



AJAY SHAH

# A REGIME OF FEAR

*To reform tax policy, government must think about it more clearly*

TAX REFORM IS one of the highest priorities in India today. The finance ministry has set up the Justice Easwar committee to reduce conflict in this area. While this is a step in the right direction, the problem runs deeper. We require a rethinking of tax policy, legal drafting, and organisational structures. Reforms must be more ambitious, and the policy work needs to be adequately resourced.

Legal risk associated with taxation and arbitrary actions of the tax authorities have created a climate of fear. The first area of work is thinking clearly about tax policy. If our foundations are confused, the private sector cannot anticipate future actions and decisions taken by the tax authorities could be internally contradictory. For example, in most mature countries, financial activities by non-residents are not taxed. We think differently, but recoil at the harmful consequences of taxing non-residents. This has resulted in a messy stalemate, where attempts to tax non-residents are held back by "exemptions". After the crisis over minimum alternate tax (MAT) on foreign portfolio investors (FPIs) had subsided, it was reported the income tax authorities were trying to establish whether FPIs have permanent establishments in India in order to open a new battlefield. This cat-and-mouse game is the result of a mistake at the core of tax policy. Similar concerns bedevil the taxation of firms. We have one of the highest corporate tax rates. To reduce the damage, we have an array of exemptions.

---

In most mature countries, financial activities by non-residents are not taxed. We think differently, but recoil at the harmful consequences of taxing non-residents. This has resulted in a messy stalemate, where attempts to tax non-residents are held back by exemptions. After the MAT crisis subsided, tax authorities were trying to establish whether FPIs have permanent establishments in India in order to open a new battlefield.

This has created complexity, unpredictability and legal risks. The first pillar of reform is sound economic thinking on tax policy.

The second pillar concerns drafting of income tax law. Poor drafting has set the stage for chronic battles between the income tax department and citizens. Legal risk is embedded in a law when words and phrases such as "reasonable", "public interest", "opinion" or "believe" are used. These could mean almost anything depending on the reader. A modern, well-drafted law would not use such words and phrases. The present income tax law uses "reasonable" 59 times, "public interest" 14 times, "opinion" 76 times, and "believe" 27 times. Section 147 authorises an assessing officer to reopen assessments if there's "reason to believe" there has been evasion.

Another element of archaic drafting that plagues the Income Tax Act is the use of "provisos" that create exceptions to the general principle. The phrase "provided that" occurs 450 times. So, the law is founded on faulty tax policy. Exceptions were introduced to mitigate its adverse consequences. And this has been done shabbily.

The third pillar is rethinking the foundations of public administration. The strategy in modern states has been to place tax policy and the drafting of the finance bill in their equivalent of the department of economic affairs. But tax administration should be kept at arm's length from the finance ministry. The tax administration should not have a say

in tax policy. This reduces politicisation and ensures policy is not distorted in ways attractive to administrators.

A recent study showed tax authorities win only 23 per cent cases before the judiciary. An important source of the problem is the present system of targets. To set targets better, statutory tax-base surveys need to be carried out. For example, today, tax officers are given an aggregate target, such as Rs 20 crore. In a modern tax regime, a tax officer would get an aggregate target, along with several sub-targets: Say, Rs 5 crore from persons earning below Rs 20 lakh a year, Rs 5 crore from persons earning Rs 20-50 lakh, and so on.

A procedural tax administration law, distinct from the Finance Act, is required. This should specify the organisation of legislative, executive and quasi-judicial functions in tax administration. This would have many similarities with the clarification on the working of financial agencies in the Indian Financial Code (IFC).

Justice Easwar and his team have been given a first deadline of three months, and a total time of a year. A permanent technical team is required to think about tax policy, draft high-quality legislation, continually refine the law based on experience and feedback, etc. For comparison, it's estimated that 15,000 man-days went into the drafting of the IFC by a team of over 150 people.

*The writer is professor, NIPFP, Delhi*