Reading between the tax lines

World Bank report suggests India's tax gap is smaller than its peers' — but inter-country comparisons can be misleading

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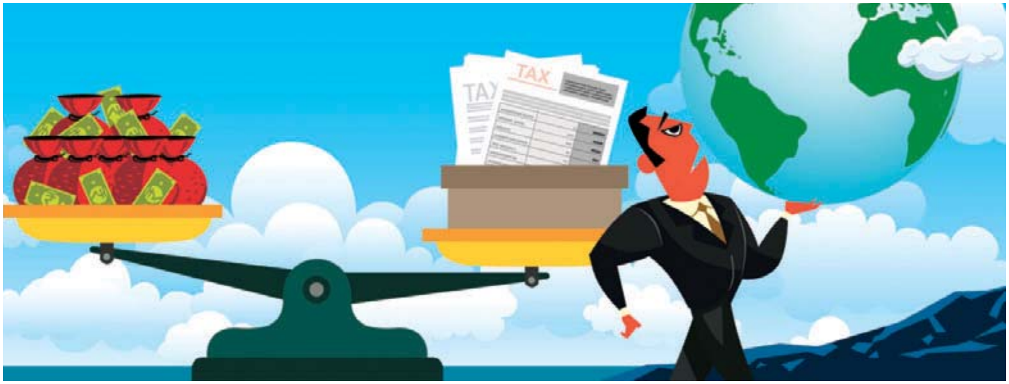

Fiscal policy discussions in India have consistently emphasised the need to raise the country's tax-to-gross domestic product (GDP) ratio. The analysis in this context follows two distinct lines of reasoning. Given the articulated need for an expanded role of the government in a developing country like India, a higher tax-to-GDP ratio is argued to be desirable. Policy prescriptions here focus on identifying new sources of revenue and reducing or eliminating exemptions and concessions. The other line of argument focuses on measuring the "tax gap" — the difference between potential revenues and actual collections. Policy options in this approach include improving tax administration, as the gap could be attributed to evasion and avoidance. In recent studies, potential revenues are estimated using a stochastic frontier approach with cross-country data.

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Many of the studies in the latter approach combine data from all types of countries to obtain an estimate of potential revenue. Clearly, this potential revenue is based on a comparison of the performance of different countries. The World Bank recently released a report titled "The South Asia Development Update, April 2025", which adopts a somewhat different approach and arrives at different conclusions. To understand what we can take away from this report, the results are summarised below.

The study focuses on emerging market and developing economies (EMDEs) and examines the performance of four major categories of taxes — corporate and personal income taxes in direct taxes, and consumption and trade taxes in indirect taxes. For each of these categories, India's tax gap is benchmarked against the average performance of EMDEs. The results of the analysis suggest that in aggregate, the tax gap for India is smaller than the average for EMDEs.

This overall result follows from the following: For personal income tax and consumption taxes, the tax gap for India is considerably lower than the EMDE average, and less than 0.25 per cent of GDP. On the other hand, the performance on the corporate income tax and trade tax front is not as good. The tax gap for corporate income tax is above the EMDE average and is estimated to be above 1 per cent of GDP. For trade taxes, India's performance in tax gap is similar to the EMDE average, at 0.20 per cent of GDP.

These results are both interesting and challenging. They are interesting for the country because the narrative changes from one of a significantly inefficient tax collection system to a system that is similar to, or even better than, that of other EMDEs in some tax categories. On the face of it, this is reassuring. To understand why the results are challenging, we consider the results for some of these categories of tax revenues.

For corporate income tax, the study uses market capitalisation and corporate tax rates. The average price-to-earnings (P/E) ratio for India over the past five years ranges from 21.59 to 23.89. In contrast, the average for EMDEs lies between 12.23 and 15.27 (*https://worldperatio.com*). A higher P/E ratio suggests lower incomes for a given level of market capitalisation. It is, therefore, to be expected that using market capitalisation to assess corporate income tax performance can over-estimate the potential and, consequently, over-estimate the tax gap. Further, the methodology uses tax rates. For corporate taxes in India, given that we have two regimes in place — one with fewer exemptions and lower rates, and another with more exemptions and higher rates — it is not clear which rate should be used, or what the implications of changing the reference rate would be.

For personal income tax, the base considered is labour income. However, if one analyses the composition of non-corporate incomes reported for purposes of income tax, as reflected in the direct taxes data, wages and salaries only account for 51 per cent of total income in 2023-24. The rest comprises non-corporate business income, income from house property, and income from capital gains.

It is possible that the base for non-corporate income tax is underestimated, and hence the potential too is under-estimated in the context of the personal income tax regime. Another factor to consider is the exemption threshold. It is widely accepted that too few people/entities pay non-corporate income tax, since the regime has high exemption thresholds. It would, therefore, be expected that compared to countries with lower thresholds, India's tax gap should be higher. The results, therefore, appear somewhat counter-intuitive.

Turning to trade taxes, the analysis uses the value of imports and the tax rates. The data for this category is more consistent across countries and hence provides a better benchmark for performance. Clearly, the tax gap in this case can be attributed to a range of exemptions and concessions provided within the Customs duty structures.

It should be noted that since many countries are part of free-trade agreements (FTAs) and provide some concessions or exemptions for specific purposes — as well as set-offs against exports — the analysis should be interpreted as indicating the extent to which India differs from other EMDEs. India appears to have "more" exemptions and concessions that the average EMDE, which in turn implies a higher tax gap than the average EMDE.

What is the primary takeaway from this discussion? Inter-country comparisons of revenue performance should be read and interpreted cautiously. Significant differences in the tax structures, as well as in the structure of the economy, can provide misleading results. For corporate income tax and non-corporate income tax, the underlying incomes are difficult to isolate from broad macro aggregates as discussed earlier. Any proxy used could behave differently across countries.

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The views are personal