IMPACT OF TRC REFORMS ON TAX REVENUE, SAVINGS AND INVESTMENT IN INDIA

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Introduction:

The Government of India set up a high powered Tax Reforms Committee (TRC) in August 1991 to make recommendations relating to both direct and indirect taxes in India. This committee was expected to suggest measures to rationalize the tax system and to make it an efficient one comparable to world nations. In fact these expected tax reforms are part and parcel of the general framework of economic reforms, initiated in India since June 1991. This committee headed by Raja.J. Chellaiah, Former Director of National Institute of Public Finance and Policy. Eminent academics and administrators like Shri. S.V Iyer, Shri. U.V Eradi and V. Rajaraman were the members of the committee. In view of the existing defects of Indian tax system and also in view of bringing comprehensive tax reforms in India, the committee was asked to give its recommendations on the following Terms of Reference.

Terms of Reference:

1. Ways of improving the elasticity of tax revenues, both direct and indirect, and increasing the share of direct taxes as a proportion of total tax revenues and of GDP
2. Making the tax system fairer and broad-based with necessary rte adjustments, particularly with regard to commodity taxation and personal taxation.
3. Rationalization of the system of direct taxes with view to removing anomalies, improving equity and sustaining economic incentives
4. Identifying new areas for taxation
5. Ways of improving compliance of direct taxes and strengthening enforcement
6. Simplification and rationalization of customs tariffs with view to reducing the multiplicity and dispersion of rates and to eliminate exemptions which have become unnecessary

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7. Reducing the level of tariff rates, keeping in view the need for mobilizing resources to facilitate fiscal adjustment and the objective of promoting international competitiveness
8. Simplification and rationalization of the structure of excise duties for better tax compliance and administration
9. The scope of extending the Modvat Scheme
10. Any other matter related to the above points or incidental thereto.[1]

The committee recommended several measures to re-structure the tax rate, expand the tax base and rationalization of tax concessions given to various individuals and sectors. The recommendations of the committee in the Interim Report, submitted in December 1991 and Final Report submitted in 1992. The distinction of these reforms recommended by R.J. Chelliah is that they were immediately implemented by the central government unlike the tax reforms of earlier committees. Therefore, the recommendations of both direct and indirect taxes have an important bearing on the Indian economy, especially on the growth and composition tax revenues of central government, savings and investment in the economy. Therefore, a modest attempt has been made in this Paper to analyze the impact of the recommendations of the Taxation Enquiry reforms Committee, (1991) with the following specific objectives.

Objectives:

1. To examine the impact on tax revenue of central government
2. To make an analysis of the impact of tax reforms on savings and investment in the Indian economy

Methodology:

In order to analyse the above mentioned objectives, an Analysis has been made for the period 1990-91 to 2007-08. The year 1990-91 has been chosen the central government started implementing the economic reforms though tax reforms were implemented at a later stage. The Indian Economy has been impacted very much due to the global economic recession. Since 2008-09 onwards. So the analysis has been limited up to 2007-08.

The data and information have been collected from the Reports of Taxation Enquiry Committee 1991, various Reports of the Union Finance Commission, Budget Documents,

Reports on Currency and Finance, Quarterly Bulletin of Reserve Bank of India, Reports of the CMIE, Reserve Bank of India and statistical abstracts published by central statistical organization, New Delhi. Simple statistical techniques such ratio and percentages have been used to make the analysis.

Important Reforms:

The committee followed a philosophy of reducing tax rates and increasing tax base with regard to both direct and indirect taxes. It recommended a drastic reduction of tax rates in the case of Income Tax, Corporation Tax, Wealth Tax and Gift Tax within the ambit of direct taxes and custom duties and union excise the duties in indirect taxes. Following are the important aspects that the Tax Reforms Committee considered while making its detailed recommendations

1. Reforming the personal taxation system by reducing the marginal tax rates
2. Reduction in the corporate tax rates
3. Reducing the cost of imported inputs by lowering the customs duties
4. Reduction in the number of customs tariff rates and its rationalization
5. Simplifying the excise duties and its integration with a Value-Added Tax (VAT) system
6. Bringing the services sector in the tax net within a VAT system
7. Broadening of the tax base
8. Building a tax information and computerization
9. Improving the quality of tax administration[2]

The major reforms recommended by the Committee with regard to direct and indirect taxes are briefly presented in the following Table-1

Table-1
Major Reforms in Direct and Indirect Taxes in Brief

a) Direct tax			
Income Tax			
Years	Minimum rate	Maximum rate	Number of rates
1985	10	50	4
1992	20	40	3
1997	10	30	3
• Widening of the tax base by the introduction of presumptive taxes and adoption of a set of economic criteria for the identification of potential tax payers • Taxation of capital gains restructured by introduction a cost inflation index and rationalization in the treatment of long-term capital gains, reduction in tax rates, etc • Scope for TDS increased • Introduction of the presumptive taxes (especially for small business)			
Corporate Tax			
• Lowering of the basic rate in a graded manner from 50% in 1990 to • 30% in 2005-06 • Unification of rates for closely held and widely held companies • Narrowing of the gap in tax rates for the domestic and foreign companies • Dedicated tax centre • Electronic filing pf TDS for bulk filing introduced (2004-05)			
b) Indirect Tax			
Customs duty	Progressive reduction in the rate of customs duty on non-agricultural products, from an average of 128 per cent in the beginning of 1990s to 22.8 per cent in 2003-04		
Central excise	Reduction of 11 major ad-valorem excise duties to 3, viz, central rate of 16 per cent, merit rate of 8 per cent and demerit 24 per cent in the year 1999-2000, which relating the special excise duties on the specified goods		
Service tax	The introduction of tax on the services at the central level began in 1994-95 with three services. Viz, non-life insurance, stock brokerage and the telecommunications. The list was expand in the succeeding years. Taxed at 7%, the rate was increased to 10% in 2002-03.		

Source: The Indian economy since 1991: Economic reforms and performance ed., by B.A Prakash, published by Dorling Kindersley (India), P.v.t. L.td.

Implementation of Chellaiah Committee Recommendations

The basic philosophy underlying these recommendations is generating revenues in an efficient manner. The government agreeing with this approach decided to implement the recommendations of the Chelliah Committee in a phased manner. In fact, the government not only implemented the reforms, but also has overdone in the case of some taxes. For instance, the

committee recommended the lowest marginal rate of Income Tax to be 20 per cent. But the government fixed it at 10 per cent. Similarly same is the case with import duties. The major changes which have already been made in the direct and indirect tax policies are stated below.

Direct Taxes:

Personal income tax has been restructured with lower taxes, fewer slabs, a higher exemption limit and reduced saving-linked tax exemptions. The system of taxation of firms has been rationalized by eliminating the distinction between registered and unregistered firms and a flat rate of tax of 30 per cent has been prescribed on all partnerships. Reforms in the area of corporate taxes were postponed for the time being because of the limited room for maneuverability in the area of direct taxes. However, the corporation tax rate has been brought down to 30 per cent for domestic companies. Taxation of capital gains has been restructured so that only capital gains of price increases would be taxed. Long-term capital gains would now be taxed at flat rates after making adjustment for inflation in the cost of assets. The wealth tax has also been reformed by changing the basis of taxation from wealth to unproductive assets[3].

Indirect Taxes:

In the realm of indirect taxation the government considered customs duties to be the critical area and thus these duties were reduced. In Union Budget 2007-08, the peak level of customs duty was scaled down to 10 per cent. However, the revised rates of customs duties are still higher than in most of our competitor countries, especially on capital goods. The reforms in excise duties have been guided by the need to simplify the rate structure, to give some relief on articles of mass consumption, help the domestic capital goods industry so as to increase its competitiveness and also reduce capital costs, assist industries suffering from depressed demand conditions and to provide relief to small-scale industry. The excise duty structure was rationalized to a single rate CENVAT (Central Value Added Tax) in 2001-02.

The guiding principle of TRC recommendations was that the tax system should be broad-based and simple, broadly neutral and with moderate rates. Making ground for moving towards a full-fledged VAT. Therefore, the central theme[4]. Regarding reform of the excise duty system-for a rational tax regime with a small number of moderate rates is the very essence of an ideal value added a tax system. The Committee had deigned a three-rate modified value added tax

(MODVAT) region at the manufacturing level at 10, 15 and 20 per cent with selective excise on non-essential commodities at 30, 40 and 50 per cent. The maximum excise duty on a commodity should not exceed 50 per cent with a few exemptions like cigarettes[5].

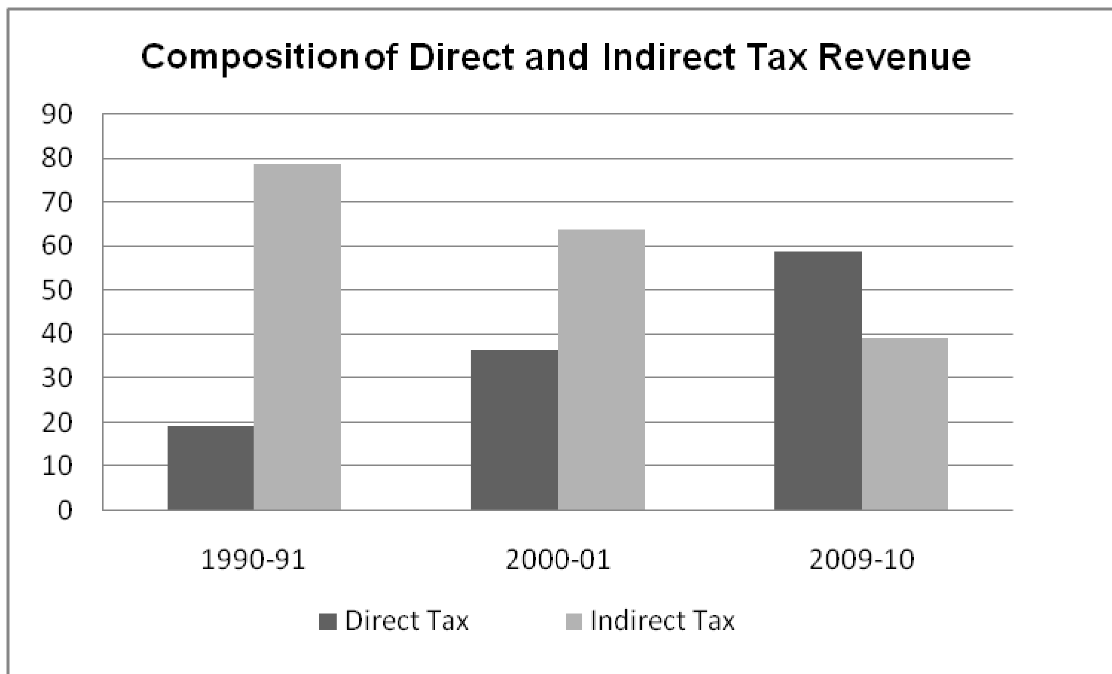
Impact on Growth and Composition of Tax Revenue:

Over the years the Indian tax system acquired highly regressive characteristics. Consequently the relatively poorer sections and the middle class have been over burden with the indirect taxes, this is mainly because of heavy dependence on indirect taxes with high rates of taxes. Moreover, higher tax rates beyond a certain level lead to a decline rate of tax yield as stated and proved by Laffer[6]. A country with welfare objectives and with aim to achieve the cherished goal of socialistic pattern of society needs to depend more on direct taxes than on indirect taxes. But contrary to this happened in India and the tax reforms committee aimed to bring change in the composition of gross tax revenues of the union government. Besides it forecast that a drastic reduction of tax rates would increase the compliance and improve tax revenues of the union government. In the initial years of implementation of the reforms of the TRC, instead of an increase in the tax-GDP ratio has declined. However, after a few years of reduction of

Tax rates and implementation of other reforms tax revenue exhibited a growth in terms of GDP as may be seen in Table-2. For instance, the tax revenue-GDP ratio which was 10.6 per cent in 1992-93 has slowly declined over the period stared increasing from the year 2002-03. The ratio has been on the increase since then and it reached to 12.0 in 2007-08. This may be due to the structural adjustment that has taken place in the Indian economy with its own time lag effects.

It has been advocated by economists like P.A Prest[7] that the welfare effects of indirect taxes are inferior to that of direct taxes. Therefore a tax structure that contains large proportion of direct tax revenue enhances the welfare of the people in the economy. The reforms made by TRC successfully brought a discernible tilt in favour of direct tax revenue in the total tax revenue of the union Government. For instance, the proportion of direct and indirect tax revenue in the gross tax revenue of the union government was 20:80 in 1990-91 which has increased to 36:64 by 2000-01. This has further increased to 59:41 in 2009-10. This is really an appreciable

consequence of the recent tax reforms as the changing composition, which may be seen in the following diagram of gross tax revenue shows more tax burden on the relatively richer sections of the society compared to relatively poorer section of the society. This may be considered as a remarkable departure that has taken place in the Indian tax system that was riddled with a highly regressive taxation for several decades.



Impact on Savings and Investment:

The committee hypothesized that the drastic reduction of tax rates of both direct and indirect taxes would leave more money with the people and the supply side economics would operate in the economy. Also these tax initiatives would increase savings both at the household and corporate levels. Increased domestic savings would give a fillip to domestic investment which in will lead to higher rate of economic growth. The a priori reasoning of the committee has been realized as the household savings, private corporate sector public sector savings increased slowly over the period. Table-3. Shows the gross Domestic Savings and its various components during the period 1990-91 to 2009-10. For stance, the Gross Domestic Savings were 22.8 per cent in 1990-91 which increased to about 33 per cent by 2004-05. It has hovered around 33-34 per cent in the later years, though it was as high as 36.8 per cent in 2007-08 and since then it declined, may be due to the global recessionary effects. Similar trend is evident with

regard to savings of the household sector which have increased from 18.3 per cent in 1990-91 to 23.5 per cent in 2009-10. The provide corporate se tor recorded a continuous increase from 2.7 per cent in 1990-91 to 8.7 in 2007-08 slowly but continuously. However, there is a decline in the ratio 7.9 and 8.1 in 2008-09 and 2009-10 respectively, perhaps due to the impact of global slowdown on the Indian economy. It may be observed from the table that the public sector savings as a ratio of gross domestic product was only 1.8

In 1990-91 which has slowly increased to 5.0 percent in 2007-08. It has suddenly fallen to 0.5 percent and 2.1 percent in 2008-09 and 2009-10 respectively due to the on set of recessionary conditions in the economy.

The increase in savings as a percentage in Gross Domestic Product after the initiation of economic reforms, particularly tax reforms have induced investments in the economy the period 1991-92 to 2009-10 has been divided as 1991-92 to 1996-97, 1997-98 to 2003-04 and 2004-05 to 2009-10 and the average percent of Gross Domestic Savings and Gross Domestic Capital Formation (Investment) recorded substantial increase in between the two periods- 1991-92 to 1996-97 and 2004-05 to 2009-10.

Conclusion:

In the broad framework of economic reforms initiated in 1991, the Tax Reforms Committee made sweeping changes in the Indian tax system with a view to make the tax system more progressive, transparent and investment induced. The TRC reforms have a distinction in the sense, that they were implemented by the union government right from 1992-93 onwards. Though economic reforms are generally responsible for any impact on macro economic issues like savings, investment and capital formation in the economy, tax reforms also contributed largely in supply side economic framework. So the above analysis indicates that there is a positive impact of recent tax reforms on Gross Domestic Savings, Domestic Investment and Capital formation. Similarly, the tax revenue as a proportion of GDP has increased over the period, through there is a decline in the early years of reforms. The tax reforms brought a compositional shift in favour of direct tax revenue compared to indirect tax revenue leading to better welfare implications of tax structure in India.

Table-2

Tax Revenue of the Central Government as a Proportion of GDP (in per cent)

Source of Tax Revenue	1990-91	1991-92	1992-93	1993-94	1994-95	1995-96	1996-97	1997-98	1998-99	1999-00	2000-01	2001-02	2002-03	2003-04	2004-05	2005-06	2006-07	2007-08
Direct Taxes	1.9	2.5	2.6	2.5	2.6	2.8	2.8	3.2	2.7	3.0	3.2	3.0	3.4	3.8	4.1	4.3	5.1	6.0
Personal Income Tax	0.9	1.1	1.1	1.1	1.2	1.3	1.3	1.1	1.2	1.3	1.5	1.4	1.5	1.5	1.5	1.5	1.8	2.1
Corporate Tax	0.9	1.3	1.3	1.2	1.3	1.4	1.4	1.3	1.4	1.6	1.7	1.6	1.9	2.3	2.6	2.7	3.4	3.9
Indirect Taxes	7.9	8.3	7.8	6.7	6.3	6.4	6.5	5.9	5.5	5.8	5.6	5.1	5.3	5.3	5.3	5.4	5.6	5.6
Customs	3.6	3.6	3.4	2.7	2.6	3.0	3.1	2.6	2.3	2.5	2.3	1.8	1.8	1.8	1.8	1.8	2.0	2.1
Excise	4.3	4.6	4.4	3.9	3.6	3.4	3.3	3.2	3.1	3.2	3.3	3.2	3.4	3.3	3.1	3.0	2.7	2.5
Service Tax	0.0	-	-	-	-	0.1	-	-	0.1	0.1	0.1	0.1	0.2	0.3	0.4	0.6	0.9	1.0
Gross Tax Revenue	10.1	10.9	10.6	9.3	8.9	9.3	9.4	9.1	8.3	8.9	8.9	8.2	8.8	9.2	9.4	9.9	11.1	12.0

Source: Economic Survey, GOI, Various Issues

Table-3
Gross Domestic Savings During Select Years

Year	Household Sector	Private Corporate Sector	Public Sector	Total
1990-91*	18.3 (80.3)	2.7 (11.8)	1.8 (7.9)	22.8 (100.0)
2000-01*	21.6 (91.1)	3.9 (16.5)	-1.8 (-7.6)	23.7 (100.0)
2004-05	23.3	6.6	2.3	33.2
2005-06	23.2	7.5	2.4	33.1
2006-07	22.9	8.0	3.6	34.4
2007-08	22.6	8.7	5.0	36.8
2008-09	23.8	7.9	0.5	32.2
2009-10	23.5	8.1	2.1	33.7

Note: 1. * Denotes Per cent of GDP at Market Prices 1999-00 Series
2. Percentages of GDP at market prices 2004-05 series
Source: Economic Survey 2011-12 and CSO

Tbale-4
Gross Domestic Capital Formation (Investment) in Select Years

Year	Public Sector	Private Sector	Valuables	Errors & Omissions	Adjusted Total
1990-91	10.0	14.2	na	1.9	26.0
2000-01	6.9	16.6	0.7	0.1	24.3
2004-05	7.4	23.8	1.3	0.4	32.8
2005-06	7.9	25.2	1.1	0.4	34.7
2006-07	8.3	26.4	1.2	-0.2	35.7
2007-08	8.9	28.1	1.1	0.1	38.1
2008-09	9.5	24.6	1.3	-0.8	34.5
2009-10	9.2	25.2	1.7	0.7	36.5

Note: 1. * Denotes Per cent of GDP at Market Prices 1999-00 Series
2. Percentages of GDP at market prices 2004-05 series
Source: same as above

Table-5
Growth of Saving and Investment During the Reform Period.

As per cent GDP in 2004-05 series

	Item \ period	1991-92 to 1996-97	1997-98 to 2003-04	2004-05 to 2009-10
1	Gross Domestic Capital Formation (Investment)	23.9	24.9	35.3
2	Gross Domestic Savings	22.7	24.9	33.7
3	Saving Investment Gap	-1.2	0.0	-1.5

Source:; Economic Survey 2011-12 and RBI Bulletin, March 2008.

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