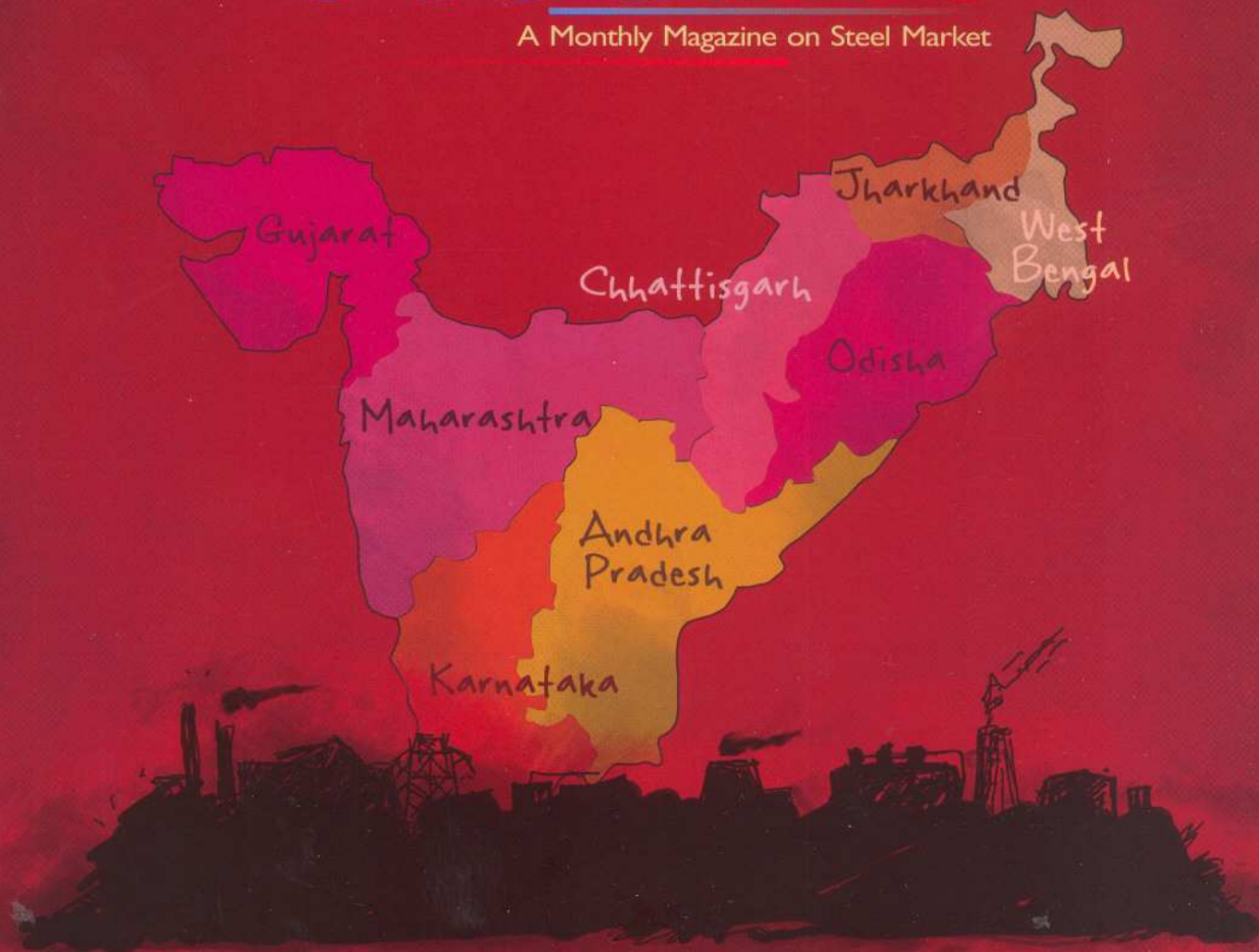


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DYNAMICS OF THE INDIAN DRI INDUSTRY

Exclusive Steel 360 Report



India needs Innovative Tax Reforms



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Conversion of personal income tax into expenditure tax and then merging it with indirect taxes will improve compliance and boost savings for promoting investment vis-à-vis growth besides reducing black money. This will be the right blend of Development & Populist Politics.

Taxation is an important source of public finance. Taxation rates should be judicious so that it does not put stress on taxpayers. Its laws should be simple & compliant. Tax collection system should not lead to harassment. Multiple taxes should be merged that will reduce administrative and collection cost. A simple & judicious tax system shall improve compliances and increase number of taxpayers.

Proposed GST (Goods & Service Tax) is a good initiative in this direction. More taxes should be merged into GST, which are excluded in the present proposal. But, personal income tax in its current format needs a complete review; since its compliance is very low. Recently, 'Banking Transaction Tax' was discussed in media, but this will reduce transaction through bank which is counter-productive. India certainly needs innovative tax

reforms that can widen tax base, increase number of taxpayers and provide higher compliance that will collectively contribute to the growth & development of the nation.

Only about 3% of Indians file personal income tax returns as compared to 45% or more in USA. Most of the taxpayers do not disclose their true & fair income. About 49,000 individuals disclose an annual income of above INR 10 million. This means, there is

gross violation of the income tax law. If the majority does not abide to any particular law, it must be amended instead of declaring everybody as law violator. It will at least prevent demoralization & disobedience of law. Respect for the law must prevail.

Currently, personal income tax rate is reasonably fine. Even if rates & slabs are modified favourably, I don't believe that tax compliance ratio will improve. There is reluctance from taxpayers since money goes out from their savings. The associated compliance costs and harassment by taxmen are equally responsible for such low rate of filing. On top of it, taxpayers feel that tax payments are not used in the public interest. Lack of visible infrastructure and persistent inflation are the principal causes for such an adverse opinion about the government.

In the process, sizeable savings are converted into black money and it is not routed to banks and capital market, rather deployed in gold and real estate. This cuts financial savings and slows investments. On the other side, gold investment builds pressure on the trade balance of the country. Associated ills of such black money are well known to all.

This situation demands an innovative reform in the income tax law with an open mind. This subject has been dealt with in the book 'Turn Around India'. It prescribes to convert personal income tax into an expenditure tax and then to merge the outcome with indirect tax. In general, compliances of indirect tax are far better. Higher income groups will spend more, so they would pay more tax which will satisfy the legislature's intention. The middle and the salaried class will be most happy with such changes. As per the prevailing trend, nobody likes to pay

income tax out of their savings but does not mind paying little more tax while consuming goods.

We need domestic savings of more than 38% of GDP on a consistent basis for financing investments and achieving 9% growth. China has been saving 48-53% of GDP since 2005 and has been maintaining double-digit growth. Our savings rate declined from a peak level of 36.9% in FY08 to about 30% in FY13. It is likely to slide down further with stagnant personal income. Corporate savings are dwindling due to sluggish demand clubbed with high input cost. Government savings are declining owing to expansion in subsidy. The inflow of foreign savings is also not encouraging and mostly utilized for funding trade deficit. Therefore, it requires a multi-directional approach on all fronts. However, let us focus on few quick reforms for increasing household savings, which constitutes about 70% of entire country's savings. Hike in interest rates does not increase domestic savings as per expectation. Therefore, we must bring innovative tax reforms to boost savings & growth.

In the event of converting income tax to expenditure tax, total savings will register an unprecedented jump. Most of the savings will be routed through banks and the capital market. Therefore, interest rate will come down by 200-250 basis points, giving fresh impetus to investment & growth. The biggest beneficiary will be the government itself, since it is the largest borrower. Their interest outgo will reduce by about INR 0.8-1 billion per annum. Most important benefit amongst all is reduced black money and rise in public morale. It will certainly moderate gold investments and ease pressure on trade balance.

Total revenue from personal income tax was about INR 1.9 trillion amounting to about 1.9% of GDP and 17.5% of central taxes in FY13. Loss of revenue can be partly compensated by increasing GST (proposed) by about 2.5%, which will be easily accepted by the public. For the time being, excise, service tax & custom duty can be raised until GST is implemented. Gap of revenue if any, can be compensated by increasing non-tax revenue in the form of annual fee on the owners of a car, air conditioner and luxurious apartments among other things, mostly owned by the upper middle and rich class. However, there are even chances of an upsurge in revenue due to the resultant growth of economy and saving on interest outgo.

If there is some minor loss of revenue in the initial years, it is to be viewed under a broader perspective. Such path breaking and innovative reforms shall certainly boost financial savings, increase investable resources and boost the economy. This will also generate lot of goodwill for the government amongst the middle class; those are frustrated with stagnant income and inflation. It shall also pave a path for new generation corporate tax reforms as discussed in the book 'Turn Around India'. Such bold reforms will speak about commitment of the government for growth and improvement of investor sentiment. It will be the right blend of Development & Populist Politics. This could indeed be a trendsetter for other countries as well. ■

The above column is a personal view point of the author. Steel 360 does not necessarily endorse the above expressions & thoughts.