

HISTORY, CONSTITUTIONAL FRAMEWORK, AND EVOLUTION OF INDIAN TAX SYSTEM AND GOODS AND SERVICE TAX – A STUDY

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Abstract

The strength of a nation's economy depends upon the system of taxation. If correct approaches are taken it keeps revenue consistent and manages growth in our economy. Our tax structure has a three-tier federal structure consisting of the Union Government, the State Governments and the Local Bodies. Any tax levied not backed by law or is beyond the powers of the legislating authority is unconstitutional. The basic framework for the tax system in independent India was provided in the constitutional assignment of tax powers. The principle of separation in tax powers between the central and state governments is adopted as the basis of policy. Schedule VII enumerates the subject matters of taxation with the use of three lists. Until 2003 India's constitution did not explicitly recognize and assign to any level of government the power to tax services. As all residuary tax powers were assigned to the central government, in 1994 this authority became the basis for levying a tax on selected services and the 88th Amendment to the Constitution of India assigned the power to tax services to the central government. Tax policy was employed as a principal instrument to correct severe budgetary pressures and significant changes were brought by many countries across the globe. Another motivation for reform was provided by the internationalization of economic activities arising from increasing globalization. This paper analyzes the structure of Indian tax system, its constitutional framework and the current changes in the system in the light of recent change to introduce GST.

Introduction

The strength of a nation's economy depends upon the system of taxation which if taken correct approaches, can keeps revenue consistent, stimulates industrial activity and manages growth in our economy. Through efficient measures, the tax system can lead to revenue mobilization in response to growth and result in revenue grows slightly faster than GDP. India's well developed tax structure has a three-tier federal structure consisting of the Union

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Government, the State Governments and the Local Bodies. These three bodies are authorized with the imposition of the different duties and taxes, which are prevalent in the country. In most cases, these local bodies include the local councils and the municipalities. According to the Constitution of India, the government has the right to levy taxes on individuals and organizations. However, the constitution states (Article 265)¹ that no one has the right to levy or charge taxes except the authority of law. Whatever tax is being charged has to be backed by the law passed by the legislature or the parliament. Any tax levied by the government which is not backed by law or is beyond the powers of the legislating authority may be struck down as unconstitutional. The Indian Constitution² distributes legislative powers including taxation, between the Parliament and the State Legislature.

This paper analyzes the structure of Indian tax system, its constitutional framework and the current changes in the system. Though it is difficult to achieve the ideal objective, reforms helps us to keep the focus on further reforms. The impact of historical and institutional factors in shaping Indian tax policy is also noted.

Tax- Meaning and Implications

A tax may be defined as a "pecuniary burden laid upon individuals or property owners to support the government, a payment exacted by legislative authority.³ It is not a voluntary payment or donation, but an enforced contribution, exacted pursuant to legislative authority. It may be direct tax or indirect tax, and may be paid in money or as its labor equivalent A Direct tax is a kind of charge, which is imposed directly on the taxpayer and paid directly to the government by the persons (juristic or natural) on whom it is imposed. A direct tax is one that cannot be shifted by the taxpayer to someone else. Whereas an indirect tax is a tax collected by an intermediary (such as a retail store) from the person who bears the ultimate economic burden of the tax (such as the consumer). The intermediary later files a tax return and forwards the tax proceeds to government with the return. Thus the term indirect tax is contrasted with a direct tax, which is collected directly by government from the persons (legal or natural) on whom it is imposed.

¹ Article 265 of Constitution of India.

² Article 246 (Seventh Schedule)

³ http://mospi.nic.in/mospi_new/upload/statistical_year_book_2011/SECTOR-1-INDIA%20AN%20OVERVIEW/CH-06-DIRECT%20&%20INDIRECT%20TAXES/DIRECT-INDIRECT%20TAX-WRITEUP.pdf on 2110 16

History, Constitutional Framework, and Evolution of Indian Tax System

The traditional taxation has been in force in India in different forms from ancient times. Manu, the ancient law giver, lay down that traders and artisans should pay one-fifth of their profits in silver and gold, while agriculturists, depending upon their circumstances, were to pay one-sixth, one eighth or one-tenth of their produce. Kalidasa in the Raghuvansha says⁴ thus of King Dileepa: 'It was only for the good of his subjects that he collected taxes from them, just as the Sun draws moisture from the Earth to give it back a thousand fold'. The word 'kara', which refers to taxes, finds mention in the SrimadBhagvatam⁵. The Sanskrit word 'danda', is the manifest form of a government's identity and consciousness. Chanakya mentions in the ArthaShastra, about 'Koshamoolodanda' and comments that the treasury and its inflows are the sources of a government's might. Most of the taxes of Ancient India were highly productive and the combination of direct taxes with indirect taxes secured flexibility in the tax system. In the medieval period, the Sultans of Delhi collected taxes under five main categories. The Mughal emperors granted land revenue rights to a mansabdar in exchange of promises of soldiers during wartime. The Treaty of Allahabad of 1765 empowered the British and the French with the right to collect taxes on behalf of the Emperor. Thus, the British system of collectors of land revenues was firmly established well before the disintegration of the Mughal Empire after 1857. During the latter half of the 19th century large shifts and overhauls took place. In July 1860, James Wilson, the first Finance Member of the Governor General in Council, quoted thus from the authority of Manu while introducing the act for levying income tax in the country, "As the leech, the calf and the bee take their food little by little, even so must the King draw from his realm, moderate annual taxes."⁶

As the financial obligations increased and there was a need to revamp the tax system. In 1919, with the introduction of the federal structure through 'Diarchy' taxes on income and some

⁴ T. N Pande, *The evolution of Income Tax*, <http://www.thehindubusinessline.com/2000/02/14/stories/211464tn.htm> On 23 10 16.

⁵ P.Amarjothi .P and C. Azhakaraja, *A Study on Indian Revenue Generators*, 12 IOSR Journal Of Humanities And Social Science 2, (2013), <http://iosrjournals.org/iosr-jhss/papers/Vol12-issue2/A01220107.pdf>. on 21 10 2016

⁶ <http://www.ssrshetty.co.in/income-tax-return-itr.html> on 23 10 16

other taxes were made a central subject. In 1922 historic enactment of a new Income Tax Act led to the setting up of a comprehensive taxation system with its own administrative machinery. The Income-tax Act, 1922, gave, for the first time, a specific nomenclature to various Income-tax authorities.⁷ In 1924, a Central Board of Revenue was created to administer central taxes. The attainment of Independence marked another paradigm shift for taxation. Now the objective of collecting revenues was no longer the preservation or advancement of British interests, but their own welfare. The major direct taxes levied by the Centre are on personal and corporate income excluding tax on agricultural income for which the authority to levy tax is with the states and wealth tax. The indirect taxes levied and collected by the Centre are Central Excise Duty, customs duty and service tax. A fixed proportion of the taxes collected by the Centre devolve to the states, based on the recommendations of the Central Finance Commission, which is set up every five years to review this sharing mechanism.

The basic framework for the tax system in independent India was provided in the constitutional assignment of tax powers. The principle of separation in tax powers between the central and state governments is adopted as the basis of policy. Schedule VII enumerates the subject matters of taxation with the use of three lists. List - I mentioning the areas on which only the parliament is competent to make laws, List - II dealing with the areas on which only the state legislature can make laws, and List - III Listing the areas on which both the Parliament and the State Legislature can make laws upon concurrently is provided in Schedule VII. While there are separate heads of taxation provided under lists I and II of Seventh Schedule of Indian Constitution, there is no head of taxation in the Concurrent List.

As stated earlier the central government has the power to levy the major broad-based and mobile tax bases, which include taxes on nonagricultural incomes and wealth, corporate income taxes, customs duties, and excise duties on manufactured products. Over the years the last item has evolved into a manufacturers' VAT on goods. Similarly tax powers assigned to the states include taxes on agricultural incomes and wealth, sales taxes, and excises on alcoholic products, taxes on motor vehicles and on transport of passengers and goods, stamp duties and registration fees on

⁷ Income Tax Department, Government of India, <http://www.incometaxindia.gov.in/Pages/about-us/history-of-direct-taxation.aspx> on 23 10 16

transfers of property, and taxes and duties on electricity. States also have powers to levy taxes on entertainment and on income earned by engaging in a profession, trade or employment; some states have retained these powers for themselves, while others have assigned them to local bodies

Although the state list also includes property taxes and taxes on the entry of goods into a local area for consumption, use, or sale, these have been assigned to local bodies. It was 73rd Constitutional Amendment, enforced from 24th April, 1993 empowered to levy taxes by the Panchayat. A State may by law authorize a Panchayat to levy, collect and appropriate taxes, duties, tolls etc. Also 74th Constitutional Amendment, enforced from 1st June, 1993 empowered to levy the taxes by the Municipalities. A State Legislature may by law authorize a Municipality to levy, collect and appropriate taxes, duties, tolls etc.

Until 2003 India's constitution did not explicitly recognize and assign to any level of government the power to tax services. As all residuary tax powers were assigned to the central government, in 1994, this authority became the basis for levying a tax on selected services. In 2003 an amendment to the constitution specifically assigned the power to tax services to the central government and the 88th Amendment to the Constitution of India (Article 268 A) ⁸ assigns the power to levy a service tax to the central government, with the proceeds being collected and appropriated by the central and state governments, in accordance with principles formulated by the Parliament.

Reforms Carried Out –A Description

The last 20 years had witnessed significant changes and many countries across the globe have undertaken reforms. Tax policy was employed as a principal instrument to correct severe budgetary pressures⁹. In many developing countries, pressing fiscal imbalance was the driving force. In others, the transition from plan to market necessitated wide ranging tax reforms. Efficiency as well as the addressing of the issue of replacing public enterprise profits with taxes as a principal source of revenue was the objectives behind these tax reforms. Another motivation was

⁸ This Article provides for the insertion of a new article 268A which states that taxes on services shall be levied by the Government of India and such tax shall be collected and appropriated by the government of India and the States in the manner provided in clause (2).

⁹ Ehtisham Ahmad and Stern Nicholas (eds.) *Theory and Practice of Tax Reform in Developing Countries*, (Cambridge: Cambridge University Press, 1991).

provided by the internationalization of economic activities arising from increasing globalization¹⁰. Tax policy in India has evolved as an important component of fiscal policy that played a central role in the planned development strategy. In particular, tax policy was the principal instrument for transferring private savings to public consumption and investment¹¹ by India's Constitution. Inevitably tax policy in the country has responded to changing development strategy over the years. In the initial years tax policy was guided by a large number of demands placed on the government¹² and effort was put to raise taxes from those with an ability to pay, without paying attention to the efficiency factors of the instruments for the purpose. Because of the size of the country, its multilevel fiscal framework, the unique reform experience, and difficulties in calibrating reforms posed by institutional constraints, the Indian tax reform experience can provide useful lessons for many countries.¹³

The evolution of the tax system in independent India started with the implementation of the report of the Taxation Enquiry Commission.¹⁴In fact, this was the first comprehensive attempt to review the existing tax system and design a system that would cover central, state, and local taxes and was intended to fulfill a variety of objectives such as raising the level of savings and investment, transferring resources from the private sector to public sector, etc. On the indirect taxes side, a major simplification exercise was attempted by the Indirect Taxes Enquiry Committee¹⁵, but recommendations of this committee, however, were not initiated until 1986. Systematic and comprehensive attempts to reform the tax system at the central level started only after market-based economic reforms were initiated in 1991, when the Tax Reforms Committee (TRC) laid out a framework and a road map for reforming both direct and

¹⁰ M.GovindaRao & R. KavitaRao, *Trends and issues in tax policy and reform in India*. Paper presented at the India Policy Forum, New Delhi, 25 July 2005, https://www.brookings.edu/wp-content/uploads/2016/07/2005_rao.pdf on 21 10 16

¹¹ AMARESH BAGCHI AND STERN NICHOLAS, *TAX POLICY AND PLANNING IN DEVELOPING COUNTRIES*, (Oxford University Press, 1994).

¹² AMARESH BAGCHI AND PULIN NAYAK, *A Survey of Public Finance and the Planning Process: The Indian Experience.* IN *TAX POLICY AND PLANNING IN DEVELOPING COUNTRIES*, (Amareesh Bagchi and Nicholas Stern ed., Oxford University Press, 1994)

¹³ M.GovindaRaoRao, & R. Kavita Rao, *Supra* n.10

¹⁴ Government of India. 1953. *Report of the Taxation Enquiry Commission.* (New Delhi: Ministry of Finance, 1953).

¹⁵ Government of India 1977. *Report of the Indirect Taxation Enquiry Committee.* New Delhi :Ministry of Finance

indirect taxes.¹⁶The reforms since 1991 with their emphasis on simplicity and efficiency, are a marked departure from the past. The Tax Reforms Committee combined economic principles with conventional wisdom in recommending comprehensive tax system reforms dealt with restructuring the tariff structure. The TRC recommended a number of measures to broaden the tax base by minimizing exemptions and concessions, drastically simplifying laws and procedures, building a proper information system, and computerizing tax returns, and thoroughly modernizing administrative and enforcement machinery. The tax system at the central level was considerably simplified and rationalized by 2005, although these reforms were neither uniform nor consistent and the system was far from perfect.¹⁷Tax reforms at the state level were not coordinated with those at the center and practice was that individual state governments tried to appoint committees from time to time and reform their tax structures even after 1991.

To persuade the states to rationalize their tax systems along the lines recommended by the study group, the government of India appointed a State Finance Ministers' Committee to make recommendations to phase in the VAT within a given timeframe. This was later transformed into the Empowered Committee of State Finance Ministers and it was recommended that the states shall adopt floor rates to minimize the "race to the bottom." The committee's recommendation that the VAT be implemented in 2003 was postponed repeatedly, until April 2005. The major landmark in tax reform at the state level was in simplifying and rationalizing the sales tax system the introduction of value added tax in 21 states from 1 April 2005.¹⁸ The introduction of the VAT was a major reform exercise, even if it may cause some confusion and uncertainty. The VAT tax base has strengthened the information base for tax administration, resulting in improved compliance for other taxes and thereby enhancing the overall productivity of the tax system.¹⁹Thus, although a VAT is not necessarily a "money machine," the conventional conclusion holds

¹⁶ Government of India 1991. *Tax Reforms Committee, Interim Report*. New Delhi: Ministry of Finance.

¹⁷ Shankar Acharya. 2005. *Thirty Years of Tax Reform in India. Economic and Political Weekly* 40 (May 14 2005): pp. 2061-69 Reprinted in Shankar Acharya, 2006, *Essays on Macroeconomic Policy and Growth in India*, Oxford University Press.

¹⁸ M. Govinda Rao, *Tax system reform in India: Achievements and challenges ahead*, *Journal of Asian Economics*, Elsevier, vol. 16(6), 993-1011(2005).

¹⁹ Indira Rajaraman, *Fiscal Developments and Outlook in India*. NIPFP Working Paper No. 15. (National Institute of Public Finance and Policy, New Delhi 2004)

that a properly administered VAT is the best way to make up for the revenue loss from trade liberalization²⁰.

Though evolution of the Indian tax system shares concerns similar to other countries it is different and even unique. In developing countries tax reforms were led by the International Monetary Fund or like agencies, whereas Indian one borne a domestic brand. Though some assistance from multilateral financial institutions was there, they were not deciding the agenda for tax reform. But at the same time, the reforms were broadly in conformity with international trends and with international best practices.²¹

Thus since the year 1991, the Indian tax system has undergone some significant change and these changes were initiated in accordance with the country's W. T. O. commitments as well as the liberal financial policies. Some of the major changes in the structure of taxation in the nation are discussed above. Indian tax system has come a long way from the narrow based, complicated and confusing to the one that is far more efficient. The various reforms have been done to improve revenue productivity and also to minimize distortions. The reforms that converted the state level sales tax into VAT are noteworthy here. Even after the reforms of 1991, the steps to make the tax system broad-based, productive and efficient continued which resulted in the present GST.

The latest reform reaches an innovative idea of GST with motives to subsume all indirect taxes at the center and the state level, to make one-country-one-tax, to reduce the cascading effect of taxes on taxes and thus to increase productivity and transparency, increase tax-GDP ratio and to reduce/eliminate tax evasion and corruption. GST is a single tax on the supply of goods and services, right from the manufacturer to the consumer. Credits of input taxes paid at each stage will be available in the subsequent stage of value addition. GST essentially is a tax only on value addition at each stage. The final consumer will bear only the GST charged by the last dealer in the supply chain, with set-off benefits at all the previous stages. Under GST, there would be only one tax from the manufacturer to the consumer, leading to transparency of taxes paid to the final consumer. So there will be relief in overall tax burden. This is because under the GST regime, the entire supply chain will be efficient leading to gains and

²⁰ Richard M Bird., and Eric M. Zolt., *Redistribution via Taxation: The Limited Role of the Personal Income Tax in Developing Countries*, (International Studies, 2005)

²¹ Richard Bird. 1993, *Federal Provincial Taxation in Turbulent Times*. ,Canadian Public Administration³⁶, 479-96.

prevention of leakages. It is expected that it will result in the overall tax burden on most commodities to come down, which will benefit consumers.

Conclusion

Tax administration, has progressed and more to be covered in reforming the tax system. It is a continuous exercise for improving revenue productivity and minimizing distortions. Coordinated reforms should be undertaken at the central, state, and local levels. A major objective should be minimization of distortions and compliance costs. These new changes to form a new direct tax code had been planned expecting that lower taxes and simpler rules will ensure compliance and more revenue. Having no space for complicated clauses, sub-clauses and caveats and saying good bye to unnecessary exemptions, the new direct tax code will have an impact on all including common man to the big corporate organizations. It is expected that it will disincentivise tax evasion because if a person don't pay tax on what he sell, he don't get credit for taxes on his inputs. Moreover, people will buy only from those who have already paid taxes on what they are supplying and all these will make a lot of currently underground transactions will come over ground²²brightening India's future more.



²² <http://economictimes.indiatimes.com/wealth/personal-finance-news/gst-bill-likely-to-benefit-common-man-in-long-run/articleshow/53570923.cms> on 23 9 2016.