

Anomalies & Solutions - Indian Tax System

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Summary

Since 1947, nearly one dozen expert committees, including the Kelkar Task Force, have persisted in giving totally wrong advice to the government due to their neglect of the most basic and fundamental problem of the system, namely massive tax evasion.

Tax evasion continues to cause immense damage not only to the finances of the government but also to the economy of the country, because a major part of the tax evaded money goes abroad.

Tax evasion can be stopped almost totally and income-tax revenue doubled from its fixed level of 3% to 6% of GDP, by following what President Putin has done in Russia.

India's Revenue Stagnant at 3 % of GDP Against 8% in many other Developing Countries

Since 1947 the main object behind the appointment of nearly one dozen expert committees, including the Kelkar Task Force (KTF), was to advise the government on how to collect more revenue. Till the 1950's, almost all the developing countries of the world, including India, were collecting income-tax (IT) revenue between 2 to 3 % of GDP. While those countries which adopted sensible tax systems have succeeded in pushing up their IT revenue to around 8 %, in India it still remains at 3 % of GDP only. The government goes on appointing one expert committee after another in quick succession, in the vain hope of getting the right advice.

Failure To Make Systematic Study

However all these committees have been giving totally wrong advice because none of them conducted a systematic study of the subject. They should have raised and answered the following three questions in order to arrive at sound conclusions.

1. How Much Revenue Other Countries Are Collecting

They should have started their study by finding out how much revenue similarly placed countries, which have started growing industrially after the second world war, are collecting.

If they had done so they would have found a wide gap between the quantum of India's and those countries IT revenues. The following table shows the amount of revenue collected in five countries during 1996-97.

2. How Other Countries Have Succeeded ?

Huge gap between the amount collected by India and other countries should have set these committees thinking and forced them to find out the reason behind it. If they had pursued the subject seriously they would have discovered that the reason behind the vast difference in figures

of revenue was the massive tax evasion in India. Although it is difficult to measure the quantum of tax evasion there exist some indicators which give a broad idea.

Quantum Of Tax Evasion In India

A rough idea about the quantum of tax evasion in India could have been formed on the basis of the following three major indicators:

(i) the number of individual tax returns with income above Rs 2 lakh (in terms of rupees of 2003) has hardly doubled in the course of last six decades. In 1939 there were 2.7 lakh such returns and currently their number is around 7 lakh only. Actually the number of persons with income over Rs 2 lakh must have gone up 30 times or 50 times. This one fact alone shows how widespread tax evasion in the country is.

(ii) the quantum of income taxed in the hands of companies in many developing countries exceeds 15 % of GDP, while in India it is hardly 5 %.

(iii) huge quantity of black money that changes hands in property transactions, or sent abroad or spent lavishly within the country.

Even a quick survey of other countries would have shown the extremely low level of tax evasion in them. Actually the very fact that they are collecting large amount of revenue shows that evasion must be negligible.

3. Why Tax Evasion So Large In India ?

The most important question that these committees should have considered is the reason behind so much tax evasion in India. They were not unaware of the existence of substantial tax evasion. But they always disposed of the subject casually by blaming it either on low morality of India's taxpayers or loopholes in law or laxity in administration. They kept making meaningless suggestions such as 'change the mindset of the taxpayers'

Other Countries Rates

If any of these committees had looked at the rates of successful developing countries it would have at once discovered why their tax evasion is negligible and the revenue collected by them is two to three times more than India's. A few countries main rates are mentioned here.

The city of Hong Kong has the most ideal tax system in the world. Without taxing interest, dividend, capital gains and international trading income, it has been collecting more IT revenue than the whole of India, even in absolute terms. For individuals its exemption limit is about Rs 14 lakh, starting rate is 2% and maximum rate is 20%. Companies are taxed at 15%. The city is also almost totally free of the evils like litigation, bribery and accumulation of tax arrears. Because of massive

voluntary compliance, it does not need an army of law enforcers. It employs one Commissioner (counterpart of CBDT), two deputy commissioners and five assistant commissioners.

Singapore has exemption limit of Rs 5 lakh, starting rate of 4% and applies its maximum rate of 22% to income above the equivalent of Rs one crore. Rates of mainland China are far from the ideal, but unlike India it has the good sense to apply the rate of 30% to income above the equivalent of Rs 30 lakh.

Russia taxes entire individual income at the single rate of 13%.

India's Rates

A comparison with India's rates would have shown that the rate structure is the main culprit responsible for forcing most of the taxpayers to evade tax on a major part of their income. Just like the other countries mentioned above, even India had a fairly reasonable rate structure till 1939 (although the top rate was 59.4%, applicable to income above Rs 5 crore). Income upto Rs 2 lakh (in rupees of 2003) was exempt and the starting rate was 4.7%. Thereafter under the misconception that higher rates will lead to higher revenue, India went on raising the rates. The rates were increased in two ways. One was to push up the top rate, applicable to high income earners, which reached nearly 98%. This has, however, been brought down to 31.5%. But the much more damaging method was to go on shifting the super heavy rates to absurdly low levels of income. History of one such rate, that is the 30% rate, will show how the government recklessly went on making the burden of tax intolerable and forcing major part of the income to flow outside the tax system. The rate of 30% was applicable to income above Rs 60 lakh in 1939, 6 lakh in 1959 (in rupees of 2003) and now it applies just above the petty amount of Rs 1.5 lakh. By the 1960's rates had become intolerable for higher income groups, but two-third of the individual taxpayers were still paying tax at 3% and 6% only. Subsequent increases in rates have forced most of them also to become tax evaders. In 1960 income above Rs one lakh (in rupees of 2003) was taxed at 3% and it is now taxed at 20%. Pushing up the rate nearly 7 times at certain levels of income is the root cause of massive tax evasion.

Merciless Taxation of Partnership Firms

India is not only taxing the individuals at atrocious rates but also the business entities. Partnership firms are the most mercilessly taxed class of taxpayers and consequently evade tax on the bulk of their income. In most of the countries their income is taxed only once, and that is in the hands of partners, as was being done in India also till 1956. Thereafter India started the most oppressive system of taxing firms and partners both. And since 1993 it has switched over to the equally obnoxious system of taxing even the pettiest of firms at the rate applicable to companies.

Look at the absurdity of the current system. If one individual earns income of Rs 10 lakh he pays tax of Rs 2,87,700 but if two or ten individuals share the same income through a firm they pay tax of Rs 3,67,500. Such patently unfair provisions have driven firms largely outside the tax system.

Currently they appear to be the biggest tax evaders in the country. The KTF also finds nothing wrong with this and wants the present system of taxing partnership firms to continue.

Heavy Burden on Corporate Income

Currently the tax burden on distributed corporate income works out to 56.67%, if shares are held directly by individuals and 60.08% if they are held through an intermediary investment company. The rate of 30% recommended by the KTF is alright for large companies. But small companies will never be prepared to pay tax at 30%. Currently they evade tax on the bulk of their income. To persuade smaller companies to pay tax, and to induce the larger partnership firms to become companies, the KTF could have recommended the UK pattern of taxing companies at three rates of 10%, 20% and 30%.

The secret of success of many developing countries in pushing up their IT revenue lies in inducing the larger partnerships to become companies, paying tax at 10% or 15%, without subjecting their distributed income to multiple taxation.

Extremely Naive Ideas About Appropriate Rates

None of the expert committees tried to find out the type of rates necessary to improve compliance and bring down tax evasion. They had extremely naïve ideas about rates. For instance, in 1992 Chelliah Committee recommended the rate of 27.5% on income above Rs 50,000 (equal to Rs one lakh of to-day). Such recommendations were based on massive ignorance. It never occurred to the learned members of this committee that by proposing a rate 9 times higher, compared to its level in the 1960's, they would be promoting tax evasion and not revenue.

Two years back, Shome committee recommended that the rate of 30% should be applied on income above Rs 2 lakh. And the KTF wants it to be applied above Rs 4 lakh. Instead of treating the subject of rates as the most crucial part of their task, all the one dozen or so expert committees dealt with it in a most casual manner. That is why they failed to make appropriate recommendations and the IT system continues to go from bad to worse.

What Misled The Committees

It seems what has been misleading all the expert committees, comprising highly learned people, is the drastic reduction in the top rate from its peak point of nearly 98%. What further keeps misleading them is that India's maximum rate is very close to the top rate of many of the developed countries. All these committees have failed to realize that it is not the maximum rate alone which matters. What governs acceptability by the taxpayers is the rate applicable at each level of individual income, and the rates applicable to different business entities.

Principle Governing The Rates

Countries like Russia and Hong Kong have discovered the most appropriate principle that should govern the fixation of rates, i.e they should be acceptable to the vast majority of the taxpayers so

that evasion is kept at the lowest possible level. And they have also found that even the richest of the rich cannot be persuaded to pay tax at a rate higher than 15, or at the most 20 percent. Unacceptable rates cannot be enforced by any type of penal or coercive measures, except in the case of taxpayers like salary earners. That is why currently the developed countries are able to enforce their atrocious rates mainly against salary earners, who cannot easily escape.

Folly And Futility Of Widening The Tax Base

The only way to increase revenue is to bring down sharply the quantum of tax evasion by a few lakh large income earners. But some of the committees have planted in the minds of policy makers the extremely naïve idea that revenue can be increased by widening the tax base. Consequently the government continues to pursue the thoroughly wasteful and harassing activity of imposing the tortuous burden of filing returns on petty income earners, through schemes like one-in-six. Bringing more than two crores of them into the tax net has hardly led to any increase in revenue, because they either disclose no taxable income or only token amounts.

Attack on Exemptions Entirely Due to Ignorance

All the committees have failed to realize that revenue remains at an extremely low level primarily due to massive tax evasion and pushing out of medium and small scale business entities largely outside the tax system. Consequently they keep blaming other things like exemptions. The most glaring example currently in the news is the attack of KTF on individual exemptions. It believes that as the rates have come down almost all individual exemptions should be withdrawn.

If KTF had looked at the past history it would have discovered that till 1960's there were hardly any exemptions. And the reason for that was that individual income above Rs one lakh (in rupees of 2003) was till then taxed at only 3 percent. Thereafter reliefs and exemptions had to be brought in because the government went on raising the rates and income above Rs one lakh started getting taxed at 20%. KTF wants that the rate of tax at this level of income should continue at 20 percent but exemptions must go. Most of the expert committees have been making this type of recommendations because of their failure to study the basic facts.

Agricultural Income Rightly Not Taxed

Another example of a recommendation based on total ignorance is that taxing agricultural income will reduce tax evasion and increase revenue. If KTF had looked at the data of other countries it would have discovered that probably none of them is actually able to collect tax in respect of agricultural income. In countries like the US, farmers always show more agricultural losses than income, and thereby reduce tax even on non-agricultural income. Imposition of this tax in India will mean harassment of illiterate farmers and benefit only the inspectors and tax practitioners. It cannot yield any revenue.

President Putin Shows The Right Way

Till 1999 Russia's IT rates were as atrocious and tax evasion as massive as India's. Then came

President Putin, who had no financial or tax background but through sheer commonsense he discovered within a few months that rates were the main culprit in the IT system . Broadly following the Hong Kong pattern, he immediately switched over to the single rate of 13% for taxing individuals. Later he got approved legislation prescribing rates ranging between 20 to 24% for companies and 6% for taxing dividend income. Consequently distributed corporate income can suffer tax of at the most 28.5%. These changes in rates brought down tax evasion to such an extent that Russia's deficit budget got converted into surplus the very next year.

Recently he has got approved the most remarkable system for taxing businesses owned by small companies, partnership firms and sole proprietorships. Those having turnover equivalent to about Rs 2 crore can pay tax at 15% of net income or 6% of turnover. After paying IT, they will not be liable to pay even sales tax and value added tax.

This is the way to bring down tax evasion to its normal level and increase the revenue. For his act of wisdom in reforming the IT system President Putin has received compliments from all over the world, and particularly from President Bush, who is now trying to follow him in the US.

Immense Damage Caused By Wrong Advice

Failure of all the expert committees to deal with the problem of massive tax evasion seriously has caused immense damage not only to the fiscal health of the government but also to the economy of the country. Large chunks of tax evaded income cannot be kept safely within the country and are sent to tax havens. Consequently, ever since the years of the second world war, India's economy continues to be deprived of large quantity of investable resources and lags behind countries which are largely free from tax evasion.

All Evils Arise from Tax Evasion

IT system stands thoroughly damaged. It is afflicted with many other evils like complexity of law, huge litigation and widespread corruption. All these evils are also ultimately traceable to massive tax evasion. But these expert committees, instead of dealing with the root cause of the problems, have been submitting voluminous reports fiddling with trivial issues.

Revenue Can Be Doubled from 3% To 6% of GDP

Tax evasion can be stopped almost totally, the whole system cleaned up and revenue doubled to around 6% of GDP by adopting sensible rates, as is being done by President Putin in Russia.

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