What Should India's Tax Reform Trajectory Look Like?

Honing in on a consumption-based tax system should be the ideal goal, rather than slashing corporate tax rates.

Finance minister Nirmala Sitharaman’s latest move to cut basic corporate tax rates to 22% from 30%, for domestic companies that currently don’t avail any tax exemptions, has received a celebratory response from India Inc.

Termed as a ‘bold’ move by most within the business community, the step has been welcomed at a time when a dismal private investment growth scenario is seen across most sectors over the last five years. Not only has India’s manufacturing growth not taken off, in an indictment of the government’s ‘Make in India’ plan, but export trends are not pretty either.

In hope of boosting fresh investments in manufacturing amidst other sectors, the finance minister also slashed corporate income tax to 15% (from 25%) for domestic companies that are incorporated on or after October 1 and those likely to commence their production on or before March 31, 2023.

Further, in the case of capital markets, to increase the flow of funds, the government has effectively decided to roll back its ‘increased surcharge’ on certain investors.
While these steps may cyclically address waning private investment sentiment, it will certainly affect the government’s fiscal deficit mark and at the same time likely impact India’s tax-GDP ratio.

On closer observation, if we look at tax data over the last three years, the average income tax collected last year has seen a declining trend, even as the overall tax base has continued to widen from the government’s quest to formalise India’s economy. Last October 2018, e-filing of tax returns increased up to 70%, while the average income tax paid by individuals came down by 32% (to Rs 27,083).

In the two years before that, the e-return filing growth (year-on-year) went up by 24% and 29% respectively, and average income tax paid was Rs 44,000 and Rs 40,200 respectively.

One reason for this could be that the government, in its effort to get more people under the taxable base, is gradually increasing some individual (and corporate) tax exemptions, which allows more people to report their incomes and file e-returns, but subsequently end up paying less tax annually. This, inversely affects the fiscal base, in terms of tax revenue, for the government.

With shrinking collections from tax revenues, and the corporate tax cuts announced now, the government may end up most likely making strategic cuts to its welfare expenditure plans (or worse delay disbursements to ministries) over coming months, in order to keep its fiscal deficit mark ‘low’.

And if this happens, not only will this worsen India’s progress in terms of human capital development (channelised through social welfare schemes), but also exacerbate some of the existing income and wealth inequities that are entrenched within India’s economic landscape.
This should make one wonder: to what extent will the measures that the government is currently undertaking, actually address the ‘structural’ inequities driving the economic slowdown?

**Wealth creation hasn’t disappeared**

After all, it isn’t as if wealth creation has disappeared in India. In its 2018 Global Wealth Report, Credit Suisse reported how the richest 10% Indians own 56% of the nation’s wealth, where the richest 1% own 51.5% of the wealth, while the bottom 60% owns less than 5%. It is remarkable how in a democracy, the richest 1% have been able to consistently maintain their share of wealth year-on-year, while the majority remains meekly destitute.

Corporate tax cuts, in a sense, provide a sugar-rush to an economy. Investors feel happy, albeit more temporally in the short term, buying more stocks, which puts a smile on the faces of stock traders and India’s financial markets. Others will invest majorly in greater capital-intensive modes of production, which may drive nominal growth rates for a period, but hardly do much to boost employment or create higher wage-paying opportunities.

As Adam Smith has argued extensively, the wealth of a nation actually lies in ensuring greater ‘labour productivity’, a higher ‘per-capita income’ (across income classes) and greater ‘division of labour’ (through competitive market selection). To Smith, the ‘science of the legislator’ (i.e. the state) may best ensure this by allowing greater competition in labour-intensive modes of production – offering a competitive price to an average consumer, while allowing the workforce to gain skills on the job for higher wages over time.

Slashing corporate tax and organising loan melas to push for ‘cheaper’ business lending may accentuate existing income and wealth inequities while narrowing
competitive behaviour. One likely reason for this is how most big-businesses in India (across automobiles, pharma etc.) rely on capital-intensive modes of production. With tax cuts, they, and other foreign companies, might increase their scale of investment for greater profit. As a result, the nature of the ‘tech-based investment models’ may hardly change the existing scale (and rate) of labour productivity or generate higher-wage paying opportunities for participating workforce across groups.

There is, in fact, a stronger case for fiscally incentivising labour-intensive or higher wage-producing sectors and businesses the within them. Even countries like Taiwan, South Korea, during phases of industrialisation in the 1960s and 70s, allowed for a greater policy-complementarity between labour and capital intensive sectors to ensure a greater (and skilled) participation of workforce across sectors.

At the same time, in India, from the perspective of fiscal policy, a way to ensure fiscal consolidation while progressively creating fairer wealth and income distribution may require a progressive consumption tax over time.

**Consumption tax**

The idea in favour of imposing a consumption tax, especially in countries where consumer sentiment is strong and wealth inequities are higher, has been debated by economists for some time now. Kenneth Rogoff in a [recent article](#) presented a case for imposing such a tax in the United States too, where wealth inequalities across income classes have increased since the late 1970s.

A consumption tax is seen as a tax imposed on consumption, as opposed to some other measure of ability to pay, most notably income. In India, our data on consumption-based surveys (even at household levels) and trends seen within them has been observed as a principal method for understanding and analysing various kinds of inequities, and thus, can allow policy-makers to have a reasonably fair idea on considering a consumption tax that progressively accrues income from higher consumers.

In practice too, consumption is much easier to measure than income, and the dynamic efficiency gained from encouraging savings and investment could be large. As in India, we have already been seeing a gradual erosion of household savings, a consumption-based tax structure can help encourage the value of savings –for further (domestic) investments and financial credit-creation. The transitional difficulties, often associated in implementing such a system, are more likely in nations where consumption-based data and its sources are weak.

In India, a relatively more robust consumption-based household data allows any such transitional costs to be minimised. For a start, in a graduated implementation cycle, at least one can consider imposing a marginal consumption or spending tax side-by-side to existing income-taxes, which can then be phased out over time.
Another advantage of a consumption-based tax system is one that may allow certain natural resources (like water) to be used in fixated quantum. A higher carbon-consumption tax may over time channelise resources towards ‘renewable’ or eco-sensitive modes of production, which will take the policy-discourse away from providing any ‘subsidies’ on renewables but to encourage them through a consumption-based tax system.

With high unemployment levels amongst educated youth, real-wages diverging in rural and urban areas (due to poor farm incomes), and the broader real-wage growth trend flattening across sectors, Smith’s constitutive elements of ‘wealth’ – seen in the relative importance of labor as against any other factor of production – can be progressively realised through a fairly imposed consumption-based tax system.

As one of the measures, this can allow the state to accrue income from higher consumers (i.e. those with a higher willingness to pay) and allow for greater fiscal incentivisation of worker-productive sectors of occupation and production, which in India would relate to agro-based industries and those part of a farm-to-factory manufacturing supply chain.

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