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Reforming Indian Income Tax Enforcement

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Abstract

The purpose of this paper is to document and trace the causes of the poor and declining revenue performance of the income tax in India and to suggest measures for improvement based on a review of international experience. The paper starts by reviewing evidence that the performance of the income tax in India has been poor compared with other countries with similar per capita GDP. Furthermore the performance has a negative secular trend. It is then argued that this is due to low or falling compliance rather than other handicaps. This can, in turn, be traced to ineffective administration due to a reliance on enforcement tools with limited potential, inappropriate organizational structures, lack of computerization and inefficient allocation of limited manpower resources coupled with a growing taxpayer population.

International experience in administrative reform is reviewed paying particular attention to Mexico, the Philippines, Singapore and Spain and the process of computerization that has taken place in many CIAT countries, particular attention is paid to information system reform, organizational restructuring and auditing in order to derive appropriate policy lessons for India.

1. Introduction

Large scale evasion of income taxes is a well known characteristic of the Indian economy and the principal cause of a substantial underground economy .² Apart from making the tax system inequitable, tax evasion increases fiscal pressure on the government, which in turn leads to inflationary deficit financing and inadequate expenditure on essential infrastructure and social safety nets. These pressures also limit the scope of reduction in import tariffs and indirect taxes.

Since 1991, Indian tax reforms have dealt primarily with reform of rates of tax and, to a lesser extent, with widening the base of taxes. Relatively little effort has been made to initiate improvements in tax administration or strengthen enforcement of existing tax rules in order to curb evasion. Yet, as the experience of other developing countries suggests, tax reform which is not accompanied by suitable changes in tax administration is usually ineffective. In light of this, an examination of the nature of income-tax enforcement and directions for its reform is necessary.³

The purpose of this paper is to examine Indian income tax enforcement and suggest measures which can lead to its improvement. These suggestions draw upon a number of studies of Indian income tax administration, as well as international experience.

In broad terms, tax enforcement covers a range of activities all of which contribute to the ability of the government to ensure that taxes due to it, according to the prevailing law, are indeed collected. Logically, the first step is to designate a body to whom the task of collecting the tax is delegated: the *tax administration*. Specifying the legal authority of the tax administration to undertake various activities needed to collect taxes from those required to pay taxes is the next step. Legal powers of a tax administration range from the prosaic -- such as the power to design tax forms -- to the controversial and coercive power to enter and search dwellings of private individuals. These powers determine the extent to which it is feasible for a tax administration to set up an adequate *information system* to ascertain taxes due from various individuals (or other legal entities); to *assess and collect* these taxes; and to *penalize* those not

comply with their tax obligations. The legal basis for Indian income tax administration and enforcement is laid out in the Income Tax Act, 1961. The powers specified in this Act are comprehensive and broadly in accordance with powers delegated to tax administrations in other countries.'

The actual use of powers by the Indian income Tax Department (ITD), however, is far from adequate. The internal organization of the Department and the structure of delegated powers is perceived to hinder effective administration. The information system is outmoded and grossly inadequate, Assessment and tax collection are carried out inefficiently, and are plagued with mounting arrears. Penalties are frequently watered down through various forms of amnesties, are imposed on very few tax offenders, and that too after protracted delays owing to penalty and court procedures. On the other hand, tax procedures are cumbersome and impose substantial compliance costs on taxpayers. Such harassment is allegedly aggravated by widespread corruption within the ITD. In consequence, the contribution of the Indian income tax to government revenue has deteriorated over the past 25 years and tax compliance has declined steadily. There is therefore a need for drastic reform of income tax administration in India.

The rest of this paper is organized as follows. In Section 2 problems with the Indian income tax and its administration are examined in greater detail. The section begins by comparing the performance of the Indian income tax with other countries to assess the seriousness of the problem in proper perspective. It then discusses possible causes for the poor and deteriorating performance of Indian income tax revenues, and argues that tax evasion is the major cause. This leads to an examination of the proximate causes for falling tax compliance since the mid-1960s. The section closes with an examination of the major problems encountered with enforcement of the income tax by the ITD. Section 3 describes recent experience of other developing countries with administering income taxes and in reforming their tax administrations. Finally, Section 4 concludes with an assessment of lessons for Indian policy makers, drawing on reforms suggested by studies both of the Indian context as well as international experience.

2. Dimensions of the Problem

This section attempts to substantiate the following broad hypotheses:

The performance of the income tax in India has been poor by international standards and has been deteriorating over the past three decades.

Compliance with the personal income tax has steadily worsened over this period.

The two principal tools of enforcement in India: search and seizure activity, and prosecution of tax offenders, have been ineffective in influencing levels of tax evasion.

Problems with the internal organization of the Indian tax administration render it unable to cope with a steadily increasing workload.

International Comparison: Is the problem with income tax collection in India really serious in comparison with other countries at a comparable level of development? Table 1 presents basic cross-country statistics on tax effort in the late 1980s. For countries with per capita income below (US) \$360, tax revenue formed about one seventh of their GDP in the late eighties. In contrast, in countries with per capita income between \$1620 and \$6000 tax revenues amounted to a fifth of their GDP, while in countries with per capita incomes exceeding \$6000 it amounted to one third of GDP. Income taxes accounted respectively for about 3.5 per cent, 6.8 per cent and 11 per cent of their GDP for these three groups.' Correspondingly, developing countries tend to rely more on indirect taxes, particularly on foreign trade. Trade taxes, largely import duties, accounted for 5.3 per cent, 3.12 per cent and 0.72 per cent of GDP for the three groups respectively.

TABLE 1: TAX STRUCTURE AND PER CAPITA INCOME								
RANGE OF GNP PER CAPITA (US \$)	AVERAGE GNP PER CAPITA (US \$)	TOTAL TAXES	INCOME TAXES			DOMESTIC TAXES ON GOODS AND SERVICES	FOREIGN TRADE TAXES	OTHER TAXES
			TOTAL	INDIVIDUAL	CORPORATE			
(a) As a percentage of GDP								
INDIA	311	11.3	2.1	1.0	1.1	5.2	4.0	0.1
Below 360	239	14.0	3.5	1.4	2.2	4.6	5.3	0.7
360 - 749	517	19.7	5.7	2.5	2.9	4.7	7.6	1.5
750 -1619	1127	18.6	6.0	2.2	4.1	6.1	4.6	1.9
1620 -6000	2996	19.8	6.8	2.1	3.8	5.4	3.1	4.7
ALL DEVELOPING	1241	18.1	5.5	2.1	3.3	5.2	5.1	2.2
Above 6000	13477	31.2	11.0	8.5	2.4	9.4	0.7	10.1
(b) As a percentage of total taxes								
INDIA	311	100	18.4	8.7	9.6	45.8	35.1	0.6
Below 360	239	100	24.7	9.7	15.6	32.5	37.8	5.0
360 - 749	517	100	29.2	12.9	14.9	24.1	38.6	7.7
750 -1619	1127	100	32.1	11.7	21.9	32.5	24.9	10.4
1620 -6000	2996	100	34.4	10.8	19.2	27.3	15.8	24.0
ALL DEVELOPING	1241	100	30.5	11.5	18.2	28.9	28.4	12.2
Above 6000	13477	100	35.1	27.1	7.6	30.2	2.3	32.4
Source : Burgess and Stern (1992). ⁶								

India, with a per capita income below \$360, belongs to the first group of countries. *Its performance is distinctly poorer than the average for this group*, with total tax revenue forming about one ninth of GDP. India's performance with respect to collection of income taxes is especially weak, with income taxes generating about 18 per cent of all tax revenues, as against a group average of 25 per cent. This causes a stronger reliance on domestic indirect taxes.

In absolute terms, the performance of Indian income tax collections appears especially poor. For instance, the personal income tax generated about Rs. 50 billion in 1989-90, which was less than the entire amount spent on the fertilizer subsidy that year!⁷ The number of income tax assesses in 1989-90 was approximately 5.2 million, forming less than 0.6 per cent of the total population.⁸

From the cross-sectional evidence in Table 1 as well as from the experience of many developing countries, it is evident that the process of economic development is usually associated with growth in the relative contribution of personal income taxes to revenue. This results from a variety of factors, such as a widening of the taxpayer population, increase in personal incomes, and improvements in administration and enforcement technology. The *Indian experience runs counter to this general pattern: the* contribution of income taxes has diminished over the past two decades despite economic growth. Over the period 1970-90 the share of Indian income tax revenues in total central tax revenue fell from 14.7 per cent to 9.7 per cent. The proportion of personal income tax in non-agricultural GDP⁹ fell from 2.17 per cent to 1.89 per cent.¹⁰ Not only is the standard of income tax collection in India low by international standards, it appears to be deteriorating in recent decades.

The implications of the falling capacity to collect income tax are serious. The government is forced to rely increasingly on excise, sales and customs duties, as well as administered price hikes for public sector products. These taxes are regressive and inflationary. They create problems of coordination of indirect taxes between the central and state governments. The resulting

cascading effects distort relative prices, besides encouraging excessive vertical integration. Imports are discouraged by the high levels of tariffs and spending on essential infrastructure and social services is restricted. Direct taxes are inherently less regressive, being related more closely to ability to pay of taxpayers, and less distortionary.

Proximate causes: What were the principal causes of this deterioration? The fact that agricultural income is exempt from the (Central) income tax under the Indian Constitution, the high exemption limit of the income tax, and falling tax rates can all be ruled out as possible explanations. Figure 1 reveals that the share of agriculture in GDP declined substantially between 1965 and 1992. Moreover, the ratio of income taxes to nonagricultural GDP displayed a falling trend over this period. ¹¹ Since the income tax exemption limit is about three and a half times *per capita* income, only a small fraction of the population not engaged in agriculture is actually subject to the tax. However, Figure 2 shows that the ratio of the exemption limit to per capita income fell substantially from about 6.5 in 1965, to 3.5 in 1992. Hence, while the exclusion of agricultural income and the high exemption limit contribute to the low level of income tax revenues relative to nonagricultural GDP, they cannot explain the deteriorating trend. Finally, Figure 2 reveals that the average effective tax rate increased over this period, despite reductions in top marginal rates.

FIGURE 1

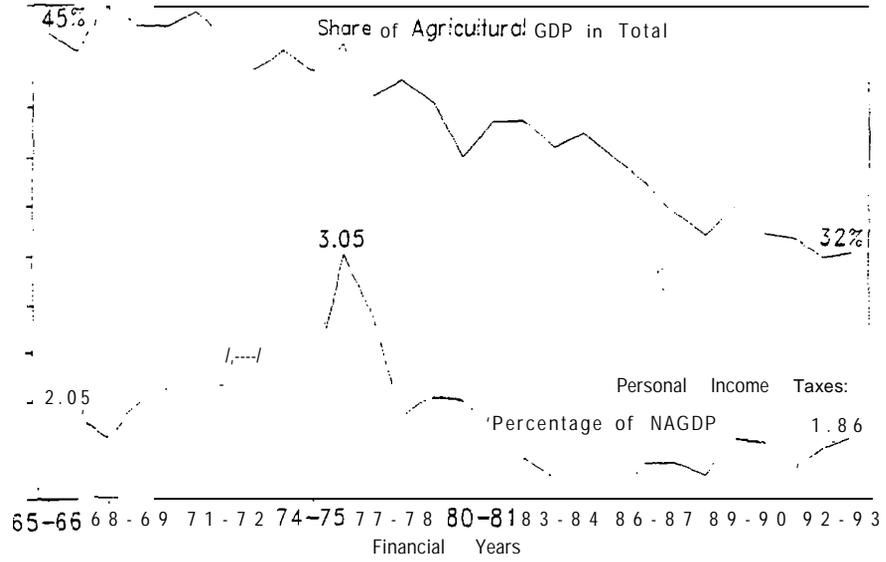
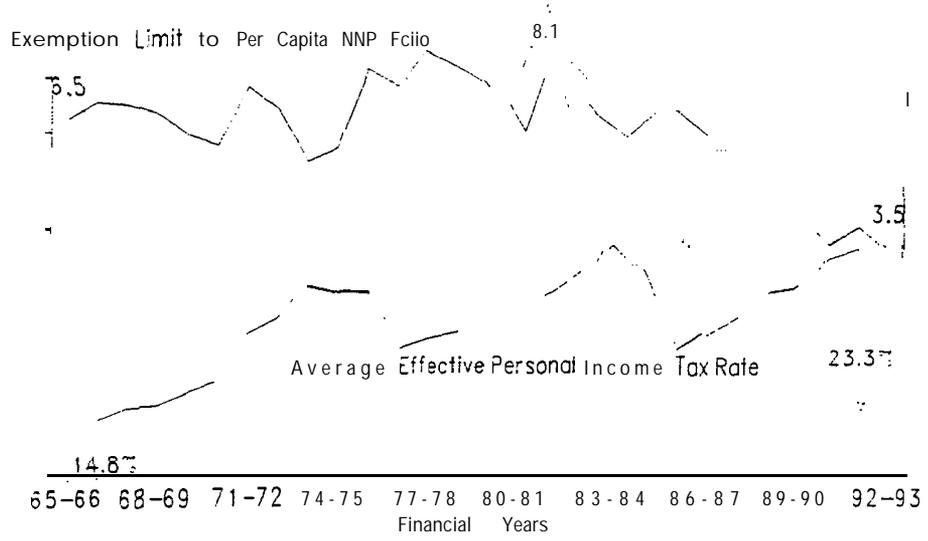


FIGURE 2



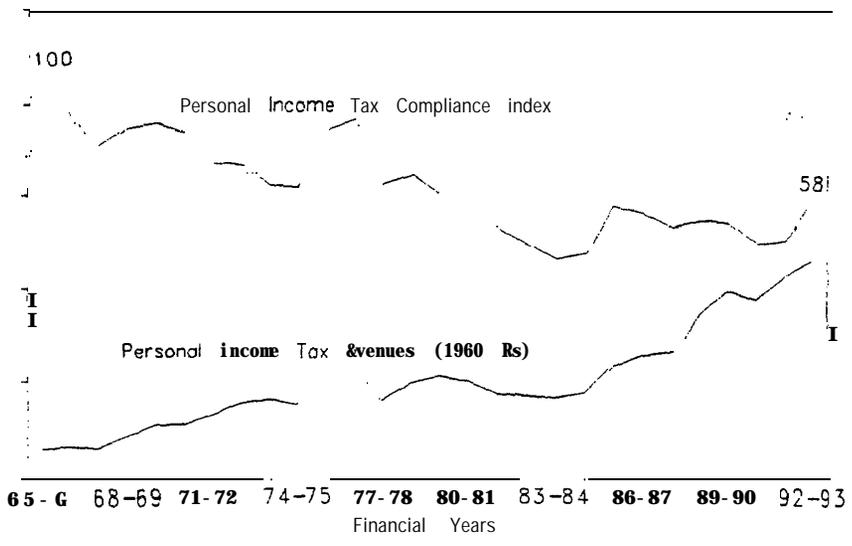
Falling compliance appears to be the principal cause for deteriorating income tax collections during this period. Das-Gupta, Lahiri and Mookherjee (1995) (hereafter DLM) have examined the time series behaviour of an aggregate index of compliance with the personal income tax. This compliance index measures the fraction of taxes due that were actually collected.¹² The compliance index is displayed in Figure 3. While subject to considerable year-to-year fluctuations, the index followed a secular downward trend. In particular, the level of compliance in 1991 was less than half that in 1965.

It is interesting to contrast the downward trend in tax compliance with the upward trend in income tax revenues. Even after adjusting for inflation, revenues increased sharply, especially since 1985-86. This revenue growth has masked the fall in compliance levels. Put another way, the growth in revenue is below what ought to have been achieved, given the growth in nonagricultural GDP and in tax rates during this period.

Causes of deteriorating compliance: Possible explanations for the decline in tax compliance were analysed in DLM. These include macroeconomic variables (nonagricultural GDP and inflation), tax structure (marginal tax rates and the exemption limit), and enforcement efforts of the ITD (search and seizure activity, quantity and quality of assessments, penalties and prosecutions). Besides these variables, the effects of tax amnesties are examined in Das-Gupta and Mookherjee (1995a).

The conclusions of these papers throw some light on the causes of falling compliance. Variables with statistically significant negative effects on tax revenues and compliance include tax rates, the exemption limit, audit intensities, and tax amnesties. Since the exemption limit declined

FIGURE 3



during the past decade. it could not have contributed to declining compliance, especially since 1980. The candidates for explaining deteriorating tax compliance can therefore be narrowed down to the rise in tax rates, the fall in audit intensities, and the repeated offering of amnesties.

The evidence suggests that marginal tax rates exercised a significant negative effect on both compliance and revenues. In other words, the fall in compliance tended to outweigh the direct effect of changing the tax rate: India appears to have been operating on the negatively sloped part of the Laffer curve. Moreover, contrary to the downward movement of the maximum marginal tax rate, the average marginal tax rate rose substantially since 1965, owing partly to the effects of inflation induced bracket creep, thereby serving to reduce compliance.

Audit intensities turn out to be the only dimension of ITD enforcement effort which exercised a significant effect on compliance. Consequently, one factor contributing to the fall in compliance has been the declining fraction of taxpayers coming under scrutiny assessment, combined with the reduction in time devoted to individual scrutiny assessments, especially since the mid-1970s.¹³ Prosecution effort (measured by number of prosecutions launched against tax evasion, or success with respect to convictions obtained or compounding of tax offenses) had no appreciable impact on tax compliance. Search and seizure (measured by value of assets seized in searches, the principal tool of the ITD in collecting information about taxpayer assets, had a statistically significant positive effect on compliance, but the magnitude of this effect was negligible.

Tax amnesties in 1965-66, 1980-81, 1985-87 and 1991-92 had negative effects on compliance and revenue.¹⁴ The direct receipts from the amnesty were substantially outweighed by a number of induced effects on filing behaviour, and on penalties collected during non-amnesty years. Moreover, repeated amnesties signal weak ability of the government to enforce the income tax. The only exception to this pattern was the 1975 amnesty, which exercised a positive impact on

compliance and revenues. This **amnesty**, however, coincided with an **internal emergency characterised** by stronger enforcement of **laws** and curtailed civil liberties, and the positive compliance effects **observed** in 1975 could owe to this rather than the **amnesty**.

One other important variable identified by DLM in explaining year-to-year **fluctuations in compliance** and revenues was the inflation rate. Higher inflation **tended** to reduce **compliance** and revenues, both via its indirect effect on effective tax **rates** (owing to lack of indexation of **tax brackets**), as well as directly (by inducing taxpayers **to delay tax** payments or **to shift white assets** into black). However, since **there** have been no **noticeable** trends in inflation over the past three decades, it cannot be viewed as a cause of the secular decline in compliance.

Table 2 reports estimates of the extent to which revenues **would** have increased in any **given year with** a switch of the policy that year **to** the corresponding 'best practice' policy **over** the period **1965-92**, based on the importance of different **explanatory** variables identified by **DLM**.¹⁵ Limiting attention to past best practice is a natural way **to** incorporate possible administrative and political constraints **on** policy reforms. **The** estimates suggests that in the **early 1990s, one could expect** a revenue increase of the order of 30 percent **by** reforming tax structure: in **particular** by reducing **marginal** tax rates to the **level** of the mid- 1960s. The only reform in enforcement policy **with** a significant potential impact on revenues (of the order of 40 percent) would be in **audit policy**, involving an increase in **the frequency** and **extent** of **time** devoted per audit. **Stepping up search and seizure activity** or prosecution effort, the principal **tools** of enforcement policy of the ITD **during the past few decades**, would yield **negligible** revenue additions.

Problems with income tax administration in India: Table 2 indicates that the revenue improvements possible from reform of **conventional policy** tools are modest in relation to the magnitude of **tax** evasion estimated **by Acharya and associates (1985)** or **Virmani (1986)**. Hence

Table 2: INCOME TAX REVENUE IMPROVEMENTS POSSIBLE WITH BEST PRACTICE TAX AND ENFORCEMENT POLICIES
(Percentage of Income Tax Revenue)

FINANCIAL YEAR	INCOME TAX REVENUE (% OF NAGDP)	EXEMPTION LIMIT	MARGINAL TAX RATES	SEARCH AND SEIZURE	ASSESSMENT EFFICIENCY	TOTAL	REVENUE WITH BEST PRACTICE (% OF NAGDP)
1965-66	2.05	41.6	0.0	11.2	2.2	55.0	3.17
1966-67	1.99	40.4	5.3	16.5	0.0	62.2	3.23
1967-68	1.89	37.4	10.6	14.6	2.1	64.7	3.11
1968-69	2.03	36.6	11.2	28.1	22.4	98.2	4.03
1969-70	2.19	34.2	12.7	14.5	27.7	89.2	4.14
1970-71	2.20	31.6	12.6	13.3	28.8	86.2	4.09
1971-72	2.29	14.3	23.4	10.9	33.0	81.4	4.15
1972-73	2.36	10.8	26.1	10.3	26.8	73.9	4.10
1973-74	2.32	3.6	31.3	9.7	20.2	64.9	3.82
1974-75	2.27	2.7	29.4	5.3	23.8	61.2	3.66
1975-76	3.05	16.4	31.9	4.5	24.1	76.9	5.39
1976-77	2.65	16.4	20.5	5.3	23.5	65.7	4.39
1977-78	1.98	25.4	23.8	12.9	27.2	89.3	3.74
1978-79	2.11	23.5	24.8	12.1	16.0	76.3	3.73
1979-80	2.10	19.1	30.1	7.5	12.3	69.0	3.55
1980-81	1.95	12.9	25.2	6.2	13.5	57.8	3.08
1981-82	1.71	29.8	27.2	4.9	15.8	77.8	3.04
1982-83	1.60	25.2	35.6	5.5	16.0	82.3	2.92
1983-84	1.50	19.4	38.3	5.9	24.0	87.7	2.81
1984-85	1.48	15.1	32.1	6.6	37.2	91.0	2.83
1985-86	1.69	21.7	19.6	5.2	40.2	86.7	3.15
1986-87	1.69	17.3	19.6	2.9	39.2	79.0	3.02
1987-88	1.62	12.6	21.5	1.2	42.1	77.3	2.87
1988-89	1.85	8.4	26.0	1.3	43.5	79.1	3.31
1989-90	1.84	5.2	28.3	2.1	39.1	74.6	3.21
1990-91	1.69	0.0	29.7	0.5	39.7	69.9	2.87
1991-92	1.80	3.5	31.7	1.7	40.0	76.9	3.18
1992-93	1.86	10.8	18.0	0.0	33.9	62.7	3.02

Source: Das-Gupta, Lahiri and Mookherjee (1995)

policy-makers should examine the possibility of reforming the institutional setting of income tax administration in India. The need for administrative reform is also highlighted by the limited deterrent effect of the two **principal tools** Of enforcement **policy**, viz. searches and prosecution activity.

In a descriptive study of the **ITD**, Das-Gupta, Mookherjee and **Panta** (1992) (hereafter DMP) reported serious problems with the administration of the income tax in India. The study was based on a field survey of five income tax ranges and interviews with officers of **the ITD**. **It examined the** information system, methods of record-keeping, manpower allocation **policies**, target-setting methods, performance incentive systems, and appeals, penalty and prosecution policies. **Major** problems were identified in each of these different aspects of ITD functioning, and are described below in further detail.

The information system of the ITD appears to be outdated and out of line **with** contemporary requirements. Computerization of operations or data on taxpayers is practically nonexistent, while taxpayer record-keeping is primitive and tamper-prone. There is no **functioning** system of taxpayer identification numbers; the system of tax withholding is grossly inadequate. **While** a **system** of third party reporting **exists** on paper, **percolation** of **information** to **assessing** officers is slow. Consequently, audit operations fail to **utilize** available information concerning transactions of taxpayers.

Manpower resources of the **ITD** grew substantially **slower** than its workload. **However**, DMP found no evidence that this owed to improved efficiency in the *utilization of manpower*. **The ITD** appeared to pay limited attention to the rational allocation and deployment of manpower **across** different units of the **ITD**, or to the design of effective systems of planning and evaluation, audit selection, work targeting, and **employee** incentives. In particular, the **ITD** displayed little awareness of the effects of these systems on revenues and taxpayer compliance. For instance, it

reacted to a growing workload by stressing the disposal of pending *assessments and collection* of tax **arrears**, while allowing the quantity and quality of scrutiny assessments to deteriorate sharply. In simulations of alternative manpower deployment strategies, Das-Gupta and Mookherjee (1995b) find substantial scope for improving the revenue productivity of manpower devoted to assessment.

In *penalty and prosecution* activity, DMP identified a similar tendency to emphasize **quantity** over effectiveness. Penalties and prosecutions have increasingly been oriented towards **the punishment** of relatively technical violations (such as failure to deposit tax deducted at source, or failure to pay advance tax). The consequence is that relatively less effort has been devoted to penalizing tax evasion.

On these **grounds**, therefore, it may be argued that weaknesses in administration represent a principal cause of **the** poor performance of income taxes in India. These administrative **weaknesses** have atrophied especially with the sharp growth in workload, arising in turn from the increasing number of taxpayers. It is therefore appropriate to turn to the experience of other **countries** in the area of income tax administration.

3. International Experience

Tax reforms have been carried out in several countries in recent times in what appears to be a worldwide movement towards modern tax systems. India is therefore in the happy position of being able to draw upon international experience in planning its own reforms. The purpose of **this section** is twofold. First, the experience of selected countries is used to assess the importance of **effective administrative reforms** in successful tax reform. Second, **the experience with detailed**

administrative reforms in these countries is used to identify choices that might be considered seriously in designing administrative reforms in India.

A brief description of the countries reviewed and their experiences is appropriate at **this point** to motivate their selection. *Mexico* undertook a complete overhaul of its tax administration as **part** of the economic reforms initiated in the late 1980s. Besides modernization of administrative systems, tax enforcement was stepped up greatly. Tax performance in Mexico improved **markedly thereafter**. Spain completely overhauled its tax information system **by introducing** comprehensive computerization, but took few measures to increase the severity of tax enforcement. It too realized significant gains and cost economies, though these **gains** were perhaps less spectacular **than Mexico's**. *The Philippines* has undertaken extensive income tax reform during the past twenty years but has paid less attention **to** administrative reform. Improvement in tax revenue **realization has been** sporadic over the period. **In contrast** to most other countries, *Singapore's income tax retains* several traditional features such as the absence of self-assessment or withholding **taxes and, until** recently, field audits. However, it has one of the most automated tax systems in the **world**, and has a record of successful prosecution of a small number of high profile tax evaders. Its persistence with outmoded tax provisions has not prevented a satisfactory tax performance, owing largely to its advanced administrative systems.¹⁶ *The importance of improved administration in successful tax reform is, therefore, supported by the experience of these countries.* Additional **support** for this position can be found from the experience of many other countries as well. For **example**, Indonesia's income tax has not fared well despite drastic tax simplification and base broadening, due **mainly** to slow implementation of administrative reform." **On** the other hand, countries such as Colombia, Costa Rica, Ecuador and Jamaica achieved substantial gains from comprehensive reforms which included administrative reforms. ¹⁸

One lesson that appears warranted is the importance of political **will** in initiating successful reform. The fiscal crises in such countries as Argentina, Bolivia, Colombia and Peru during the

1980s resulted in the election of governments with a mandate to carry out economic reforms. **This enabled** reforms **such** as the successful **overhaul** of tax systems, which had not been possible **with the weak** governments that had prevailed earlier. **with respect to specific areas** of administrative reform, the most far reaching changes were achieved in modernizing the tax information system. **This involved large scale** computerization and use of modern information processing technology, **besides organizational** reforms intended to enable effective utilization of information. In contrast, increased levels of auditing and stepped up prosecution activity did not appear to have been widespread. Following computerization, reforms in the organizational structure of **tax** administration and of employee incentives formed a second major initiative in many countries. **These will** shortly be reviewed in greater detail below.

Overall Perspective: Many countries, particularly in Latin America, witnessed significant reforms in tax administration during the 1980s. **Silvani** (1990) characterized the 1980s as the ‘winning **decade for tax** administration’. **The motivating factor for these reforms** was the **onset of fiscal** crises during the early 1980s. Foreign borrowing could no longer be relied upon to overcome fiscal problems; neither could inflation which was already prevailing at a high level in most of these countries. The initial reaction of many countries was to introduce reforms in tax law to encourage investment; index for inflation and broaden the tax base. These reforms were largely unsuccessful **in** substantially increasing revenues. Consequently, **during the 1980s**, significant **changes** in tax administration were introduced in many Latin American countries. Similar reforms were initiated in other countries for a variety of reasons. Spain and Portugal embarked on ambitious tax modernization programs **to** enable them to “catch up” with the rest of the European Community. The end of the **Marcos** era in the Philippines heralded many economic reforms, **including** tax reform, though administrative reform was less thoroughgoing. Indonesian reforms

Table 3 Tax Collection Costs and Revenues				
Country	Collection Costs (% of Revenues)		Revenues (% of GDP)	
	1980	1989	1980	1989
Colombia	1.11	0.68	8.4	9.9
Costa Rica	1.15	0.99	12.8	15.0
Ecuador	1.43	0.66	12.8	16.0
Indonesia	NA	NA	22.8 (6.6)	16.0 (9.2)
Jamaica	NA	1.83	24.8	31.4
Mexico	1.11	0.22	15.3	18.6
Philippines	0.98	0.79	12.5	13.2
Spain	NA	NA	13.6	23.2
Singapore	0.69*	0.80*	17.5	16.9

Notes: 1. Indonesia: Non-Oil Tax Revenue in Parentheses.
2. *: 1984 and 1990.
Sources: Country studies cited in the text.

were motivated by falling petroleum prices causing deteriorating terms of trade and declining capital inflows in the early 1980s, leading to a perception that non-oil revenues needed a boost.

Most successful reform initiatives were associated with strong political support from the highest levels. Such support was necessary to overcome inertia within the administration and resistance from adversely affected taxpayers, and to make available necessary finances and leadership. The political will resulted from the need for elected governments to successfully resolve ongoing fiscal crises to ensure a continuation of their mandates.

A careful quantitative assessment of the results of reform in different countries is not available. Two basic indicators are, however, presented in Table 3 for countries which have successfully overhauled their administrations (as well as for Indonesia and the Philippines). Singapore's atypical performance reflects, in part, a deliberate reduction in its tax burden, besides a wage hike for tax employees. Though its real tax revenue declined in 1985 and 1986, tax buoyancy with respect to GDP for increased from 1.44 during 1980-85 to 1.5 during 1986-1992 (Das-Gupta, 1994b). Overall, the figures suggest that appreciable gains can be achieved by reforming administration.

Specific Reforms

International experience with five specific components of administrative reform are now described in more detail: information system; organizational structure; auditing; tax collection; and treatment of offenders. The review is selective and concentrates on aspects of relevance to the Indian situation.

The Information System: The major components Of a tax information system include sub-systems dealing with the identification of potential taxpayers, ascertainment of their tax dues from their own records and from the records of third parties, monitoring the progress of tax proceedings with particular taxpayers. and keeping track of tax collections. Several other sub-systems, ranging from those that facilitate internal control of operations to those that permit tax officers and taxpayers to make informed decisions are also important. From the point Of view of Indian reform, three reform trends have been significant. The first is computerization of the information system, which usually starts with basic taxpayer identification, construction Of taxpayer master files and current accounts, and then proceeds to an overhaul of systems for tax filing, record keeping and retrieval, and cross-matching. A second initiative involves strengthening Of withholding systems. Introduction of presumptive taxes forms a third reform which can compensate for weaknesses in the information system.

The most important reform initiative has undoubtedly been computerization, which brings with it several unique benefits, such as: (i) a tamper-proof, readily accessible and updatable information base on the identity of taxpayers, their payment records, and third party information; (ii) cross-matching of information from different sources concerning the activities of any taxpayer; (iii) efficient collection and tax recovery operations; (iv) sophisticated audit selection programs and enhanced information on taxpayer activities speedily available to tax auditors during audits; (v) less corruption owing to reduced scope for person-to-person contact between officials and taxpayers, and reduced auditor discretion over conduct of audits; (vi) improved taxpayer information and assistance services; and (vii) a comprehensive information base for managerial planning and supervision.

Virtually all comprehensive computerization programs have included the following components: a system of nation-wide taxpayer identification numbers and identity cards; a

Taxpayer Master File (listing all **potential** taxpayers, with identifying information); a Taxpayer Current Account (containing a record of tax related transactions); and a Tax Data Base, used in audits, taxpayer assistance and management control. The development of these components represents the natural first stage of a computerization programme. These were successfully introduced over a period of about **30** months or less by many Latin American countries, usually **with external** assistance from the Inter-American Tax Conference (CIAT) and the Inter-American Development Bank (IDB).¹⁹ Countries such as Mexico or Spain, achieved even more comprehensive computerization within a relatively short span of time: 1988-93 for Mexico and 1984-91 for Spain.²⁰

The returns to investments in information technology appear to have been **realized** fairly quickly: indeed, virtually no country witnessed any disruption in its revenue collections during the transition period. Virtually all the CIAT-IDB assisted programs in Latin America realized immediate benefits, especially with respect to collections and recovery operations. In countries for **which data** on **costs of these investments** are available,²¹ the investments were invariably below **one** percent of average yearly tax revenues. The absolute cost of computerization was below US \$10 million, with **the** exception of Spain and Mexico. The total Mexican investment has been estimated at about US \$18 million, as against an annual revenue of US \$26197 million in 1989.

Computerization brings with it the need for complementary legal reform. These include changes in filing requirements and filing processes, and treatment of signatures in **electronically** filed returns and tax demand notices. In addition, issues of taxpayer rights to privacy and security **also** have to be tackled. Mexico has introduced a number of innovations designed to track transactions of small taxpayers, including the mandatory use of sales registers that track sales in retail establishments, of invoices that carry taxpayer identification numbers of both buyer and seller, and the use of industry association affiliations to **register** small businesses. It should also be noted that virtually **all** the countries surveyed have a system of nation-wide taxpayer identification

numbers, which have been in place for several decades. The only exception is the **Philippines**, which is still consolidating its taxpayer identification system.

An important component of the information-cum-tax **collection** system is **withholding** of **tax** at source. Withholding from wages (**PAYE** systems), interest and dividends is an important **source** of revenue for most countries studied. An exception to this is Singapore. The Philippines has compensated for its relative lack of success with computerization with a major extension of **withholding** taxes. This was facilitated by a move away from global income taxation to **schedular** taxation, which involves separate tax schedules for different sources of income in order to reduce the **complexity** of administering the tax. Creditable **withholding** taxes on bank deposit interest, dividends and royalties at a flat rate of 15 percent, and on money market interest at a flat **rate** of 35 percent were introduced in the late **1970s**. These were soon followed by an expanded withholding system, under which all persons making payments to residents were required to withhold taxes at rates ranging between 2.5 and 35 percent, and a progressive (**10** and 20 percent) final withholding tax on property sales. To encourage compliance with these, a number of penalty provisions were introduced in 1979 and subsequently strengthened in 1987. To circumvent bank **secrecy** laws, central bank auditors monitor compliance with interest withholding requirements by commercial banks. The overall results of these reforms have been striking: the share of withholding taxes in total revenue collections increased from 7.8 percent during 1972-81, to 16.2 percent **during 1982-85**, and 19.7 percent during **1986-91**. In **1990** and **1991**, collections **from** withholding taxes amounted to about 3.5 percent of GDP, exceeding those from income and corporation taxes combined! This experience contrasts with that of India, where a 1991 measure to introduce withholding from bank interest had to be withdrawn after one year.

In order to deal with hard-to-tax groups (such as retailers, professionals or other **service** sector categories) whose incomes are hard to measure, **presumptive** taxes have been used in **various** countries. The most well known **example** is the tax on real assets introduced in Mexico,

Colombia and Argentina during the late 1980s. In Mexico, for instance, this is levied at 2 percent of the gross inflation-adjusted assets of a company, principally aimed at reducing tax evasion based on 'innovative' accounting methods. It is a minimum tax, refundable to companies in years of above normal profit declarations. This tax has been the most controversial of all the Mexican tax reforms of the past decade, with numerous court cases filed -- suggesting that the tax has exercised considerable bite. Revenue returns have been of the order of 0.3 percent of GDP.²²

Organizational Restructuring: The experience of other countries suggests that Indian tax administrators can consider five potential sets of organizational changes: increasing functional specialization; reducing regional decentralization; awarding greater autonomy to the tax administration; altering manpower allocation Systems; and reforming employee compensation policies. These are elaborated in turn below.

There has been a general trend amongst the CIAT countries towards adopting a functional structure for tax administration, with different departments specializing in different functions (such as assessment; collections and recovery; information processing; taxpayer assistance; and penalties and prosecutions). This is also true of the three Asian countries examined. Indeed, it is difficult to visualize effective computerization of operations if a tax administration is not organized along functional lines. There has also been a trend towards unifying administration of direct taxes, indirect taxes and customs duties. These stand in direct contrast to the organization of the Indian system, where different functions tend to be simultaneously carried out by local units in isolation from one another, and where different taxes tend to be administered by different bodies.

Unlike Indian administration, certain functions such as planning, evaluation and taxpayer assistance are explicitly recognized by building them into the organization structures of tax administrations in many countries. For instance, the Philippines created a management information

system in 1981, and have a practice of *creating* and implementing long range plans for improvements in selected areas. This facilitated the phased introduction of major pieces of tax reform (such as the Modified Gross income Tax), based on feedback from different quarters, over a period of some five or six years. Spain has an advanced computer-based planning and evaluation function, making available continuously updated statistics on collections and audits classified in various ways (by taxes, regions, functions etc.), projecting future revenues, and monitoring progress towards achievement of different targets. Computers are -also actively employed in providing assistance to taxpayers, with respect to providing answers to taxpayer queries, and assistance with preparation of tax returns. Computer-based taxpayer assistance is also provided in Chile, Colombia, Canada and Portugal.

Another distinctive feature of the Indian administration is the high degree of decentralization of tax to local units, with relatively little sharing of overhead 'staff' functions, limited supervision from higher levels, and substantial discretion to local officials. In contrast, the trend in many countries is to increase the degree of centralized control and resource-sharing. This makes it difficult for local officers to tamper with records, besides allowing centralization of audit selection and manpower allocation. For instance, Spain and the Philippines have created regional offices that act as an intermediate level of the tax administration hierarchy. These regional offices have special branches for collection, assessment and administration. Taxpayer records and other sensitive information are usually stored at central information processing departments, and are electronically accessible to the entire administration. In contrast, taxpayer files are stored in single paper copy at local offices in India, causing limited and delayed access to other offices.

Greater autonomy of the tax administration is important if the administration is to retain the flexibility to respond to administrative problems quickly and effectively. Autonomy over salary levels, incentive systems, training, and procurement has been increased in varying degrees in a number of countries, such as Argentina, Colombia, Ghana, Peru and Singapore. An important

dimension of autonomy concerns the budget of the tax administration. In several countries **this is linked** to revenues collected. For example, the **Internal Revenue Authority** of Singapore is an **independent statutory corporation** whose **income consists** of agency fees paid to it by **the** government of Singapore. The fee is linked to **tax collections** achieved, relative to a pre-decided target. A second dimension of autonomy **pertains** to personnel **policy**. In Peru and Singapore, **extensive** autonomy **over employment** conditions, including the hiring and firing of employees, **has** existed since the early 1990s. **Peru's** tax administration utilized its powers to drastically reduce staff strength and increase salary levels on a merit basis. Singapore revised wages in **line with** market wages, a measure that was made possible by the fact **that** tax officials are not part of the civil service. The degree of autonomy in Spain, on the other hand, has been **limited** by the **constraints** imposed by **the** civil service of which the tax administration forms a part. In India, by Contrast, almost **all** items of expenditure, and not just the overall budget, require approval by **officials** outside the tax administration. **Furthermore**, tax officers form part of the civil service, thereby restricting the scope for introducing wage and employment conditions appropriate to the **particular** needs of tax administration.

The previous section noted how **the** increasing ratio of workload to manpower in India has **caused** significant dilution of the frequency and quality of taxpayer audits. **Other countries** have also **witnessed** significant growth in workload, without significantly increasing manpower allocated to audit operations. Most important, **this problem** was successfully confronted **without reducing** the effectiveness of audit operations. **The** Mexican tax administration, for instance, Shrank **its** staff strength by over 20 percent between 1988 and 1991, despite an over 20 percent increase in **the** number of taxpayers, and an 80 percent increase in the fraction of taxpayers audited. During the same time there were impressive gains in the yield of individual audits. In Spain the number of taxpayers more than doubled between 1981 and 1992, **but** the number of tax inspectors and **sub-inspectors** employed increased only 11 percent. In the Philippines **the** number of **taxpayers**

increased 12 percent between 1976 and 1988, but total employment was almost stationary during this period. By and large this was made possible by the increasing computerization of operations, which allow automation of routine tasks. The task of manpower management is greatly facilitated by granting the tax administration autonomy over manpower recruitment and deployment decisions.

A final area of organizational reform concerns compensation of tax administration employees. Some countries like Mexico and Peru have recently introduced flexible hiring and firing policies, with use of incentive systems offering substantial rewards to tax officials based on revenue collections. *These appear to have exercised a significant impact in curbing corruption and increasing revenues.* Spanish tax administration employees, on the other hand, are part of the general civil service whose salary levels are not comparable with the private sector and rely little on positive incentives. Reliance is placed instead on a sophisticated system of decentralizing decisions and evaluating the performance of individual cost or budgetary centers. The tax administration in Singapore also relies on non-monetary incentives for employees, besides revising wages upwards quite substantially to bring them in line with market wages. Employees of the tax administration in the Philippines are part of the general civil service, where incentives are provided by systems of promotion. Similar to Indian practice, work targets are assigned in detailed quantitative terms, and success of individual employees and departments in meeting centrally laid down targets are monitored and used in performance evaluations. Salary levels are periodically upgraded. Overall, the system is believed to be characterized by a lot of corruption and low work incentives. In the Indian context, where official corruption is alleged to be more akin to the Philippines and (pre-reform) Mexico, a system of positive incentives would appear to be appropriate. It may be argued, however, that the more fundamental reform involves granting autonomy to the tax administration, whose budget is linked to its performance; the self interest

of the administrators themselves can then be subsequently relied upon to reform employee incentives without external direction.

Auditing: The following three dimensions of **audit policy** are Important: the types of audits carried out, selection of which taxpayers to audit, and the number of audits of different kinds carried out by an auditor on a **yearly** basis. Most countries **conduct two** or more types of audits of differing intensity. In systems with a high degree of computerization such as Canada, Singapore or the **United States**, mechanical checking of returns **for arithmetical** and prima *facie* correctness (or **pre-auditing**) is usually performed automatically. Cases selected thereafter for audit can be subjected **either** to a desk audit, or a more comprehensive **field** audit (as in Singapore). The **former type** of audit is **useful** in **detecting** questionable tax deduction claims, while the **latter** is appropriate **for the** detection of tax evasion. For a small number of serious fraud cases, **tax** investigations conducted by specialized teams are often used (e.g., in the Philippines, Singapore and the United States).

In order to maximize the returns to audit, selection of cases is best performed at the national level so that uniform criteria are applied to all taxpayers. Furthermore, criteria can be designed to facilitate computerized selection of **returns** as in **Canada, Mexico**, Singapore, Spain **and** the United States. These criteria reflect past experience of characteristics of audited taxpayers whose reported income deviated **substantially** from the income subsequently assessed.

In most countries studied, the number of audits carried out per year by a single auditor was **less** than thirty, implying an average of about ten **days** per audit. Audit proportions run above 10 percent in Chile and Portugal, between 2 percent and 10 percent in Argentina, Costa Rica, El Salvador, Guatemala and Mexico, and less than **2** percent in Ecuador, Spain, Panama and the Philippines. Typically countries auditing a larger **fraction** Of taxpayers (such as Chile and Portugal) have less intensive audits.

It is instructive to compare these with Indian practice. The standards of auditing in India have been significantly diluted by the growing workload over the past two decades.²³ The fraction of taxpayers audited in India fell from about 60 percent in the early 1970s to below 3 percent in the 1990s. This, however, masks trends in audit intensity, since the definition of a scrutiny assessment (the Indian term for an *audit*) has been progressively strengthened since the 1960s. For instance, an assessing officer carried out almost 400 scrutiny assessments a year in the early 1980s, as against a little over a hundred by the late 1980s. With respect to the audit frequencies expressed as a proportion of the total taxpayer population, Indian practice does not seem out of line with international practice.

The major discrepancies arise with respect to the quality of audits. With each assessing officer carrying out a hundred audits a year, an average of three days were spent per audit. Moreover, only a small fraction (about 20 percent on average) of the time of tax inspectors is spent on field enquiries, so the audits are overwhelmingly desk audits.

Moreover, the decision of which taxpayers to select for audit is predominantly delegated to the relevant assessing officers, with little oversight exercised by any centralized body. The officers are often issued general guidelines by the ITD concerning which taxpayers to select, but these tend to be designed without much thought to consequent effects on taxpayer reporting incentives, and also leave substantial room for subjective judgments and discretion to the assessing officers. There was also little evidence that assessing officers utilized information available concerning transactions of taxpayers to the ITD, or any other systematic procedure.

Another practice in India that contrasts markedly with other countries is the extensive reliance on search and seizure operations by its tax investigation unit. In none of the countries studied was there a strong reliance on search and seizure activity either as a tool for gathering information or for initiating prosecution for tax offenses.

The scope for **substantive** reforms in auditing practice is illustrated by **the experience** of Mexico. Prior to 1988 the auditing system was not substantially dissimilar from the current **Indian practice**. Since 1988 a variety of measures were introduced to reduce corruption, and motivate auditors in a positive manner. **These** include **reliance** on **preprogrammed** 'laptop' audits, which substantially reduced the scope for auditor discretion; a *system* of bonuses based on additional revenues collected, amounting on average to about **130** percent of the overall wage bill; induced attrition of corrupt **officials**; and increased job rotation. Vigilance activities were also stepped up: for example, auditors are subjected to polygraph tests, and an audit which yields no additional revenues can be closed only by an **official** from a different **department**. Second, the audit **selection** system is now based on a computerized information base; selections are decided by **the** programming Departments of **local** offices, on the basis of criteria issued by the central **office**. **Third**, large taxpayers are required to be inspected by private auditors, just as in the case of financial statements: the returns are filed electronically, and the third party auditor is held **partly** responsible for irregularities or improper disclosures **in the** return. This has freed audit manpower resources within the tax administration away **from** large taxpayers to middle sized and small taxpayers.

In Spain, improvements in auditing have been achieved through an enhanced information base. especially **with the** development of 'expert systems' software **allowing** identification of **taxpayers** according to the intersectinn of different criteria relating to **transactions and assers**. A **national** data base is also used to identify potential non-filers. Taxpayers are selected for audit at **local offices** based on criteria laid down by the central office: the latter also lays down targets in terms of the number of audits to be carried out, and revenues expected to be realized. However, there is no system of financial incentives for auditors, or Other mechanisms to insure auditor **responsibility**. For instance, **additional** tax demands *made by* auditors **are** frequently appealed by taxpayers and subsequently overturned, and the tax auditor has **little** responsibility beyond issuing

the original demand. Not surprisingly, levels of tax evasion appear to be quite high: it is estimated that about 68 percent of income was concealed under the personal income tax in 1992, with special concentration in construction, restaurant and transport sectors. In these respects, the Spanish situation is similar to that in India, despite the deployment of a sophisticated computer system. The contrasted with Mexico serves to highlight the importance of offering positive incentives to inspectors.

Tax Collection: The main point of interest here is the extensive privatization of tax return filing and tax collection operations through commercial banks. The degree of privatization varies, but the feature itself is common to most CIAT countries, as also the Philippines and Singapore.²⁴ While tax collection is also carried out through banks in India, the system is poorly designed and cumbersome in contrast to the systems prevailing in other countries studied. Reform of the Indian collection system along the lines of systems in Mexico or Colombia could greatly increase its efficiency.

Appeals, Penalties and Prosecution: It is worth considering the striking reforms achieved by Mexico in these areas, and contrast the resulting system in Mexico to that currently prevailing in India.

The Mexican reforms were designed to encourage incentives for voluntary settlement by taxpayers and strengthen prosecution of large tax offenders. First, an 'autocorrection' facility was introduced to reduce frivolous or strategic penalty litigation whereby penalty rates are reduced by half (from 100 percent to 50 percent) if the taxpayer complies with the additional demands made by the tax inspector. As many as 70 percent of all additional demand cases are now settled in this

fashion, serving to reduce **the** pressure on the appeals and court system. Second, the appeals procedure allows only one level of appeals, and is now time bound. The incentive to delay payments via frivolous appeals have also been reduced by introducing inflation adjustments **to** penalties, as **well** as liability rules where taxpayers must compensate the tax administration for **legal** expenses incurred in case the **appeal** is overturned. Finally the administration increased prosecution effort markedly, **with** special **concentration** on large offenses. **More than 500 tax** evasion prosecution cases have been launched since 1988, with over 200 people given jail sentences (**in contrast** to only three prosecutions in the entire history of the system prior to 1988).

The Indian system involves excessive delays, even by **the** already low **standards** of countries such as Spain and the Philippines. Appeals are not time bound and *ex parte* hearings are not allowed. Various amnesty and settlement programs dilute the deterrent effect of penalties, as **does the fact** that many prosecutions are launched against tax offenses of a technical nature which do not involve large scale tax evasion. The discretion allowed to tax officials and settlement authorities over terms of **settlement** and granting of immunity stand in sharp contrast **to the** formula-bound autocorrection approach used in Mexico.

In conclusion, the experience of many developing countries illustrates the wide range of reforms that could be considered by the Indian tax administration. Their experience also suggests that such a reform process is **logistically** feasible over a five to eight year horizon. Financing costs have tended to be low in relation to **annual** revenues, and revenue returns have usually been realized fairly quickly without any major disruptions. Nevertheless, serious reforms require political will at **the** highest level within the tax administration, as well as in the government. The **following** section attempts to summarize some Lessons that Indian policy **makers** could **learn** from **the** experience of other countries.

4. Lessons for Indian Policy

The first point that needs emphasis is that continuation with current administrative and enforcement practices cannot lead to dramatic improvements in the performance of the income tax in India. This is evident from Table 2 which demonstrated *the possibility of at most 60 to 70 percent revenue increases from switching to “best practice” levels of these policies over the period 1965-92.*²⁵ However, almost **half** of this improvement would owe to increases in assessment **efficiency**, reflecting a return to the audit frequencies of the 1960s. **Changes** in tax structure **would** yield less by comparison. **Furthermore, even if both tax structure and tax administration reform are carried out to the levels of best practice since 1965, the order of gains insufficient to restore the performance of the Indian income tax to the level of other developing countries.**²⁶

Consequently, reform of income tax administration must be more thoroughgoing if income taxes are to increase their contribution to revenue significantly. Areas requiring reform have already been identified in preceding sections, and are summarized below.

The first main area is the information system. Necessary reform measures **include** computerization, introduction of a nation-wide system of taxpayer identification numbers, current accounts and taxpayer master files; a major extension of the withholding system; improved **methods** of cross-matching of information-from different sources; and a special drive to track down **non-filers.**²⁷ The second area involves organizational restructuring, where the government could consider the following reform measures that appear to have been effective in other developing countries: increased autonomy to the tax administration over salary levels, hiring and firing of

employees, procurement, and privatization of select operations: increased functional specialization, and increased centralization, in order to reduce discretion of local officials and to improve sharing of overhead resources; the creation of new units for long term planning and evaluation, and taxpayer services. The third main area where reforms are necessary is auditing. There is a need to enhance the quality of audits by allowing auditors more time to carry them out, for instance by reducing quantitative norms. Audit selection procedures which make effective use of available information need to be introduced. Most importantly, improvements in auditor incentives and monitoring need to be introduced to reduce corruption. A fourth possible area of reform concerns ways of improving the effectiveness of current manpower resources of the tax administration to cope with the large workload. This may involve the introduction of rational manpower allocation plans designed to increase revenues without increasing total employment, and improved training and infrastructural facilities. Finally, appeals, penalties and prosecution activities should close off loopholes exploited by large scale tax evaders; emphasize formula-based voluntary settlement, and engage in selective but intensive prosecution launched against large tax evaders.

A gradual program of modernization of the tax administration can be introduced in a phased manner. The transition requires careful management to limit resistance from entrenched interests. To be implemented successfully, the reforms therefore have to be sequenced appropriately. Two main sources of resistance can be expected: affected taxpayers, and employees of the tax administration. Elements of the reform programme which would appeal to these two groups should be given strong emphasis at the outset. The experience of other countries suggests that with a few notable exceptions, greater emphasis has been given to improvements in the information system within the tax administration, rather than heightened activities of audits and prosecutions. This may have been partly to avoid strenuous opposition from middle class taxpayers.

In similar fashion, the **Indian** reforms could also limit resistance from taxpayers by initially focusing on computerization, and improvements in taxpayer services. The culture of **acquiring** information concerning tax offenses via brute force can **be** replaced by a less visible but more comprehensive method based on extended third-party teponing and withholding. **The number and geographical spread of collection centers** for tax returns could be enhanced, special **offices dealing with** taxpayer enquiries could be opened, and processing of refunds could be speedier and offered on an automated, impersonal basis.

The support of internal employees could be sought by **including** programs of salary enhancements, improved work facilities, flexible work targeting systems, positive reward-based incentive schemes, less frequent transfers, and improved training (especially with respect to computer-based tasks). These changes will necessitate a certain degree of autonomy to the tax administration. DMP report that their interviews with assessing officers revealed a positive attitude towards a reform package which **included** these elements.

Improvements in audit systems could be brought about by redesigned manpower **allocation** schemes, which are unlikely to meet with much resistance from employees. For instance, an important component of the intensity of audits of **specific** groups of taxpayers (defined by occupation, region or scale of reported income) is the amount of manpower allocated to their assessment. Das-Gupta and Mookherjee (1994b) show that manpower allocation norms have a strong impact on revenues collected, owing to induced **effects** on audit **frequencies** and **therefore** on taxpayer incentives to **disclose** income. For instance, the current practice of organizing taxpayers into wards and circles, based on **size** of reported income, has the effect of lowering audit **frequencies** for wards (corresponding to **low** income **disclosures**) relative to **circles** (corresponding to **high** disclosures). This increases the incentive for a high income taxpayer to disclose little, in order to be **included** in a ward where the likelihood of audit is low. This perverse effect can be

avoided by allocating more manpower to **circles**, or better still, abolishing the ward-circle distinction altogether.

Reforms in **penalties** and **prosecution** policies are **also** essential, and are likely to **be** unpopular. However, they are likely to reduce harassment of middle class taxpayers if oriented towards punishment of large scale tax **evasion** rather than **small** scale **technical** offenses. Of course, the closing of various loopholes exploited by large tax evaders will meet with **political** resistance, and in this one respect the government has to stand firm. Increased autonomy of the tax administration (for example, at least analogous to that offered to the Reserve Bank of India), **is** a possible method of increasing the distance between **officials** responsible for **initiating** prosecutions, and channels of political influence.

These reforms would necessitate a **shift** in the **fundamental orientation** of the Indian tax **administration**, away from relatively **technical** objectives such as clearance of pending **assessments**, better tax recovery percentages, and prosecution of technical offenses, towards raising additional revenues, detecting and punishing tax evasion.

This gives rise to the **fundamental** question: is there the requisite political **will** to enact such **reforms** in India? In many countries with weak, democratically elected governments (such as Argentina, Bolivia, Colombia or Peru), such a will has nevertheless been forthcoming, owing to a severe fiscal crisis,' and **election** of a new government with a **clear** mandate to carry out deep-seated **structural economic** reforms. This opportunity was clearly present in **India in 199 1**, when the current government took over. The likelihood of enacting such reforms have progressively weakened ever since.

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ENDNOTES

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2. For example, Acharya and associates (1985) estimated the size of the underground economy at 18 percent of GNP and income evading tax at 186 percent and 243 percent of income assessed to tax in 1975-76 and 1980-81 respectively. Virmani (1986) obtains an even higher estimate for 1975-76.

3. See, for example, the studies reported in Bird and Casanegra de Jantscher (1992).

4. See, for example OECD (1990) and Hussey and Lubick (1992).

5. The disparity is more pronounced if social security taxes are included in total tax revenue.

6. The figures are based on 3 Year averages for years closest to 1987 for which data were available. GNP per capita is measured in 1987 US dollars for the year 1987. The sample included 82 countries.

7. See the Indian Economic Statistics (Public Finance) for 1991-92.

8. See the Report of the Comptroller and Auditor General of India: Revenue Receipts - Direct Taxes for 1991-92.

9. The potential base of the Indian income-tax corresponds roughly to personal income from non-agricultural sources, since agricultural income is exempt under the Indian Constitution. Of course, this base is eroded by the exclusion of various incomes for "merit good" or other, less praiseworthy, reasons. Since data on personal income from non-agriculture are not available, and Non-Agricultural GDP is closely correlated with non-agricultural personal income (the correlation coefficient between GDP and personal income for 1960-92 was 0.9987), the former is usually taken as a proxy for the potential base of the income tax.

10. See Government of India, Tax Reforms Committee (1991).

11. The average ratio for 1960-61 to 1974-75 was 2.18 percent, as against 1.78 **percent** for the period 1977-78 to 1992-93. The peak was achieved during 1975-76 amidst the internal emergency, a period of curtailed civil liberties and harsh police measures.

12. The compliance index is the ratio of actual income tax collections, to the product of non-agricultural GDP (a proxy for the tax base) and the average effective tax rate (computed by averaging the effective tax rate across different income groups). The level of this index is subject to a number of biases, but it is less likely that year-to-year fluctuations are similarly affected. This was confirmed by **examining** how the index was modified with respect to treatment of deductions, and arrears or exclusion of registered firms, for years for which data concerning these variables were available. Indeed, the index is biased upward if black income is **not** fully reflected in measured non-agricultural GDP. The reader is invited to consult **DLM** for additional **details**.

13. Time series of these variables are reported in Das-Gupta, Mookherjee and Panta (1992).

14. An amnesty during the 1975-77 emergency did have a positive effect on revenues. As pointed out earlier, this was an exceptional period.

15. The estimates in Table 2 should be treated with caution and viewed as illustrative, for a variety of reasons. For one, independent switches of assessment policy and search and seizure policy to their respective best practice levels may not be feasible in **any** one year, given the manpower and budgetary resource constraints on the ITD. The presence of such constraints would, however, reduce the revenue gains possible from changes in conventional enforcement policy, thus strengthening our qualitative conclusion. Secondly, the estimates are based on coefficient estimates reported in **DLM**, which are sensitive to changes in the specification of statistical equations. However, the qualitative nature of the results are less sensitive to specification changes.

16. The country studies are based on Mookherjee (1994b) for Mexico, Mookherjee (1994c) for Spain, Das-Gupta (1994a) for the Philippines and Das-Gupta (1994b) for Singapore.

17. See Gillis (1990) and Nasution (1994).

18. See Mookherjee (1994a).

19. The list of **countries** includes Costa Rica, the Dominican Republic, Ecuador, El Salvador, Guatemala, Honduras, **Panama**, Suriname and Uruguay.

20. Besides the basic components mentioned, Mexico has computerized data-entry from filed returns; information on sales and purchases by businesses and financial deposits; and has a system for cross-matching these deposits. It has also automated tax collection, issue of notices to delinquents, tax refunds and audit selection. In addition to having computerized all sub-systems that the Mexicans have, Spain is also able to utilize information on luxury expenditures by taxpayers, identify non-filers and provide computerized assistance to taxpayers. The computer data base is also utilized more extensively for managerial control in Spain. Essentially the same level of computerization as in Spain is present in Singapore. However, Singapore also has automated return-filing and tax payment systems.

21. These countries are Costa Rica, Chile, El Salvador, Spain, Guatemala and Portugal.

22. For a comprehensive review of presumptive taxation see, for example, Tanzi and Casanegra de Jantscher (1987).

23. Furthermore selection of cases for audit is unscientific or largely discretionary: See DMP.

24. Some countries such as Mexico have also privatized information processing functions and the printing and distribution of tax forms.

25. Further details of these estimates are available in DLM.

26. Furthermore, the tax structure identified by the regression as best practice from the point of view of revenues (the 1965-66 structure) involved high tax rates which are undesirable on other grounds.

27. The research of virmani (1987) suggests that non-filing comprises the bulk of the tax evasion problem in India.