

Down To Brass Tax

The Telegraph, Calcutta, February, 28, 1997

Jeffrey Sachs & Nirupam Bajpai

A key element of India's economic liberalization has been tax reform. New Delhi's tax reform strategy is largely based on the Raja Chelliah committee report. It proposed that the share of customs duties in total taxes be reduced and the share of direct taxes raised. More revenue needed to be mobilized via excise duties by transforming them into value added taxes. Maximum rates of personal and corporate income taxes were reduced.

Last year the Centre levied a new minimum alternate tax on firms whose total income, after deductions, was below 30 per cent of the book profit. If so the firm's income was deemed to be 30 per cent and taxed accordingly. The effective rate worked out to 12 per cent of book profit calculated under the Companies Act.

Thanks to higher growth and tax reforms, tax revenues of Centre and states, which fell from 16.7 per cent of gross domestic product in 1991-92 to 15.2 the next year, recovered to almost 16 per cent in 1995-96. The loss in revenue was due to reduced customs and excise duties as a result of the reforms started in 1991. Growth made taxes buoyant again. The rise in Central tax revenue was largely due to greater direct tax collection.

The Centre made reasonable progress over indirect taxes. Import tariff reform aimed to reduce the cost of intermediate and capital good imports and lower the protection provided to Indian industry. Customs duties, though lowered, remain higher than India's competitors, reducing India's attractiveness to investors.

Reforms of commodity taxation were initiated in 1993-94 to rationalize the then existing excise modified value added tax system. Under MODVAT credit of duty is allowed on inputs used either for producing excisable finished products or intermediate products. Over time the ambit of MODVAT has expanded. But its conversion into a full fledged VAT up to the manufacturing stage is far from complete.

Other Central excise duty reforms include cuts in the number of *ad valorem* rates, phasing out of exemption notifications and simplifying the procedure to value excise duty.

Briefly put, the increased share of direct taxes, and decline in indirect taxes indicates the tax reform strategy since 1991 is basically working. But more needs to be done. For both direct and indirect taxes, we suggest measures to improve the yield of direct taxes. To augment revenue from personal income tax, the government should broaden the tax paying population. Base widening can be done in two ways: bring large numbers of potential taxpayers into the net, and eliminate the tax exemptions and deductions provided to serve non-tax objectives.

Attempts have been made to broaden the base of presumptive taxation (where incomes are estimated) by including shopkeepers, small transport operators and the like. Later, a new estimated income scheme for contractors with turnover up to Rs 40 million and for owners of up to 10 trucks

was introduced. Presumptive taxation is suitable since evasion is rampant in the unorganized sector. Easy to administer, such levies increase equity and efficiency by taxing those who never paid taxes earlier.

The experience of countries like France, Israel and Turkey with presumptive taxation is not encouraging. We don't expect significant results. Nonetheless, India should continue to improve on the scheme. A major reason people avoid the scheme is fear of getting into the books of tax authorities. The relationship of the presumptive tax to the rest of the tax system needs clarification. Extending estimated income schemes to cover more activities would be worthwhile.

Base broadening can also be done by removing the exemptions and deductions allowed on various grounds of social and economic policy. Several incentive provisions have been withdrawn. Many remain. A number of Income Tax Act concessions could be removed. This would help further lower tax rates. There is also a case for levying tax on free or concessional rent accommodations provided to public employees. Similarly, since restrictions on private sector salaries have been removed, fringe benefits for such employees need to be taxed.

State governments need to tax agricultural income. Small farmers can be exempted. In the past 30 years agricultural incomes, especially for large landowners, have risen considerably: particularly in Punjab, Haryana, western Uttar Pradesh; deltaic West Bengal and coastal Andhra Pradesh, Tamil Nadu, Kerala, coastal and eastern Karnataka. The states, need tax systems simple to administer, of moderate rates and broad based.

Corporate taxation also needs to see an increase in the number of taxpaying companies. There are many firms which pay hefty dividends without paying income tax: zero tax companies. They used incentive provisions in tax laws to show, no taxable profits. The present process of eliminating incentives was supposed to eradicate zero tax companies. This has not happened. The persistence of the zero tax firm points to a need to introduce a minimum tax in order to improve fairness and revenue buoyancy.

Though a step in the right direction, MAT will not tackle under reported profits through manipulated transfer pricings. Nor is it applicable if there is no taxable income. In other words, if firms post losses under both the Companies Act and the Income Tax Act. Firms with enough investments to allow for depreciation provisions could well show zero taxable income. Companies could charge the same depreciation rates under the Companies Act in their books as well, and thereby show zero book profits. MAT may serve its purpose better if levied on gross corporate assets instead of book profits. Additional revenue of Rs 100 to 170 billion, about one to 1.7 per cent of GDP, could be mobilized based on realistic assumptions about coverage and a rate of return in the range of 1.6 to two per cent on the book value of assets.

Of the Centre's indirect taxes, consider first customs duties. In the last five years import duties have plummeted. But India needs to bring them down to east Asian levels. In the World Economic Forum's list of 49 country tariff rates, India had the highest in the sample.

The Chelliah committee recommended average tariff rates be brought down to 25 per cent. We believe this to be thoroughly inadequate. Most importantly, tariff rates on imported capital goods used for export, and on imported inputs into export production, should be duty free.

There is also the question of liberalizing consumer goods imports. Such liberalization has not occurred because of misconceptions, fears and ignorance of the benefits of liberalizing such imports. Protecting consumer goods industries diverts resources to inefficient production causing higher prices. Lack of international competition leads to minimal quality upgrading in consumer sectors.

Another area of reform of indirect taxes is domestic commodity taxation. Today's system is an excise-MODVAT framework. Reforms are required to make this a comprehensive VAT at the central level. VAT is the major tax instrument in many countries since it is practicable and avoids cascading. Over time VAT will be instrumental in generating dynamic efficiency gains. VAT has worked well in federations like Brazil, Germany Mexico and is being introduced in China and Pakistan.

Transformation to a VAT at the Central level needs to be supplemented by reformed indirect taxes at the state level. Inefficient state sales tax regimes and disharmony between Centre and state taxes means indirect tax system as a whole remain complex and distortionary. State sales tax rates differ: from six per cent in Orissa to 22 in Gujarat. Some states are reforming sales taxes gradually. However, most have yet to initiate tax reforms. In 1993 Kerala and Tamil Nadu introduced VAT on some commodities. Some states, like Madhya Pradesh, Uttar Pradesh and West Bengal, are streamlining sales tax administration.

We suggest India adopt a comprehensive VAT. The suggested tax regime would constitute a national level VAT shared between Centre and states. The revenue implications of the tax policies outlined earlier cannot easily be calculated. We would expect to lose further revenues through customs and to raise revenue via base broadening and MAT. Conservatively the overall impact would be small, so that MAT reform would finance further liberalization on trade taxation.
