

Tax Policy and Administration

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We have here three valuable contributions that address the question of tax policy and administration from three distinct perspectives. Yet there is one unifying theme, which is that sound tax policies and effective tax administration are the essential prerequisites to good governance. The first paper makes a strong case for introducing presumptive taxation in the sphere of direct taxes, and in particular personal income taxes, to significantly push up the direct tax to GDP ratio in India. The essential burden of the argument rests on the premise that if the information costs of ensuring perfection by adopting the theoretically ideal base of actual income is impossibly high, then presumption could be first best (p.31). The second paper addresses the question of the "reform" of property taxes which is the principal source of revenue for local governments. In particular it is seen that the annual rateable value (ARV) system has enough flexibility to allow for reform measures that may make it responsive to shifts in the real estate market. The final paper examines the interrelationship between tax administration and the phenomenon of tax evasion. In this context the paper goes on to make a case for widening the scope for tax deduction at source (TDS) combined with a suitable penalty structure to improve tax compliance. We shall now proceed to examine each of the papers in turn.

*Tax Evasion and Tax Administration:
A Focus on Tax Deduction at Source*

We first take up the paper which deals with the vital issue of trying to combat tax evasion by adopting tax deduction at source (TDS) or withholding taxes. Even though a comprehensive reform of the direct tax system has already been in place for about 5 years, with the top marginal tax rate set at 40 per cent, tax evasion continues to be a vexing problem. While it is true that in the post 1991 period the yield of the direct tax system has definitely improved, we are still very far from realising the potential that may be legitimately expected.

The literature as tax evasion is quite substantial and there is an influential strand that looks at the problem of tax evasion from the point of view of the tax payer as a decision under uncertainty where the tax payer chooses the optimal level of concealment of income so as to maximise his expected utility. The extent of evasion is seen to be a function of the individual assessee's attitude towards risk, the probability of detection function and the nature of the penalty function, in the event of detection. Quite already, *ceteris paribus*, a tighter regime characterised by a higher probability of detection and more severe penalties would involve additional greater tax compliance. But this would involve additional costs, both in terms of a more efficient detection apparatus as well as a more powerful enforcement machinery. One additionally has to contend with the fact that more resources put into the detection and enforcement machinery may not automatically increase the efficiency of the system if one allows for corrupt tax administrators.

There are a number of aspects of tax administration that the paper takes note of which are useful to summarise:

- (1) Penalties should be realistic. The higher they are, the less likely that they would be applied.
- (2) Penalties must be implemented expeditiously.
- (3) The structure of penalties must include possible (jail term) or incarceration.
- (4) As regards tax amnesties the overall agreement seems to be that amnesties are counter productive because they may even encourage tax evasion in the long run aside from being iniquitous.

The paper then goes on to make a strong case for incorporating or widening the scope of tax deduction at source (TDS). The advantages are several:

- (1) Tax and income flows are concurrent or parallel.
- (2) Compliance is improved and enforcement costs are reduced.
- (3) The government has a better cash-flow position.
- (4) Among those within the TDS net, the tax burden is shared more equitably.

The main disadvantage of the TDS are—

- (i) inability to capture large taxpayers, and most importantly,
- (ii) it presupposes a large information network with a body of trained personnel to run the system. This also calls for computerisation of the tax system.
- (iii) A number of aspects remain untapped under the TDS, for e.g., perquisites.

The incomes covered under the scheme of TDS include, principally,

- (i) salaries
- (ii) fees for professional or technical services
- (iii) interest and dividends
- (iv) rents from real estate
- (v) Capital gains of non-residents.

The contribution of TDS in gross collection of income tax increased from about 23% in 1980-81 to 37% in 1989-90 and it stands at around 31% as of now.

There is no gainsaying that TDS or withholding would lead to greater tax yield. But for this there has to be an adequate infrastructure by way of computerisation and trained personnel for cross verification of TDS claims.

Among the suggested strategies are—

- (i) access to bank accounts by the tax administration and
- (ii) full application of legal penalties.

Presumptive Taxation and Governance

The next paper under review confines itself to adopting presumptive taxes in the sphere of direct taxation. Even though the ratio of direct taxes to GDP has moved up somewhat in the post 1991 period and today stands at

around 3 per cent, this is much lower than the figure of about 5.5% for all developed countries for 1989 as reported in a paper by Burgess and Stern (1992). This paper argues that there is substantial scope for governing more direct tax revenues by adopting presumptive taxation.

The notion of presumptive taxation rests on the identification of objectively measurable indicators specific to each sector of economic activity and the use of these to establish the potential tax base of the assesses. This method assumes importance when there is widespread concealment of income on the part of particularly the self employed and the hard to tax groups thereby reducing the revenue potential of the traditional or regular income tax system. Recognising the seriousness of the problem of evasion in developing countries, Musgrave (1987) was led to conclude that "a more realistic approach is needed, using presumptive taxation, applied outside and in lieu of the regular framework of income and sales taxation, as well as estimated tax bases, applied within the context of the regular tax system". Elsewhere in the same paper Musgrave goes on to say: "Small taxpayers, involving five employees or fewer, may be reached most effectively by a presumptive tax, imposed in lieu of the regular income and sales tax." Musgrave emphasises that the presumptive tax ought to be computed conservatively so as not to exceed the amount that would be payable under the regular tax, and it leaves the taxpayer free to demonstrate that a lesser liability is called for.

This paper argues, quite rightly, I think, that the imposition of the Rs. 1400 flat tax (under section 115K) on small business, whether or not presumptive tax, has really been non starter. This has been applicable for non-tax paying retail traders with a turnover ceiling of under Rs. 5 lakhs. The revenue yield has been marginal, in 1995-96. It is placed at 0.23% of total income tax.

Secondly the present MAT (minimum alternative tax) on corporate book profits is not really a presumptive tax. An asset-based corporate MAT could, on the other hand, be regarded as a presumptive tax and its revenue potential might have been more substantial.

The paper then goes on to argue for the use of production indicators for presumption, for example, the asset base of the enterprise, or floor area of consulting premises. It is contended that consumption indicators are to be shunned because they are capricious or even inequitable. It is not clear to me why consumption based norms are inherently likely to be inequitable.

The paper then goes on to make an examination of two sectors, services and agriculture. As regards services it is seen that the evasion has been widespread: the average net income of even rural legal practitioners fell above the taxable threshold for the year 1983-84. It is suggested that a legal enterprise with at least one hired worker is worthy of consideration for a presumptive levy. Kansal's 1990-91 survey of medical practitioners referred to in the paper, also shows large scale evasion.

As regards agricultural income tax, it is clear that the Raj Committee's agricultural holding tax (AHT) is nothing other than a presumptive tax on land.

It is suggested that there is substantial scope for garnering additional revenues making use of presumptive tax.

While the above argument is unexceptionable it would be worthwhile to first fully utilise the scope of regular income especially by (i) improving the information system and computerisation and (ii) have better trained personnel.

Property Tax Policy and Local Governance

We turn our attention now onto the question of property tax. Some of the most critical inadequacies of the pattern of development we are experiencing pertain to the woeful level of provision of municipal services. These include water supply, sewerage, garbage collection, provision of street lighting and the like. The principal source of revenue in the hands of local authorities is property taxes which account for about 40 to 50 per cent of local government finances in developing countries. They account for some 25-28 percent of the total municipal expenditure. Property taxes account for about 2.6-2.8 per cent of all taxes raised in the country and it constitutes less than a mere quarter percentage point of GDP. Quite clearly if local governments have to govern at all, let alone govern effectively, the resources available in their hands have to be substantially bolstered.

Since property taxes are determined by State governments, there is wide variation in the application of this tax across states. The tax is obligatory in some states and optional in some others, and there are many municipalities that do not levy any property tax at all. However the mainstay of the property tax system across the country is assessment on the basis of the annual rateable value (ARV) of land and buildings. The ARV

is defined to be the gross annual rent which a property may reasonably be expected to be let out from year to year. The ARV is a hypothetical rent which is held as a proxy for the market rent of the concerned property. Most state municipal legislations have provisions for revaluation of ARVs once every 3 to 5 years, and alterations of assessments in the interim if additions and alterations are made to the property. In practice, however, changes in ARVs are brought about tardily and often not at all. There are a number of deductions and rebates allowed on the ARVs that have reduced the yield of the property tax. Further there are several categories of properties, which, even though making heavy demands on municipal services, stand exempted from the payment of property taxes. Finally the presence of rent control requires that property tax be levied on the basis of standard rent or fair rent. All of these have contributed to substantially narrowing the base of the property tax system. In certain studies the assessment to market rent ratio is seen to be as low as 25 to 35 per cent.

Quite clearly there is a strong case for increasing the yield of property taxes in the country. Towards that end, the paper makes a case for adopting a modified method of determining ARV with reference to certain attributes that may possibly be: plinth area, land area, location, type of construction, type of use and age. Such a system has already been adopted in Andhra Pradesh and also Patna city with beneficial results.

Finally, summarising, it cannot be denied that there is a substantial scope for deploying presumptive taxes on income, property taxes as well as TDS to bolster tax revenues. As regards presumptive taxes there is of course a case for exploiting the regular system to the fullest before we think in terms of employing the presumption route. In order to work out a well calibrated presumptive direct tax system the information system has to be substantially stepped up but then if that is the case then one may as well employ the regular tax system to the fullest. Nobody can really seriously take exception to bolstering the property tax system or the system of TDS.

Adopting of the measures suggested here would make the system more efficient as well as more equitable. While good governance must mean more efficient resource allocation one cannot underestimate the importance of fairness as an inseparable part of good governance.

In the discussion that followed one important point that emerged was that we have considered here three distinct approaches of bolstering tax revenues. What is however important to remember is that the total tax

burden on individuals ought not to be excessive. In other words, one may well think in terms of garnering additional tax revenues in terms of individual taxes such as personal income tax and property tax but there should be some judgement in terms of the totality of the tax burden that a person is likely to incur. It needs to be ensured that the total incidence is not too excessive or burdensome.