

# India's Tax System: Increasing Progressivity

*Malini Chakravarty*



*It is hoped that introduction of GST would help to simplify and rationalise the tax system and increase compliance. At the same time, it is also important that the government take some steps to increase direct taxes that would help increase progressivity of India's tax structure*



We all pay taxes to the government in some form or the other in our daily lives. These taxes we pay play an important role in financing different functions that the government performs. There are many responsibilities that the government is required to fulfil. These include ensuring the rule of law; providing public goods and services; building physical and social infrastructure; investing in education of the population; alleviating poverty, etc. Clearly, the government needs to mobilise a significant amount of financial resources in order to fulfil its many commitments. The government mobilises financial resources for funding its different activities mainly through taxes, user fees/ service charges and borrowings. The sources of funds which neither create liabilities nor reduce assets are called **Revenue Receipts**. Other sources of funds such as borrowings which create liabilities or those that reduce assets (e.g. disinvestment) are called **Capital Receipts**. Thus, taxes and user fees/service charges are some examples of revenue receipts of the government while borrowings are capital receipts.

## Tax Revenue and Non-Tax Revenue

Government's revenue receipts can be further divided into two categories:

tax revenue and non-tax revenue. **Tax Revenue:** Tax revenue refers to the money collected by the government through payments imposed by law. **Non-Tax Revenue:** Non-Tax Revenue refers to revenue of the government raised through instruments other than taxes such as fees/user charges, dividends and profit of public sector enterprises, interest receipt, penalty or fine, etc. For most countries across the world, tax revenue forms a significant proportion of government revenues.

## Direct and Indirect Taxes

Taxes can be broadly classified into two kinds: Direct Taxes and Indirect Taxes. **Direct Taxes:** Those taxes for which, the burden of the tax falls on the entity that is being taxed are known as direct taxes. In other words, an entity that directly pays this kind of a tax to the government bears the burden of that particular tax and cannot shift the tax burden. Direct taxes are levied on incomes, property and wealth. **Indirect taxes,** on the other hand, are those taxes for which the tax-burden can be shifted or passed on to other persons later through business transactions of goods/ services. These taxes are indirect because the agent who bears the burden of the tax is not the one on whom it is normally levied. Indirect taxes include Customs Duties, Excise Duties, Service Tax, and Sales Tax/ Value Added Tax (VAT).

The author is presently working with Centre for Budget and Governance Accountability (CBGA). Her research interests include issues related to macroeconomics, public finance, international trade and social protection.

## Taxes: Different Types

There exist a number of taxes, both direct as well as indirect, that are levied on incomes of various kinds, production and sale of goods and services within the economy and others that are levied on cross-border movement of goods. Examples of some of the different types of taxes that exist in India is given in the box.

### Division of Taxation Powers between Centre and States

The Constitution of India clearly demarcates the taxation powers at different levels of governance. Thus, the power to levy taxes and duties has been divided among the governments at the three tiers i.e. Central Government, State Governments, and Local Bodies.

The power to levy taxes on corporations and personal income (except for tax on agricultural income, which the State Governments can levy) lies mostly with the Central government.

In the arena of indirect taxes, the Central government has the authority to impose a broad spectrum of excise duties on production or manufacture and service tax on services provided, while States are assigned the power to levy tax on the sale of goods and some other taxes. Some of the indirect taxes that the Centre levies are Customs Duties, Central Excise, Sales Tax and Service Tax.

State Governments have been vested with the power to levy: Sales Tax, Stamp Duty (a duty on transfer of property), State Excise (a duty on manufacture of alcohol), Land Revenue (a levy on land used for agricultural/non-agricultural purposes), Duty on Entertainment and Tax on Professions. The system of Sales Tax levied by State governments has been replaced with Value Added Tax (VAT) since 2005 when all States moved to the VAT system.

Local Bodies have been empowered to levy tax on properties (buildings, etc.), Octroi (a tax on entry of goods

Direct Taxes	Indirect Taxes
<ul style="list-style-type: none"><li>• <b>Corporation Tax:</b> This tax is levied on the incomes of registered companies/corporations in the country (whether national or multinational/foreign). National companies in India are taxed on the basis of their aggregate income, irrespective of its source and origin. Whereas foreign companies are taxed only on income that arises from operations carried out in India. <b>Taxes on Personal Income:</b> This is a tax on the income of individuals, firms, etc. other than Companies, under the Income Tax Act, 1961.</li><li>• Direct taxes also include other Taxes such as the ‘<b>Securities Transaction Tax</b>’, which is levied on transaction in listed securities undertaken on stock exchanges and in units of mutual funds.</li><li>• <b>Capital Gains Tax:</b> Profits generated from the sale of a <i>capital asset</i> (physical and financial), such as, any kind of property held by an assessee, paintings, jewellery and ornaments, business stocks, mutual funds, etc., are taxable as capital gains, either short-term or long-term. The capital gain or net profit which is taxable is basically the difference between the price at which the asset is sold and the price at which it was purchased. The tax is applicable in the year in which the sale of the capital asset takes place.</li><li>• <b>Wealth Tax:</b> This is a tax levied on the specified assets of certain persons including individuals and companies, under the Wealth Tax Act, 1957. Wealth tax is not levied on <i>productive assets</i>. Therefore, investments in shares, debentures, UTI mutual funds etc. are not subjected to wealth tax. Wealth tax was, however, abolished in 2015-16 and replaced by an additional surcharge to be paid by the super-rich.</li><li>• <b>Property Tax:</b> As per the Income Tax Act of India, incomes from properties are regarded as one of the heads of income. Therefore, tax is levied on the income from property. These usually include buildings, flats, shops and land etc.</li></ul>	<ul style="list-style-type: none"><li>• <b>Excise Duties:</b> It is a type of tax levied on those goods, which are manufactured in the country and are meant for domestic consumption.</li><li>• <b>Sales Tax:</b> It is generally charged at the point of purchase or exchange of certain taxable goods, charged as a percentage of the total value of the product.</li><li>• <b>Value Added Tax (VAT):</b> VAT, is a multistage tax, levied only on the ‘value added’ at each stage of a supply chain and not on the entire value of sales; in VAT, taxpayers receive credit for tax already paid on the inputs in earlier stages of the supply chain.</li><li>• <b>Service Tax:</b> It is a tax levied on services provided by an entity and the responsibility of payment of the tax lies on the service provider.</li><li>• <b>Customs Duties:</b> It is a type of tax levied on goods imported into the country as well as on goods exported from the country.</li></ul>

for use/consumption within areas of the Local Bodies), Tax on Markets and Tax/User Charges for utilities such as water supply, drainage, etc. In the last few years, Octroi has been abolished in a number of Local Bodies.

### Distribution of Revenue collected in the Central Tax System

For various reasons, imbalances arise between the taxation powers and expenditure responsibilities of the Centre and the States respectively.

In order to address this, a Finance Commission is set up once every five years to recommend sharing of financial resources between the Centre and the States, a significant part of which pertains to the sharing of revenue collected in the Central government tax system. At present, revenue collected from all Central taxes, barring those collected from Cesses, Surcharges and taxes of Union Territories, and an amount equivalent to the cost of collection of central taxes – is taken as the shareable / divisible pool of Central tax revenue. The 14<sup>th</sup> Finance Commission (beginning April 1, 2015), has recommended devolution of 42 per cent of the shareable / divisible pool of Central tax revenue to States every year and the Centre is to retain the remaining amount for the Union Budget.

### Tax-GDP Ratio and Progressivity of Taxes in India:

A country's tax-GDP ratio is an important indicator that helps to understand how much tax revenue is being collected by the government as compared to the overall size of the economy. A higher tax-GDP ratio gives more room in a government's budget so that it can spend more without borrowing. However, despite many years of high growth, India's tax-GDP ratio continues to remain low, so much so that it has the lowest tax-GDP ratio among the BRICS countries. There is therefore, an urgent need to raise this ratio.

Another aspect of India's structure is the lack of progressivity in it. Taxes that impose a proportionately greater burden (in relation to their consumption or income) on the lower income groups than on the upper income groups are described as being **regressive taxes**. Indirect taxes, therefore, are generally considered to be regressive since the rich and the poor are subject to the same tax rate for similar goods they consume. Direct taxes, on the other hand, are considered to be **progressive** since they are linked to the tax-payer's ability to pay and the average tax rate increases as the taxable income of the

### India's Tax- GDP Ratio (Centre and States combined) (in per cent)

Year	Total Tax-GDP Ratio	Direct Tax-GDP Ratio	Indirect Tax-GDP Ratio
2001-02	13.39	3.11	10.28
2002-03	14.08	3.45	10.63
2003-04	14.59	3.86	10.73
2004-05	15.25	4.23	11.02
2005-06	15.91	4.54	11.37
2006-07	17.15	5.39	11.77
2007-08	17.45	6.39	11.06
2008-09	16.26	5.83	10.43
2009-10	15.5	5.8	9.6
2010-11	16.3	5.8	10.50
2011-12	16.3	5.6	10.7
2012-13	16.9	5.6	11.3
2013-14(RE)	17.1	5.7	11.4
2014-15 (BE)	17.4	5.8	11.6

**Note:** RE – Revised Estimate, BE – Budget Estimate;

**Source:** Indian Public Finance Statistics 2014-15, Min. of Finance, Govt. of India.

tax payer increases. In India, more than 60 per cent of total tax collected (Centre and States) is accounted for by indirect taxes, implying that the tax structure is extremely regressive.

### Reforms in Taxes:

Over the years, a number of tax reforms, especially in the indirect tax system, have been initiated by the government to make India more tax-friendly as well as make the tax system less complicated. One major tax reform being pursued currently refers to the Goods and Services Tax (GST). Although, the sales tax was replaced by the VAT in all States by 2005, at present, a number of other indirect taxes are levied in addition to the VAT. This leads to the problem of cascading effect of taxes, whereby an item is taxed several times from the production to the final retail sales stage. That, in turn, has the effect of raising the tax component of products and results in higher tax-induced prices. Further, multiple taxes imposed by different States and the Central Government give enormous scope for tax evasion.

The GST is to put an end to the complex web of multifarious indirect taxes that exist at present and replace

them with one indirect tax: the GST. It is similar to a VAT and hence, is expected to reduce the problem of cascading effect of taxes. It is to be levied on most goods and services barring items such as petroleum, tobacco, alcohol, etc. The GST, though a single tax, would comprise two components: a central GST and a State GST. As per the Committee headed by A. Subramanian, the number of rates is likely to be limited to: i) a standard rate to be levied on majority of goods and services, ii) a lower rate on merit goods and essential items, and iii) a higher rate on non-merit goods like luxury goods. With the GST, the demarcation of taxation powers between the Centre and the States would get diluted considerably as both the Centre and States can impose indirect taxes on production as well as sale of goods and services.

It is hoped that introduction of GST would help to simplify and rationalise the tax system and increase compliance. At the same time, it is also important that the government take some steps to increase direct taxes that would help increase progressivity of India's tax structure. □

(E-mail: malini@cbgaindia.org)