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TRC gave direction to India’s tax reforms

By: **M Govinda Rao** | July 6, 2021

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July 2021 marks three decades of economic reforms. Much has been written on the severe fiscal and BoP crises leading to their initiation. The bold reform measures included two-step devaluation, adoption of new industrial policy, and initiating the process of opening up of the economy. The Budget presented by then finance minister Manmohan Singh on July 24, 1991, also announced the appointment of two Commissions—one on financial sector reforms with M Narasimhan as the chairman and another on tax reforms with Raja Chelliah as the chairman. Although there were many attempts at reforming the tax system prior to that, the directional change in the tax system for market economy was initiated in the reports of the Tax Reforms Commission (TRC).

A systematic approach to redesigning the tax system was imperative to give market orientation in resource allocation, and the fiscal crisis provided the opportunity. Richard Bird reviewing the reports of the TRC in the EPW (December 11, 1993) noted, “Fiscal necessity, compelled with the desire to let market forces to play a greater role in allocating resources ….virtually mandates major reforms in the cracking tax structure India has inherited from the past”.

The TRC combined economic principles with the best-practice approach. There are three parts in the report. In the first interim report, the TRC set out the guiding principles and applied them to taxes on income and wealth, tariffs and taxes on domestic consumption. The first part of the final report focused on reforms in administration and enforcement of both direct and indirect taxes. The second part dealt with restructuring the tariff structure. The basic principles of the recommendations were to broaden the base, lower marginal tax rates, reduce rate differentiation, simplify the tax structure and make the administration more effective. The overall thrust was to (i) decrease the share of trade taxes in total tax revenue; (ii) increase the share of domestic consumption taxes by transforming the domestic excises into VAT and (iii) increase the relative contribution of direct taxes.

That the tax system prevailing at the time was obsolete, chaotic and cracking is not an exaggeration. In 1973-74, the personal income tax structure had 11 brackets with the highest rate at 85% and a surcharge of 15% which meant a 97.75%-rate for those with income more than `2 lakh. Corporate tax rates, too, were high with distinction made between widely held and closely held companies. In the case of customs duty, there were over 100 rates, ranging up to 400%, in addition to non-tariff barriers. The excise duty was distortionary and complicated with the introduction of modified value added tax (MODVAT) without reducing the number of rates, as had been recommended by the Jha Committee.

TRC’s important proposals included reduction in the rates of all major taxes, i.e., customs, individual and corporate income taxes and excises, to reasonable levels, maintain progressivity but without inducing evasion. It recommended measures to broaden the base of all taxes by minimising exemptions and concessions, drastic simplification of laws and procedures, building a proper information system and computerisation of tax returns, and a thorough revamping and modernisation of administrative and enforcement machinery. It also recommended taxes on domestic production should be fully converted into a VAT, to be extended to the wholesale level in agreement with the states, with additional revenues beyond post-manufacturing stage passed on to the latter.

The 1985-86 income-tax reform had reduced the brackets to four and the highest marginal rate to 50%. The TRC Commission recommended three rates (20%, 30% and 40%). Similarly, the corporation tax structure had different rates, of 50% for widely held companies and 50% for closely held companies, and this was unified at 40%. Further reform in 1997 saw tax rates reduced to 10%, 20% and 30% in the three brackets.

The TRC recommended custom tariff rates of 5%, 10%, 15%, 20%, 25%, 30% and 50% by 1997-98. This meant a considerable rationalisation of more than 100 rates, ranging up to 400%. Of course, the seven rates of import duties, broadly varying with the stage of production, was excessive. Nevertheless, the directional change of lowering the rates reducing dispersion was pursued by successive governments until it was reversed in 2018.

Interestingly, after the TRC submitted the report, Chelliah was made the adviser to the finance minister to implement the recommendations. Income tax rates were further rationalised into 10%, 20% and 30% in 1997 when P Chidambaram was the finance minister. In general, all finance ministers moved towards reducing the import duties to make manufacturing competitive until 2018 when the trend was reversed. Of course, the MODVAT and service tax were merged with state-level indirect taxes to evolve GST. All said, tax reform is still a work in progress, but surely the TRC was instrumental in making a directional change.