General Studies – 3 ***Topic: Issues relating to intellectual property rights.***

Tax to GDP Ratio

1) Introduction

- The tax-to-GDP ratio is the ratio of tax collected compared to national gross domestic product (GDP).
- The tax-to-GDP ratio gives policymakers and analysts a metric that they can use to compare tax receipts from year to year.
- The number of taxpayers is a key indicator of fiscal capacity

2) Background

- Major reason for the poverty of the Indian State was the dependence on land revenue for a large portion of tax collections. These revenue were low as well as inflexible.
- Today tax base is no longer dominated by land.
- Yet, the problem of low tax collections persists.

3) Reasons for low tax to GDP

- "Generous" government policy
- Tax exemption raj that benefited the richer private sector.
- India has relatively large informal/unorganised sector, and tax evasion is more rampant in informal sector compare to organised sector.
- Low per capita income, high poverty, keeps tax collections low.
- Out of 25 crore households in India, 15 crore belong to agricultural sector which are exempted from taxes.
- A parallel economy of unaccounted incomes and expenditures exists which goes untaxed.
- India has one of the highest numbers of disputes between tax administration and taxpayers, with lowest proportion of recovery of tax arrears.
- India’s direct to indirect tax ratio is roughly 35:65. This is in contrast to most OECD economies where the ratio is the exact opposite, 67:33 in favour of direct taxes.

4) India's Tax system

- The 2016 Economic Survey said that India’s ratio of tax-to-GDP is 5.4 percentage points below that of comparable countries.
- The actual number of people who pay tax is lower because of those who report zero tax liabilities.
- India has one direct tax payer for every 16 voters.
- Only 1% of India’s population pays income tax.
- India's tax to GDP ratio is 16.6 per cent, which is much lower than the emerging market economy average of 21 per cent and OECD average of 34 per cent.

5) Measures to increase tax-to-GDP:

- Check on exemptions like transfer pricing, Base erosion and profit shifting (BEPS) etc
- Widening of the individual tax payers’ base as suggested by Economic survey.
- Implementing the recommendations of Tax Administration Reform Commission (TARC) to merge CBDT and CBEC.
- Use of PAN, simple laws among others to increase tax buoyancy.
- Attitudinal change in citizens by invoking sense of duty towards the nation.
- The benefits of Information and Communication Technology (ICT) systems have to be reaped.

- Need for effective dispute settlement mechanism
- Create a special task force to track economic activities that are predominantly settled in cash thus bringing the parallel economy under the tax net
- Monitoring jewellery stores to find people who bought gold without paying taxes

6) **<u>Implications</u>**

- The imbalance between the number of people who pay income tax on the one hand and the number of people who can vote on the other hand has profound implications for the Indian social contract.
- It creates political incentives for successive governments to borrow money to buy votes rather than build an effective tax system that will spur economic growth.
- Citizens are also less likely to put pressure on governments to spend wisely on public goods.
- The Indian State is incapable of spending for national security, a modern welfare system or public goods from its tax revenue.
- Because of low tax revenue government has to borrow heavily. The result is a persistent deficit bias in Indian fiscal policy.
- Successful nation states cannot be built on widespread tax evasion.
- Most of the tax burden falls on the precisely the high-productivity sectors that need to grow.
- Lack of adequate tax base create avenues for creation of black money and It hampers governance due to generation of black money and parallel economy
- Lower revenue collection reduces the Government capacity to incur expenditure for welfare schemes. For ex. Recent cut in the budget of ICDS, shutting down of Nutrition Bureau etc.
- It will increase government's dependence on Indirect tax which is regressive.
- Widen social inequality due to ineffective distribution of economic resources

7) **<u>Way Forward</u>**

- Political efforts to bring India's informal sector into the formal sector, levelling the playing field, and increasing total wealth
- Reduce tax rate as India has one of the highest tax rates in the world and thereby preventing tax evasion.
- Focus on widening tax base rather than deepening it
- Simplification of direct tax laws as suggested by Justice Easwar committee must be looked into.
- Introduction of GST coupled with robust IT infrastructure (ex. Project SAKSHAM, Project INSIGHT) will bring transparency and accountability in tax payment and collection.
- "In the long run, if India is to stay "on the line" as its per capita income grows, it will need to build fiscal capacity," the Survey said.
- Economic survey has suggested taxing farm sector.

8) **<u>Conclusion</u>**

- Nobel-winning economist Joseph Stiglitz summarizes that optimal tax system would be "progressive income taxes, complemented by indirect taxation, property taxes and capital taxes that enhance the progressivity that can be achieved by the tax system while limiting the level of distortion
- India must work towards achieving this ideal.