

Indian Tax System: Compliance by Design

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Abstract

Taxes matter. They are required to finance social goods which the markets fail to provide. Since taxes are compulsory payments, it is important to evolve the design and implementation features to ensure effective compliance with the tax to ensure both horizontal and vertical equity. Tax compliance is a multiplicative function of the rate of tax, probability of detection, and penalty rate. The best practice approach to tax policy and reform is to evolve the system with a broad base, and low and less differentiated rates. Such a simple system with reasonable rates minimises the three costs associated with taxes namely, the collection cost to the government, compliance cost to the taxpayer, and distortion cost to the economy. Avoiding multiple objectives makes the tax system simple and broad-based and requires low tax rates to collect a given amount of revenue. A strong technology platform for administering the tax increases the probability of detection and enhances voluntary compliance. The paper discusses the important aspects of tax compliance in terms of design and the importance of technology in the administration of taxes in India.

Keywords: Tax compliance, Tax administration, Tax rates

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1. Introduction

Taxes matter. They are required to ensure the security and safety of people, and to provide basic public services that the markets fail to provide (or provide adequately). The markets fail to provide public goods because they are ‘non-rival’ in consumption and ‘non-excludable’. Due to these characteristics, people will not reveal their true preferences and therefore, prices cannot be charged for them; in large communities, they cannot be financed from voluntary contributions either. These must necessarily be financed from compulsory payments.

There are other services that the markets can provide, but not adequately, as the social benefits in respect of them are larger than private benefits. These are so meritorious that everyone should have access to minimum standards of such services; therefore, the governments should either directly provide them or subsidize their provision.

The objective of any tax system is to mobilize resources needed to finance public and merit goods to create such generalized externalities. However, the levy of taxes entails disincentives, making it important that the taxes should be designed and implemented with minimum adverse effects. In other words, while the tax system erodes private incomes, it is necessary to design taxes to create the ecosystem required to carry on private businesses and thus, complement the markets.

2. Tax Compliance by Design

The best practice approach to tax design and reform attempts to maximize revenues while minimizing the three costs associated with it, namely: the cost of collection, the compliance cost, and the cost in terms of economic distortions.

- The cost of collection is the administrative cost of actually collecting taxes; the simpler the tax system, the lower this cost.
- Compliance cost is the cost of paying taxes, and this too is lower when the tax system is simple and transparent. The higher the compliance cost, the greater the incentive to avoid and evade the tax.
- Taxes alter the relative prices of commodities and services in the economy and cause unintended consequences on resource allocation. The distortions are high when the structure is complicated and the marginal tax rates are high.

Thus, the best practice approach to tax design and reform is to broaden the base, have low and less differentiated rates, and evolve a simple and transparent tax system.

It is important to design the structure and operational details of the tax system so that voluntary compliance with the tax is encouraged and the incentive to wilfully avoid and evade is minimized. Besides simplicity, transparency, and reasonableness of the tax rates and effective administrative and enforcement systems, voluntary tax is encouraged when there is a strong linkage between the payment of the tax and the benefits from public services.

When the benefits of public services and effective governance are visible, people do not grudge about paying taxes. That is the reason why at local levels, it is possible to link revenue and expenditure decisions, and people are more compliant with taxes. Of course, in the Indian context, there is hardly any decentralization, and this has resulted in the vicious cycle in which poor quality of public services and low levels of tax collections reinforce each other. In other words, when people see that paying taxes improves their access to public services, and that tax revenue is not wasted, voluntary compliance will be higher.

Tax compliance is a multiplicative function of the rate of tax, probability of detection, and penalty rate.

2.1 Tax Rates

Tax compliance is low when the tax rates are high because, at high rates, the reward to avoid and evade the tax is high. In fact, in 1973–74, there were 11 income tax rate brackets in personal income tax with the basic rates monotonically rising from 10% to 85% and with a surcharge of 15% added, the marginal tax rate on those individuals with income above Rs. 20 lakh was 97.5%. On top of that, there was a wealth tax, which caused the tax payments to be more than the income earned for high net-worth individuals, leaving no incentive to earn the income, and if they did, they had no motivation to pay the tax.

At this rate, evasion and avoidance became rampant, and less than one % of the population paid the tax; the revenue from individual income tax was just about 0.8 % of GDP. Under such a tax system, tax evasion was not even considered wrong or immoral! Considerable simplification of the tax structure was done in 1986-87 by reducing the number of brackets from 11 to 4 and reducing the marginal rate to 50%.

However, it was the Committee chaired by Raja Chelliah that made significant recommendations for the simplification and rationalization of the rates. These were implemented in 1992 by rationalizing the rate brackets, and reducing the marginal rate to 40%. Later, in the 1996-97 budget when Mr. Chidambaram was the Finance Minister, further simplification of the tax structure and rationalization of the tax rates was implemented by limiting the rate categories to three (besides exemptions), and reducing the highest marginal rate to 30%. This significantly increased tax compliance and revenue productivity. Subsequent years have seen cesses being levied on the high-income categories for financing special programmes on activities like education and healthcare.

From the viewpoint of revenue collections, as Arthur Laffer has shown, after an inflection point, increases in the tax rates can result in reduced revenue collections. At high rates of tax, the reward for evasion is high and tax compliance low, besides its adverse effects on the incentives to work, save, and invest. After the inflection point, cutting the tax rate would actually increase revenue collections. Not surprisingly, the revenue productivity of income taxes increased in India after 1996-97.

To collect a given amount of tax, levying the tax at low rates is possible only when the tax base is broader. Therefore, one way of lowering the rates is to expand the base. This requires minimizing exemptions and avoiding various types of incentives and concessions in the tax structure. Taking multiple objectives in designing the tax results in eroding the tax base, complicates the tax system, and opens avenues for evasion and avoidance of the tax. Complexity in the tax system increases compliance costs and creates unintended resource allocation distortions.

In India the assignment of taxes on agricultural incomes and wealth to the States, and non-agricultural taxes on income and wealth to the Union government in the Constitution has created a serious anomaly, and has opened up an easy avenue to misclassify and evade the tax, thereby denting compliance. It is not surprising that many high net-worth non-agricultural income earners also own big farms and farmhouses, which facilitates the misclassification of incomes.

In this connection, the recent reforms implemented by the government of India are noteworthy. In 2019-20, in the case of corporate income tax, for domestic companies, the government reduced the rate of tax to 22% if they forgo various exemptions and concessions. When the surcharge of 10% and cess of 4% is included, the aggregate tax rate works out to 25.17%, as against 34.2% with tax preferences. The minimum alternative tax (MAT) rate was also reduced to 15% (which works out to 17.16% with surcharge and cess). New companies are to be taxed at 15%.

In the case of personal income tax too, the option was given to forgo the tax preferences and pay the tax at lower rates. The tax exemptions on savings, insurance premiums, and the deductions allowed for home loans are not allowed if the new tax regime is opted. Altogether, the number of tax brackets in the new tax regime has been increased from 3 to 7, with multiple slabs covering levels of incomes up to Rs. 15 lakh.

While it is advisable to broaden the base and lower the rates, it is also important to reduce the number of tax brackets to keep the rate structure simple. When there are large differences in the rates between the brackets, there will be attempts to juggle incomes to pay the tax at lower rates. Besides, giving options to choose from two different structures – one with a narrow base and high rates and another with a broader base and lower rates – does not help in simplifying the tax system, and will not help in improving compliance.

The government will do well to redesign the system with fewer brackets and lower rates with no exemptions, in the case of both corporation and personal income tax. The draft direct taxes code in 2009 tried to attempt such a system; however, when the draft was put out for discussion to the stakeholders, everyone wanted the incentives and deductions to be phased out in sectors other than their own, and finally the reform did not go through. The new government which came to power in 2014 simply dropped the idea. The initiative to phase out exemptions and deductions and lower the rates by the present Finance Minister is a good idea, but the Minister will do well to drop the options in the next budget and limit the tax brackets to three.

The value-added tax (VAT) on goods and services or the Goods and Services Tax (GST) is an important example of improving compliance by designing the tax system with self-policing principles. The taxpayer is forced to declare his turnover to avail of the input tax credit and in the process voluntarily comply with the tax. Not surprisingly, in many countries, the VAT has turned out to be a “money machine”, and this has led to as many as 166 countries of 193 countries with UN membership opting to adopt one form of VAT or another. However, there are some important prerequisites for ensuring voluntary compliance and reaping potential revenue productivity.

2.2 Structure and Objective of Taxes

First, the structure of the tax should be simple. Having a large exemption list and multiplicity of rates makes the tax base narrow, and creates scope for tax evasion through the misclassification of goods and services in favour of lower-tax rate items. In fact, 81 % of the countries that have embraced VAT since 2000 have opted to adopt a single rate of tax. This not only removes the incentive to misclassify but also reduces complications. When GST is levied at multiple rates, if the tax rates on inputs are higher than that of the outputs, resulting in what is termed as the “inverted duty structure” thereby creating complications and payment of refunds. .

The objective of equity is served better by keeping the threshold high, so that the focus is on the ‘whales’ rather than the ‘minnows’ (Keen, 2013). In any case, the tax policy has proved to be ineffective in reducing income inequality (Rao, 2015/16). If the focus on equity is on reducing poverty rather than reducing inequalities, the policy has to shift to the expenditure side of the budget, rather than trying to create a differentiated tax structure with high marginal rates.

Reducing the incomes of the rich does not increase the incomes of the poor. The objective of equity is better served through the expenditure side of the budget by allocating resources towards programmes to empower the people and alleviate poverty. Second, it is important to keep the tax rates low. At low rates of tax, the incentive for evasion is less, and compliance is better.

In India, having multiple rates of GST, and levying the highest rate at 28%, creates an incentive to create a ‘grey market’ for such goods, by keeping the entire chain of transactions out of the tax purview. Besides, even if the item in question is bought predominantly by high-income earners, it can have significant forward linkage – a large downstream labour-intensive service industry. Therefore, it is necessary to estimate the total economic impact of high rates, using a general-equilibrium model, before designing the rates in a multiple-rate system.

In India, this is particularly true of taxes on motor cars and building materials such as cement, steel, and paints. which are taxed at 28%. India’s GST structure is very complicated, robbing its inherent advantages of self-policing and compliance. Besides four major rate categories, there are special rates on precious metals, and a cess levied on demerit goods to compensate the States for any loss of revenue suffered by them by making the transition to GST. The loss is computed by applying the growth rate of 14% on the base of the revenues from the state and local taxes subsumed in the GST in 2015-16. The GST does not include excise and sales taxes on petroleum products and electricity. The revenue from these items constitutes as much as 40% of consumption taxes in the country; to that extent, the problem of cascading continues.

An important pre-requisite for enhancing compliance with the tax is the adoption of a standard numbering system. The probability of detection improves with standard numbering and is traceable in an interlinked numbering system. In the Indian context, the linking of GST registration number with the income tax permanent account number (PAN) helps to match the payment of income tax with the GST turnover and helps in the better compliance of the tax. When the GST turnover is reported, it is possible to establish a relationship with the declared incomes to identify the

doubtful cases. As the probability of detecting increases, voluntary compliance with both taxes increase.

2.3 Robust Technology Platform

The most important factor in determining tax compliance is the application of a reliable and robust technology platform for tax administration. Clear evidence of this in India is found in the administration of both income tax and GST. In the case of the former, the report of the Comptroller and Auditor General (CAG) in 2002 revealed that a large proportion of those who are required to deduct the tax at source did not pay the tax and file the return. It led to the introduction of Tax Identification Number (TIN) to track the deduction and match it with the actual payment in the banks. The result was a huge improvement in compliance with both individual and corporate income taxes, resulting in an increase in the tax from about 3% of GDP in 2003-04 to 6% of GDP in 2007-08.

An equally important instance of the importance of the application of technology in tax administration is seen in the implementation of GST. It is critical to scrutinize and settle the input tax credit claimed by the exporters expeditiously and correctly. Furthermore, as GST is a destination-based tax, technology is critical to track and ascertain the final destination of the goods and services when the tax is levied on inter-state transactions, to then allocate revenue to the relevant state(s) through a clearing house mechanism. Therefore, firming up the technology platform is critical to compliance with GST.

In India, although the GST came into existence on July 1, 2017, the inability to settle the technology platform resulted in poor compliance with the tax in the first four years. Although the GST was designed to be revenue-neutral, it was expected to generate a significant increase in revenue productivity over the medium and long term, through improved compliance with the tax. However, the experience in the first four years was not encouraging. The revenue productivity of the tax suffered greatly, resulting in a significant deceleration in the growth of revenue from GST.

The compliance audit on the technology platform done by the CAG in 2019 pointed out some important shortcomings. It observed the postponement of the originally envisaged GST returns (GSTR- 1,2,3) due to technical glitches, and the inability to undertake the originally envisaged universal verification of invoices to match input tax credit (ITC) from the simplified returns (GSTR -3B) as principal reasons for evasion of the tax. The CAG's report concluded, "...*On the whole, the envisaged GST tax compliance system is non-functional*" (p. 22).

Further, the settlement of IGST to the States also could not be done properly. The system failed to generate the required modules such as appeals and refunds from the returns. The failure of the technology platform to verify invoices for ITC has led to false claims and refunds using fake invoices. Similarly, the inability to validate the registrations has led to the creation of several shell companies to issue fake invoices, which eventually disappear, leading to poor compliance with the tax.

The fact that the annual return filing date was repeatedly postponed for almost two and a half years, due to technical glitches, did not permit the detection of wrong ITC claims. In the absence of

a clear paper trail, the assessment was based entirely on trust, and with the low probability of detection of evasion, it provided opportunities for unscrupulous businessmen to evade the tax. In fact, the annual return filing for 2018-19 was repeatedly postponed till December 2020. Similarly, the inability to validate and debar the ineligible taxpayers from availing composition levies led to the misuse of the option.

Based on the information made available from the All India Enforcement Drive by the CBIC through the Directorate of Revenue Intelligence and other CBIC formations from November 2020, it was reported that more than 5700 cases involving an amount of Rs. 40000 Crore were detected in the fiscal year 2021.¹ Indian GST with a complex structure with the simultaneous levy of Central and State level destination-based tax, wide-ranging exemptions, and multiple rates requires a robust technology platform, and the failure to erect that had adverse effects on the compliance of the tax. With the stabilization of the technology platform, we have seen significant improvement in compliance and revenue productivity.

3. Conclusion

Tax compliance matters. Compliance by design is possible only when the tax structure is kept simple and reasonable. It is equally important to ensure ease of paying the tax, effective administration, use of technology in administration and enforcement, and friendly and effective taxpayer service. The objective of tax policy is to raise revenues, and designing the tax to pursue too many objectives does not help them to achieve them, while defeating the main objective of raising revenue.

GST has self-enforcing features and, if properly designed, it could turn out to be a “money Machine”. However, a strong and effective technology platform is an important prerequisite for the success of GST, particularly in countries levying subnational GST. The role of tax reform should be to design the tax system to promote voluntary compliance.

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Notes

¹ See: GST evasion of ₹40,000 crore detected from fake invoicing, fraud claims

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