

Efficient, Equitable and Enforceable: three “Es” for reforming India’s tax system and better finance public services

By Isabelle Joumard, Head of the India desk, OECD Economics Department

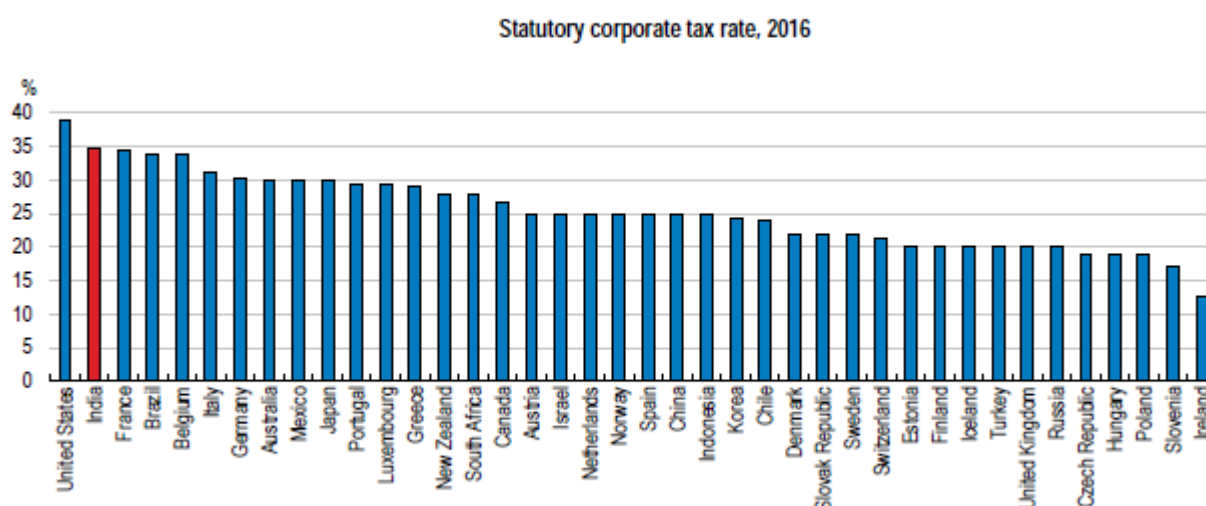
Promoting inclusive growth in India requires improving social and physical infrastructure. Public spending needs are large: only 40% of the population had access to sanitation facilities in 2015; public spending on health is just above 1% of GDP, compared to 7% on average in OECD countries and 3% in the other key emerging economies; only a small fraction of the population contributes to a retirement scheme. More than 20% of the population (almost 270 million persons) lived with less than USD 1.9 a day in 2011.

India needs to raise more tax revenue to finance access to better quality public services for all while putting the relatively high public debt-to-GDP ratio onto a declining path. Implementing the landmark Goods and Services Tax (GST) – a national value added tax – will promote the competitiveness and productivity of Indian companies. While the GST has been designed to be revenue-neutral, at least in the short- and medium-run, it should be complemented by a comprehensive reform of income and property taxes to raise additional revenue and make the overall tax system more efficient, equitable and enforceable.

Efficiency of taxes could be increased through lower rates and a broader base. Although the statutory tax rate on companies

is high (Figure 1), various special rates, exemptions, deductions, rebates, deferrals and credits result in much lower effective tax rates and create a bias against labour-intensive activities. The government's plan to reduce the corporate income tax rate from 30% to 25% while removing most exemptions is most welcome. That said, different tax regimes for small enterprises and social security contribution requirements – only companies with more than 20 permanent employees have to pay- continue to generate disincentives for firms to grow and create quality jobs.

Figure 1. The corporate income tax rate is high



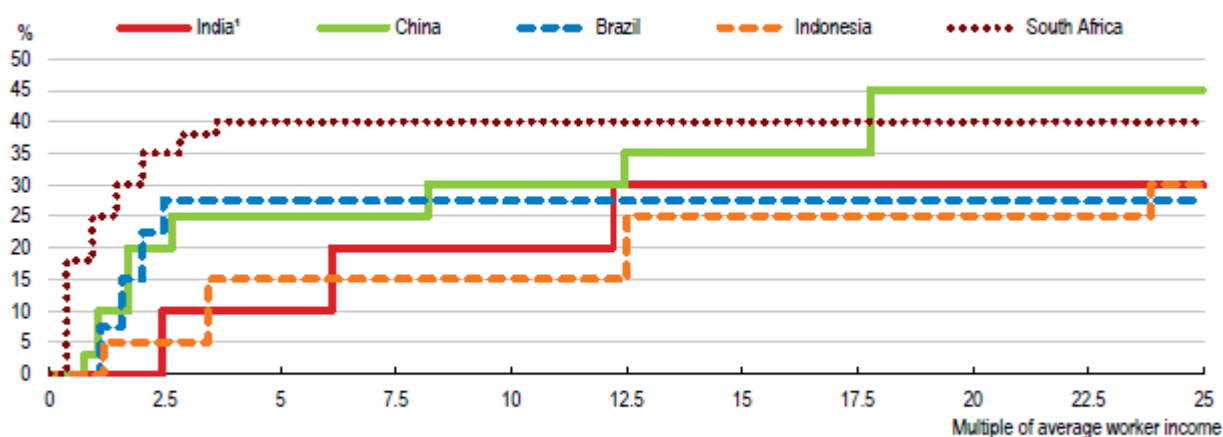
Source: OECD Tax database; and Deloitte.

Equity is an issue. Less than 6% of the population pay the personal income tax, which is a very low share by international standards. An individual does not pay any income tax until income is around $2\frac{1}{2}$ times the average wage in the organised/formal sector, a much high level than most other emerging economies and OECD countries (Figure 2). Personal income tax is also reduced by generous tax concessions (e.g. mortgage payments) which benefit the rich more. There is no tax on agricultural income of large-scale farmers. Estimates presented in the *2017 OECD Economic Survey of India* suggest that bringing the personal income tax schedule in line with other emerging economies and scrapping tax concessions would

increase personal income tax revenue by about 50%. Property taxes could also raise more revenue. Inheritance taxes are virtually absent, despite the extreme concentration of wealth in the hands of a few, while revenue from real estate taxes stands at about 0.2% of GDP which is well below the level in OECD and other BRIICS countries.

Figure 2. The personal income tax embodies little progressivity

Statutory marginal personal income tax rates by income, FY 2014-15



1. The average worker income is for the organised/formal manufacturing sector as reported in the Annual Survey of Industries.

Source: Annual Survey of Industries; OECD Taxing Wages 2015; and Ministry of Finance of India.

Enforceability could be improved to enhance public perceptions of the tax system fairness. The government has taken several measures to reduce tax evasion, such as penalties for not filing returns or filing with inadequate asset and income disclosure. India has also taken steps to prevent base erosion and profit shifting. In particular, the treaty with Mauritius – more than 20% of FDI position – was renegotiated in 2016, giving India a right to tax capital gains channelled through Mauritius from April 2017. However, proliferation of tax concessions and lack of clarity of tax regulations raise compliance and collection costs. Ensuring clarity and certainty in tax legislation and employing more skilled tax officers would strengthen the tax administration and make the system fairer and more effective.

References:

OECD (2017), OECD Economic Surveys: India 2017, OECD Publishing, Paris.