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Tax and spend (please)

Excessive taxation can dull incentives and hinder growth But so apparently does too little. Governments with meager tax revenues can't provide basic public goods. Worse yet, low tax revenues in poor countries often result from defects in the tax collection systems (rather than low tax rates) that also promote unproductive enterprise.

The case of India illustrates the importance of a well-designed tax system. For instance, in the city of Bangalore, Information Technology companies have built world class campuses replete with manicured lawns and high speed data communication networks. Outside the verdant campuses however lie open sewers and uncollected garbage. The roads are in a state of acute disrepair, or have never been properly constructed in the first place. So whereas technology companies instantaneously transmit terabytes of data to remote continents, the local transportation of goods and people seems to proceed at an almost medieval pace.

Businesses in Bangalore run captive bus services, contract with private suppliers for drinking water and install generators to insulate themselves from interruptions in electricity supply. Outside the city, where electricity is available only a few hours a day, businesses have to rely entirely on their own supply.

The state can't fix the shambles because it is broke. The Indian government's debt exceeds 70 per cent of GDP so more than half its tax receipts go to paying interest.

The debt isn't the consequence of excessive spending in the past however. The Indian government's expenditures amount to about 15% of GDP. Average government spending in the OECD is around 40% of GDP; the South Korean number – the lowest of any Asian OECD country – is about 24%. Rather, the Indian government's financial difficulties derive from the tax side. The tax to GDP ratio in India is in the single digits – about half that in Korea and the other Asian tigers.

Low tax collections reflect a badly designed and administered tax system. The rates and rules for personal and corporate income taxes appear reasonable by international standards. Nonetheless, the Indian government collects income taxes amounting to only about 3.7 percent of GDP, which is about half the Korean number.

Agriculture accounts for about a quarter of GDP; however, even wealthy farmers' don't have to pay taxes. Export oriented companies in the software and other industries enjoy tax holidays on their profits, although their employees do pay taxes on their personal incomes. And, in spite of the reasonable rates, tax evasion, especially by business owners is widespread.

In part, cheating occurs because the government hasn't invested in personnel or in the systems to detect tax evaders. And evaders who do get caught, don't face jail time and can often bribe their way out of trouble.

More subtly, the tax evasion of "direct" taxes on their incomes and profits reflects the mess in the system of "indirect" taxes levied on the production and consumption.

Excise taxes account for over 60 percent of the Indian government's indirect taxes, which in turn represent the same proportion of its total tax receipts. The basic excise tax has been fixed at 16% of the value of a firm's output. Then there are a variety of concessions, exemptions and surcharges. For instance a "concessional duty rate" of 8 per cent is levied on categories like food products, matches, cotton yarn and computers. An additional "special excise duty" (SED) of 8 percent is levied on products that include polyester filament, cars, air conditioners and tires. An "additional excise duty" ('AED', not to be confused with 'SED') is levied on "goods of special importance" like sugar, tobacco and textiles.

Some goods, like cement, and are taxed by weight or by volume rather than by their value.

Exemptions are numerous and complex: For instance, businesses with less than Rs. 10 million in total revenues don't have to pay excise axes. Nor do businesses located in certain troubled or backward areas. Overall, the exemptions fall under 70 broad categories, subdivided into 259 entries, 52 conditions and 7 lists, with each list containing numerous items.

The exemptions invite abuse. For a price, low ranking officials who have considerable discretion in applying the conditions, can be persuaded to reach favorable interpretations. Goods taxed at high rates (e.g. polished granite) are sold as goods taxed at lower rates (e.g. unpolished granite). A business with Rs. 20 million in sales will record sales of less than Rs. 10 million. Or it may operate multiple units where each unit has sales of less than Rs.10 million and, ostensibly, different owners.

The evasion of excise taxes is more contagious than the evasion of taxes on profits and incomes. If one firm evades excise taxes, (and the tax rate is high compared to pre-tax profit margins in the industry), its competitors also have to cheat, just in order to survive. In contrast, if a firm evades 'direct' corporate income taxes, survival does not require its competitors to do the same thing. And as evasion increases, governments levy 'additional" or "special" duties, which leads to further evasion.

Collections of direct taxes also suffers. The bribe paid to the excise tax collector for a favorable classification, the difference between the value of polished and unpolished granite, and the under-reporting of true revenues, creates "black" funds which cannot be declared on income-tax returns.

In addition to impairing the ability of the state to provide basic public goods, schemes to evade indirect taxes also discourage businesses from adopting more productive technologies. Low per capita incomes in India derive from the poor productivity of its workforce. And improving productivity requires technologies that involve large scale operation. But because indirect taxes are more easily avoided or evaded by operating many small units instead of one large unit, economies of scale cannot be realized. It's worth noting that in the software industry where *all* units are exempt from indirect taxes, Indian companies do operate at efficient scale.

Could India emulate the example of China, where the rationalization of indirect taxes in 1994 set the stage for a great boom? Or are coalition governments in a vigorous democracy incapable of such reform?

The problem certainly has deep historical roots.

Before the British arrived, rulers collected revenues through a combination of tax farming, tribute and pillage. This was also the case in many parts of Europe. But whereas Europe subsequently established tax systems suited for an advanced economy India did not.

British colonial governments in India had a stronger ideological aversion to income taxes than did democratic governments back home. And, the pitiful provision of public goods did not demand a broad tax base. Instead, the colonial government relied on customs duties on goods that landed at a few ports and excise duties on goods produced by a relatively small manufacturing sector. Rates were generally high and highly variable. For instance in 1931, the general tariff on imports was set at 31.25%, the rate on luxury items at 50% and on sugar, 190 %.

After Independence, elected governments sought more revenue to pay for expanded public services. Income taxes rates were raised to at near confiscatory levels, but loopholes and poor enforcement meant that the government continued to rely on an increasing hodgepodge of customs and excise duties. Through the 1980s, this proportion was about 80 per cent.

In the last decade however the tax system has been considerably improved. With more sensible rates, the share of direct income taxes has nearly doubled. Conversely, the removal of protectionist tariffs has reduced reliance on customs duties. Excise taxes have at least partially been reformed. Although the system is still rife with exemptions, the number of excise tax rates has been reduced from 100 to three; and, some of the distortions have been moderated through the introduction of "value added principles".

Remarkably, these reforms followed the end of one-party rule by the Congress party, in a period during which the country has been governed by a succession of coalitions. Apparently there has been a broad consensus for tax reforms. Even business owners who admit to evasion say they would welcome a system where they all had to pay their taxes.

Last year the BJP-led government introduced legislation, which was nearly unanimously approved by Parliament, mandating sharp reductions in the budget deficit. It then appointed a Task Force to formulate the necessary changes in tax and spending policies. This July, the Task Force proposed raising taxes (rather than cutting spending), through, among other things, removing most indirect tax exemptions. By then, the BJP-coalition had been replaced by a Congress-led coalition. The new government too seems to have favored the Task Force's proposals. If India's ruling and opposition parties follow through, they will go a long way to sustaining the country's economic growth and in dispelling the idea that democracies cannot do what's needed for development.