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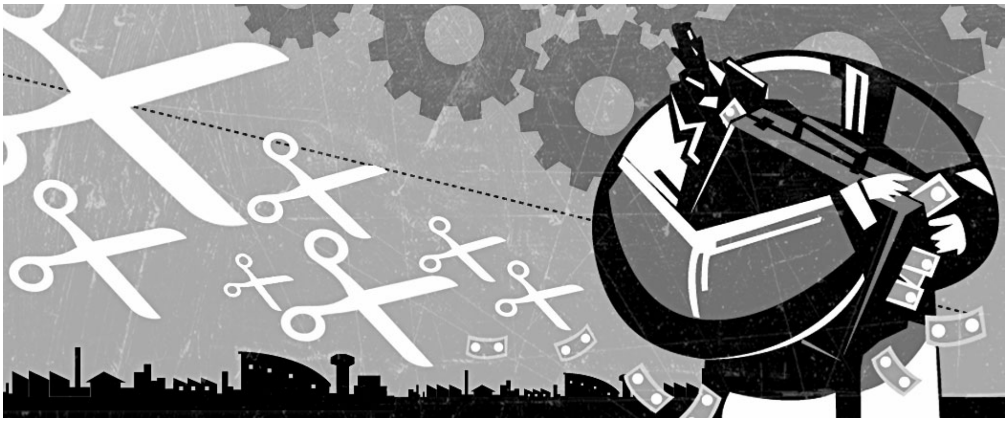

Prioritise GDP, not tax revenues

The present tax policy is focused on increasing tax revenues, whereas it should try to obtain the same number of rupees of taxation, while enabling a higher GDP

SNAKES & LADDERS

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It is widely understood that the Indian taxation of corporations is unusual by world standards. This is also the case with the Indian taxation of foreign investors. The taxation of non-resident investors drives up the cost of capital for Indian firms, and adversely impacts physical investment in India. It hampers the growth of financial services and allied industries, and hampers the liquidity and market efficiency of financial markets.

Let's start in a world where India has residence-based taxation: That is, non-residents are not taxed. Suppose we try to sell foreigners Indian government bonds, and suppose the supply and demand are equalised at an interest rate of (say) 10 per cent.

Now suppose we add one more clause: We tell the foreign investor, “Of the interest that you earn in India, we want one percentage point as income tax.” The interest rate required by the foreigners will immediately go to 11 per cent. The true cost of capital for the government does not change. Money is paid by public debt management and this shows up as income tax.

Many things do change. The bond market will involve a great deal of procedural friction, where the government first pays 11 per cent on its cost of borrowing, and then gets back a tenth of this as taxation. This is one illustration of the superiority of what all advanced countries do: Residence-based taxation.

Similar problems are found with Indian private corporate equities. We have taxation on transactions in the form of a securities transaction tax (STT). This violates the principles of public finance, where all taxation on transactions is considered “a bad tax”. Instead of trading the shares of Infosys in India, the foreign investor will prefer using the Infosys ADR at the New York Stock Exchange (NYSE), where there is no STT.

The order flow that could have come to India is diverted to the NYSE. This reduces the liquidity and pricing efficiency of Indian financial markets. It also hampers the revenues of securities firms and other support services associated with the financial markets. Our attempt to tax foreigners is inducing a loss of exports and GDP in India.

The Mauritius treaty was a key part of protecting India from the consequences of mistakes in tax policy. India has long had bad tax policy, but the distortions imposed upon FPIs were limited through the Mauritius treaty. It all worked out okay, as long as fees were paid to service providers in Mauritius. Over the years, these protections have subsided. Now, there are many features of the Mauritius or Singapore treaties which are unusual by the world standards. As an example, the Mauritius treaty taxes royalty payments in ways that are not found elsewhere in the world. Similarly, the definitions and categories under ‘permanent establishment’ in the Singapore treaty are out of line with the way the rest of the world works.

The lost revenue adds up to rather large numbers, particularly when we look at the Nifty derivatives and the rupee derivatives. In about 2007, India had almost a 100 per cent global market share in the trading of India-related securities. From that point onwards, we have introduced a series of measures in financial regulation, taxation, and capital controls, which have induced a steady loss of financial markets business. Activity in the two largest financial products — the Nifty and rupee — is steadily moving out of India. With the INR, it is estimated that the loss of revenue for India, in 2016, works out to ₹60,000 crore per year *(http://ifrogs.org/POLICY/ndfReport.html)*.

Similarly, India-related fund management should take place here in India. Indeed, India should have become a base for global fund-management in South Asia or Asia. But this has not worked out. A great deal of India-related fund management has exited the country, in response to the policy environment, and the policy risk associated with future changes in taxation, capital controls, and financial regulation.

These problems are a test of our public policy capabilities. In the limit, we run the risk of becoming like some Latin American countries, where the financial markets have entirely moved to New York.

Tax policy is hampering the real economy. The most important raw material for a firm like Tata Steel is not coal or iron ore, it is capital. The global investor equalises the post-tax return obtained through putting equity and debt capital into competing steel companies in China, Taiwan, Australia, South Korea, or India. A foreigner who looks at a bond issued by Tata Steel only counts the post-tax rate of return, and compares this against the post-tax returns that can be obtained by other large steel companies of the world. When India has higher taxation, the cost of capital for Tata Steel goes up.

The Indian taxation of capital — corporate income tax, dividend distribution tax, cess, and STT — induces a higher cost of capital for Tata Steel, when compared with that obtained by its rivals abroad. This hampers the possibility of making and exporting steel from India.

Such enhancement of the cost of capital, for equity and debt capital of India's firms, is not in India's interests. It will induce a lower scale of investment, because the hurdle rate for investment projects in India goes up.

Tax policy is focused on increasing tax revenues or increasing the tax/GDP ratio. We should instead be asking how to obtain the same number of rupees of taxation, while enabling a higher GDP. Our objective should be a high GDP, not a high tax/GDP ratio. Tax reform is one of the important elements of the path to a $5 trillion GDP. Suppose we are at ₹20 of tax revenues on ₹100 of GDP. Suppose tax reforms make it possible to go to ₹20 of tax revenues and ₹150 of GDP. This is a highly attractive outcome. The purpose of tax reforms, and all economic policy, should be to foster GDP growth.

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