2014

MAJOR DIMENSIONS OF INEQUALITIES IN INDIA: TAXATION

In the last few decades, across the globe, not only has inequality in income persisted, it has also been growing over time. In the case of India too, there has been a considerable increase in inequality with the spending gap between the rich and poor almost doubling in the last five years. A large part of the increase in inequality in India can be explained by the kind of policies adopted in the country. Taxation policy, which is an important tool to address this problem, is one such area that has not been used effectively in India. As a result, this has also contributed to the problem of growing inequality in the country.

INCOME AND TAX POLICY

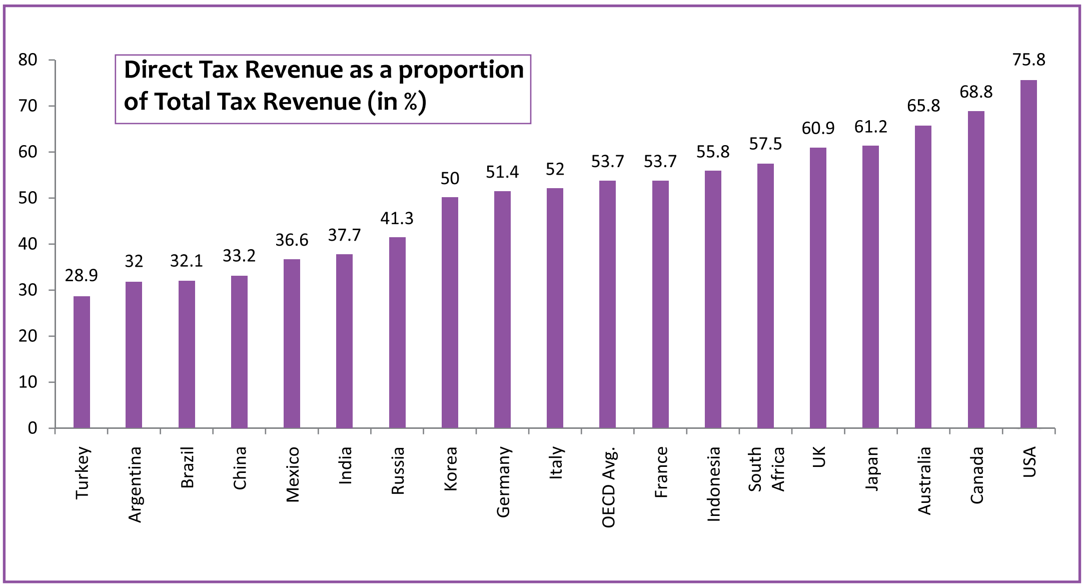
Progressive taxation is one of the least distortionary policy tools available to help control the rise in inequality by redistributing the gains from growth[1]. Although a progressive individual income tax system has been in place in India since 1922, only about one-third of the total taxes in the country are generated from direct taxes. As is evident from Figure 1, developed countries have far more progressive tax structures, compared to most developing countries. However, it is possible even for developing countries to have a relatively more progressive tax structure. This is exemplified by South Africa, Indonesia[2] and Russia, which fare better in terms of the contribution of direct taxes to total tax revenue compared to other countries in the BRICS (including Indonesia), such as India, Brazil and China.

There are several factors that explain why India has one of the narrowest direct tax bases. The slow growth of the income tax base over time has been one of the major reasons for this. The number of income tax payers, which was less than 1 percent of the population in 1986, increased to just about 3 percent by 2008, and to a little more than 3 percent by 2012-13.

1 T. Piketty and N. Qian. 2009, "Income Inequality and Progressive Income Taxation in China and India, 1986–2015", American Economic Journal: Applied Economics 2009, 1:2, pp: 53–63.

2 Even though data for Indonesia pertain to the Central Government, given that the Center's share in total revenue is around 90 percent, the picture would not change much if General Goverment is considered.

Figure 1: Tax Structure across G20 Countries



Note: All country values are for year 2010, except Argentina (2009), OECD Avg. (2009), China (2009), Mexico (2009) and India (2009-10). Figures are for General Government except Indonesia. Indonesia figure pertains to Central Government.
Source: Prashant Prakash, 2013, "Property Taxes across G20 Countries: Can India get it Right?" CBGA and Oxfam India.

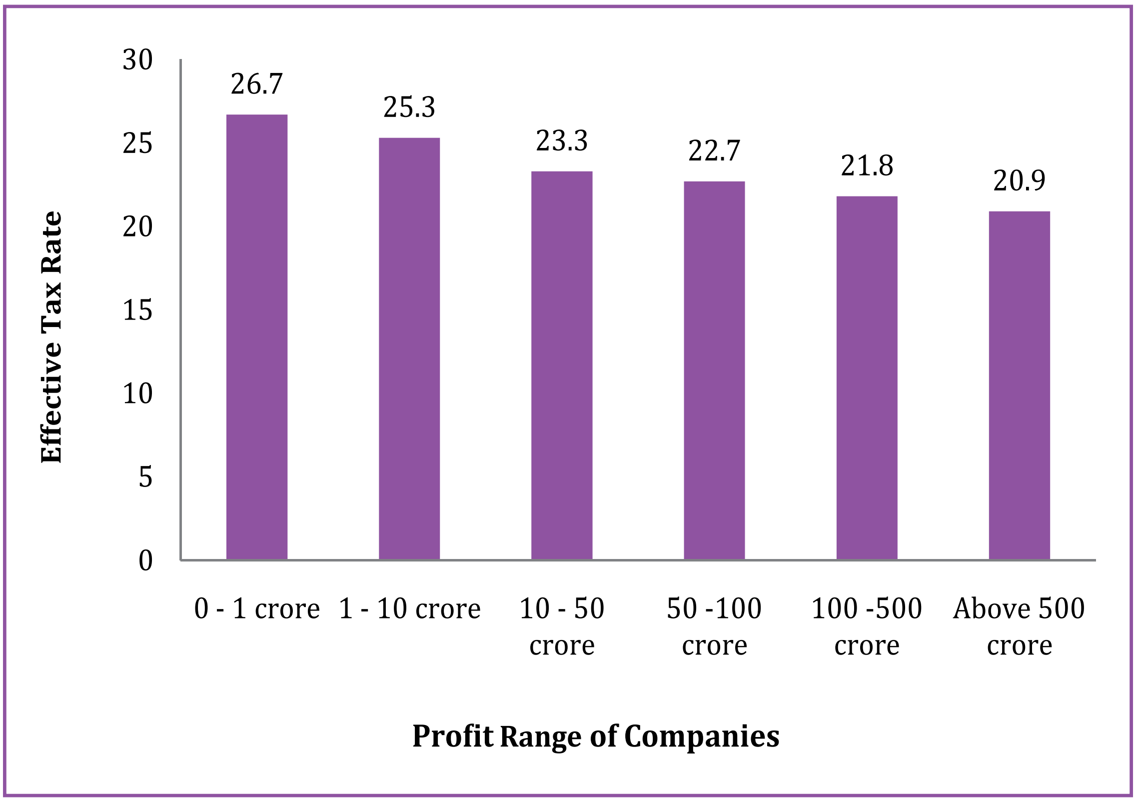
CORPORATE PROFITS, CAPITAL INCOME, WEALTH AND TAX POLICY

Income tax on individuals, however, forms only one part of the problem. As several studies show, because of a plethora of tax concessions and incentives given to the private corporate sector, the effective tax rates[3] paid by the private corporate sector is not only much lower than the statutory tax rate[4], it has also been on the decline[5].

As per the Statement of Revenue Foregone[6] published every year by the Union Government since 2006-07, the effective tax rate paid by the corporate sector (both manufacturing and services sector) reduced from 24.1 percent in the financial year 2010-11 to 22.9 percent in 2011-12 and further to 22.4 percent in 2012-13 (as against the statutory tax rate of 32. 5 percent in 2012-13). Further, companies earning highest profits are the ones which pay the lowest effective tax rate. In 2012-13, for instance, while the effective tax rate was 26.7 percent for companies with profits before tax (PBT) up to Rs. 1 crore, for larger companies, with PBT of Rs. 500 crore and above, it was only about 21 percent.

[3] Effective tax rate is the ratio of total taxes paid [including surcharge and education cess, but excluding Dividend Distribution Tax] to the total profits before taxes and expressed as a percentage.
[4] Statutory tax rate refers to the legally imposed tax rate.
[5] Lower effective tax rate implies that companies are paying less tax relative to their profits.
[6] Because of exemptions/concessions in the Central Tax System.

Figure 2: Effective Corporate Income Tax Rate across Companies in Different Profit Slabs, 2012-13, (in %)



Source: Compiled from Statement of Revenue Foregone, under the Central Tax System: Financial Year 2012-13, Union Budget 2014-15, Ministry of Finance, Govt. of India.

This has not only weakened the direct tax base of the country but also strengthened the tendency of rising inequality. This arises from the fact that the effective tax rates have been going down precisely at a time when the share of national income going to surplus-takers[7] has been increasing and that going to wage earners has been declining[8].

Other direct taxes too have not been used effectively to combat inequality. A case in point of a neglected source of revenue as well as a generator of inequity relates to the tax concessions accorded to returns on stock holdings, such as exemptions on dividend incomes and long term capital gains. Tax on long-term capital gains (LTCG) from transactions in securities[9] (such as equities, including mutual fund equities, etc.) was abolished in 2004. Tax on short-term capital gains (STCG), i.e. for securities traded within the year of their acquisition, was reduced to a flat 10 percent[10]. Prior to this, STCGs were taxable as ordinary income, according to the

[7] Surplus includes profits, rents and financial incomes.
[8] J. Ghosh, 2012, "Inequality in South Asia", Frontline, Vol. 29: No. 15, Jul 28-Aug 10.
[9] For securities held for more than 12 months.
[10] It was increased to a flat rate of 15% at a later date.

income tax slab of the taxpayer. Similarly, dividend incomes in the hand of the unit holder have been totally exempt from taxes since the late 1990s. As is known, in most countries, asset holdings tend to be more sharply skewed compared to income. In India too, the miniscule proportion of the population that invests in equity belongs to the upper income groups. Several analysts have noted that with the returns from these assets having increased manifold in the 2000s, the abolition of tax on long term capital gains from securities and the tax exemption on dividend income (particularly in the absence of inheritance tax and/or gift tax) have been important factors contributing to rising inequality and concentration of wealth[11],[12] (see table below).

Table 1: Tax Free Dividend Income of India's Top Promoters, 2012 (in Rs. Crore)

Promoter	Tax Free Dividend
Azim Premji	1345.1
Mukesh Ambani	1240.7
Rahul Bajaj	917.4
Anil Agarwal	790.2
Keshub Mahindra	312.2
Shiva Nadar	304.9
Gautam S. Adani	304
Narendra K. Patni	291.7
Dilip S. Shanghvi	268.4

Source: V. Vyasulu, (2013), "Big Fish Need A Bigger Net!", Outlook Magazine, February 18, 2013.

Indeed, as Thomas Piketty in his book '*Capital in the Twenty-First Century*' (2014) has argued, income from capital and inherited wealth have been powerful drivers of inequality in the advanced capitalist countries, up to the First World War as well in the period since the 1970s. He pointed out that up to the early 20th century, income from capital and not earnings, predominated at the top of the income distribution. Minimal taxation on wealth at that time ensured that wealthy individuals could easily reinvest a substantial part of their income. Consequently their wealth and their incomes grew at a faster rate than the economy, thus reinforcing their economic dominance. On the death of these wealthy individuals, their wealth passed on to their heirs. As a result, inherited wealth was concentrated in the hands of a very small minority.

[11] A. Bagchi, 2007, "Rethinking Tax Treatment of Capital Gains from Securities", Economic and Political Weekly, XLII No. 4, January 27, pp: 287 - 290 .

[12] S. L. Shetty, 2011, "Growing Inequality: A Serious Challenge to the Indian Society and Polity", in P. Jha (ed.) *Progressive Fiscal Policy in India*, Sage Publications, New Delhi, India.

A similar situation has resurfaced in the last few decades, which has once again brought to the fore the importance of wealth tax – which can be a powerful tool for limiting inequality – in order to restrain the growing concentration of inherited wealth.

Although wealth tax is an important source of direct tax revenue, especially in tax structures of most of the other G20 and BRICS countries, it is clearly a neglected source of revenue collection in India. The proportion of wealth tax in total tax revenue is one of the lowest in India (0.42% only, i.e. less than 0.01% of the GDP in India for 2011-12). A conservative estimate by Centre for Budget and Governance Accountability (CBGA) has shown that the revenue potential of inheritance tax and wealth tax in India is around 0.8 percent of GDP (for 2011-12)[13].

Paradoxically, between 2000 and 2013, India's private wealth has reportedly zoomed up by 300 percent - from USD 1.2 trillion to 3.6 trillion. However, only about 20 percent of this wealth is owned by the bottom 70 percent of India's households (State of World Wealth Report, Credit Suisse, a Switzerland based global bank, 2013). There were 2 billionaires in India in the mid 1990s. By 2012, this number has increased to 46 (Forbes, 2012). Wealth of these 46 billionaires constituted 10 percent of India's GDP in 2012. Wealth held by billionaires in India arise from three major sources - inheritance, self-made and 'inherited and growing' (terms coined in the Forbes list), the last being for billionaires who inherited their wealth and subsequently experienced substantial growth in wealth.

A study by Gandhi and Walton (2012)[14] shows that while a large number of Indian billionaires (21) are 'self-made', about 40% of total billionaire wealth is in the 'inherited and growing' category. All of the Indian billionaires are associated with corporate activities. For about 43 percent of the Indian billionaires, accounting for 60 percent of the total wealth held by the Indian billionaires put together, the primary sources of wealth have been the real estate, construction, infrastructure or ports sector, media, cement and mining sector. For the rest 57 percent, accounting for 40 percent of the rest of the wealth, the primary sources have been the software industry, pharmaceuticals and biotech, banking, liquor and manufacturing sector (Ibid). It is clear from this information that notable wealth creation occurred in sectors with substantial potential for rent extraction and rent sharing between private and government players. In addition, income inequality is underestimated due to hidden wealth, owned mostly by the richest segment of the population. In his 2013-14 budget speech, the Union Finance Minister Mr.

[13] Prashant Prakash, 2013, "Property Taxes across G20 Countries: Can India get it Right?" CBGA and Oxfam India.
[14] A. Gandhi and M. Walton, 2012, "Where do India's Billionaires get their Wealth?", Economic and Political Weekly, Vol. – XLVII, No. 40, October 6, pp.1-14.

P. Chidambaram had quoted that out of the 3.7 crore income tax assessees in India, there were only 42,800 people with income of more than Rs. 1 crore a year, which might be a gross underestimation. In addition, official estimates of income also fail to capture the assets held by some people in offshore 'tax havens' (e.g. Mauritius, Cyprus, Cayman Islands etc.).

TAX DODGING: A SERIOUS CONCERN

Tax evasion (illegal practice of non-payment of tax liabilities) and tax avoidance (deliberate acts of reducing one's taxes by legal means) are the two major ways of escaping taxes. The popular ways of tax dodging are:

a) Money laundering - an attempt to conceal the identity of illegally obtained proceeds;

b) *Hawala* -an informal process of funneling money from one location to another through a network of *Hawala* brokers;

c) Tax Havens - jurisdictions with zero or low tax rates that also offer a high degree of secrecy in financial matters;

d) Transfer pricing – this refers to the transaction price of goods and services between related companies. Although not illegal in nature, severe manipulation in transfer pricing takes place in order to shift profits from high tax countries to low tax countries; and

e) Trade mispricing - it occurs when import / export of particular goods or services are invoiced at a higher / lower rate of market price.

In short, a huge amount of tax revenue is forgone because of tax dodging and tax exemptions / tax concessions. There is a need for a thorough scrutiny of all such exemptions / concessions in the Central Tax System in India for revenue augmentation. Even if the government could raise additional revenue worth 3 percent of GDP by such a process, it would enable the country to pursue a far more substantive fiscal policy to address inequality.

REGRESSIVE TAX STRUCTURE

As mentioned earlier, despite having a progressive individual income tax system since the early 1900s, not only does India have one of the lowest direct tax to total tax ratio, it also has one of the lowest overall tax-GDP ratios (about 17 percent in 2012-13) among the G20 and BRICS countries.

Because of the several exemptions and loopholes, among other things, associated with direct taxes discussed above, nearly two-thirds of the total tax revenue comes from indirect taxes. However, indirect taxes are known to be inherently regressive in nature as it is likely that a disproportionate part of the tax burden is borne by the poorer households. In other words, it is likely that the poorer sections pay out a larger share of their income in the form of taxes, compared to richer households. Thus, indirect taxes, especially when imposed on mass consumer goods, can widen the income gap and aggravate inequality in the society.

In short, a relatively regressive tax structure (as compared to other G20 countries), problems of tax evasion, various exemptions, low direct tax rates and administrative bottlenecks in collecting taxes on personal income and wealth are among the major constraints in resource mobilisation and improving distributional impacts of taxation in India.

A MUCH NEEDED TAX REFORM

Global forums like the G20 and BRICS have placed issues like financial transparency and international tax cooperation on the top of their agendas. For instance, the G20 Summit in Los Cabos (2012) identified the issue of tax avoidance by Multi-National Corporations (MNCs), by exploiting loopholes in the international tax system, as a serious concern. It therefore explicitly referred to the need to prevent Base Erosion and Profit Shifting (BEPS)[15] in their final declaration and called on the OECD to develop an action plan to address these issues. The communique issued after the meeting of G20 finance ministers in 2014 stated that, by the Brisbane Summit in September, 2014, all G20 members would start taking effective, practical and sustainable measures to counter BEPS by MNCs across all industries. The G20 countries have also agreed to start automatic sharing of tax information by the end of 2015.

Like the G20, the BRICS forum too is working on areas of tax policy issues[16] such as international taxation, transfer pricing, prevention of cross-border tax evasion and avoidance, exchange of information, sharing of best practices in tax system administration and resolution of disputes. The BRICS countries have promised to extend cooperation on the issues of tax policy and tax administration (PIB Release, 2013)[17]. Thus, in the domain of taxation and its potential in tackling inequality, the G20 and BRICS have initiated a few concrete measures, though a lot more needs to be done.

In India too there is a need to put tax reforms at the top of the policy agenda in order to address the problem of inequality. A fairer tax policy – involving, among other things, policy measures to increase the share of direct taxes in revenue

[15] Base Erosion and Profit Shifting (BEPS) refers to the negative effect that tax avoidance strategies of multinational companies have on national tax bases.
[16] Before, the fifth BRICS summit, the Heads of the Revenue Departments in BRICS countries met in New Delhi on 17th and 18th January, 2013 and discussed on seven areas of tax policy issues.
[17] http://pib.nic.in/newsite/PrintRelease.aspx?relid=91684.

through a proper scrutiny of the several exemptions/concessions - can help to narrow the gap between the rich and the poor. It would also have a direct impact on the fiscal space to expand the scope of social sector expenditures and effective service delivery mechanisms of the government.

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THE AUTHOR ACKNOWLEDGES EDITORIAL INPUTS BY MALINI CHAKRAVARTY

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PUBLISHED BY:

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