AN INTERNATIONAL COMPARISON OF TAX REGIMES

A Discussion Paper by

Centre for Budget and Governance Accountability

2010

This document is for private circulation and is not a priced publication.

Supported by: Christian Aid

Author: Ria Sinha
Edited by: Vijay Thappa, Pooja Parvati, Subrat Das, Bhumika Jhamb
Editorial Inputs: Matti Kohonen (Tax Justice Network),
Oliver Pearce (Christian Aid - UK), R. John Suresh Kumar (Christian Aid – India)
Design & Printing : Sanjiv Palliwal (SHIVAM SUNDARAM)

This is a discussion paper, which presents the finding of an ongoing research study at CBGA. For clarifications and suggestions for improvement, please write to ria@cbgaindia.org.

For any queries, please contact:

Centre for Budget and Governance Accountability
A-11, Second Floor
Niti Bagh, New Delhi-110049
Tel.: 011-41741284/86/87
Fax: 011-26537603
Email: info@cbgaindia.org

Website: www.cbgainida.org

An INTERNATIONAL COMPARISON of TAX REGIMES

TABLE OF CONTENTS

LIST OF TABLES, FIGURES AND BOXES

Tables

Figures

Boxes

SECTION 1

Introduction

1.1 Rationale

Over the last decade, budget analysis has proved to be a very useful strategy for civil society actors in India, especially in their efforts pertaining to governance accountability. Numerous civil society groups in the country have started engaging with budget analysis and at various levels of governance (such as, the Union Government, State Governments and institutions of local self governance), with the primary objective of improving the development outcomes of one or more of the disadvantaged sections of the population. However, most such initiatives have been restricted only to the expenditure side of the budget. The revenue side of the budget has been largely unexplored until now.

Hence, it is extremely important to demystify the revenue side of the budget, in particular the policies and practices pertaining to taxes. We may note here that the magnitude of tax revenue collected in India has been lower than that in several developed countries as well as some of the developing countries; as a result, the overall public resources available to the government in India for making investments towards socio-economic development and other purposes have been inadequate in comparison to several other countries. Consequently, the magnitude of public expenditure in India has been lower than that in several developed countries as well as some of the developing countries.

Taxation plays an intricate and pivotal role in the growth and advancement of any nation. The objectives of taxation policy of any country are akin to the general economic and social policy of the same. While the economic objectives of taxation include simplicity, efficiency, fairness and revenue sufficiency of the government, the social objectives incorporate the principles of transparency, representation of citizens, accountability and proper regulation (both social and economic). Being a major and vital source of revenue, a sound taxation system is imperative for the public finances of a country and improving citizen participation (Cobham 2007; Fjeldstad 2008) whether that is in any stage of the progressive process, developing, developed or transitional. It has been argued, for instance by Bird and Zolt (2003), that taxes are necessary both to finance desired public spending in a non-inflationary way and ensure that the burden of paying for such spending is distributed in a fair manner. The other fair goals of taxation include **revenue generation**, wherein several short term measures such as provision of the basic necessities for sustenance, socio-economic goals and the long term measures such as the broader development perspectives, can be addressed by revenue generation. Other than this, **redistribution** is the second role of a tax system. Redistribution of income allows a given society to achieve human development gains by lifting its poorest citizens out of the shackles of poverty and thereby reduce inequality. Cobham (2005) states that, "**re-pricing economic alternatives** is another important purpose of taxation". Specifically, taxation can be governments' main tool to influence the behavior of their individual and corporate citizens. Levying taxes on pollution can in effect help in negating the negative externality that results out of it. Finally "**representation"** is important so that stakeholder groups, and especially ones who represent low-income or marginalised groups, have their say in tax policy (Ayee and Joshi 2008), so that policy-making is not skewed only towards the powerful lobbyists. Finally Avi-Yonah (2003) states that "**regulation**" plays a key role as the government via the tax system can also monitor the activities of multinational companies, of professional and self-employed persons, and agricultural workers, to take some examples of sectors that may fall outside the tax net if given exemptions, or being part of the informal economy. Regulation was the impetus for installing the corporate tax regime in the USA, to control the activities of the "robber barons", the large industrial groups in the turn of the 19th century USA.

Tax systems around the world have undergone significant reforms in the last twenty years due to the varying ideologies and levels of development. In this study, we have tried to evaluate the existing regimes of taxation in the developed as well as developing economies along with a detailed comparison with that of India, which is yet a developing country with low incidence of taxation.

1.2 Scope

The study intends to evaluate the existing tax structure in India in comparison to some of the developed countries as well as a few developing countries. For this purpose, the following countries have been selected: Malaysia, Mexico, South Korea, Japan, USA, UK and Canada. In some cases, we have also looked at the tax system in China. The time period covered in the study is from 2000 to 2008; though in some cases, we have included data since early 1990s for the Indian tax system.

1.3 Objectives

Our first objective is to assess the significance of tax revenue for the fiscal policy space available to the government in India and other select countries. Secondly, we try to assess the overall magnitude of tax revenue as compared to the overall size of the economy for select countries. Thirdly, we try to assess the marginal tax rates in the income and corporate taxes prevailing in India and other select economies. Fourthly, we compare the costs incurred on tax administration in these countries. Finally, we compare the progressivity of the tax systems in select countries.

1.4 Methodology

The study incorporates data from various sources. Data for India has been obtained from the Indian Public Finance Statistics (2008-09) and (2009-10). Data for USA, UK, Japan, South Korea, Mexico and Canada have been obtained from the OECD Revenue Statistics (1965-2008). For Malaysia, data has been attained from the Ministry of Finance, Government of Malaysia. Data on the Chinese counterpart have been taken from the State Administration of Taxation (SAT) for years 2004 to 2006. Due to unavailability of comparable data on the Chinese tax system for the other years, only three years (2004 to 2006) have been incorporated in this analysis. The study has paid adequate attention to the issue of comparability of the tax revenue figures for the select countries, in particular on the need for capturing total tax revenue for every country selected.

1.5 Limitations of the Study

The study covers select countries, only a couple of which are developing countries. However, limited availability of comparable data on taxes for different countries (especially the non-OECD countries) has been the main reason for this limitation.

SECTION 2

Fiscal Space and Tax Revenue

The fiscal space for the government in a country like India depends significantly on the overall magnitude of tax revenue, it being a sustainable source of government funding. Among the other major sources of revenue for the Government in India, non-tax revenue, accounting for 14 percent (approx) of total revenue in the form of revenues accrued from state owned enterprises, interest payments, disinvestment proceeds and borrowing constitute major components. However, the last two sources of funds are one-off payments and are not sustainable in the long run. Too much dependence on any of these three sources of funds could imply a number of serious concerns. Hence, tax revenue plays a very important role for the overall fiscal policy space available to the government.

Box 1: FRBM Act

The Fiscal Responsibility and Budget Management Act was enacted by Parliament in 2003 to bring in fiscal discipline and the government had notified the FRBM Rules in July 2004.

Key features included:

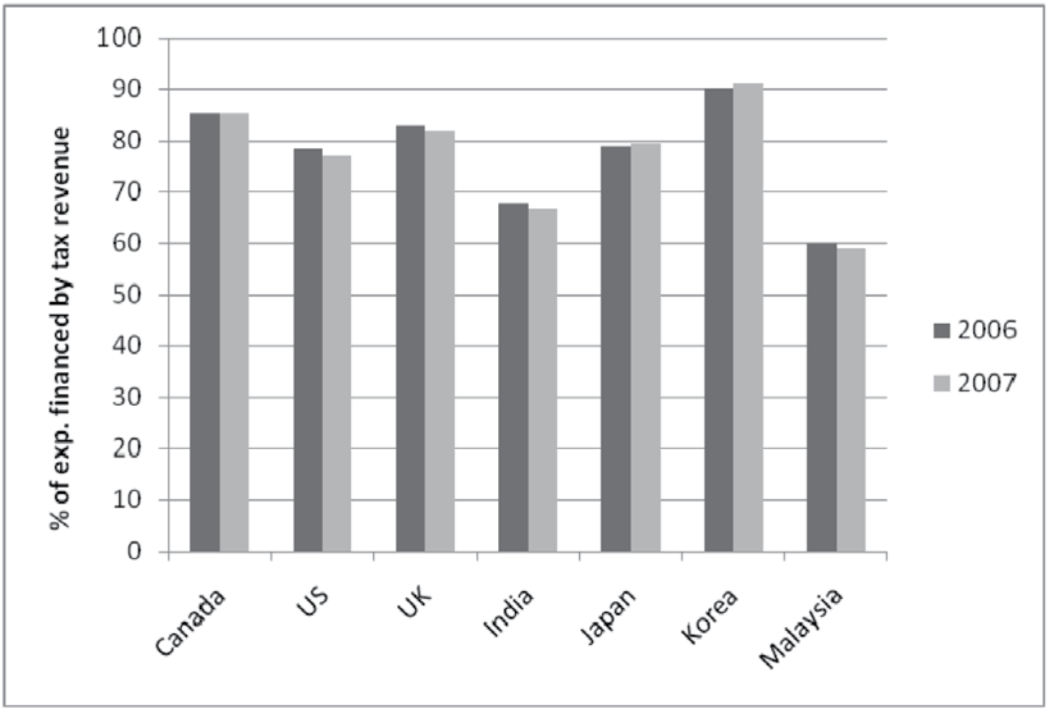
- Revenue Deficit has to be reduced to nil in five years beginning 2004-05
- Each year, the government is required to reduce the revenue deficit by 0.5 percent of GDP.
- Fiscal Deficit to be reduced to 3 percent of GDP by 2008-09 or a reduction of 0.3 percent of GDP every year.
- These requirements have been relaxed on a couple of occasions in the last few years.
- However, the 13th Finance Commission has required both the Centre and the States to pursue these targets again from 2010-11.

In the context of the fiscal policy space of the government, the significance of tax revenue is much more in the era of Fiscal Responsibility and Budget Management (FRBM) Act. This is because the FRBM Acts for the Centre and States have mandated elimination of Revenue Deficit and significant reductions in Fiscal Deficit in the Union and State Budgets.

Figure 1 gives an estimate of the dependence of the study countries on tax revenue for financing their government expenditures. Generally the major sources of revenue of any government include tax revenue, non-tax revenue and foreign borrowing. Of these, tax revenue is the best possible source of financing government expenditures in an equitable, sustainable and non-inflationary manner. Dependence of an economy on non-tax revenue and foreign borrowing might have certain adverse macroeconomic consequences.

In Figure 1, two data points corresponding to years 2006 and 2007 have been incorporated.

Figure 1: Extent of Govt. Expenditure Financed by Tax Revenue



Source: OECD Revenue Statistics 2009; Ministry of Finance, Govt. of Malaysia; Indian Public Finance Statistics, 2008

The extent of government expenditure financed by taxes is comparatively low in India as compared to the developed countries of Canada, UK, USA and Japan. While this share (of government expenditure financed by tax revenues) goes up to 90 percent in case of South Korea, it has been close to 80 percent in Canada, UK, USA and Japan. However, in India, this share has been less than 70 percent. Thus, we need to question the policy priorities in India pertaining to resource mobilization.

SECTION 3

Tax-GDP Ratio – A Comparison Across Countries

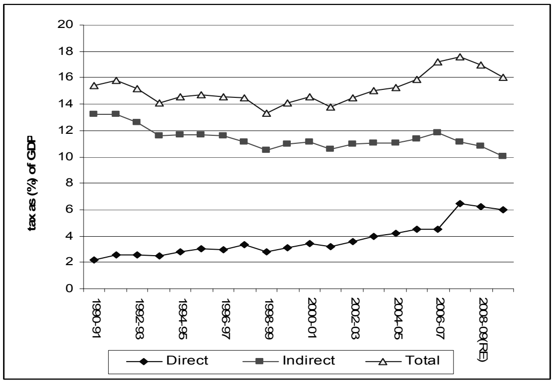
India's low level of tax-GDP ratio has been a cause for concern since long. Particularly after liberalization, there was a slump in the gross central taxes due to reduction in the rates of customs duties[1] and excise[2]. This was specifically done to open the economy to worldwide competition and enable foreign countries to utilize the advantages of terms of trade. But the net result was that the tax-GDP ratio for India registered a sharp decline during the 1990s and in the early years of the present decade. Figure 2 illustrates the tax-GDP ratio of India since 1990s.

The magnitude of Total Tax Revenue in India fell sharply from 16 percent of the GDP in 1989-90 to 13.8 percent of the GDP in 2001-02, before it started recovering gradually from 2002-03. During this period, while the magnitude of the States' Own Tax Revenue increased marginally from 5.36 percent of the GDP in 1989-90 to 5.59 percent of the GDP in 2001-02, the magnitude of Central Taxes fell noticeably from 10.62 percent of the GDP in 1989-90 to 8.21 percent of the GDP in 2001-02.

1 Customs duty is an indirect tax which is levied on goods of international trade. It is a kind of consumption tax. It is of two types: Import duties are levied on imports and export duties are levied on export of goods

2 An excise is an inland tax on the production and sale of a specific good within the territory of the country.

Figure 2: Tax-GDP Ratio of Total Taxes (Centre and States) in India



Source: Indian Public Finance Statistics, 2009-10, Govt. of India

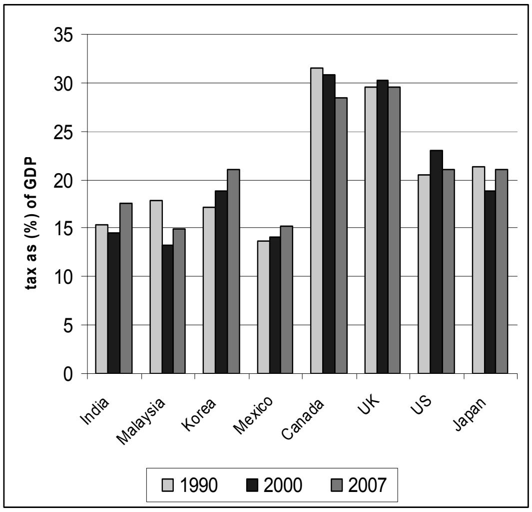
The decline in the magnitude of Central Taxes over the 1990s was rooted in some of the major policies taken by the Central Government during the era of economic liberalization. The reduction of customs duties under the policy of trade liberalization and the subsequent reduction of excise duties (to enable domestic producers in India to get the same advantage as those in other countries from which India imported commodities) led to a significant decline in the magnitude of indirect taxes, which fell from 13.7 percent of the GDP in 1989-90 to 10.6 percent of the GDP in 2001-02. The collections from direct taxes increased from 2.3 percent of the GDP in 1989-90 to only 3.2 percent of the GDP in 2001-02, which was mainly because of the inability of the Central Government to increase collections from direct taxes significantly in an era of rationalization (that is, reduction) of direct tax rates. As a result, the tax-GDP ratio for the country registered a sharp decline during the 1990s and in the early years of the present decade.

During the period 2002-03 to 2007-08, the collections from direct taxes improved noticeably from 3.56 percent of the GDP to 5.7 percent of the GDP, which was not only due to the improvement in tax administration in the country but also because of the skewed process of growth of the Indian economy that generated more surpluses for the private corporate sector. Likewise, the collections from indirect taxes went up from 11 percent of the GDP in 2002-03 to 12.43 percent of the GDP in 2007-08 (BE), and the increase in collections from Service Tax contributed significantly in this regard. As a result of these improvements, the magnitude of Total Tax Revenue in India increased from 14.5 percent of the GDP in 2002-03 to 18.14 percent of the GDP in 2007-08 (BE).

However, it has been pointed out in the context of the increase in the magnitude of direct tax revenue that, over the last decade, the share of the private corporate sector's surplus has increased very fast, and hence the government should have collected much greater magnitudes of tax revenue through corporate and personal income taxes. Likewise, the revenue collected through service tax too should have been much higher than what the government managed to collect.

The recent economic crisis (of 2008 and 2009) had a disparaging impact on the tax-GDP ratio of India, specifically on the central taxes, while the State tax-GDP ratio remained more or less unaffected. The magnitude of total tax revenue in India continues to be far below the levels of tax revenue collected in several other countries as compared to the size of the country's economy), and it is inadequate from the point of view of the magnitude of public investment needed in the country. Figure 3A compares the overall tax-GDP ratio of the study countries.

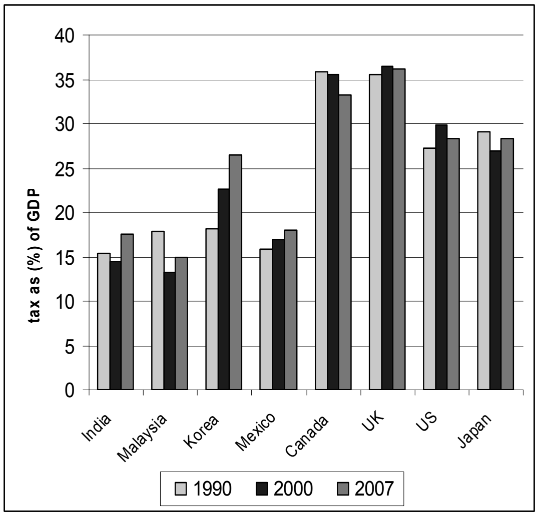
Figures 3A: Tax-GDP Ratio (Including SSCs)



Source: OECD Revenue Statistics, 1965-2008

A significant proportion of the tax revenue of the OECD countries comprises of the social security contributions (SSCs)[3]. Taking this into consideration we give comparisons based on the tax-GDP ratio including the SSCs and excluding the same. Figures 3A and 3B highlight the low tax revenue of India as compared to the other countries selected.

Figures 3B: Tax-GDP Ratio (Excluding SSCs)



Source: OECD Revenue Statistics, 1965-2008

Figure 3A shows the tax base in the study countries including the social security contributions (SSCs). These SSCs contribute a significant amount of tax revenue in the developed countries. The low tax base of the developing countries is evident from the graph. The SSCs are not included in the GDP calculation of the developed countries. Thus for parity considerations, we exclude the social security contributions in the tax-GDP calculation in Figure 3B. Nevertheless, the tax-GDP ratio in the developing countries including India is much lower compared to the select developed countries.

3 Social security is basically a protection provided in old age, disability, unemployment etc. for which the employees are taxed from their incomes. It is a type of PAYE (Pay as you earn) tax, which is regressive in nature.

SECTION 4

Marginal Tax Rates[4] and VAT – A Comparative Analysis

Tax rates play an important role in the determination of tax revenue in any form of government. In this context, the Laffer Curve hypothesis (by Arthur Laffer) argues that beyond a certain tax rate, higher rates shrink the tax base to such an extent that revenues ultimately decline, thereby proposing an inverted U shape to the curve. The rates of income and corporate taxation have been reduced over a period of time in India, which partly indicates the adherence of our policy-makers to the Laffer Curve hypothesis.

Box 2: Laffer Curve

Laffer curve, proposed by Arthur Laffer supposes that, for a given economy, there is an optimal income tax level to maximize tax revenues. If the tax rate is fixed below this level, raising taxes will increase tax revenue, and if the tax rate is fixed above this level, raising taxes will actually lead to decrease in tax revenues. The theory has never been proven to hold true, but it forms the basis of the agenda to cut corporate taxes in particular.

4 Marginal rate is the rate that applies to the last rupee of the tax base. The tax structure is said to be progressive if the marginal rate increases with increase in the income.

However, the hypothesis that tax rates being brought down further in India will lead to revenue augmentation is unsubstantiated. The Laffer Curve hypothesis has no evidence for developing countries like India. The following tables compare the marginal rates of personal income and corporate income taxation in the select countries.

4.1 Corporate Taxation

Indian companies are subject to a corporate income tax[5] of 30 percent. An education cess[6] (EC) of 2 percent and a Secondary and Higher Secondary Cess (SHEC) of 1 percent applies on the tax payable, resulting in an effective rate of 33.99 percent. But long term capital gains are subject to an effective tax rate of 22.66 percent. Certain tax incentives apply to a broad range of industries, including export oriented undertakings, industrial undertakings in the free trade zones and technology parks, research companies, mineral oil production, news agencies and waste processing businesses. In UK, the main rate of corporation tax is 28 percent. But for small companies, the tax rate is 21 percent for profits up to GBP 300,000. Certain tax deductions apply for research and development. The effective federal rate of tax on corporations in Canada is 28 percent, following certain deductions. In addition to this, a provincial tax rate applies, which varies across jurisdictions. Tax deductions are provided for scientific research. Prescribed financial institutions are also exempt from tax. USA has a highly graduated system of corporate tax rates ranging from 15 percent to 35 percent. Tax incentives are available for research and development, certain domestic production activities and preservation of natural resources. Taking all the national and local taxes into account, Japan generally levies an effective statutory rate of 42 percent for companies with paid-in capital of up to 100 million yen and 41 percent for companies having paid-in capital of more than 100 million yen. Korea has quite moderate rates of corporate taxes, the rates being 11 percent and 12 percent for taxable amount of 200 million won (KRW). Mexico charges a flat rate of 28 percent on corporate income, surtaxes and surcharges being absent.

Table 1 shows the highest rates of marginal corporate taxation which applies to the study countries.

5 Corporate tax refers to a tax imposed on entities that are taxed at the entity level. These taxes are direct taxes as they are levied on the corporate profits.

6 In India, it is supposed to be a tax on tax or a surcharge which is applied on a specific commodity or service and the revenue that is raised from it is also meant to meet certain specified objective.

Table 1: Highest Marginal Rates of Corporate Taxation

	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008
India	35	38.5	39.5	37.7	36.7	35.8	36.6	33.7	33.9	33.9
China	33	33	33	33	33	33	33	33	30	25
South Korea	30.8	30.8	30.8	29.7	29.7	29.7	27.5	27.5	27.5	27.5
Malaysia	28	28	28	28	25	28	28	28	27	26
Mexico	35	35	35	35	34	33	30	29	28	28
UK	31	30	30	30	30	30	30	30	30	28
Canada	44.6	44.6	42.1	38.6	36.6	36.1	36.1	36.1	33.5	33
USA	40	40	40	40	40	34	40	40	40	40
Japan	48	42	42	42	42	42	40.69	40.69	40.69	40.69

Source: World Development Indicators, World Bank

4.2 Personal Income Taxation

India follows a moderately graduated personal income tax[7] regime with marginal rates varying from 10 percent to 30 percent. The exemption limits are higher for female and senior citizens. In UK, the personal income tax rates vary from 10 percent to 40 percent. The numbers of income tax slabs are higher in Canada. Individuals pay income tax at graduated marginal rates, ranging from 15 percent to 29 percent. There is higher number of tax slabs in China with graduated marginal rates, ranging from 5 percent to 45 percent. The presence of higher number of tax slabs in China results in bracket creep and tax evasion. USA has the provision of filing joint and individual returns with graduated rates ranging from 10 percent to 35 percent. Japan has six graduated tax slabs with rates varying from 5 percent to 40 percent. Republic of Korea has moderate rates of income taxation, ranging from 6 percent to 35 percent. Progressive taxation follows in Malaysia, with rates varying from 1 percent to 27 percent. Federal Republic of Mexico has income tax rates ranging from 1.92 percent to 28 percent, subject to withholding taxes.

Table 2 shows the highest rates of marginal income taxation which applies to the study countries.

7 A personal income tax is a tax on the individuals on the basis of 'pay as you earn' (PAYE). This is a direct tax in which the individual has to pay the tax directly to the government. The tax burden is not shared.

Table 2: Highest Marginal Rates of Personal Income Taxation

	2003	2004	2005	2006	2007	2008	**2009**
India	30	30	30	30	30	30	30
China	45	45	45	45	45	45	45
South Korea	36	36	35	35	35	35	35
Malaysia	28	28	28	28	28	28	27
Mexico	34	33	30	29	28	28	28
UK	40	40	40	40	40	40	40
Canada	29	29	29	29	29	29	29
USA	35	35	35	35	35	35	35
Japan	50	50	50	50	50	50	50

Source: World Development Indicators, World Bank

4.3 Value Added Taxation (VAT)

Value Added Taxation[8] was introduced in India in 2005 to eliminate the cascading effect of multiple sales taxes. This tax is generally levied on the supply of goods and services within States in India. The general rate in India is 12.5 percent. Zero rates apply to the export of certain goods. Certain supplies of goods are exempt from VAT, e.g. books, periodicals, electrical energy, milk, prawns, fish, rice and wheat. Figure 4 shows the comparative rates of VAT in select developed and developing countries. Apart from UK, the other developed countries register quite low rates of VAT. The rate of VAT in India is quite high compared to that of Korea and Malaysia. USA, on the other hand has no VAT, but has different sales tax on final purchases levied by the State governments.

VAT being an indirect tax, generally imposes an indirect tax on consumption and hence taxes the poor and the rich alike, leading to a decrease in the progressivity of the tax structure. Thus, reducing the rates of VAT without hampering the macroeconomic stability will be beneficial for the Indian economy. The marginal income and corporate rates being

8 VAT is a tax on the estimated market value added to a product or material at each stage of its manufacture or distribution. The tax burden is passed on to consumers. It is a kind of consumption tax.

moderate, those might not be reduced further, but the implementation of graduated corporate rates is likely to influence the existing tax structure.

Box 3: Cascading Effect of Sales Tax

The cascading effect problem can be more clearly understood through an illustration: Let us assume there are three producers in an economy — A, B and C.

Sales Tax

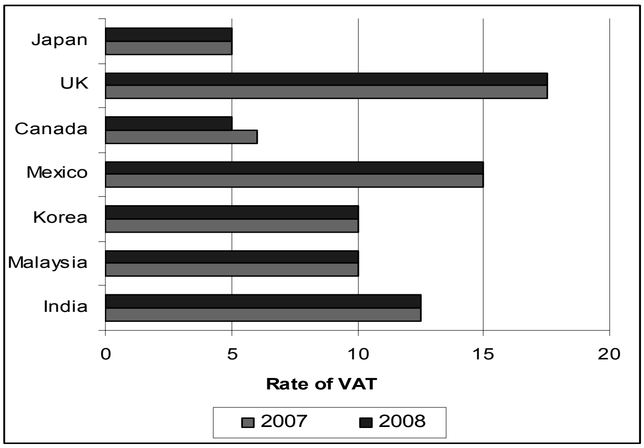
Producer/Manufacturer	Cost of input (in Rs.)	Value of output (in Rs.)	Tax rate	Selling price including tax rate (in Rs.)	Tax Burden
Producer A	-	100	10%	110 (100+10% of 100)	Rs. 10
Producer B	110	150	10%	165 (150+10% of150)	Rs. 15
Producer C	165	200	10%	220 (200+10% of 200	Rs. 20

Value Added Tax

Producer/Manufacturer	Cost of input (in Rs.)	Value of output (in Rs.)	Value Addition (in Rs.)	Tax rate	Selling price including tax rate (in Rs.)	Tax Burden
Producer A	-	100	-	10%	110	Rs. 10
Producer B	110	150	50 (150-100)	10%	155 (150+10% of 50)	Rs. 5
Producer C	155	200	50 (200-150)	10%	205 (200+10% of 50)	Rs. 5

Thus in VAT, B will pay tax on only Rs 50 i.e., value added by him. It does not matter whether a product passes through 10 or 20 stages or even 100 stages, as every producer will pay tax only on 'value added' by him to the product and not on the selling price of the product.

Figure 4: VAT Rates in Select Countries



Source: KPMG Corporate and Indirect Tax Survey, 2009

SECTION 5

Tax Administration

While we are arguing on the efficiency of tax system, another parameter in this regard is the concept of **compliance cost**[9] **and tax collection charges**[10]. Generally, the costs associated with taxation are administrative costs, avoidance costs and compliance costs. One of the works of Slemrod, Whiting and Shaw (2006), dedicated to the Tax Implementation Issues, emphasize on the importance of administrative and compliance costs of taxation. According to them, if all taxpayers were scrupulously honest, an administrative system would be required to provide information about tax liabilities and to record payments. But, of course, not all taxpayers are honest. Because of that, no government can announce a tax system and then rely on taxpayers' sense of duty to remit what is owed. Thus, according to them, paying taxes must be made a legal responsibility of citizens, with penalties attendant on noncompliance. In one such analysis, James, Dasgupta, Everest-Phillips and Valliancourt (2009) identifies that the major goals of effective Tax Administration are to (i) educate taxpayers about taxes and their tax obligations, (ii) help honest taxpayers comply, and (iii) enforce compliance on tax evaders. Table 3, gives a brief idea of the costs of tax collection per hundred units of tax revenue. Though in most of the developed countries apart from USA, the trend is not clear, India along with South Korea and Mexico shows decreasing costs of tax collection, as is clear from Figure 5.

9 A compliance cost is expenditure of time or money in conforming to government requirements such as legislation or regulation. For example, in case of filing a tax people have the extra burden of having to keep detailed records of all input tax and output tax to facilitate the completion of tax returns. This may necessitate them having to employ someone skilled in this field, which would be regarded a compliance cost.

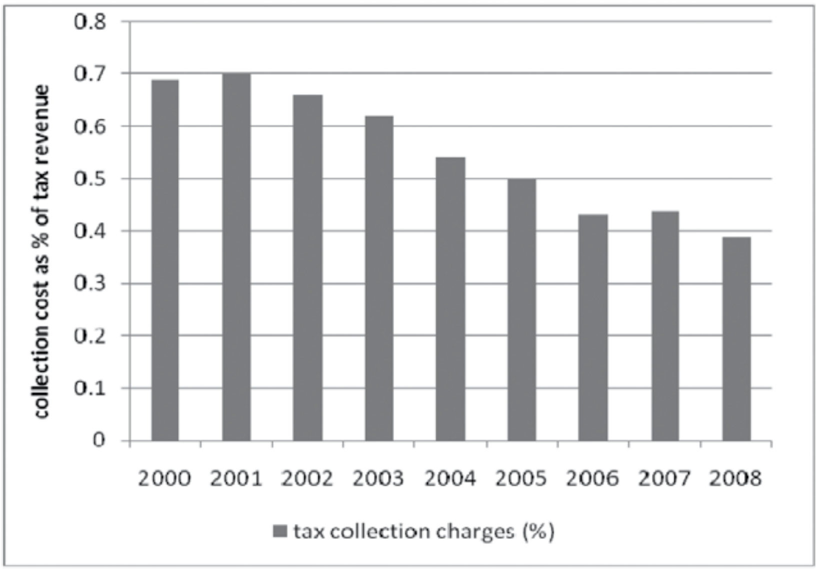
10 Tax collection charge is the cost borne by any government to collect all kinds of taxes.

Table 3: Administrative Cost Per Hundred Units of Tax Revenue

	Administrative costs / net revenue collections (percent)							
	2000	2001	2002	2003	2004	2005	2006	2007
India	0.69	0.70	0.66	0.62	0.56	0.50	0.44	0.45
South Korea	0.80	0.85	0.85	0.82	0.86	0.81	0.79	0.71
Malaysia	-	-	-	-	-	1.2	1.14	1.29
Mexico	-	-	1.44	1.41	1.29	1.18	1.06	0.95
UK	1.10	1.06	1.11	1.04	0.97	1.10	1.12	1.10
Canada	1.07	1.08	1.2	1.33	1.17	1.31	1.35	1.22
USA	0.43	0.46	0.52	0.57	0.56	0.52	0.47	0.45
Japan	1.42	1.54	1.66	1.67	1.58	1.69	1.56	1.53

Source of basic data: Indian Public Finance Statistics, 2008-09; Country survey responses, annual reports of revenue bodies, also reprinted in Comparative Information Series (2008), Tax Administration in OECD and selected non-OECD countries.

Figure 5: Tax Collection Charges in India



Source: Indian Public Finance Statistics, Govt. of India, 2008-09

In this context, we also take into account the burden of tax administrative costs on the aggregate Gross Domestic Product of the country. Due to lack of sufficient information, we incorporate the data of six study countries in Table 4.

Table 4: Tax Administration Expenditure as a Percent of GDP

	Tax Administration Expenditure as (%) of GDP		
	2005	2006	2007
India	0.08	0.08	0.08
Korea	0.12	0.12	0.12
Mexico	0.09	0.09	0.09
Canada	0.22	0.23	0.21
Japan	0.14	0.14	0.14
USA	0.08	0.08	0.08

Source of basic data: Indian Public Finance Statistics, 2008-09; Country survey responses, annual reports of revenue bodies, also reprinted in Comparative Information Series (2008), Tax Administration in OECD and selected non-OECD countries.

Table 4 gives a representation of the more or less constant burden of administrative expenditure on the national output of India, while it illustrates a decreasing trend for the other developed countries. In the present context of India, it is difficult to draw immediate inference with regard to whether higher expenditure in tax administration is better. Had the country possessed a very efficient and comprehensive tax administration, then perhaps lower expenditure would have been better. However, as the Comptroller and Auditor General of India points out, India's tax administration is not effective. So, for India, a higher expenditure would have been better.

The Compliance Audit, 2009, of the Comptroller and Auditor General of India provides a review of the tax administration prevalent in India. Several observations of the audit are listed below.

- The Tax-GDP ratio had reduced from 6.6 percent in 2007-08 to 6.3 percent in 2008-09. But for every unit growth in GDP, direct taxes had grown only by 0.6 percent in 2008-09, thereby reversing the trend in tax buoyancy[11]. Thus, the deceleration in tax collection was sharper than that of GDP.
- As pointed out in the audit, the taxpayer base had grown rapidly over the last five years from 271.8 lakh taxpayers in 2004-05 to 326.5 lakh taxpayers in 2008-09, indicating a growth rate of 20.2 percent. But in 2008-09, the number had declined by 3 percent, the decline being sharper among corporate assesses. It had also noted that the department concerned was not utilizing the mechanisms including inspection and survey, information sharing with other tax departments to widen the tax base.

11 Buoyancy is measured by the ratio of percentage change in tax revenues to percentage change in GDP.

- The Filing Rate and Non-Filing Rate[12] have still not been done in India, which is being assessed in modern tax administrations. The Permanent Account Number (PAN)[13] allotted to a taxpayer, is the unique identification number that helps track individual tax compliance. There were 807.9 lakh PAN cardholders as on 31 March 2009, of whom only 326.5 lakh assesses had filed their return of income relevant to the financial year 2008-09. This gap of 481.4 lakh assesses was higher than the corresponding figure in 2007-08. Therefore, the Board should identify the reasons for large scale stop filing or non-filing.
- The effective tax rate for companies was 22.2 percent in 2007-08, being substantially lower than the statutory rate of 33.9 percent. The audit had also pointed out that the tax concessions have been availed mostly by large companies.
- 84 percent of the tax collection came through voluntary compliance, thereby moving towards international practice of greater reliance on self-assessment in tax administration.

12 It is defined as the percentage of the taxpayer population with a filing requirement that filed timely returns and the amount of unpaid taxes due from delinquent and non-filed returns respectively.

13 PAN is issued by the department, but the front-end of the process has been outsourced to UTI Technology Services Ltd. (UTITSL) and the National Securities Depository Ltd. (NSDL) with effect from 1 July 2003.

With regard to the efficiency of tax collection, the department had achieved greater efficiency in completion of scrutiny assessment cases, thereby bringing down the pendency cases from 54 percent in 2006-07 to 44 percent in 2008-09. On the issue of computerization of the Income Tax Department, the Performance Audit 2009 of the Comptroller and Auditor General of India broaden our overview of the performance seen in the same. In the context of the e-TDS system of the Income Tax Department for electronic filing of returns of the tax deducted at source started in 2005, CAG assesses the extent of utilization of all the software features, the efficiency and accuracy of processing, adequacy of security measures and the level of data integrity. With regard to this, the audit had noticed cases of imperfect external interface with other related modules. It was also noticed that the data accuracy could not be ensured in the e-TDS system as the authorities responsible for data entry were outside the control of the Income Tax Department. The Audit had also noticed that there was delay in development of the e-TDS application and the networking system.

Some specific recommendations of the Audit with reference to the Income Tax administration are listed below:

- There is urgent need to ensure better linkage with the various external interfaces.

- The accuracy and validation of the data has to be ensured to increase data integrity and greater reliability.
- Data backup should be taken and tested regularly for retrieval along with proper security measures.
- There is also need to fix the time limit for processing of e-TDS returns so that better tax compliance is ensured and thereby loss of revenue is minimized. The networking system also needs to be strengthened to enhance the processing of the e-TDS returns.

In the context of administrative reforms in the Indirect Tax system, the Audit addresses system deficiencies associated with Central Excise, Service Tax and Customs.

- The payment of duty through CENVAT[14] rather than by cash is excessive indicating possible misuse of CENVAT credit facility. Hence suitable measures have to be undertaken to counter this problem.
- Further, many products escape from stockyards without paying cutting and bending duties, resulting in loss of indirect tax revenue. Thus there is need to amend the procedures needed for regulation.
- Audit has further observed that in certain cases the production declared on which duty was paid was substantially lower than the declared capacities. Thus the government is required to set up an internal control for proper monitoring of the investigation units.

With regard to proper administration in the service tax, the observations and recommendations of the Audit are as follows:

- The internal control mechanism existing in the department to bring unregistered service providers into taxable arena was ineffective and inadequate. Hence a large number of unregistered service providers are escaping thereby leading to a substantial amount of tax evasion.
- Further the government needs to continually monitor the data on assessee base and revenues collected and investigate the reasons for decline in revenue from a particular service despite increase in the registered tax base, to ensure that the decline is not due to tax evasion.
- Additionally, the internal control mechanism to verify the correctness of the returns filed was inadequate and several cases of short levy of service tax by suppression of the value of services.

With regard to the recommendations in the purview of customs, the suggestions of the

14 Value Added Tax in India was initiated at the Central level for a particular group of commodities through the Modified Value Added Tax (MODVAT) scheme on March 1, 1986. It was converted to Central Value Added Tax (CENVAT) in 2002.

Audit are:

- Deficiencies were observed in the design, application and validation control of the Indian customs electronic data interchange system (ICES). Accordingly, there is urgent need to review the business rules mapped in the system.
- Wastage of resources was also noticed as the data available in the system was not utilized and manual processes were used instead. Hence the system needs to be modified so that all business processes are done through the system instead of doing it manually.
- The Audit has also revealed some systems as well as compliance weaknesses relating to grant of project import benefits and finalization of project import cases. Hence there is urgent need of effective monitoring of cases related to project imports.

Thus, the recommendations of the CAG report indicate that the Indian taxation system requires improvement relating to administrative transparency and costs of tax collection.

SECTION 6

Progressivity of the Tax Structure in India vis-à-vis Select Countries

There have been many discussions regarding the indicators of measuring the extent of progressivism of any countries' tax structure. Regardless to say, one indicator of the same is the composition of the direct and indirect taxes in the country. Direct taxes are levied on the income of individuals and corporations i.e. the tax payer directly pays the tax to the government without sharing the tax burden. On the other hand, indirect taxes are regressive[15] in nature, taxing the poor and the rich in the same manner. Hence, a tax structure is said to be progressive[16] if people with higher incomes pay a higher proportion of their income in taxes. Hence a country's dependence on direct taxes tends to measure the level of tax progressivity in the system. In reality, marginal rates do not always materialise due to factors like tax evasion, exemption, avoidance and the outcome of a tax system thus depends on all sorts of factors in addition to the nominal tax rates.

15 Tax structure is said to be progressive if the marginal tax rates increase along with the increase in taxable income amount.

16 Tax structure is said to be regressive if the marginal tax rates decrease along with the increase in taxable income amount.

6.1 Shares of Direct and Indirect Taxes

The following table provides a comparison of the direct and indirect taxes in the countries of India, South Korea, Malaysia, Mexico, Japan, USA, UK and Canada.

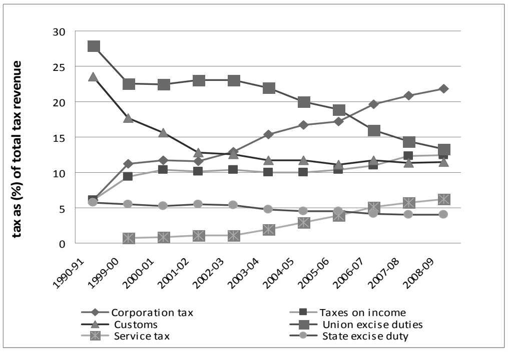
Table 5: Composition of Tax Revenues

	Individual Income Tax	Corporate Tax	Property Tax	SSC	Taxes on goods and services	Payroll Tax	Total
	Taxes as percent of Total Tax Revenue						
INDIA	12.4	20.9	0	0	65.9	0	99.2
CANADA	37.4	11.0	9.9	14.4	23.6	1.9	98.2
USA	38.1	10.9	11	23.3	16.6	0	99.9
UK	30.1	9.4	12.6	18.4	29.2	0	99.7
JAPAN	19.5	16.8	8.9	36.4	17.9	0	99.5
MEXICO	27.7		1.7	15.3	52	1.4	98.1
KOREA	16.7	15.1	12.8	20.8	31.3	Negligible	96.7
MALAYSIA	12.2	33.8	NA	0	27.1	0	96

Note: The comparison pertains to the year 2007
Source: Author's calculations based on OECD Revenue Statistics (1965-2008); Indian Public Finance Statistics (2008-09), Govt. of India; and Ministry of Finance, Govt. of Malaysia

The composition of the tax structure of the study countries reflects the reality that developing countries depend primarily on the revenue accrued from indirect taxes for the functioning of the economy. The Social Security Contribution in Japan is the highest, thereby accounting for this regressive element in its tax structure. Whereas in USA, UK, Canada and Japan, revenue ensued from direct taxes comprises of 60 percent, 52.1 percent, 58.3 percent and 45.2 percent respectively, the statistics for India is a meager 34.1 percent. This reflects the extent of regressivism in India's tax structure. But since liberalization, India's dependence towards direct taxes is steadily increasing in comparison to indirect taxes. Figure 6 highlights this view.

Figure 6: Trend of Direct and Indirect Taxes in India



Source: Indian Public Finance Statistics 2008-09, Govt. of India

The share of revenue from the major direct taxes viz. corporation tax and income tax has increased since liberalization, the rate of increase being higher for corporation tax, indicating the importance of the corporate sector in functioning of the Indian economy. On the other hand, the rates of two major indirect taxes i.e. customs duties and central excise were slashed in the liberalization era. On the States' side, the dip in the revenue occurred due to decrease in the rates of sales tax, the principal contributor to State revenue, owing to tax competition among the States to promote trade and industry.

6.2 Share of General Consumption Taxes

For the purpose of this study, we have incorporated sales tax[17] and VAT as general consumption taxes. It is to be noted that consumption taxes are generally regressive in nature as they tax the poor and the rich alike. The lesser the composition of these taxes, the more progressive is the tax system. The following table shows a brief comparison of these taxes in the study countries.

Table 6: Composition of General Consumption Taxes

	1990	1995	2000	2005	2007
	As percent of total tax revenue				
India	20.8	20.4	23.9	23.2	19.3
Canada	14.1	14	14.2	14.9	13.6
USA	8	8	7.6	8	7.7
UK	16.9	19	18.1	18.6	18.2
Japan	4.4	5.4	9.1	9.5	8.8
Mexico	20.8	16.9	18.7	19.1	20.4
Korea	19.7	18.9	17	17.5	15.8
Malaysia	11.5	11.7	12.7	9.5	6.9

Source: Author's calculations based on OECD Revenue Statistics (1965-2008), Indian Public Finance Statistics (2008-09), Govt. of India and Ministry of Finance, Govt. of Malaysia

Table 6 demonstrates the huge revenue collected in India from the consumption taxes.

17 A sales tax is a consumption tax charged at the point of purchase of certain goods and services.

This regressive element is highly evident from the data. On the other hand, the Federal Govt. of USA and Japan levies comparatively low taxes on general consumption, VAT being absent in the former. In the countries studied, apart from Malaysia, the other developing countries have already introduced VAT, which has reduced the distortionary effect of multiple taxes.

From the discussion, it is evident that progressivism in the Indian Tax system is far below the international levels. The obvious implications of which have been identified below:

- High revenue accrued from indirect taxes in India implies that a vast percentage of the young population in India (in the age group 20 to 24) end up paying higher taxes instead of availing the social benefits of education, health etc. On the other hand, a lower percentage of the population at the higher end of the age pyramid ends up paying less direct tax.
- The economic problem of income inequality in the country is aggravated by the regressive nature of the Indian tax structure.
- India loses a huge volume of tax revenue due to its low corporate tax base and high tax exemptions in the corporate sector.
- As previously pointed out in the reports of Comptroller General of India, tax administration in India is inefficient coupled with lack of computerization and unskilled tax officials.

SECTION 7

Concluding Remarks

From the discussion, it is evident that the progressivity of the tax structure in India is far below the international levels. Also, the country needs to significantly increase its tax-GDP ratio for adequate resource mobilization. In terms of the tax rates in personal income and corporate tax, we found that India already has moderate rates and graduated slabs. Thus, at present there may be no strong rationale for reducing the tax rates further.

The efficiency of tax administration in India is apparently being judged by the decreasing trend of costs of tax collection per unit of tax revenue, though the critical review in Performance and Compliance Audit of the Comptroller and Auditor General (CAG) of India insists on certain reforms to be undertaken in the direct and indirect tax administration coupled with increase in transparency of the same.

As regards India's tax system, we need to look into the problem of huge magnitude of tax revenue being foregone every year due to a plethora of exemptions in the Central Government tax system. The total magnitude of tax revenue foregone due to exemptions/ deductions/ incentives in the Central Government tax system has been estimated (by the Central Government's Finance Ministry) to be Rs. 5.02 lakh crore in 2009-10. What it implies is: a liberal estimate of the amount of additional tax revenue which could have been collected by the Central Government in 2009-10, if all exemptions/ deductions/ incentives (both in direct and indirect taxes) had been eliminated, stands at a staggering 8.1 percent of GDP. Not all kinds of tax exemptions/ deductions/ incentives can be eliminated; however, there could be a strong case for removing those exemptions which are benefiting mainly the privileged sections of population.

We also need to evaluate India's tax system and tax policies from the perspective of gender. Infact, it would also be pertinent to demystify the diverse implications of the country's tax system and tax policies for the underprivileged sections of the population. Apart from this, we also need to assess the Direct Tax Code (which is going to be implemented soon) and evaluate to what extent this is likely to usher in a new tax regime of transparency and greater compliance.

Bibliography

- Aasness, Jorgen, Andreas Benedictow and Mohamed F. Hussain (2002), *"Distributional Efficiency of Direct and Indirect Taxes"*, Rapport 69, Economic Research Programme on Taxation.
- Alessandrini, Michele and Tullio Buccellato (2008), *"China, India and Russia: economic reforms, structural change and regional disparities"*, Centre for the Study of Economic and Social Change, Europe.
- Bird, M. Richard and Eric M. Zoly (2003), "*Introduction to Tax Policy Design and Development*", draft prepared for a course on Practical Issues of Tax Policy in Developing Countries, World Bank
- Chandrasekhar, C.P. and Jayati Ghosh (2006), "*Macroeconomic Policy, Inequality and Poverty Reduction in India and China*", IDEAS Working paper series.
- Chattopadhyay, Saumen (2 009), "*Assessing Tax Policy and Tax Compliance in the Reform Era*",
- Chattopadhyay, Saumen and Arindam Dasgupta (2002), *"The Income Tax Compliance Cost of Indian Corporations"*, NIPFP, New Delhi.
- Clausing, Kimberly (2007), "*Corporate tax revenues in OECD countries".*
- Compliance Audit of the Comptroller and Auditor General of India, Report No.4, Direct Taxes, 2009-10
- Cremer, Helmuth, Pierre Pestieau and Jean-Charles Rochet (1999), "*Direct versus Indirect Taxation: The Design of the Tax Structure revisited*", University of Toulouse and University of Liege
- D'amico, Domenico (2005), "*Tax systems and Tax Reforms in South and East Asia: China*", Working paper No.394, University of Rome, Italy.
- Damme, Lauren, Riffany Misrahi and Stephanie Orel (2008), "*Taxation Policy in Developing Countries: What is the IMF's Involvement?* The Bretton Woods Project, DV406 Consultancy Project
- Das, Subrat (2007), "*Let's Talk About Budget*", Centre for Budget and Governance Accountability, New Delhi
- Davies, G. David, "*United States taxes and tax policy*", Published at Cambridge University Press, Cambridge
- Global Corporate Tax Handbook, 2009
- Global Individual Tax Handbook, 2009
- Gorden, Roger and Wei Li (2005), "*Tax Structures in Developing Countries: Many Puzzles and a Possible Explanation"*, University of Virginia.

- Government of India, Ministry of Finance, department of Economic Affairs, Indian Public Finance Statistics 2009-10
- Government of India, Ministry of Finance, department of Economic Affairs, Indian Public Finance Statistics 2008-09
- Government of India, Ministry of Finance, department of Economic Affairs, Indian Public Finance Statistics 2009-10
- Government of India, Ministry of Finance, department of Economic Affairs, "Indian Public Finance Statistics 2007-08".
- Government of India, Ministry of Finance, Department of Revenue, Discussion Paper on Direct Taxes Code, 2009.
- Government of India, Union Budget 1997-98, Budget Speech
- Government of India, Union Budget 2000-01, Budget Speech
- Goyal, A Krishn (2006), "*Impact of Globalization on Developing Countries (With Special Reference to India)*", Birla Institute of Technology, Oman
- Hensman, Rohini (2001), "*The Impact of Globalisation on Employment in India and Responses from the Formal and Informal Sectors*", CLARA Working paper, Amsterdam.
- Islam, Azizul (2001), "*Issues in Tax Reforms*", published in Asia-Pacific Development Journal, Volume 8, Number 1.
- James, Sebastian S., Dasgupta Arindam, Everest-Phillips, Max and Vaillancourt, Francois (2009), A Handbook on Tax Simplification, Tax Administration Simplification, Chapter 5.
- Jha, Praveen and Subrat Das (2010), "*India's Fiscal Policy space for investing in Children*", forthcoming publication by Institute of Human Development (IHD) and UNICEF.
- KPMG's Corporate and Indirect Tax Survey, 2007, KPMG
- KPMG's Corporate and Indirect Tax Survey, 2008, KPMG
- KPMG's Corporate and Indirect Tax Survey, 2009, KPMG
- Le Blanc, Marc (2005), "*Horizontal Equity and Personal Income Tax System*", Economics Division, Library of Parliament, Canada.
- Livingston, A.Michael (2006), "*Progressive Taxation in Developing Economies: The Experience of China and India*".
- Lorie, Henri (2003), "*Priorities for Further Fiscal Reforms in the Commonwealth of Independent States*", IMF Working Paper
- Madden, David (2000), "*Taxation, Debt and Public Finances*", University College, Dublin.

- OECD (2009), *Revenue Statistics 1965-2008 – Edition 2009*, OECD, Paris.
- OECD (2009), *Revenue statistics*: Comparative tables, *OECD Tax Statistics* (database)
- OECD, *Consumption Tax Trends*, 2005
- OECD, Policy Brief, 2007, "*Consumption Taxes: The way of the future*".
- Pandey, Manoj (2006), "*Direct Tax Reforms in India-Policy Initiatives and Directions*", University of Ljubljana.
- Performance Audit of the Comptroller and Auditor General of India, Report No.25, Direct Taxes, 2009-10
- Piketty, Thomas and Nancy Qian (2009), "*Income Inequality and Progressive Income Taxation in China and India, 1986-2015*"
- Poirson, Hélène (1993), "*The Tax System in India: Could Reform Spur Growth*", IMF Working paper.
- Rao, Govinda M. (2000), "*Tax Reform in India: achievements and Challenges*", published in Asia-Pacific Development Journal.
- Rao, Govinda M. and R. Kavita Rao (2006), "*Trends and Issues in Tax Policy and Reform in India*", NIPFP, New Delhi.
- Report of the Task Force on Direct Taxes, December, 2002
- Saez, Emmanuel (2002), "*Direct or indirect tax instruments for redistribution: short-run versus long-run*", working paper 8833, National Bureau of Economic Research, Cambridge.
- Sengupta, Abhijit (2007), "*Determinants of Tax Revenue Efforts in Developing Countries*", IMF Working Paper
- Shuanglin, LIN (2009), "*The rise and fall of China's government revenue*", EAI Working Paper No.150.
- Srinivasan, T.N, *"China and India: Economic Performance, Competition and Cooperation: An Update".*
- Tax Administration in OECD Countries: Comparative Information Series (2004), prepared by Forum on Tax Administration, Compliance Sub-group.
- Tax and Budget Bulletin, 2007, CATO Institute.
- Tax and Development, Tax Justice Focus, quarterly newsletter of Tax Justice Network, Volume4, Number 4.
- The International Tax Handbook, 2nd Edition
- U.S. Department of the Treasury, Office of Tax Policy, *"Approaches to Improve the Competitiveness of the U.S. Business Tax System for the 21st Century".*

NOTES

NOTES

NOTES

About CBGA

Centre for Budget and Governance Accountability (CBGA) promotes transparent, accountable and participatory governance, and a people-centred perspective in the policies shaping up the government's budgets. CBGA's research on public policies and budgets, over the last eight years, has focused on the priorities underlying budgets, quality of government interventions in the social sector, responsiveness of budgets to disadvantaged sections of population and structural issues in India's fiscal federalism. Research on these issues has laid the foundation for CBGA's efforts pertaining to training and capacity building on budgets (mainly with the civil society organisations in the country) and policy advocacy with important stakeholders. Please visit the website www.cbgaindia.org to know more about the organisation.

A publication by:

Centre for Budget and Governance Accountability
A-11, Second Floor, Niti Bagh
Khel Gaon Marg
New Delhi - 110049, India
Phone: +91-11-41741285/86/87
Email: info@cbgaindia.org
Web: www.cbgaindia.org

CBGA
Centre for Budget and Governance Accountability

christian aid