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SOURCING INSIGHTS

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Tax Reforms Needed For Sustained Growth

R.P. Gupta

In the recent budget, the Finance Minister announced that the country will once again return to the 9-10 percent growth trajectory. No doubt, our country demonstrated growth rate of 9 percent on consistent basis from 2003 to 2008. It is also true that our country has the potential to exceed a 10 percent growth. But I have all apprehensions about achieving such ambitious growth in future years, unless some innovative steps and bold reforms are taken. The apprehensions are stronger about sustained growth on a year-to-year basis.

During 2003-08, high growth could be achieved due to low base and a favourable global scenario. There was a dip in growth rate during 2008-09 due to global crisis. But the recovery process started in the current year riding on fiscal stimulus and timely action by the government. The global economy will need more time to recover. On the other hand, fiscal stimulus has to be withdrawn in a phased manner for fiscal prudence.

Hence in general, the situation is not favourable like it was during 2003-08. But faster recovery has definitely improved investor's confidence in the country and globally. This has been partly reflected in the capital market after the Budget.

Considering the confidence level in Indian economy by the investors, I do not foresee any problem in achieving a 7 to 7.5 percent growth in the next five years. But if we are really serious about achieving double digit growth, and that too on a consistent basis for the next decade; we have to take innovative and bold steps. Let us not forget that the base is increasing on a year to year basis. Hence, sustainable double digit growth for the next 10 years requires something different.

Investments should exceed 40 percent of GDP

Investment in the productive and infrastructure sector is the only mantra for higher growth rate. During 2003, the investments were 25 percent of GDP which went up to 38 percent of GDP by 2008 and hence, we could achieve a 9 percent growth rate. This dropped to 35 percent of the GDP in 2009. Though 2010 figures are not available, it may come down further. We have to maintain investment/GDP ratio in the range of 40 to 45 percent for sustainable double digit growth on continuous basis.

Though growth comes from investment in productive sector, unless we invest in infrastructure also, the productive sector will not be able to perform. There will either be production cuts due to energy supply constraints, or there will be logistic constraints due to inadequate transport network. Hence, simultaneous investment in both the sectors is essential for sustainable growth. If the capacity is augmented and utilisation is not done by the productive sector, it will cause more harm than good.

Savings needs boost to support investment

Obviously, the investments in the productive and infrastructure sector need capital resources. Such capital resources will come either through domestic saving or through foreign saving i.e. forex inflow. At present our domestic savings are not enough to provide sufficient capital to the productive and infrastructure sector. It increased from 26 percent to 36 percent of GDP during 2003 to 2008,.but dropped to 32 percent in the year 2009 and will perhaps dip even lower in 2010.

The Indian economy depends highly on forex inflow, which will first bridge the gap of trade deficit which is about 10 percent of GDP. Then only surplus is utilised for investment or consumption, as the case may be. In the present global scenario, we should not presume that forex inflow will continue and will take care of our needs. We have to increase our own strength in terms of increased domestic savings. If we are strong enough, forex inflow will also support and not the other way round.

Savings does not reduce demand

There is a misconception that higher savings means low consumption leading to demand reduction and affecting GDP. Savings are ultimately channelised through intermediaries like banks and capital markets largely for capital investment. The capital investment itself will create demand besides augmentation of new capacity. In fact, developing economies like India need "investment led spending" and not "consumption led spending" for faster growth. On the other hand, the developed economy needs demand push through higher consumption. The scope of investment in these countries has reduced due to saturation.

If this concept is well recognised, then quality of expenditure in the government budget will also change. Though government spending is increasing on year to year basis in every Budget, the ratio of revenue to capital expenditure is going up with no sizeable increase in capital expenditure. This needs to be reviewed in next year's Budget. Of course, government spending is nearly 20 percent of GDP. But it is to be well directed to promote growth and bring about a long-term solution for the welfare of the public and not limited to short term sops. Last fiscal stimulus and government spending was to promote consumption, which provides short term support only.

Promote savings through tax reforms

If savings are to be boosted by 5 percent of GDP in a single year in a single stroke, the only answer is to eliminate personal

Income tax and rationalise corporate tax. Of course the idea may sound absurd as most countries impose income tax and the government cannot afford to lose Rs 1.2 lakh crore per annum in today's fiscal tightness situation. It appears to give relief to the rich, which cannot be accepted.

However, I am suggesting suitable solution to answer all above apprehensions. Basically, the concept of income tax is to tax the rich and then spend the tax revenue for general public welfare. I do not propose to change this concept in the larger public interest. However, I suggest we replace income tax by expenditure tax which was discussed a few years ago also. Obviously, a rich person will spend more and hence, he has to pay higher expenditure tax on his spending. If he opts for higher saving, then such savings are channelised through banks and other intermediaries for onward investment in the productive and infrastructure sector, which ultimately contributes to the growth of the country and public at large. In other words, he spends and enjoys and pays expenditure tax or else lets him save and contribute to the national economy.

As it is, the compliance of personal income tax in our country is very low. Tax payers are just perhaps 5 to 7 percent of the population.and true and fair income is not disclosed by all. This only creates dishonesty which is not good for the country. This increases the scope of black money generation, which either finds a way to other countries, or is invested in gold. If any law is violated by the majority, it is better to amend the law. However, it is important to abide by the law and respect it.

Merge income tax with proposed GST

The government has already decided to introduce GST merging several taxes (state & central). The proposed GST is consumption based, unlike excise duty and service tax which are production based. Hence, for all practical purposes, GST is an expenditure tax. Keeping this model in view, if additional central GST is imposed in lieu of personal income tax, then the desired purpose of income tax shall be served. The only care to be taken is that additional GST may not be leviable on all products like GST. The basic items like food, cheaper cloth and few more such items may be exempted. All such goods which are consumed by the middle and upper class may be levied with additional central GST. Luxury items and services may have higher rates.

In the Budget 2010-11, the projected personal income tax is Rs 1.2 lakh crore, which amounts to 16 percent of total central tax revenue. On revenue neutral base, this will translate anywhere between 3 to 3.5 percent in shape of GST, which can be easily absorbed by the economy. This will improve the compliance and simplify the tax regime. Even the collection cost will come down drastically. I am sure if we adopt this innovative model, India will be a trendsetter and other countries will follow sooner or later.

Interest rate will come down

It has been historically observed that with minor income tax relief in savings, savings are boosted. If income tax is totally eliminated, the banks and capital markets shall be flush with funds. India is the largest importer of gold. A sizeable portion of domestic saving is being channelised into gold deposits, and that too bypassing the income tax. Such money will be routed to the productive sector through bank deposits, contributing to the economy.

With increased savings and bank deposits, the interest rate is bound to come down by a minimum of 200 basis points. The largest beneficiary will be the government itself. The present borrowing of the government is about Rs 45 to 50 lakh crore. With drop in interest rate, the interest payment shall reduce by Rs 0.8 to 1 lakh crore every year.

The interest saving itself could be 75 percent of personal income tax for the government.,Saving in interest payment will reduce revenue and fiscal deficit by about 1.25 percent of GDP. Low interest rate will also facilitate viability of infrastructure and capital intensive projects, which our country needs the most.

It is a well known fact that the salaried person bothers too much for the personal income tax as it is being deducted at source itself by the employer.

If indirect tax is levied in lieu of personal income tax, he manages his expenditure and does not make any big hue and cry. But personal income tax payment always worries him, as it goes away from his savings. They will be the happiest people if personal income tax is merged with GST in shape of expenditure tax as proposed.

Other benefits

At present India is being watched by all developed countries. Such bold and innovative tax reforms will strengthen our image globally. It will result in more FDI, NRI remittances, strengthening our forex reserves as well as resource to fund infrastructure and productive sector.

The flight of money to other countries will be stopped or rather will be reversed, which will have a cumulative benefit on the economy. The capital market will also get a boost. This will facilitate a massive disinvestment programme by the government as well as availability of fresh capital to the productive sector. The cost competitiveness will improve due to lower interest regime promoting exports. Housing demand will increase with low interest rate giving boost to the economy.

Likewise, cumulative benefits will be available, but the biggest benefit will be the morale boosting of the Indian public and compliance of tax laws. I feel tax laws should be designed in such a way that it does not pinch the tax payer. This will result in higher compliance. Indirect tax is any day better than direct taxes, as it is in-built in the cost of goods and services, and the.consumer has an option depending upon his purchasing power.

Corporate tax to be rationalised

There has been a good growth in corporate tax and.hence corporate tax should continue. But at the same time, there has to be focus on increasing the compliance through reforms and not through punitive action.

Finance Ministry report on corporate tax (2007-08)

Profit before Tax	No. of Companies	Share of Corporate Tax (in percentage)	Effective tax rate (appx) (in percent)
Up to Rs 1 cr	387484	5.63	24
Rs 1 crore to Rs 10 cr	18117	7.81	22.5
Rs 10 cr to Rs 50 cr	3433	9.36	21
Rs 50 cr to Rs100 cr	611	5.4	20
Above Rs 100 crore	806	71.4	21.8
Total	410451	100	22.24

It is clear from the chart that 5000 companies contribute 86 percent of corporate tax, and balance 14 percent tax comes from 4 lakh companies. Hence, obviously the compliance ratio is very poor. The corporate tax needs to be re-designed for better compliance and to promote law abiding behaviour, of course without losing revenue. I therefore, suggest rationalisation of corporate tax by giving relief to SME corporates in particular for better compliance.

Proposed slab tax rate & MAT for corporates

Income Range	Tax Rate (in %)	MAT (in %)
0-1.0 crore	10	7.5
1.0-10.0 crore	15	10
10.0-100.0 crore	20	12.5
100.0 crore & above	25	15

All the surcharges should be merged with base rate. With the proposed rationalisation, the compliance will definitely improve. It will also give a huge boost to corporate savings which can be effectively utilised in the productive sector. It will attract FDI as well. I am sure that revenue will increase by such rationalisation and not otherwise. Unless corporate savings are maximised, fresh capacity additions for higher GDP becomes difficult. Banks extend credit, but matching equity funds are to be brought in by corporates. Access of capital market for additional equity is limited to very few big corporates only.

It is a well known fact that, SME sectors contribute the maximum to the Indian economy in terms of GDP, employment and exports. But the SME sector depends largely on its own savings due to limited access to capital market and cheap credit from domestic and foreign banks. Hence, its savings should be maximised in a legitimate manner by reducing direct tax. Such corporate savings shall be obviously re-invested in the productive sector itself, contributing maximum to economic growth. The big corporates earning 100 crore and above have easy access to capital resource and can afford to pay higher tax from their savings. Hence, the proposed rationalisation shall bring justice and equity to SME sector. It will motivate them to grow as well as to pay legitimate tax.

GST & direct tax code

The proposed GST model is definitely a good tax reform. Of course, it will require several amendments, but should be implemented at the earliest after they are done. By and large, dual reporting to the state/central government will not exist. Small business, say, with a turnover of Rs 25 crore may deal with the state government and balance with the Central government. It will reduce duplicity and positive steps to reform.

The government has already come up with a direct tax code draft incorporating several changes in the present model. In my opinion, it will not bring any substantial impact on the economic growth. On the contrary, asset base MAT in DTC is a great disincentive for fresh capital investment. Exempt exempt and tax (EET) concept of saving shall also de-promote savings vis-à-vis investment. The proposed code has been prepared on the concept of mistrusting the tax payer and hence, armed with discretionary power with tax authorities. We need innovative tax reforms for contributing to the ultimate growth of the country on a sustainable basis. I think DTC requires total review.

To sum up

Our country has the potential to grow at a double digit rate for the next 10 years. But to exploit the potential, we need several innovative and bold reforms. The proposed tax reforms on income tax and corporate tax is one among them and not all. It is essential for the government to undertake huge infrastructure spending. We are to become self-reliant for capital resources. This is possible only through higher domestic savings, of course clubbed with other administrative reforms.

The proposed tax reform in income tax and corporate tax are revenue neutral rather than revenue increasing in nature. Merging of income tax with GST will maintain the legislature's intention to tax the richer people in the other mode. The proposed reform shall give constant boost to savings vis-à-vis investment and finally to GDP growth. More important is to sustain the growth at least for the next 10 years so that poverty ratio is substantially reduced.

Our country has all the potential, but it requires a bold decision as the government took in 1991 for de-licensing, which has changed the industrial scenario of the country. The reforms can be taken post Budget also. ■

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