FOUNDATION FOR DEMOCRATIC REFORMS
A Scientific and Industrial Research Organization
Recog. by DSIR, Govt. of India

NEWSLETTER
Volume: 5 Issue: 1| February 2019

SPOTLIGHT | INSIGHTS | STORYBOARD | EVENTS | INTERVIEW | BOOK REVIEW

INTERVIEW 1

An interview with DD Director, Vijay Bhagawan

INTERVIEW 2

Dr. M Govinda Rao discusses various economic issues ranging from tax-to-GDP ratio to taxing agricultural income.

Our tax policy is like the Kamadhenu: Dr. M Govinda Rao

- Shailaja J and Sujith Kumar N

In a freewheeling interview, Economist and 14th Finance Commission member, Dr. M Govinda Rao discusses various economic issues - increasing tax-to-GDP ratio, taxing agriculture, the need for an objective tax policy including rationalisation of GST, among others. This is Part II of the two-part series.

1. The tax-to-GDP ratio of India is far below the developed countries. In light of liberalization, should we argue for increasing the tax-to-GDP ratio?

Let me give a slightly eclectic picture on that. By and large, it has been a historical fact that the tax-to-GDP ratio in developed countries is higher; it increases with per capita income.

On expenditure side there's something called Wagner's law - the law of increasing state activity;

expenditure-GDP ratio increasing with per capita GDP and obviously, this requires increasing tax-to-GDP ratio with per capita incomes.

Another phenomenon is the tax structure change during development. In the early stages of development, your administration is poor and tax collection is basically at the gates. So the customs duty is the highest but as an economy develops domestic trade taxes become more important and finally when the economy matures you get more taxes from domestic trade taxes and as it matures further, the governments develop a capacity to garner more from direct taxes.

Three years ago, in the Economic Survey, there was a chapter where it said, "if you compare tax-to-GDP ratio between less developed and more developed countries, India ranks lower, but then if you compare per capita income it is neither low nor high". But my study contradicts this.

2. Could you please elaborate upon it?

In a paper to Asia Pacific Sustainable Development Journal, I had taken the tax-to-GDP ratio of 98 countries. On a statistical basis, I took tax-to-GDP ratio and per capita income to get an average picture.

I regressed tax-to-GDP ratio of these 95 countries with their per capita incomes and controlled for income from natural resources, (for example countries rich in petroleum products need not collect more taxes), and urbanization.

At present, our aggregate (Centre plus State) tax-to-GDP ratio is 16.5 to 17%, but my number shows if the average behavior holds, it should be about 19.5%. Even this 3% difference can make a lot of difference for allocations to education and health. The expenditure on healthcare today is an abysmal 1.4% of GDP and for education, just about 3% of GDP. Even half a percentage more in each for these sectors could make a lot of difference.

3. Is GST going to help in increasing the tax-to-GDP ratio?

Yes, but I think we need to do a lot more reforms. GST is a work in progress.

One is rationalization, I would even say that it is desirable to increase the threshold to Rs. 50 lakh, for they now constitute over 75% registrations but pay less than 5% of taxes. Focus on the rest and your technology will be manageable with smaller numbers.

Also, there are four tax rates and three rates of cesses. I hope they will eventually reduce it to two rates. People say that a Mercedes car and a Hawai chappal can't be taxed at the same rate but it is a wrong analogy. You are only saying rich man takes Mercedes Benz and poor man takes Hawai chappal, but what is the employment generation by Benz and that by Hawai chappal. It might well be that Mercedes is generating much higher employment which means a number of people's poverty is alleviated. Employment intensity in production is also important. Of course in this country, it is impossible to see one rate of tax, but at least it should come down to two rates of tax and then reduce the compliance burden on people.

I think income tax revenue will sharply increase because of the linking of PAN with the GST numbers. As a result, a GST registered trader will have to account it for it in his income tax. It has happened everywhere, it will help us in increasing tax-to-GDP ratio, but to achieve 19% you need of a lot of reforms. Taxing agriculture is one of them.

4. Isn't taxing agriculture quite problematic today?

Yes, there are problems with taxing agriculture. It is not agriculture *per se* but under its guise, a large number of people owning a simple farmhouse are diverting income and evading tax.

A study by the National Institute of Public Finance and Policy (NIPFP) showed that by taxing the agricultural income we can increase the tax-to-GDP ratio by 0.5%.

There are also corporates involved in agricultural income. For example ITC, it's not just the farmers. It is a sensitive area but I can assure you that the poor farmer will never get taxed, the reason being, even if exemption limit is 5 lakh rupees, it's only a handful of large farmers who have that.

5. What do you think about our overall tax policy?

Our tax policy is like the Kamadhenu; it has to pursue so many objectives - revenue, equity, backward area development, scale industries, infrastructure, special economic zones, so on and so forth.

If you go on increasing tax exemptions it's not going to increase tax revenues. The ideal thing would be to get rid of all tax exemptions or concessions, pursue one objective tax policy of revenue and then reduce the rates, broaden the base, and have a simple and transparent tax system. There are a huge number of tax exemptions which are being misused.

For instance, many of the MNCs including Google, Flipkart, Amazon have their branch offices or subsidiaries in tax havens like Cayman Islands and they transfer their incomes as royalties, interest payments, etc. In the process of doing that, they reduce their tax burden here. In our country, the tax burden on the MNCs is much lower than on domestic companies.

Basically, the tax-to-GDP ratio is low not only because of low per capita income but because we have messed up our taxation system. GST is likely to improve it, but I think we do need much more money for our development (reining in the fiscal deficit, increasing expenditure on education and healthcare, etc.).

6. There's a perception that people don't pay taxes because they don't see commensurate returns in terms of the services

from the government. How will compliance increase?

By and large, that may be true, but if that is the case there should have been a greater tax payment at the local body level too because your garbage is taken and water supply is given. But that doesn't happen.

In fact, my book starts with the question "why do we need a government?" A government must be giving something which the market is not giving. Let me tell you a story, In early 20th century, China was infested with a large number of roaming bandits and when there were so many roaming bandits there was no incentive to save or invest and no growth was possible. At that time, the stronger among the roaming bandits entered into an agreement with the residents in a jurisdiction to provide safety and security from other bandits in return for their giving a share of their incomes. Everybody agrees as the uncertainty is gone. So the roaming banditry becomes stationery banditry. Under a stationary bandit, your life and property rights are secured. So here there is an incentive to save and invest and growth was possible - but that growth pattern is determined by the bandit. That growth may not be encompassing, So in order to make it encompassing we need to have a participatory democracy.

The basic lesson from the story is that we need to provide basic public goods including ensuring safety, security and protection of property rights. Markets cannot provide this.

When you have a beautiful Municipal park and when there are 100 people visiting the park, you are not getting 1/100th of the benefit, you are getting the whole benefit of the park. Your consumption and other person's consumption are not added, so this is called non-rivalry in consumption. To give another example, defense services are non-rivalrous, you cannot be excluded. Whether you want it or not, you can get it. There can be a lot of free riding and because this happens you cannot price these; since you cannot price these you like to tax them. If you have to tax them you cannot find a quid pro quo, one-to-one relationship drawn with public goods.

So by and large, we have to be vigilant and we cannot say income tax should be used for this or that, but then you can only see that we need overall efficiency in public spending. That is the reason why we created institutions like the CAG. Because, if there is a market failure the government comes in, but what happens when the government fails? So we need to have institutions of checks and balances, so that at a lower level of government, at Municipal level we can have a one-to-one correspondence with taxes and spending but at higher levels of government, it becomes difficult.

7. Moving on, there is also a popular opinion that external aid does not necessarily lead to development, is that true?

I don't know whether external aid will necessarily lead to development but I say don't oppose it. When you are a capital investment-starved country, you can't be saying that I don't need external aid. At the same time, we should see what the conditions of the aid are; how exactly it should be utilized. We should not accept aid if it involves conditions that will not help. There was a slogan, "computer chips we will permit but potato chips we will not", that is absurd. I would have permitted potato chips but not Computer Chips, because this country requires stabilization of potato prices. Stabilization of prices cannot come from increasing MSP and procurement policy; there has to be a huge investment in agro-processing industries. You see when a person grows a tomato and he doesn't have demand he cannot store it, it goes bad. But, suppose if an FDI investor puts a tomato ketchup industry here, the prices will not go down, price stabilization will happen. We have been giving subsidies in agriculture but not making investments in agriculture. Last year onion prices fell sharply and the Maharashtra government came up with a procurement price of Rs. 7 per kg. There was a mile long queue to sell onions and they spent Rs 700 crores, but they didn't know where to store the stock. Had they invested some Rs. 50 crores in constructing cold storages and warehouses, it would have done so much good; it creates a natural demand for the product increasing employment; increasing exports and people would have paid rent and kept their produce there. So let us not be dogmatic and let's see what is good for us.

8. Economists are encouraging investment support provided to farmers like what is given by the Telangana government. What is your view on this?

Investment support is fine but we need to look at it from both sides.

- We need to make investments and help the farmer enhance production.
- We also need to create a demand for his product; the intervention has to be comprehensive.

And demand creation requires an enormous amount of investment. For production, if you say that we will subsidize the fertilizers and provide free irrigation water and electricity, it means we are misallocating the resources. And also politically it always may not be possible to do whatever economists say.

One of the major problems farmers are facing today is the fluctuation of prices. But procurement price covers only a few crops and also can not be a solution. The problem with fluctuation in prices is, when prices are good, there will be a glut in production and prices become low. So there is a cycle, we need to break these cyclical fluctuations.

Therefore, we need to have transportation, marketing network of cold storage facilities and other infrastructure in place. All these require investments.

Dr. M Govinda Rao is an economist and a member of the 14th Finance

Commission. Dr. Rao has previously served as the Director of National Institute of Public Finance and Policy and as the Director of Institute for Social and Economic Change. He has also worked in a number of advisory roles.

He was a Member of the Economic Advisory Council to the Prime Minister. He was a member of the Financial Sector Legislative Reforms Commission (FSLRC) and the Expert Committee on Multi-level Planning, Planning Commission. He has been a consultant to the World Bank, International Monetary Fund, Asian Development Bank, and the UNDP.

Dr. Rao's research interests include public finance and fiscal policy, fiscal federalism, and state and local finance. ▪