CONTOURS OF TAX DESIGN

PARTHASARATHI SHOME*

CHAIRMAN

INTERNATIONAL TAX RESEARCH & ANALYSIS FOUNDATION (ITRAF)**

BENGALURU, INDIA

All opinions expressed within this presentation are those of the author and should not be attributed to any other individual or institution unless otherwise stated. Please correspond at* **parthoshome@itraf.org . *Website* **www.parthoshome.com.**

**** www.itraf.org**

I. PRINCIPLES OF TAXATION

Introduction

- Tax design should have theoretical underpinnings in the form of principles of taxation comprising efficiency of resource allocation despite taxation’s distortionary effects, its ramifications on inequity, and its potential in economic stabilisation. Some of the well known principles comprise:
  - When economies function well, equity is of less concern. But when an economy is foundering, progressivity in taxation protects the less well-off.
  - Progressive tax rates also stabilise the economy from unwanted or unexpected fluctuations.
  - Tax design should address efficiency of resource allocation by attempting to minimise tax incentives that distort relative prices across sectors and result in erroneous signals for production—away from consumer preferences.
  - Any country authority would be interested in a revenue buoyant tax structure.
  - Despite good intentions of the tax designers, if the tax law is cumbersome and hard of interpretation, the tax system loses its sharpness and ends in litigation and, the worse is the law, the longer is the litigation process.
  - Simplicity and the associated ease of taxpayer compliance have increasingly come to be recognised as an important tenet of tax design.
  - A tax administration’s transparency, incorruptibility and impartial application of the law are crucial even as subordinate legislation or administrative rules that override legislative intent are minimised.

Conflicts Among Principles

- It is not uncommon for various principles and objectives to conflict with one another and the outcome of tax reform becoming undecipherable or anomalous.
- Indulgence in taxing capital gains appropriately leads to inequity across income sources but is said to impulse investment.
- Perennial perception of tax administrations is that MNC’s organise their tax matters to minimise tax payments globally through complex tax avoidance—separated from tax evasion—leading, in the extreme case, for some tax administrations to attempt to stem it through retrospective taxation.
- MNC’s have explicably complained that retrospective legislation leads to an uncertain—as opposed to merely risky—environment thus leading them to scale back investments from such jurisdictions.
- A well-worn method to stem both sides of the problem—tax depletion and double taxation—has been the painstakingly slow approach of double taxation avoidance agreements (DTAA’s).

Does Tax Reform Last

- How often, how far, and across what expanse of geographical reach can tax reform be said to have achieved success? It is an open secret that the predominant opinion of experts is that reform is ephemeral.
- Why? First, the term itself is variously, randomly, or even persistently wrongly, used.
  - Second, the concept of tax reform itself appears to vary across tax professions.
- Even if it is so that those differences are not terribly important, empirical evidence suggests that, after about five years of undertaking tax reform, country authorities face new challenges to the edifice that begins to crack.
- Those who are adversely affected, even if marginally, begin to lobby, often steadily and strongly, for reinstatement of their privileges, usually for sector specific tax incentives, tax holidays, accelerated depreciation, lowered VAT rates for individual commodity classifications and so on.
- In most democracies there is likely to be a change in government in four, five or six years; and the new administration likes to put its own imprint on public policy including, or in particular, on tax policy.
- Hence, with the ever longer global reach and internationalisation of taxation, a country’s tax structure gets affected by multilateral movements in international taxation and by changes in political or trading blocs.
- Thus it occurs that the term ‘tax reform’ probably possesses the worst interpretation of the second word in modern professional usage.

Tax Structure

i. Why tax expenditure as well as income

- what is the rationale or justification of taxing both the demand and supply side of the same economy?

ii. Domestic consumption and production taxes

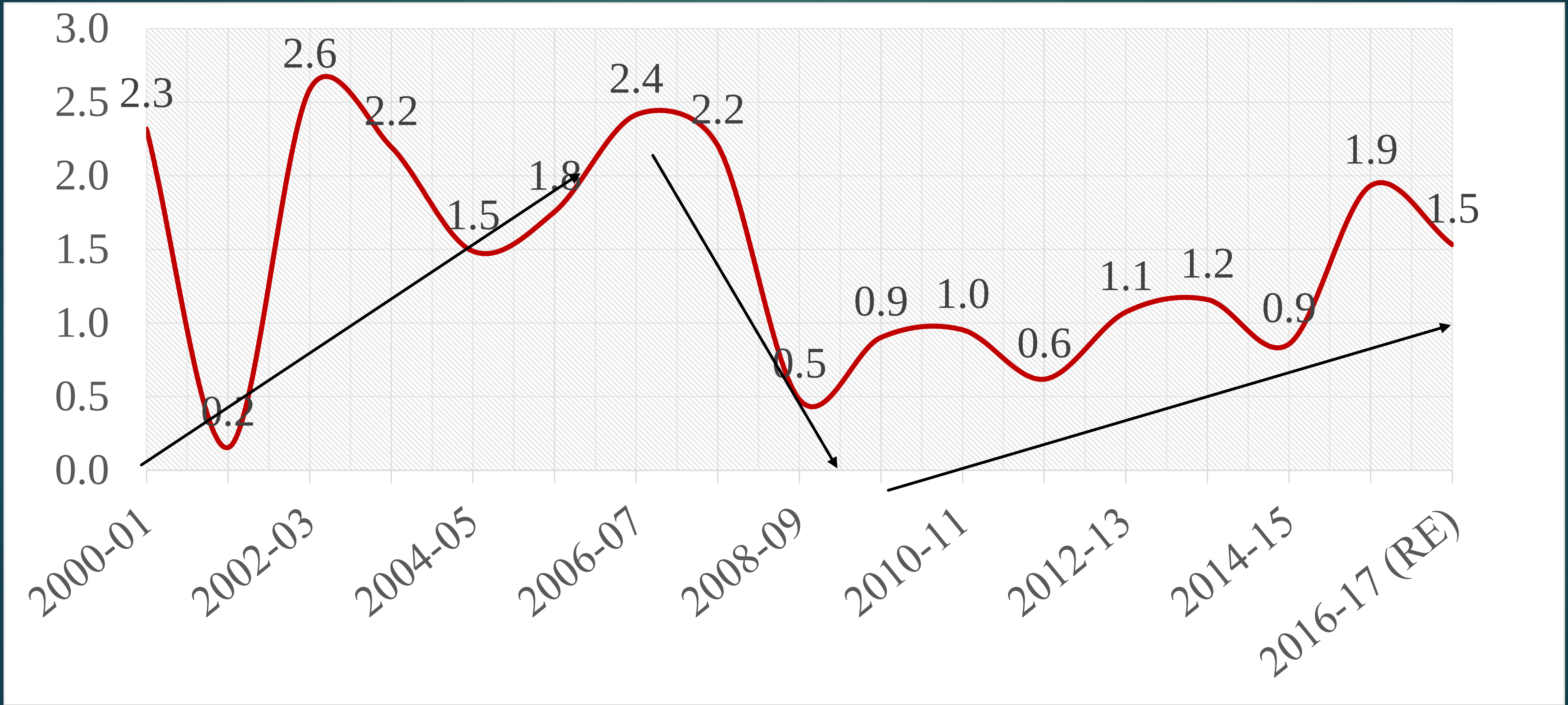
- The internationally accepted premise at present is that the best consumption tax from an efficiency and simplicity point of view is a single or two-rated **value added tax (VAT)** or **goods and services tax (GST)** that allows crediting all input taxes against all output taxes to be paid to the exchequer.
- **Environmental taxes** and **user charges** also fall in this broad category.

iii. Income and wealth taxes

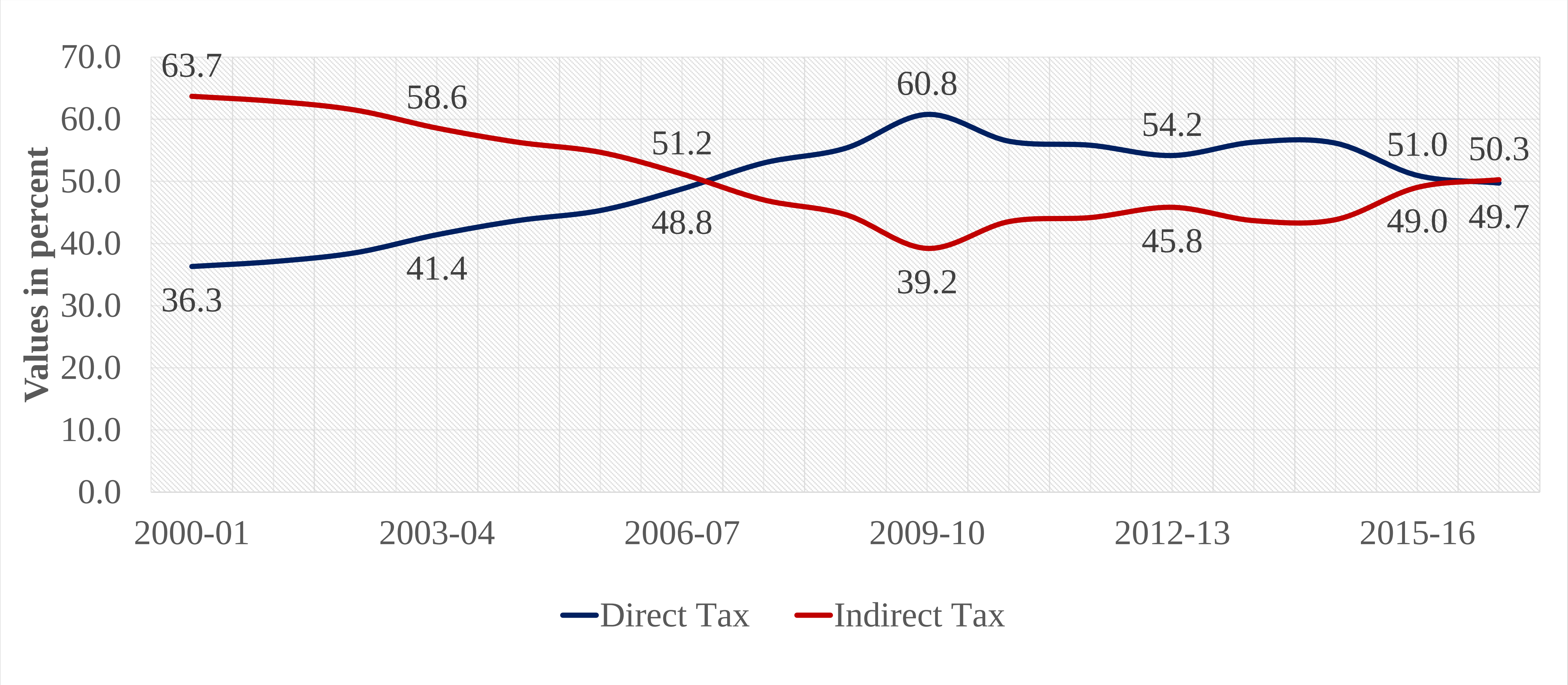
- The definition of income during a period reflects development of the Schanz-Haig-Simons comprehensive income concept including the
- Integration of dividend income in individual and corporate income tax; and arguably, capital gains as well.
- Some other concepts, among others, that have been discussed over the last half century include
- Cash-flow tax
- Presumptive taxes
- Minimum income tax; and, more recently perhaps
- International taxation—increasingly approaching comparable patterns in advanced and emerging economies

II. INDIA: COMPLEXITY OF REFORM

Buoyancy of Tax Revenue



Direct and Indirect Tax as Percent of Tax Revenue



Corporate Tax Rate Structure

- Proposals for change
  - In the 2015-16 Union Budget, on February 28, 2015, the Indian finance minister (FM) announced slashing of the corporate tax from 30 percent to 25 percent over four years.
- Analysing the corporate income tax
  - Overall, the Indian CIT structure is far from simple, with multiple objectives built into it. Despite best intentions, there are real challenges in achieving a 25 per cent corporate tax rate.
- The Indian MAT
  - MAT on foreign companies.
- BEPS and India
  - India’s position is unlikely to bring any fundamental change in the Mutual Agreement Process (MAP) that addresses double taxation, a sore point with India's treaty partners. It is noteworthy that the authorities’ position is commonly perceived to continue to affect investment adversely.

India: Structure of Corporate Income Tax

	Domestic Companies	Foreign Companies
CIT Rate	30% (25% for turnover upto Rs. 2.5 billion)	40%
MAT*	18.5% of adjusted profits	18.5% of adjusted profits
Surcharge levied on the basic tax rate based on the level of total income as follows:		
(a) Total income less than Rs. 10 million	Nil	Nil
(b) Total income Rs. 10-100 million**	7%	2%
(c) Total income above Rs. 100 million	12%	5%
Health and Education cess	4% on income tax (inclusive of surcharge, if any)	4% on income tax (inclusive of surcharge, if any)
Effective tax rates	(a) 31.2= (30x1.04) (b) 33.38{=[(30+30 x 0.07)x 1.04]} (c) 34.94{=[(30+30x 0.12)x1.04]}	41.6 42.43 43.68
Dividend distribution tax (DDT)	15% (plus surcharge at the rate of 12% and health & education cess at 4%)	Nil

*MAT is levied at 18.5 per cent of the adjusted profits of companies where the tax payable is less than 18.5 per cent of their book profits. MAT does not apply to some types of income of foreign companies. **Rs 90 = Pound 1

Cross-Country CIT Rates

BRICS		OECD		Latin America		Asia	
Brazil*	**34 % (19%)**	United Kingdom$	19 %	Argentina*	**35 %**	Singapore	17 %
Russia	20 %	United States!	21 %	Chile#	24 %	Turkey	20 %
India*	**34.94 % (D)** + DDT 29.12% (D) + DDT	Germany	29.72 %	Colombia&	34 %	Malaysia	24 %
	43.68 % (F)	Australia	30 %			Bangladesh@	25 %
China	25 %						
South Africa	28 %						

*There has to be less dispersion around 25 %, otherwise effective CIT rate likely to fall below 22-23 %. Therefore tax incentives have to go.

$: The current corporate tax rate was reduced to 19% on 1 April 2017 from 20% rate of 2016-17.

!: US government had a 35% rate that was drastically brought down to 21% in late 2017

#: In 2017, the CIT rate changes depending on the elected tax system: if attributed system is elected: 25% onwards; if semi-integrated system is elected 25.5% for commercial year 2017 and 27% for commercial year 2018 and onwards.

&: The current rate was increased to 34% from 25% rate in 2016 and 33% for 2018 and onwards.

@: The corporation tax rate is 25% for listed companies and is 35% for unlisted public and private limited companies.

Source: KPMG, 2017 CIT rates.

Goods And Services Tax

- India's GST was introduced after a decade of preparations, the first government paper having been completed in December 2007 by the central ministry of finance in cooperation with the states' Empowered Committee of finance ministers.
- The GST was finally introduced on July 1, 2017, albeit in a great hurry before crucial structural and technical aspects could be comprehensively addressed.
- **Considerations prior to GST introduction**
  - To begin with, the ideal structure of a GST needs some elaboration.
  - GST should be structured such that "tax on tax" or cascading should be done away with.
  - Another objective of a GST is to keep the number of tax rates as low as possible so that there is no significant mismatch between output and input rates.
  - In India, the GST was a political compact of fiscal federalism among the Centre and states. But few countries have achieved a comprehensive central-state GST.

Ideal GST Framework for India

Centre CGST	Selected Features	State SGST
1 general rate (1 lower rate could be accommodated)		1 general rate (1 lower rate could be accommodated)
• Broad base including petroleum, alcohol and tobacco • Goods and services to be taxed at general rate • A few low-income consumption items at lower rate • Full ITC across multiple units of a firm	Parallel chains → No ITC between CGST and SGST • Cascading to be removed from overall GST system • No CST on inter-state trade - IGST to operate	• Broad base including petroleum, alcohol and tobacco • Subsume smaller taxes • Goods and services taxed at general rate • A few low-income consumption items at lower rate • Abolish any tax on inter-state trade (CST) • Full ITC across states • Monitor inter-state trade with computerized infrastructure • Install clearing house (at central government level) for accounting and payments for inter-state trade (IGST)

Note: CGST= central GST; SGST= state GST; ITC= input tax credit; IGST= integrated GST

GST Contd…

- **The GST Council: Centre-state administration of GST**
  - ➢ The structure of the GST Council is unique. Its composition comprises the Union Finance Minister as Chairperson; the Union Deputy/Minister of State in charge of Revenue or Finance as Member; and the Minister in charge of Finance or Taxation or any other Minister nominated by each state governments as members.
- **A critical look**
  - ➢ A reformed tax is one which reduces production distortions and administrative hurdles, thus clearing the way for higher productivity of goods and services through more correct market signals.
- **Tax incidence of GST**
  - ➢ The debate during the decade prior to the GST’s introduction was for it to be structured along revenue neutral lines. But there are bound to be winners and losers among the various players: compensation.
- **Long term ramifications of exclusions**
  - ➢ Petroleum and electricity are essential inputs in the supply—production and distribution—chain. By keeping these out, both upstream and downstream cascading will occur.
- **What proportion of GDP is in the GST base**
  - ➢ One question that follows from such exclusions is what portion of GDP is covered in the GST base.

GST Contd…

- **ICT framework**
  - The shared GST Network—GSTN—between the centre and states is a unique feature.
- **GST post-introduction**
  - It has been seven months since the GST regime was introduced. One major test was when GSTN, the digital backbone, was called on to deal with a large number of simultaneous submissions; the initial experience was not good.
  - Questions that linger:
  - GST Council Policy improvement: not just correcting conflicting rates but examining inflation.
  - Will GST be a success from an administrative standpoint: is it truly revenue productive? Any measure of Revenue Gap?
  - What happens at inter-state checkpoints given that these have been removed?
  - On the flip side, are small businesses affected too adversely?
  - Is the initial tax uncertainty reflecting conflicting input and output rates only a hiccup?
  - To what extent has the tax administration done any hand holding? Is this feasible given GSTN state.

Concluding Remarks

- The GST, in its current form, has been a step up for the Indian tax authorities. There are however structural challenges that remain.
- There also are administrative challenges as well as issues of compliance cost in particular for small taxpayers who have been brought under the GST net.
- It is a commendabl to expand the taxpayer base, but auditing small taxpayers at both central and state levels will tend to increase the compliance burden on such taxpayers. Emerging practical solutions are not designed and are suboptimal.
- The authorities have to maintain keen vigilance to ensure tax compliance, ensure passing on of benefits from producer to consumer while, at the same time, not burdening taxpayers with refusal of refunds and adding to compliance costs.
- The need for such perspicacity will be carefully observed by experts and will be reflected in whether the ease of paying taxes improves or diminishes with time.

Contd…

- Since GST is known to be a revenue productive tax, the revenue trend of GST would also remain of interest to observers who remain alert over India's taxation policy and administration.
- To make the GST successful, it remains a responsibility also of the taxpayer in fulfilling his role in fully complying with the tax.
- This could represent the greatest opportunity for government-citizen co-operation and it is hoped that the process will reach a proper height of success.
- However, the continual work of improving will remain important in the future. Structural deficiencies will need to be eradicated or corrected. The overtly severe aspects of tax administration should be eased.
- Cases of serious tax evasion should be pursued to the end. And every care should be taken to minimise disputes among the authorities and between taxpayers and the tax administration.

References

Bernardi,L., Fraschini, A. and Shome, P. (edited). 2006. Tax Systems and Tax Reforms in South and East Asia, Routledge, Oxford.

Butani, Mukesh. 2016. *Tax Dispute Resolution – Challenges and Opportunities for India [Derived from Challenges of Indian Tax Administration]*, LexisNexis, New Delhi.

Baistrocchi, Eduardo (edited). 2017. *A Global Analysis of Tax Treaty Disputes*, Cambridge University Press, London.

Baker, Philip and Piston, Pasquale. 2015. 'The Practical Protection of Taxpayers' Fundamental Rights,' General Report, *International Fiscal Association*, 2015 Basel Congress, Volume 100B.

Cnossen, Sijbren. 2013. 'Preparing the way for a modern GST in India,' *International Tax and Public Finance*, August, Volume 20, Issue 4, pp 715-723.

Careful of frequent changes in GST rates, Opinion, *Financial Express*, India, 8th August, 2017.

CBEC notifies final timeline for filing tax returns for July-August, *Business Standard*, India, 9th August, 2017.

Dernburg, Thomas F. 1960. *Macroeconomics*, McGraw-Hill Companies.

Doshi, Bhavna. 2016. 'Impact of BEPS Actions of Indirect Taxes', in Shome ed. (2016, Chapter 10).

World Bank. 2016. Doing Business- 2017: Equal Opportunity for All, World Bank, 25th October.

Central Board of Excise and Customs (CBEC). 2017. *Decisions Taken on Services at 20th GST Council Meeting*, Government of India, 5th August, 2017.

Empowered Committee of State Finance Ministers. 2009. *First Discussion Paper on Goods and Services Tax in India*, India, 10th November, New Delhi.

Government of India. 2017. Goods and Services Tax (GST) Council approves the Central Goods and Services Tax (CGST) Bill and the Integrated Goods and Services Tax (IGST) Bill, 4th March, Press Information Bureau, Ministry of Finance, New Delhi.

Government of India. 2018. *Economic Survey*, 2017-18. *A New, Exciting Bird's-Eye View of the Indian Economy through the GST*, January, New Delhi.

Focanti, Diego, Hallerberg, Mark, and Scartascini, Carlos. 2013. *Tax Reforms in Latin America in an Era of Democracy*, IDB Working Paper Series, No. IDB-WP-457

Gimenez, EL and Rodriguez, M. 2016. ‘Optimality of relaxing revenue-neutral restrictions in green tax reforms’, *Governance and Economics research Network (GEN*), GEN Working Paper A 2016 – 5.
Gupta, Sunil. 2016. ‘BEPS Actions: Concerns, Ramifications, Conclusions’, in Shome ed. (2016, Chapter 11).
‘Good and simple*, ’*Editorial Comment, *Business Standard*, 2nd July, 2017, India.
‘Government must keep GST transition steady and predictable, Editorial Comment, Business Standard, 10th July, 2017, India.
Harberger, Arnold C. 1962. ‘The Incidence of the Corporate Income Tax’, Journal of Political Economy, Vol 46, pp 75-85.
______________. 1974. Taxation and Welfare, University of Chicago Press, Chicago.
Institute of Chartered Accountants of India. 2015. Background Material on GST and Annexure, June, New Delhi.
Alm, James, Sheffrin, Steven M. 2016. ‘What Drives State Tax Reforms?’, Public Finance Review, Vol 45(4), pp: 443-457.
Krzyzaniak, Marian. 1967. ‘The Long-Run Burden of General Tax on Profits in a Neo-classical World’, Public Finance/Finances Publiques, Vol 22, No. 4, pp 472-91.
Lipsey, Richard and Steiner, Peter. 1975. Economics, Harper and Brothers, New York.
Musgrave, RA. 1953. ‘General Equilibrium Aspects of Incidence Theory’, American Economic Review, Vol 43, pp 504-17.
Mieszkowski, PM. 1967. ‘On the Theory of Tax Incidence’, Journal of Political Economy, Vol 75, pp 250-62.
Modi, Arbind (Chairman). 2009, Report of the Task Force on Goods and Services Tax, Thirteenth Finance Commission, Government of India, 15th December, New Delhi.
Manohar, Navneet. 2014. ‘Computation of MAT’, in Shome (2014, V.4, Appendix).
Mintz, Jack and Chen, Duanjie. 2011. ‘Federal-Provincial Business Tax Reforms: A Growth Agenda with Competitive Rates and a Neutral Treatment of Business Activities,’ SPP Research Papers, The School of Public Policy, University of Calgary, Vol 4(1).
National Council of Applied Economic Research (NCAER). 2009. *Moving to Goods and Services Tax in India: Impact on India’s Growth and International Trade* (Working Paper No. 103), December, New Delhi.
Nuggehalli, Nigam, , 2016. ‘Multilateralism in the BEPS Initiative: Pros and Cons’, in Shome ed. (2016, Chapter 9).
Newsletters (Chairman), Chairman’s Desk, CBEC website, July-August, 2017, Ministry of Finance, Government of India.
Pigou, A.C., 1932. *The Economics of Welfare*, 4th Edition. Macmillan and Co., London.
Poddar, S. & Ahmad, E. 2009. ‘GST Reform and Intergovernmental Considerations in India,’ Working Paper No. 1/2009-DEA), Ministry of Finance, Government of India.

Roxan, Ian. 2002. ‘General Anti-Avoidance in the United Kingdom,’ in H. Erlichman (ed.), *Tax Avoidance in Canada: The General Anti-Avoidance Rule*, pp. 83-115, Irwin Law, Toronto.
___________. 2012. ‘Limits to globalisation: some implications for taxation, tax policy, and the developing world,’ LSE Law, Society and Economy Working Paper Series, 3/2012, Law Department, London School of Economics and Political Science, London, UK.

‘Remove tax uncertainty,’ Editorial Comment, *Business Standard*, 8th August, 2017, India.

Rohtagi, Roy. 2005. *Basic International Taxation: Principl*es, Vol. I (2nd ed.), Oxford University Press, Richmond, United Kingdom.

Ruiz, SVl, Peralta-Alva,A. and Puy, D. 2017. Macroecoenomic and Distributional Effects of Personal Income Tax Reforms: A Heterogenous Agent Model Approach for the US, IMF Working Paper, WP/17/192.

Shome, Parthasarathi. 1978. ‘The Incidence of the Corporation Tax in India: A General Equilibrium Analysis’, *Oxford Economic Papers*, Vol 30 (1), pp 64-73, reproduced in Shome (2014, II.1).

__________. 1981. ‘The General Equilibrium Model Theory and Concepts of Tax Incidence in the Presence of Third or More Factors’, *Public Finance*, Vol 36(1), pp 22-38, reproduced in Shome (2014, II.3).

__________ and Schutte, Christian. 1993. “Cash-Flow Tax, Staff Papers, Vol. 40, No. 3, pp 638-662, International Monetary Fund, Washington D.C.

__________ (edited). 1995. *Tax Policy Handbook*, International Monetary Fund, Washington, D.C., reproduced in Shome (2014, V.3).

Papers:

“Introduction”, Chapter-1.

“Cash Flow Tax”, Income and Wealth Taxes, Chapter-4.

__________ (Chairman). 2001. *Tax Policy and Tax Administration for the Tenth Five Year Plan*, Report of The Advisory Group, Planning Commission, Government of India, New Delhi.

_________. 2011. “Fiscal Stimuli and Consolidation,” in Olivier J. Blanchard, David Romer, Michael Spence, and Joseph E. Stiglitz ed., *In the Wake of the Crisis: Leading Economists Reassess Economic Policy*, International Monetary Fund, M.I.T Press, Cambridge, Massachusetts.

__________ (Chairman). 2012. Expert Committee on General Anti-Avoidance Rules (GAAR), Government of India, New Delhi.

__________. 2012. *Tax Shastra: Administrative Reforms in India*, United Kingdom and Brazil, Business Standard Books, New Delhi.

__________. 2012. "Rebalancing and Structural Policies—An Indian Perspective," *Oxford Review of Economic Policy*, Volume 28, Number 3, pp. 587–602.

__________. 2012. Pushing forward on GST, *Business Standard*, 18th June.

__________ (edited). 2013a. *Indian Tax Administration: A Dialogue*, Orient Blackswan, New Delhi. Paper: "Introduction".

__________. 2013b. "Political Economy of Debt Accumulation and Fiscal Adjustment in a Financial Crisis," in Deepak Mohanty ed. Monetary Policy, Sovereign Debt and Financial Stability: The New Trilemma, Cambridge University Press, India.

__________. 2014. *Taxation Principles and Applications: A Compendium*, Lexis Nexis, New Delhi. See various chapters on VAT and GST in an international context.

__________ (edited). 2015. The G20 Development Agenda: An Indian Perspective, Cambridge University Press, New Delhi.

Papers:

"Introduction- Group of G20", Chapter-1.

"Greening the G20 Agenda: A Way Forward", Chapter-7.

__________ (Chairman). 2015. *Tax Administration Reform in India: Spirit, Purpose and Empowerment (Volume- 4)*, Report of the Tax Administration Reform Commission (TARC), Ministry of Finance, Government of India, New Delhi.

__________. 2015. 'GST - Remains of a decade,' *Business Standard*, 15th September, India.

__________ (edited). 2016. *Base Erosion and Profit Shifting (BEPS): The Global Taxation Agenda*, International Tax Research and Analysis Foundation (ITRAF), Wolters Kluwer, New Delhi.

Papers:

"Introduction- A Review of Chapters", Chapter-1.

"Impact of Firm Characteristics on Firm Revenue and Tax", Chapter-5

__________ (edited). 2016. *Insights into Evolving Issues of Taxation: Existing and Continuing Challenges*, International Tax Research and Analysis Foundation (ITRAF), Wolters Kluwer, New Delhi.

Paper included: "Introduction- Taxation Issues under Discussion and Continuing Challenges", Chapter-1.

__________. 2017a. Goods and Services Tax (GST), Working Paper No. 227, Madras Institute of Development Studies (MIDS), Chennai. www.itraf.org.

__________. 2017b. Goods and Services Tax, *The Hindu Centre for Politics and Public Policy*, Interview, 19th May, India.

Shoven, John B, and John Whalley. 1972. 'A General Equilibrium Calculation of the Effects of Differential Taxation of Income from Capital in the US,' *Journal of Public Economics*, pp 281-321.

'Report Card on GST Implementation'. 2016. Press Information Bureau, 14th December, Ministry of Finance, Government of India, New Delhi.

Srinivasan, P V. 2016. "Goods and Services Tax (GST): Analysis, Findings and Suggestions", in P. Shome ed., *Insights into Evolving Issues of Taxation: Existing and Continuing Challenges*, International Tax Research and Analysis Foundation (ITRAF), Wolters Kluwer, Bangalore.

Zee, Howell H. 1995. "Tax Cascading: Concept and Measurement," in P. Shome ed., *Tax Policy Handbook*, International Monetary Fund, Washington, D.C.