

For a friendlier tax regime

The foremost job is to reform the system that creates incentives to harass the taxpayers

In general, the tyranny of status quo has been the hallmark of economic policies in India, and this is amply exemplified in tax administration more than in any other case. Much has been written on the issue, including the four-volume report of the Tax Administration Reforms Commission which, in all fairness, needs to be discussed and implemented not merely to enhance revenue productivity of the tax system, but also to improve taxpayer satisfaction and services. Unfortunately, like many other reports, this is also likely to gather dust. In many ways, the reform of tax administration is more fundamental than even the introduction of GST, but there has been very little action or even discussion on the issue. Even though the present finance minister has spoken about the need to root out "tax terrorism" on a number of occasions, he has done precious little to reform the system that creates an intimidating incentive structure forcing tax collectors to go after taxpayers even when they are sure that their demands may not be reasonable and stand the scrutiny of law. A closer analysis shows that the problem lies in the system that creates the structure of incentives and it would be unfair to place the blame entirely on the doorstep of the tax officials for this outcome.

There are many issues relating to tax administration that need immediate attention. In this column, I intend to discuss a small issue relating to why, in India, we hear so much about unreasonable demands by tax administration, enormous amount of arrears piled up in tax disputes and retrospective amendments to tax law when it does not stand to judicial scrutiny? We have had the much discussed cases of tax demand on Vodafone and the retrospective amendment to the Income Tax Act (when the Supreme Court judgement reversed the judgement of the Bombay High Court on the taxability of offshore sale of shares of a Cayman Island Company by Hutchinson group to the Vodafone group). There are also cases relating to Nokia and Shell

which have made headlines. More recently, we have seen the controversy surrounding the retrospective application of MAT on foreign institutional investors. On the latter, even the finance minister seemed to have backed the demand of the department, purely on revenue considerations based on the presumption that the move would generate an additional ₹40,000 crore. Though, later, he found to his dismay that the tax could not be applied in cases where there is a tax treaty and ultimately, the amount to be gained was less than ₹500 crore. The loss of trust with the government was enormous. Thankfully, the exit route has been provided by the Shah Commission, but the loss of credibility has been significant.

While it is true that multinationals indulge in base erosion and profit shifting through many means, the issue needs to be dealt with by a better legal framework and capacity-building, and not by retrospective amendments to the law. The problem with the tax departments in India is one of attitude, and this is true of both direct and indirect taxes. There was a case where I had sought some clarification relating to the applicability of service tax on resident welfare associations. According to the Service Tax Act, services of municipal bodies are exempt and the subscriptions paid to resident welfare associations for providing collective services for themselves are exempt up to ₹5,000 per household. What happens when the municipalities



M GOVINDA RAO

First, adopt scientifically estimated forecasts rather than targets. Second, have functional division of tasks so that the officials can gain specialisation. Third, do away with the setting of targets for tax administrators and judging their performance based on these

fail to provide services such as water supply, sanitation, sewerage and when the electricity distribution companies indulge in frequent outages often running into 2-3 hours every day in a new colony? This type of government failure forces the welfare associations to collect the funds from the residents for providing these services which can easily exceed ₹5,000 per household. When the clarification for subscriptions exceeding ₹5,000 was sought, after considerable deliberations and delay, the CBEC came out with a circular stating that service tax will apply to the entire value of the transaction if it exceeds ₹5,000! Thus, the residents have to put up not only with the failure of the government in providing local public services, but also have to pay additional service tax to the government! As far as CBEC is concerned, what matters is not fairness or logic, but simply, revenues. Thus, we have a peculiar situation where the government failure results in its collecting more taxes!

It would be unfair to blame the tax departments for keeping revenue considerations paramount irrespective of its legitimacy and fairness. The problem begins when the ministry of finance presents the budget with overly optimistic projections of revenues to conform to the fiscal targets set out in the medium-term fiscal plan. The analysis shows that in six of the last 7 years (since FY08), the actual tax revenues fell short of the budget esti-

mates by varying magnitudes and during FY14 and FY15 (RE), the shortfall was close to 10%. The unrealistic estimate of tax revenue is then broken up into collectorate-wise targets. When the performance of the officials is determined on the basis of their revenue collection performance, they simply want to collect revenues, irrespective of whether it is legitimate or otherwise. Their immediate task is to raise the demand and naturally, the aggrieved taxpayers dispute the demand and the cases pile up in the tribunals and courts. Thus, it is not surprising that by end-2013, the accumulated arrears amounted to over ₹5.8 lakh crore or 5.1% of the GDP—over 86% of this was due to disputes. Of this, about 76% was arising from the disputes up to five years and almost 47% was due to disputes up to two years.

If indeed the government is serious about creating a business-friendly environment, the foremost job is to reform the system that creates incentives to harass the taxpayers. While comprehensive tax administration reform on the lines recommended by the TARC is important, the government could initiate the process with three important initiatives. First, it should create a more scientific projection of tax revenues and adopt scientifically estimated forecasts rather than targets. Perhaps, it may be appropriate to ask the NITI Aayog to make the forecasts by taking inputs from the tax departments. The second important reform is to have functional rather than area-wise division of tasks so that the officials can gain functional specialisation. Third, do away with setting of targets for tax administrators and judging their performances based on the fulfilment of the targets. There are many other areas of reform, but these could be taken on priority.

The author is emeritus professor, NIPFP, and adviser, Takshashila Institution