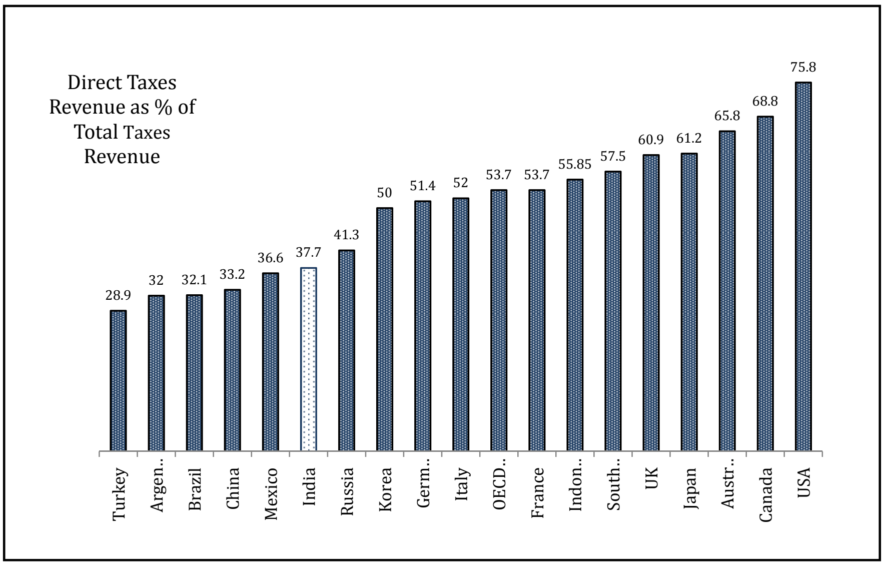
MAJOR DIMENSIONS OF INEQUALITIES IN INDIA: TAXATION

In the last few decades, across the globe, not only has inequality in income persisted, it has also been growing over time. The spending gap between the rich and poor in India has almost doubled in the last five years. Redistribution of income and wealth has suffered due to the kind of policies that exist in the country. Taxation policy, which is an important tool to address this problem, has not been used effectively in India.

Income and tax policy:

Progressive taxation is one of the least distortionary policy tools available that controls the rise in inequality by redistributing the gains from growth (Qian, 2009). Although a progressive individual income tax system has been in place in India since 1922, the country still has one of the lowest tax-GDP ratios (about 17% in 2012-13) among the G20 and BRICS countries, with the exception of only Mexico (14.5%) and Indonesia (10.89%).

Figure 1: Tax Structure across G20 Countries



Note: All country values are for year 2010, except Argentina (2009), OECD Avg. (2009), China (2009), Mexico (2009) and India (2009-10). Figures are for General Government except Indonesia. Indonesia figure is for Budgetary Central Government.
Source: Prashant Prakash (2013), "Property Taxes across G20 Countries: Can India get it right?", CBGA and Oxfam India

The progressivity of the tax structure as measured by direct tax revenue as percent of total tax revenue shows one of the narrowest direct tax base (37.7%) for India; though it is higher than that for a few countries like, Argentina (32%), Brazil (32.1%), China (33.2%) and Mexico (36.6%).

One of the reasons for this has been a very slow growth of the income tax base in India over time, as the number of income tax payers, which was less than 1 percent of the population in 1986 has increased to just about 3 percent by 2008.

Wealth and tax policy

Thomas Picketty in his recently published book *'Capital in the Twenty-First Century'* (2014)1, claimed that even in the 21st century, not earnings, but income from capital, predominates at the top of the income distribution. He argued that due to minimal taxation on wealth, wealthy individuals could easily reinvest enough of their income to ensure that their wealth and hence their incomes were growing faster than the economy, and hence reinforcing their economic dominance. When these wealthy individuals died, they passed their wealth on—again, with minimal taxation—to their heirs. Money passed on to the next generation accounted for 20 to 25 percent of annual income; the great bulk of wealth, around 90 percent, was inherited rather than saved out of earned income. This inherited wealth is concentrated in the hands of a very small minority. The book stated that the "Wealth is so concentrated that a large segment of society is virtually unaware of its existence, so that some people imagine that it belongs to surreal or mysterious entities". He emphasized in particular, for wealth taxes, global if possible, to restrain the growing power of inherited wealth. Progressive taxation—in particular taxation of wealth and inheritance—can be a powerful force limiting inequality.

Though, wealth tax is an important source of direct tax revenue, especially in tax structures of most of the other G20 and BRICS countries, but, it is clearly a neglected source of revenue collection in India. The proportion of wealth tax in total tax revenue is one of the lowest in India (0.42% only). A conservative estimate by Centre for Budget and Governance Accountability (CBGA) has shown that the revenue potential of Inheritance Tax and Wealth Tax in India is around 0.8 per cent of GDP (for 2011-12).

Paradoxically, between 2000 and 2013, India's private wealth has reportedly zoomed up by 300 percent - from USD 1.2 trillion to 3.6 trillion, while, the bottom 70 percent of India's households own only about 20 percent of the country's private wealth. (State of World Wealth Report, Credit Suisse, a Switzerland based global bank, 2013). There were 2 billionaires in India in the mid 1990's, and by 2012, this number has increased to 46 (Forbes, 2012). Wealth of these 46 billionaires constitutes 10 percent of India's GDP in 2012. The wealth of India's billionaires are coming from three major sources- inheritance, self-made and 'inherited and growing' (terms coined in Forbes list) for billionaires who inherited their wealth and subsequently experienced substantial growth in wealth. A study by Gandhi & Walton (2012) shows, that while the largest number of Indian billionaires (21) is 'self-made', about 40% of total billionaire wealth is in the 'inherited and growing' category. All of the India's billionaires are associated with corporate activity. About 43% of the total number of billionaires, accounting for 60% of billionaire wealth, had their primary source of wealth mainly from real estate, construction, infrastructure or ports sector, media, cement and mining sector. The rest 57%, accounting for 40% of billionaire wealth, had their primary source of wealth mainly from software industry, pharmaceuticals and biotech, banking, liquor and manufacturing sector(Gandhi & Walton, 2012). This information points out that notable wealth creation occurred in sectors with substantial potential for rent extraction and rent sharing between private and government players. Moreover, income inequality is underestimated due to the hidden wealth, which is enjoyed mostly by the richest segment of the population. In his 2013-14 budget speech, the Union Finance Minister Mr. P. Chidambaram had quoted that

[1] The findings of this book are taken from the review of the book by Paul Krugman in 'The New York Book Review', May, 2014 issue.

out of the 3.7 crore income tax assesses in India, there were only 42,800 people with incomes of more than Rs. one crore a year; many people would doubt this figure as a gross underestimation. In addition, official estimates of income also fail to capture the assets held by some people in offshore 'tax havens', i.e. the jurisdictions with zero or low tax rates that also offer a high degree of secrecy in financial matters (e.g. Mauritius, Cyprus, Cayman Islands etc.).

Tax Dodging: a serious concern

Tax evasion (illegal practice of non-payment of tax liabilities) and tax avoidance (deliberate acts of reducing one's taxes by legal means) are the two major ways of escaping taxes. The popular ways of tax dodging are:

a) Money laundering - an attempt to conceal the identity of illegally obtained proceeds;

b) Hawala -an informal process of funneling money from one location to another through a network of hawala brokers;

c) Tax havens;

d) Transfer pricing - the transaction price of goods and services between related companies, not illegal in nature, however, severe manipulation in transfer price takes place in order to shift profits from high tax countries to low tax countries; and

e) Trade mispricing - it occurs when import / export of a particular goods or services invoiced at a higher / lower rate of market price.

In addition to tax dodging, a huge amount of tax revenue is forgone in India due to tax exemptions / tax concessions. As per the Statement of Revenue Forgone under the Central Tax System, in 2012-13, the total magnitude of tax exemption was about 5.7% of GDP. There is a need for a through scrutiny of all kinds of exemptions / concessions in the Central Tax System in India so as to eliminate all such exemptions that are not justifiable anymore. Even if the government could raise additional revenue worth 3 % of GDP by such thorough revision of exemptions, it would enable the country to pursue a far more substantive fiscal policy to address inequalities.

Apart from India's direct tax revenue, which is around 6% of GDP, the revenue it earns from indirect taxes is about 11 % of GDP. However, indirect taxes could be regressive in nature. The incidence of tax burden is more on poorer sections than richer households, as indirect tax tends to fall more on the consumption of goods and services that make up a larger share of the expenditures by poorer sections of the population. Thus, indirect taxes can widen the income gap and aggravate inequality in the society.

Therefore, a relatively regressive tax structure (as compared to other G20 countries), problem of tax evasion and severe administrative bottlenecks in collecting taxes on personal income and wealth are among the major constraints in resource mobilization and improving distributional effects of taxation in India.

A much needed tax reform

Global forums like G20 and BRICS have placed issues like financial transparency and international tax cooperation on the top of their agendas. For instance, the G20 Summit in Los Cabos (2012) identified the issue of tax avoidance by Multi-National Corporations (MNCs) by exploiting loopholes in the international tax system as a serious concern and therefore, explicitly referred to "the need to prevent base erosion and profit shifting" in their final declaration and called on the OECD to develop an action plan to address these issues. The communique issued after the meeting of G20 finance ministers (in 2014) stated that by the Brisbane Summit in September, 2014, all G20 members will start taking effective, practical and sustainable measures to counter 'base erosion and profit shifting' by MNCs across all industries. The G20 countries have also agreed to start automatic sharing of tax information by the end of 2015.

Like G20, BRICS forum also working on areas of tax policy issues[2] like international taxation, transfer pricing, prevention of Cross-border tax evasion and avoidance, exchange of information, sharing of best practices in tax system administration and resolution of disputes and the BRICS countries promised to extend the cooperation on the issues of tax policy and tax administration[3] (PIB Release, 2013). Thus, in the domain of taxation and its potential towards tackling inequality, the G20 and BRICS have initiated a few concrete measures, though a lot more needs to be done.

Therefore, to address inequality in the country, it is imperative to put tax reforms at the top of the policy agenda. A fairer tax policy would work to narrow the gap between rich and poor and also have a direct impact on fiscal space to expand the scope of social services that the government can provide.

[2] Before, the fifth BRICS summit, the Heads of the Revenue of BRICS countries met in New Delhi on 17th and 18th January, 2013 and discussed on seven areas of tax policy issues.
[3] http://pib.nic.in/newsite/PrintRelease.aspx?relid=91684

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