, it is evident that whatever has been done so far has not been sufficient to impact positively the face of the indirect tax administration in a manner which results in a 'big push'. Therefore, the finding is that for the desired tax system to be achieved without further loss of time mere tinkering with the present law and procedures would not suffice. It is the need of the hour to move away from incremental changes, from the policy of taking ad-hoc and half-hearted measures. What is required is a formulation for a macro-jump of the Indian economy so that India is no longer perceived as a nation hesitantly approaching globalization...a strategy that revolutionizes the way things are looked at and causes fundamental changes in the way things are done in indirect tax administration. Only such a strategy would result in a quantum improvement in the administration of indirect tax system in the country. India must be seen as an economy offering the best internationally accepted standards of tax administration and tax payer facilitation .....now and for all time to come. This would no doubt positively impact the tax to GDP ratio also. Basically the strategy must provide the following elements in the tax administration :

- (i) Administration should be based on trust. This translates into clearances based on self-certification.
- (ii) To the extent necessary all checks should be based either upon intelligence or post-facto audit within a specified time frame.
- (iii) To reduce transaction costs there should be no insistence upon securities.

- (iv) Disputes and litigation should be minimized and if a dispute does arise early resolution should be ensured.
- (v) All procedures should be IT-centered in view of the comparative advantage we have in this field. Increased use of automation ensures greater transparency, accountability and efficiency.
- (vi) Reduce contact points by moving to on-line acceptance of documents.
- (vii) Decisions to be rule bound not discretionary.
- (viii) A modern tax administration depends heavily on change in mind set, which is to be achieved through time bound training.
- (ix) Confidence to be bestowed upon the tax administrators.

2.4 The outcome of this comprehensive exercise has led the Task Force to postulate certain principles, which in its considered opinion must necessarily govern an efficient and tax payer friendly tax administration. Thereafter, the Task Force has examined each of the critical areas of the present indirect tax laws and administration against the touchstone of these principles. The corollary is that such a tax system based upon these principles would encourage voluntary tax compliance, discourage tax evasion, reduce compliance and transaction costs and improve the tax to GDP ratio.

2.5 The Task Force has also duly recognized that an efficient rule bound system cannot exist in isolation and the human element in terms of tax administrators and other facilitators perform a critical role. In fact, an efficient system would demand matching performance from the implementers and facilitators or else the system would simply not be efficient. Hence, due attention has been paid to the aspects of training, automation, HRD and change in mind-set.

2.6 After giving considerable thought it is the view that the first principle which must govern the tax administration of the country is a system based upon **TRUST**. So long as the laws and procedures are made with an eye to prevent misuse, and not with the objective of facilitating the honest tax payers, there would be complexities, excessive documentation, avoidable transaction

costs, inefficiencies and corruption. Interestingly, no concrete evidence was brought out that even the present such laws, which are based upon checks and counter-checks have really impacted tax evasion. In fact, the contrary appears to be true. Thus, it is the view that our law and procedures should be based upon trust. This is not to state that there should be no checks provided against misuse. However, what is required is that instead of suspecting all tax payers the system should provide for trusting all tax payers by using modern and scientific methods of risk assessment and intelligence gathering to detect misuse by the few unscrupulous persons. Further, trust by its very nature cannot be selective as this would lead to discretion and formation of pressure groups. Hence, it is proposed that as a policy the law and procedures should be based upon the trust that the tax payer is willing to voluntary discharge his legal obligations and is required to be facilitated by providing an efficient and transparent tax administration.

2.7 The second principle which has governed the proposals of the Task Force is that in the age of mobile financial, physical and human capital we must adopt the **BEST INTERNATIONAL PRACTICES**. It is the view that having committed ourselves to fully integrate into the world economy we can no longer remain unconcerned about having procedures which are not at par with the best in the world. For instance, if the standard in the developed countries is to clear imported goods in 6 hours we should be able to evolve procedures which not only match this but do better. It is only by adopting the best international practices that we can hope to compete internationally. Thus, an endeavour has been made in this direction. It is worth mentioning at this stage that on the customs side we have the advantage of international Conventions (Kyoto and others) which have also been adopted by India. To this extent much has already been done and the C.B.E.C. has taken some steps in aligning the procedures to the extent possible, which is a matter of satisfaction. However, we must act in a hurry and quickly do much more.

2.8 The third principle is that of **SIMPLICITY**. Too many levies, too many rates of duties, too many procedures, and too much documentation, all contribute to complexities, which go against the grain of efficiency. The underlying assumption is that a simple tax law is not only easy to administer at less cost but would also encourage compliance and positively impact the tax revenues. There is a crying need for simplicity in the indirect tax laws. To illustrate, there are over 300 circulars on the subject of EOUs with some overriding the others and some modifying the others. It can scarcely be expected that these many circulars are available to all in the trade and the departmental officers are no better placed. The net result is an absence of uniformity in application, which is often taken advantage of for private gain. It appears reasonable that the

minimum effort to codify the instructions in one place after weeding out those which are no longer relevant would ensure better administration. Thus, there is a need to have a simple law, which should be applied uniformly.

2.9 An equally important principle is that of **TRANSPARENCY**. Tax administration should be rule bound and transparent. There should be as less discretion as is possible. This would increase the tax payers confidence in the administration. It has also been reported that the industry feels alienated as there is almost no institutionalized mechanism to obtain its response while framing a new policy. The concern of the industry is genuine. A remedy lies in involving the tax payers in the formulation of new policies to the extent possible. This has the inherent advantage that the users would point out the advantages and dis-advantages of the proposals as they know best. Secondly, for obvious reasons, compliance would be much better in such sort of participative and transparent policy formulation.

2.10 The next principle is that of **STABILITY**. During its many interactions it was oft repeated to the Task Force that sudden and frequent changes in policies adversely impact the business community. The difficulties get compounded when there is sudden change in the practice of assessment which has revenue implications as reportedly, tax payers are burdened by tax demands for the past 5 years. It is also the view that stability of Government policies is an essential input for healthy and prosperous business. Further, any action of the Government which takes the tax payers by surprise is bound to cause compliance problems. It is, therefore, necessary that not only a policy should be framed in consultation with all the stake holders but it should come into force only from a date in the future and not immediately. Giving sufficient notice is necessary for a healthy business environment.

2.11 The last and very important principle is that of customer orientation of the tax collectors towards the tax payers. There is no doubt that the payment of taxes is the statutory and legal obligation of the tax payers. Similarly, it is the legal responsibility of the tax collectors to collect the taxes for the exchequer. However, it is essential to realize that unless the tax payer is also viewed as customer and treated as such there would be an alienation which tax administration can ill afford. Thus, a tax payer friendly administration requires the administrators to adhere to the principle of **SERVICE** while interacting with the tax payer cum customer. This approach rests upon the assumption that tax payer cum customer facilitation is a critical input for greater tax compliance and reducing disputes and compliance costs.

2.12 It is the view of the Task Force that if the indirect tax administration frames its laws and procedures in adherence to the principles enunciated above viz. **Trust, Best International Practices, Simplicity, Transparency, Stability and Service** coupled with the use of the full potential of information technology the net result would be beneficial to the trade, industry and the Government. There would be improved tax to GDP ratio through enhanced voluntary compliance at reduced costs, and less disputes and litigation. Also the confidence of the tax payer in the administration would be restored. All in all a healthy economic environment. However, it is also important to appreciate that what is essential is not mere lip service to these principles. These have to be implemented immediately and forcefully. The attempt must bring about systemic and fundamental changes in the indirect tax administration so that we have in place an efficient and transparent tax administration, second to none in the world, facilitating the honest tax payers in the conduct of his business in the overall interest of the country. Accordingly, each of the recommendations of the Task Force must be viewed against the backdrop of the aforesated principles. It is the expectation that the individual recommendations would, when implemented, combine to change the face of the indirect tax administration in the country.

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