Phasing out tax expenditures

A close scrutiny of tax sops for SEZs, infrastructure sector and fertiliser can boost tax-GDP ratio by at least 1%

M GOVINDA RAO

In the prevailing tight fiscal environment, the Union government should not only stop giving tax preferences in response to the demands of special interest groups but should phase out the existing ones by grandfathering them

The stagnation of tax revenue-to-GDP ratio has been a matter of concern to policy makers in India. After reaching a peak of 17.6% in FY08, the tax-GDP ratio actually declined by over 2.5 percentage points, to 15.1%, in FY10 and marginally recovered to 16.8% in FY14. This is well below the IMF's estimate of median tax-GDP ratio of even the low-income countries, which is well over 20% and the median ratio for lower middle income countries is estimated at over 25% (See Junji Ueda, *Tax Policy Options for Aging Societies*, presentation at the Tokyo Fiscal Forum, June 10, 2015). Indeed, while even low-income countries have shown a steady increase in the ratio, it has shown a remarkable upward rigidity in India and this has been an important reason for ensuring adequate finances to physical and social infrastructure spending.

An important reason for the stagnation is the inability of the Union government to increase its revenue productivity. The highest level of revenues from Union taxes relative to GDP was in FY08 when it reached 11.9%; but thereafter, it declined to 9.6% in FY10, marginally recovering to 10% in FY15. In contrast, states' tax revenues relative to GDP increased from 5.6% in FY08 to 6.6% in FY14. The stagnant tax ratio, along with the proliferation of subsidies and transfers, has not only constrained the ability of the government to adhere to the fiscal rules promised in the medium-term fiscal plan, but also restricted fiscal space available for spending on physical and social infrastructure. The key to achieving fiscal consolidation, therefore, is to increase the revenue productivity of the tax system, particularly that of the Union government.

Like death, taxes are inevitable. However, they should at least be made less painful. The pain from taxes comes from the payment of hard-earned income to the government for which one is not sure what one will get as a return. The pain to the economy comes in terms of three costs associated with taxes: the cost of collection, the compliance cost and cost in terms of the distortions the tax creates. The distortion caused by taxation is equivalent to the square of the tax rate. Minimising the three costs associated with taxes requires that the tax should be broad-based with minimum exemptions, deductions and concessions, with low marginal rates, less differentiated rates and should be simple and transparent.

Unfortunately, the Indian tax system has been burdened with several objectives, and that inflicts pain on everyone, the taxpayer, tax collector and the common man and the only gainers are the concerned special interest groups. The taxpayer has to incur heavy compliance cost due to the complicated tax structures and the discretionary administration dealing with complications. The complicated tax structure creates both pains and gains for tax administration. Pains are due to complications and ambiguities and they see the revenues simply slipping away, making life difficult for the taxman especially when unrealistic revenue targets are imposed on them. Gains arise from the discretions. The economy is burdened with the enormous tax-induced distortions, thanks to various exemptions and preferences. The common-man suffers due to lower economic activity caused by distortions and yet, the tax preferences pervade and proliferate.

A close look at the number of objectives the income tax system is required to accomplish is enough to understand the complications and its ineffectiveness in achieving any. The income tax system, besides raising revenues in an equitable manner, has been designed to fulfil a number of objectives such as incentivising savings, promoting exports, achieving balanced regional development, promoting investments in infrastructure, expanding employment, promoting scientific research and development, encouraging cooperatives and charitable activities. Incorporation of all these objectives in tax laws creates enormous avenues for evasion and avoidance and no one can be sure how much of these objectives are achieved, if at all. Given all these concessions, when the companies take advantage of them and reduce their tax liability, the government comes up with a minimum alternative tax.

Since 2006, the Union government has been publishing estimates of revenue foregone from various tax concessions in the budget. For FY15, the budget estimates the revenue foregone at a staggering ₹589,285 crore. Of this, ₹301,688 crore is on account of customs and ₹184,764 crore is on account of excise duties. These are clearly overestimates due to the shortcomings in the methodology employed. The difference between the rates specified in the tariff schedule and the actual rate applied on the value of imports is taken as the revenue forgone in the case of customs duty. Indeed, when an essential commodity is imported due to domestic shortage, the government applies lower rates in public interest. There is the question of the right level of customs duty itself because that is simply the protection given to the producers. In a sense, all import duties are taxes on the people to subsidise manufacturers. Similarly, the exemptions given to imports used in the processing for re-exports should not be included in the revenue forgone because all exports should not be subject to domestic taxes to ensure competitiveness. Similarly, many people will disagree with the numbers when the excise rates are lowered for commodities to control prices in periods of shortages of essential goods.

Nevertheless, the tax–expenditure estimates bring out a glaring shortcoming in the tax system constraining the revenue productivity. The revenue lost on account of special economic zones for FY15 is estimated at ₹20,376 crore from corporate tax alone. The rationale for tax concessions for special economic zones was that they needed to be compensated for infrastructure deficit to ensure their competitiveness. Interestingly, exporters from other areas do not get the benefit and continue to face disadvantages of infrastructure and poor governance. Not surprisingly, the attempt is to move into these enclaves and the commerce ministry showcases this diversion as additional investment to argue for continuation of tax benefits. The revenue cost of SEZs for FY15 is estimated at ₹17,284 crore from excise duty and almost ₹8,000 crore in the case of corporation tax. The revenue forgone on account of tax concession to infrastructure industries works out to ₹22,230 crore. There are also customs duty reductions in the case of items like fertilisers. A closer scrutiny of these tax preferences could easily result in enhancing the tax-GDP ratio by at least 1% and that could help contain the revenue and fiscal deficits and augment the much-needed education, health or capital expenditures.

In the prevailing tight fiscal environment, the Union government should not only stop giving tax preferences in response to the demands of special interest groups but should phase out the existing ones by grandfathering them. These concessions not only give rise to complications in the tax system, thereby increasing administrative and compliance costs, creating avenues for evasion and avoidance, but also distort resource allocation.

The author is emeritus professor, NIPFP, and non-resident senior fellow, NCAER and also advisor, Takshashila Institution. Mail: mgrao48@gmail.com