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India's Progress in Tax Reforms on Recommendations Made by IMF.

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ABSTRACT

Taxation is an important tool used by governments to make sure wealth is equitably distributed among it netizens and also used the accumulated resources in development activity to facilitate and sustain economic growth. Developing countries face numerous challenges in setting up the right tax system that conforms with the global norms. Implementing global best practices has its own challenges when it comes to administering the policies. Part of the issue arises from the formidable political power accumulated with the rich that stifles any progressive reforms. India is currently placed among the top 5 largest economies, but it lags in the various developmental parameters such as low education, universal healthcare, unemployment and poverty. This paper examines the progress of India in implementing tax reforms and recommends new policies that will help it achieve optimum tax revenue to take up expenditure.

Keywords: Personal Income Tax (PIT), Government of India (GOI), Value Added Tax (VAT), Modified Accelerated Cost Recovery System (MACRS). International Monetary Fund (IMF).

INTRODUCTIONS

The Concept of taxation, evolves from the need for distributional equity, that is how a fair society ought to ensure equitable distribution of economic resources. Tax policies play an important role in the design of the tax systems, which ensure necessary levels of public spending efficiently and equitably. Any aspirational country looking to integrate into the global economy must effectively use its tax policies to achieve them. The objective of a tax system must focus on raising enough revenue to finance necessary expenditure without relying on public sector borrowing; ensure equitable mechanisms that do not disincentivize economic activities. Lastly, an effort to not deviate from international norms must be made.

The challenge that most developing countries face in setting up an efficient and effective tax system are formidable. Firstly, the economic structure that stifles any efforts to impose and collect certain types of taxes. Secondly, the incapacity of tax administration. Third, is the dearth of accurate and reliable data. Lastly, is the lack of political will to rationalize tax policy.

The tax structure in India has been going through a process continues metamorphosis since 1860's. Post independence the most significant exercise taken up by the government of India was the codification of the tax code in 1961 which delineated the tax laws. The Income Tax Act of 1961. The Constitution bestows power on the GOI to enact laws and only levy taxes authorized by the laws.

Many international organizations like the WB and IMF regularly publish studies that describe the current state of affairs relating to financial matters. This study focuses on the recommendations of the IMF for governments of emerging and developing economies to improve their efficiency and apprise them to the best practices that have been tested and proven. These recommendations act as a benchmark for many developing nations who intend to reform their tax structure in pursuit of better predictability and efficiency in establishing a fair society and delivers progress.

LITERATURE REVIEW

The earliest of proponents of government spending, JM Keynes brought froward the need for adequate government spending. He believed that an economy could still be characterized by underemployment and stagnation post an economic shock and could only alleviate itself from the ailment by increasing government spending. (Keynes 1936). The theory also put forward ideas that the economy doesn't by itself tend towards full employment, Governments have a major role in creation of aggregate demand by actively using the fiscal policy and monetary policy. These are also helpful tools that can be used to stabilize the economy as deflect and propensity of a recession.

Most literature available today recommend that the rich be taxed disproportionately than the poor but there exists a hesitation among nations to implement them. This issue is part due to the fact that the rich amass not only wealth but also political power and use this to lobby their way out of paying more taxes. This is a pertinent especially to emerging economies, who then rely on meeting their revenue requirements on consumption rather than income. As generalized by Tanzi, tax policy if the art of possible rather than the optimal. (Vito Tanzi, 1999)

Material Desire is a common feature of a consumer society. The works of Kathleen Rassuli and Stan Hollander (1986) confirm the trend and suggest that as an economy grows its expectation and consumption will rise with time. The object of interest is to develop a culture of consumption rather than mere expenditure. To quantify the boundaries of consumption and material desire it is important to focus on the finances like household income, past savings, and debt. A direct correlation exists between consumption and material desire, with the latter being the cause. If the desire is thought to be an unlimited feature, consumption is controlled by the finances. Veblenian thesis indicates that a societies desire progresses based on what was already available for the previous one. Consumers' thought process stems from institutional influences (Hodgson 1985 & Singh 1987). This Thought process helps us quantify the material desire.

Thought processes can be differentiated into two types: instrumental values and market values (Stanfield 1984). The difference in the two types is the based on the goals, the instrumental values theory positions human welfare and development as the goal in contrast to the market value theory that emphasizes on the efficiency and quantity of exchange.

The relationship between material object and individuals who use them, in a consumer society, are determined by a host of factors such as the meaning, values and norms that an individual invariably assigns to the object. These are often a result of advertising and availability, that provides the consumer with the knowledge. The consumer lacks intimate familiarity with the objects, and is superficially informed by advertisements and social display. The lack of craft knowledge also contributes to a pattern of consumption that is based on quantity rather than quality. (Stanfield and Stanfield 1980). Such orientation is the reality of today's society highly dependent on external queues and actuated by external comparison in a quantitative rather than qualitative factors.

The debate on whether to tax income or consumption leads us to an important question as to whether wealth needs to be considered as income or not. As wealth encompasses the current benefits like security and independence over and above the capacity to buy. However, if wealth is to be taxed because of its ability to secure independence, power and security then it is only fair that other personal belongings such as physical and mental ability, charisma or family name, be taxed as well.

Consumption is the determined on the basis of cash flows, where the tax base is made up of all receipts while deductions related to the expenses incurred on debt owed are allowed. In order to compare income and consumption taxes we must consider income tax without including wealth. Henry Simons defines personal income as "the algebraic sum of the market value of rights exercised in consumption and the change in the value of the store of property rights between the beginning and end of the period in question." An alternative definition is the product of private capital in a society and the labor during a period. Both these definitions are important to determine the taxable units.

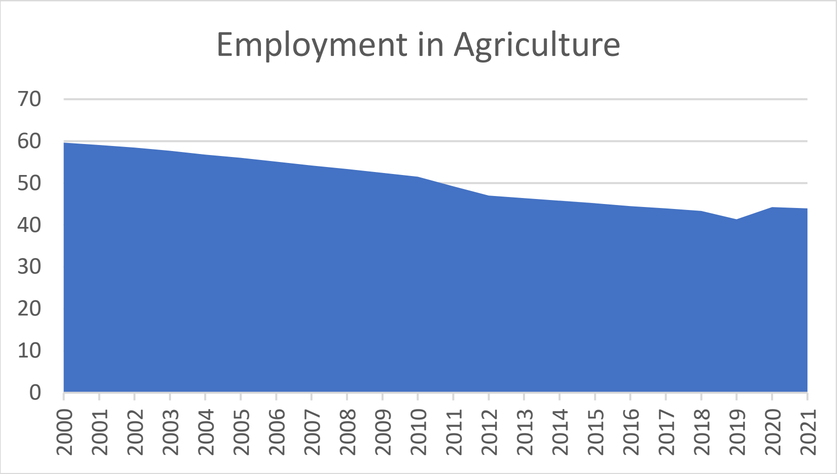
Distribution of the social product can be accomplished through income tax as income (including wealth) are a consequent of fortuity and in the absence of a tax system the producers of the social product will be deprived of their claim. The major difference between the consumption and income tax is that the former.

A Country's taxes have an impact on the investment, allocation and distribution of resources thereby determining the economic growth. (Bird 2014) Tax administration play a pivotal role in transforming an economy, as effective, efficient and capable tac authorities that are competent in mobilizing resources provide governments with sustainable, domestically- generated revenue, thereby reducing the reliance on foreign investment and aid. Tax administrations in developing countries are confronted by a host of challenges such as tax evasion, narrow tax base, inadequate workforce, presence of shadow economic activities, small scale traders who operate informally such as street hawking. The problem is further intensified when the tax administration in incapable of preventing tax evasion by registered companies and assets held offshore to avoid taxes, shifting of profits to jurisdictions where lower rates apply through transfer pricing manipulation. Such schemes of tax avoidance require a sophisticated machinery to identify and penalize malpractices.

INDIA'S PROGRESS IN IMPLEMENTING TAX REFORMS

India has come a long way since independence to in terms of economic growth. The tax structure in India has been going through a process continues metamorphosis since 1860's. Post independence the most significant exercise taken up by the government of India was the codification of the tax code in 1961 which delineated the tax laws. The Income Tax Act of 1961. The Constitution bestows power on the GOI to enact laws and only levy taxes authorized by the laws.

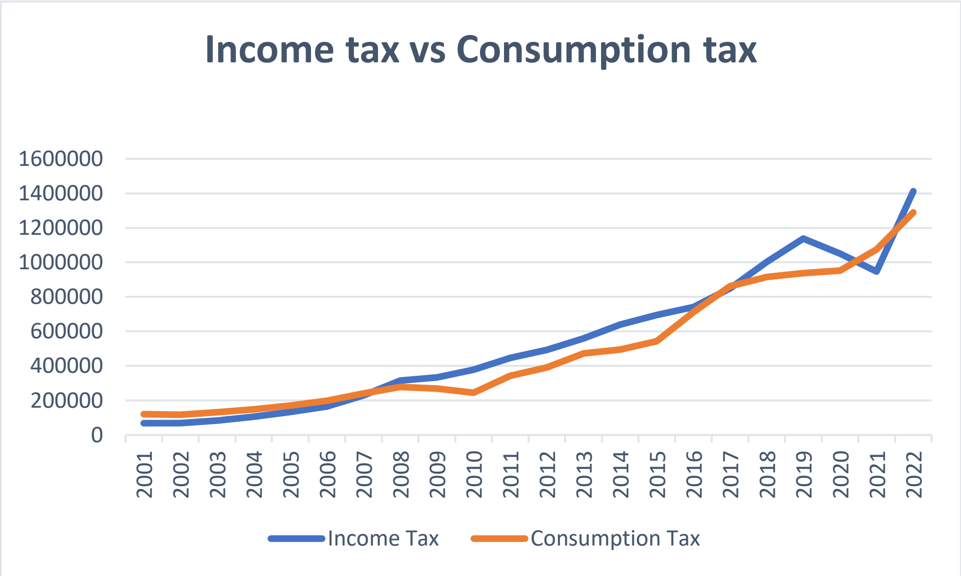
In line with India's aspiration to integrate into the global economy the Indian government has made efforts to reform the tax structure. How the obstacles in achieve them been many. For an Economy having disproportionate share of the total output and employment coming from the agriculture sector. ILO data estimates that agriculture provided 59.6% of employment in 2000 and the estimate in 2021 stood at 43.95%. Although a large portion of the population is dependent on agriculture for employment the gross value added is low, indicating that the there exist disguised unemployment and low productivity.



Source: International Labor Organization

Gross Value Added		
	at current prices	at 2011-12 prices
2020-2021	20.3	4.1
2021-2022	19	3.5
2022-2023	18.3	3.3

India also has a large informal sector that is characterized by small business entities, lack of formal jobs and level of consumption restricts the ability to implement certain modern taxes like the Value Added Tax (VAT) and income tax. Unlike advanced economies that have a larger share of tax revenue generated from Income tax, developing countries rely largely on consumption tax that is easier to tax. India has made efforts to improve this dependency and in the recent years as shown in the below chart. The income tax collections have marginally increased more than the consumption taxes.



Source: Central Board of Direct Taxes

Availability of educated and trained workforce is necessary to build a robust tax administration. Ability to invest in advanced technology; pay good remuneration and maintain a steady supply of skilled workforce determines whether a government will be successful in collecting taxes in the right quantity. Developing countries that are plagued with systematic hurdles often rely on small tax sources, foreign trade taxes thought to be the easiest of the taxes that can be collected. Increasing the share of taxes collected from income of individuals and corporates can improve the tax certainty.

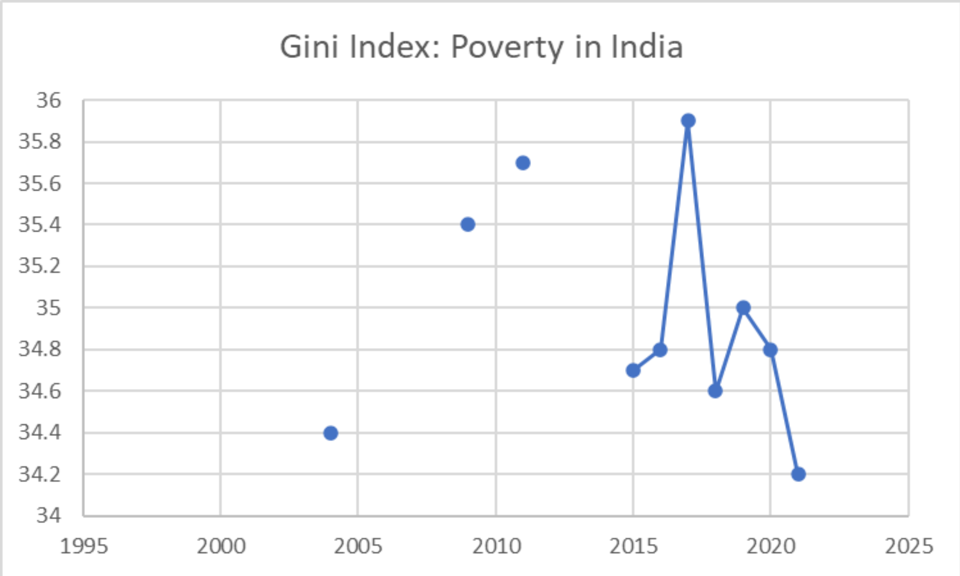
It is pertinent to note that increasing the portion of tax revenue derived from income tax doesn't call for higher taxation rates but for better administration that can ensure entities do not evade tax.

ECONOMIC DEVELOPMENT AND TAX REVENUE

Economic development gives rise to an accelerated demand for public expenditure and at the same time increases the capacity to meet such demands. A positive correlation exists between tax levels and economic development. The latter being the cause higher tax revenue. (Tanzi 1987)

Countries ought to focus on the optimal utilization of tax revenue and establishing the right tax structure rather than the level of taxes. Which will follow if the first two parameters are designed well.

The objective of a good tax structure is to establish efficient and equitable society where resources are distributed equally. Having a skewed distribution of income is detrimental to an economy as the cost associated with supporting an unskilled population have a stifling effect on the economic growth.



Source: World Bank

Developing countries have a higher gini coefficient. In India the gini coefficient has been declining.

To achieve equity consumption taxes levied at a graduated tax rate are not feasible. Hence it is pertinent to levy income taxes in a graduated rate to achieve redistribution of income.

IMPORTANCE OF DATA

The efficiency of a tax administration is reflected in its ability to affect change is the tax policy and be able to measure the outcome. Developing countries with limited ability to collect and manage data face challenge in accessing the impact of their policies. This makes it a risky affair for these nations to bring about drastic changes in the systems, consequently only marginal changes can be brought about.

ELEMINATING THE LOOPHOLES IN THE SYSTEM

Capturing an income at any point along the stream in the tax net must but be the intent of the tax administration. May systems end up with exploitable concession that end up neutralizing the effect of tax. Incoherent system design can make the system vulnerable to exploitation by taxpayers.

Corporate tax is one of the major components of income tax and plays an important role in resource allocation and economic growth. In pursuit of growth in specific sectors, governments may resort to differential tax rates based on sector. This policy tends to affect the normal functioning of market forces and leading to artificial growth in some areas in the economy that may not sustain itself unless they are subsidized. It is important for governments to practice restraint while providing such concessions if they wish to have a sustainable growth in the market.

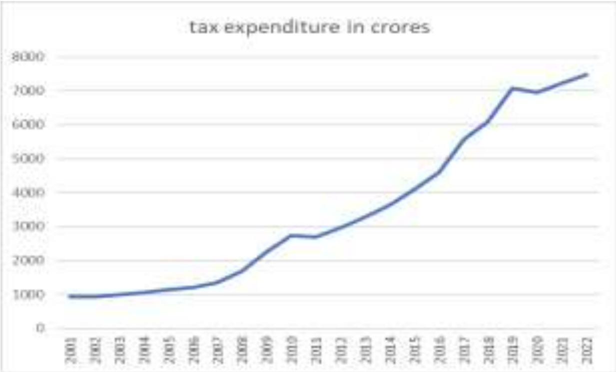
Depreciation allowed on capital assets is an important factor for investors to determine the cost of capital. The longer it takes to recover cost the less attractive an investment becomes. Many misguided economies refrain from allowing higher depreciation rates due to the fact that it reduces the taxable income. But according to proven practices in developed countries, allowing accelerated depreciation rates encourages investment and thereby increasing the tax revenue on a macro level. Accelerated depreciation also helps compensate the investor for inflation.

Ideal depreciation policy should contain minimum number of asset categories and a single rate of depreciation per category. India is yet to affect changes in this area. MACRS (Modified Accelerated Cost Recovery system is a suitable example for accelerated depreciation that can be implemented in India.

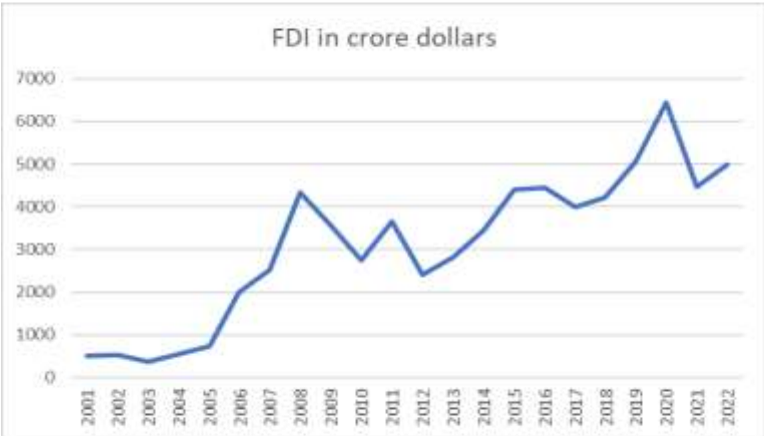
Pooling of assets I order to simplify book keeping requirements is another promising improvement in the depreciation that can help both the entity as well as tax administration in determining the capital gains and losses while disposing of assets.

Tax credits should replace tax deductions where possible to ensure that entities do not end up paying no taxes. Tax deductions tend to reduce the tax revenue and force governments to take loans to meet expenses.

ESTIMATION OF TAX REVENUE



Source: Central Board of Direct Taxes



Source: Central Board of Direct Taxes

MODEL: Y= 388586.1+0.069742*GDP-57.7975*tax_expenditure-2058.8*Unemployment+27.55651* FDI

A regression model has been developed to predict the tax revenue. GDP, Tax expenditure, unemployment and FDI have been identified as feature that influence the amount of tax that will be collected.

CONCLUSION

An optimal tax system should not interfere in the allocation process of resources and generates adequate revenue for the government to take up developmental work. Having a simple and transparent administration rules and procedures can help streamline the tax process. India has made strides in the right direction and the outcome are observable. The process of structural change may not happen overnight due to the limiting characteristics of the economy. None the less the pursuit of the optimal should not be abandoned. Reducing inequality in the society must be the goal of the governments to establish fair society.

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