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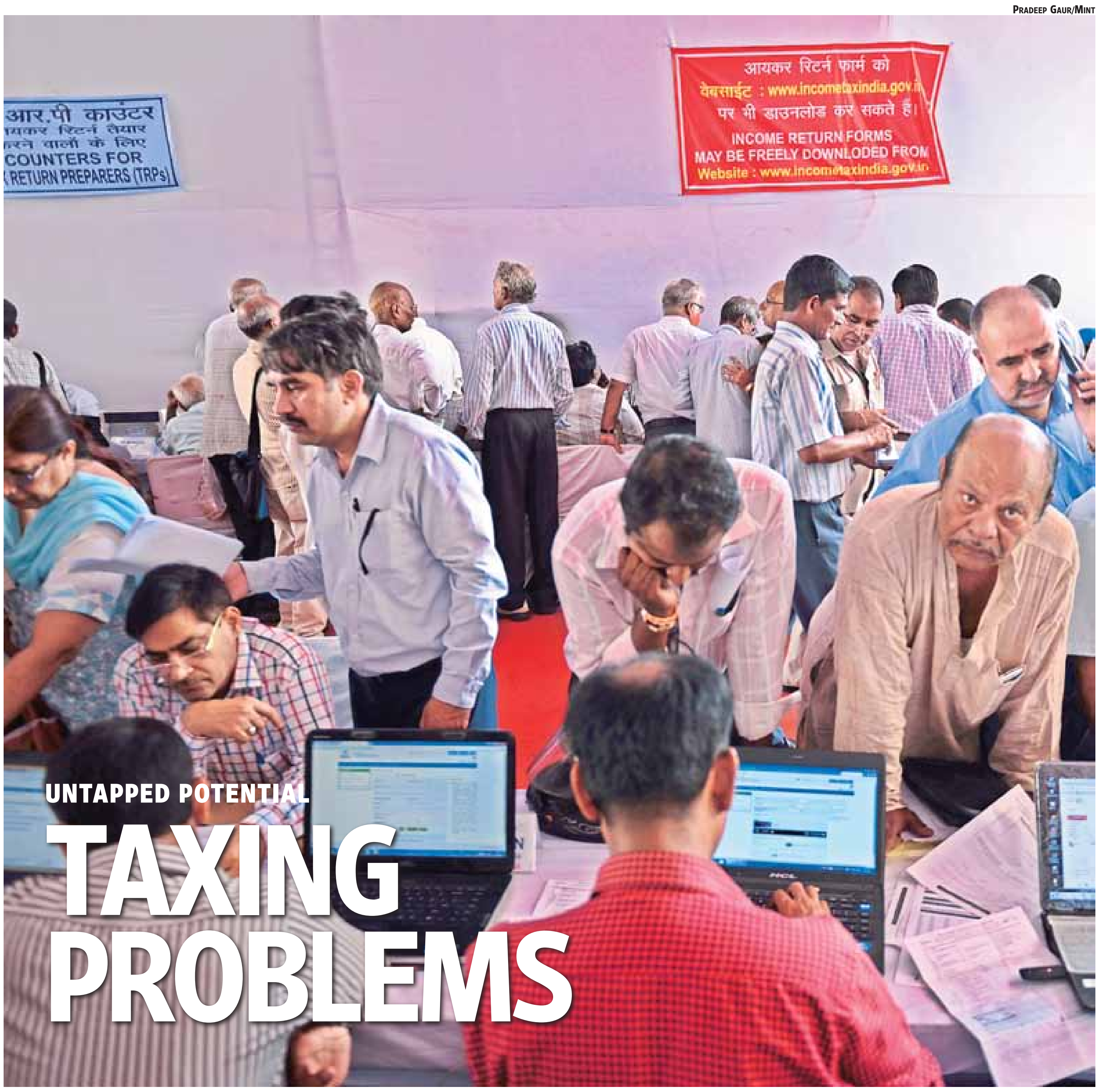

UNTAPPED POTENTIAL

TAXING PROBLEMS

EXPERT VIEW

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In mid-August, statistics on income tax returns compiled by the Central Board of Direct Taxes were placed in the public domain, for the first time since 1999-2000. Yet, this has received little attention in newspapers. It is no surprise that individuals or firms liable to pay taxes are reluctant about complete disclosure of their incomes. But it is puzzling that governments with a constitutional obligation to collect taxes have not bothered about such information for so long. Hence, this is a welcome step. These statistics must be published every year, for governments and citizens need to know. The story that emerges is striking, even if it is a cause for serious concern.

Let me begin with the big picture, which situates this story in its wider context. The tax effort in India, 69 years after independence, is simply inadequate, in comparison with other countries and in relation to our development needs.

In 2015-16, total tax revenues of the centre and states as a proportion of gross domestic product (GDP) in India were 17.5%. For the OECD (Organisation of Economic Cooperation and Development), mostly industrialized countries, the tax-GDP ratio in 2015 was 35%. Even for the small subset of OECD member-countries that are emerging economies—Chile, South Korea, Mexico and Turkey—the tax-GDP ratio was 25%.

India fares no better when compared with fellow members of the BRICS (Brazil, Russia, India, China, South Africa). In 2015, the tax-GDP ratio was 34% in Brazil, 22% in China and 27% in South Africa. The much lower tax-GDP ratio in India was not attributable to significant differences in tax rates between India and these countries.

This tax effort is clearly insufficient for economic development. It is just not enough to finance public investment in physical infrastructure—power, communications, roads, transport or ports—that is an imperative. It cannot provide the resources necessary for public expenditure on social sectors—education and health—essential not only for the well-being of our people but also as an investment for the economy.

In fact, India's tax performance has been far below its potential. Between 1965 and 1990, the tax-GDP ratio increased from 10% to 16%. Between 1991 and 2014, the tax-GDP ratio remained almost unchanged in the range of 16-17%. This is baffling. It would seem that economic liberalization, which dispensed with controls and lowered tax rates, made little difference to tax compliance. It is also puzzling because this quarter century witnessed the most rapid economic growth. A rising tide is meant to lift all boats. But it did nothing for the tax-GDP ratio.

The composition of tax revenues is also a problem. Direct taxes on income, wealth, capital gains and property contribute much less than they should. Consequently, indirect taxes on goods (excise tax and customs duties) and services (service tax) carry much of the burden. The ratio of direct taxes to indirect taxes in total tax revenue in India is 35:65, whereas it is the exact opposite at 65:35 in OECD countries.

In economics, it is widely accepted that direct taxes are superior to indirect taxes in terms of both efficiency and equity. Direct taxes are more efficient because, once the taxes are paid, households and firms have complete freedom of choice in consumption or investment decisions; indirect taxes, with different rates on different goods or services, restrict these choices, leading to sub-optimal outcomes.

Direct taxes are more equitable because taxes paid are a function of the ability to pay, since progressive systems charge higher tax rates for higher income levels; indirect taxes are regressive and impose a disproportionately large burden on the poor who must pay the same taxes as the rich on goods and services. Economists, irrespective of ideological perspectives—right or left—would agree, even if that surprises readers.

The focus of the following discussion is on direct taxes. This is the obvious problem in India, which, if and when resolved, could provide the solution. What is more, the statistics just released by the government also relate to direct taxes. It needs to be said that this information on income tax returns is for the assessment year 2012-13, so that it relates to the preceding financial year 2011-12. This lag of five years is much more than it is elsewhere or should be in India. Even so, a study of these statistics reveals worrisome realities and valuable lessons for governments and citizens alike.

> It's hard to believe that there were only 2,700 Indians with a ₹5 cr plus annual income in 2011-12

The base for direct taxes in India remains much too narrow. In 2011-12, there were only 29 million individuals who filed income tax returns. Thus, just 2.4% of the population and 6.1% of the labour force were in the income tax system. The gross total income of individuals, companies and others reported to the income tax department was ₹21.17 trillion, which constituted only 23% of gross national income in 2011-12.

This tax base could have been significantly larger. In addition to the 29 million, there were another 15 million individuals from whom tax was deducted at source but did not file income tax returns. The tax collected could also have been significantly more. The average rate of tax paid by individuals (actual tax paid divided by gross total income) was rather low at 9.2%. This was attributable to exemptions, deductions or other forms of avoidance within the law.

The situation was far better with companies. The number of companies that filed returns was 581,000, while there were only about 37,000 from whom tax was deducted at source but did not file income tax returns. The average rate of tax paid by companies was 28.1%. The story about who paid how much tax, among individuals and companies, is even more revealing. It highlights the narrowness of the base for direct taxes.

Among individuals, 50% of those who filed income tax returns paid zero income tax as their taxable incomes were less than the exemption limit of ₹2 lakh. Individuals with taxable incomes exceeding ₹2 lakh but not more than ₹5 lakh comprised 35% of the number who filed returns and contributed 8.5% of the total tax paid. Individuals with taxable incomes exceeding ₹5 lakh but not more than ₹1 crore constituted 14% of the number who filed returns and contributed 66.4% of the total tax paid. Hence, three-fourths of the income tax revenue came from these two groups. The remaining one-fourth of the income tax revenue came from the two highest income groups, which is only to be expected. Individuals with taxable incomes exceeding ₹1 crore but not more than ₹5 crore were just 0.11% (about 30,000 people) of the number who filed returns contributed 15.4% of the total tax paid. Individuals with taxable incomes exceeding ₹5 crore were only 0.01% (about 2,700 people) of the total number who filed returns but contributed 9.6% of the total tax paid.

It is, however, exceedingly difficult to believe that, in 2011-12, in the entire country, there were just 33,000 persons who had an annual income in the range of ₹1-5 crore and there were only 2,700 persons with an annual income more than ₹5 crore. But for these statistics, such a proposition would be dismissed as preposterous!

Among companies too, 50% of those who filed income tax returns paid zero tax. Companies with taxable incomes less than ₹1 crore comprised almost 48% of the number that filed returns and contributed 7.6% of the total tax paid. Companies with taxable incomes exceeding ₹1 crore but not more than ₹50 crore made up a little less than 2% of the number that filed returns and contributed 26% of the total tax paid. Companies with taxable incomes exceeding ₹50 crore were only 0.08% (489 companies) of the number that filed returns but contributed 66% of the total tax paid. There was high concentration within this group as just 58 companies, 0.01% of the total number, contributed 40% of the tax paid.

It would seem that, for individuals, three-fourths of the total tax paid was contributed by people whose primary income source was probably salaries, even if supplemented by capital gains and unearned income, although salary income was just about 30% of the gross total income reported to tax authorities. It is apparent that, among companies, less than 500 large companies contributed two-thirds of the total tax paid, while small- or medium-size enterprises contributed the remaining one-third. But one-half the number of individuals and companies who filed income tax returns paid zero tax. Taken together, this suggests that the potential for broadening the base of direct taxes is enormous.

There can be little doubt that evasion on the part of individuals and avoidance on the part of companies is widespread and large. It would be tempting to conclude that this is attributable to taxpayers alone. But that would be patently wrong. The tax collectors are just as culpable. Such an outcome is simply not possible without collusion between those who pay taxes and those who collect taxes. The reluctance of citizens in India to pay taxes is both common and strong. At the same time, the quality and the integrity of the tax administration leaves much to be desired. In this milieu, tax compliance is a casualty. The time has come for governments to address this problem in a mission mode. Zero-tolerance for black money must extend beyond rhetoric to enforce better tax compliance through incentives and disincentives.

The way forward is simple. There should be no tinkering with income tax rates, which are already moderate, possibly low, when compared with most countries, with an entry-point tax rate at just 10%. Exemptions and deductions should be eliminated. There should be no increase in the exemption limit and no changes in the rate slabs, so that, over time, inflation erodes their real value to broaden the base in terms of the number of taxpayers and raises the actual average rate of tax paid. Economic growth would then impart buoyancy to revenues from direct taxes.

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