Assessing growth dividend - Establishing a linkage between GDP growth and indirect tax to GDP ratio.

To fund public spending and to ensure redistribution of wealth the role of taxes in any economy becomes very important. However, most taxes also have an economic impact as they influence people’s behavior in unhelpful ways and all reduce the welfare of those who bear their economic burden. The challenge for tax design is to achieve social and economic objectives while limiting these welfare-reducing side effects.

Canons of Public Finance & Taxation

The characteristics or qualities, which a good tax system should possess, are described as canons of taxation. Adam Smith in The Wealth of Nations has given the four canons of taxation – equality & progressivity, certainty, convenience and economy.

While the above recommendations command near-universal support, there are few other objectives of a tax system, which cannot be ignored. In concise, a good tax system is one that is (1) designed to minimize its negative effect on welfare and economic efficiency; (2) has low compliance and administration costs; (3) is fair in terms of procedure and expectation and is (4) one which is transparent as easy to understand. In addition to above a good tax system will also take into consideration the method to deal with externalities in situations where when one person or organization does not take account of the effects of their actions on others.

The tax system affects the standard of living in different ways for different groups of the population. This is why the effects of direct and indirect taxes on the standard of living is an important subject in public economics. Governments may regard it as part of their function to achieve a more equal distribution of wealth within society, either by means of the tax system or by their spending policies. Expenditure-based taxes will tend to be regressive in their impact; i.e. they will bear more hardship on the poor than the rich, because in the nature of the case they cannot take account of the personal circumstances of particular taxpayers. On the other hand, taxes on income are considered more progressive; i.e. the rich will pay a greater proportion of their income in tax than the poor. However, this does not mean that all indirect taxes are regressive by their very nature and all direct taxes are always progressive. For example, higher indirect taxes on luxury goods are progressive in nature as the rich bear the burden of such taxes. Similarly, in today’s times of corporate competitiveness and urge for increased profit making, any direct tax on corporate income will percolate down as higher cost of the products and services being offered by such corporates which will burden the poor more than the rich. Thus, to maintain an optimal balance between direct and direct taxes has always been a challenge to the respective governments.

This paper attempts to analyze the linkage between growth in the GDP of India with the indirect tax collections. The Gross Domestic product (GDP) is the broadest quantitative measure of a country’s total economic activity. More specifically, it is the monetary value
of all the finished goods and services produced within a country’s borders in a specific time period. On the other hand, indirect taxes are primarily taxes imposed on goods and services. Therefore, by their very nature, the indirect tax collections have to have some linkage with the quantum of goods and services produced.

2. **International trends in Direct versus Indirect taxation**

Total tax revenue as a percentage of GDP indicates the share of a country’s output that is collected by the government through taxes. It can be regarded as one measure of the degree to which the government controls the economy’s resources. Globally, it has been observed that countries significantly increase the overall level of taxation (as a share of GDP) as they become richer, in line with “Wagner’s law,” which states that the size of the government—proxied by the tax (and expenditure) share to GDP—rises as the associated country’s income level also rises.²

Figure 1 below, shows the tax to GDP ratios of OECD countries in 2013 as compared to the total tax to GDP ratio (Union + States) in India. As compared to an OECD average of 34.13% during 2013, India’s total tax to GDP ratio was only 17.09%. During the said year, the tax to GDP ratio for the Union was only 10.5%. There is, therefore, considerable scope for increasing the tax-GDP ratio for India, which would provide greater fiscal space for increase in productive and developmental expenditures.

![Figure 1](image)

**Figure 1**

*Tax to GDP ratios of various OECD countries as compared to India*

*Year: OECD - 2013; India – 2013-14*

Source: OECD, Public Finance Statistics 2014-15

In addition, as shown in Figure 2 below, it is observed that the tax structure becomes more biased towards direct taxation as countries develop.²
In the Indian context, after an increase in the tax to GDP ratio during the period 1950-51 to 1989-90 from about 6 per cent to close to 16 per cent, the tax to GDP ratio in India, considering the central and state governments together, has stagnated, with some variations, in the range of 16-17 per cent for nearly 25 years implying that there has been no effective additional resource mobilization (ARM) from the tax side during the period. The gross tax to GDP ratio of the Union Government increased significantly from 7.97 percent in 2001-02 to 9.41 per cent in 2004-05 and11.89 per cent in 2007-08. The increase in direct tax revenue was due to high growth of GDP and improvement in tax administration, particularly the introduction of the Tax Information Network. The increase in indirect tax was mainly on account of a steady expansion in the base of service tax. The overall tax buoyancy during this period was about 1.5.

Figure 2
Composition of Direct versus Indirect Tax revenues of OECD countries as compared to India
Year: OECD - 2013; India – 2013-14

Source: OECD, Public Finance Statistics 2014-15

Figure 3
Tax Revenues as % of GDP for the Union Government
As % of GDP at CMP

Source: Public Finance Statistics 2014-15
The trend of high growth in tax revenue was reversed in the wake of the global economic crisis in 2008-09. The counter-cyclical measures included a duty cut of 4 percentage points in Union excise and 2 percentage points in service tax. As a result, gross tax revenue as percentage of GDP declined from 11.9 per cent in 2007-08 to 9.6 per cent in 2009-10. The additional fiscal space and the tax capacity created since 2003-04 was, therefore, almost entirely wiped out within a span of two financial years.\(^4\)

With signs of recovery and partial roll back of stimulus measures given on the indirect taxes front in 2010-11, the tax-GDP ratio recovered marginally to around 10.2 per cent in 2010-11, only to fall to 9.9 per cent in 2011-12. While it again increased marginally to 10.2 per cent in 2012-13, it fell back to 9.93 per cent in 2014-15. Thus, the tax-GDP ratio has been stagnating at around 10 per cent implying that there has been no effective additional resource mobilization from the tax side during the period.

Traditionally, India’s tax regime relied heavily on indirect taxes including customs and excise. Revenue from indirect taxes was the major source of tax revenue till tax reforms were undertaken during nineties. The share of revenue from indirect taxes has been higher than that of direct taxes for the most part of the post-Independence period. However, in 2007-08 the share of direct taxes became higher than that of the indirect taxes for the first time. This trend was maintained and is estimated to continue despite a marginal decline in the share of direct taxes. Figure 4 below, shows the growing share of direct taxes in the gross tax revenues of the Union.

![Figure 4: Growing share of direct taxes in the gross tax revenues of the Union](source: Public Finance Statistics 2014-15)

3. **Linkage between GDP growth and total Indirect Taxes in the Indian context**

Theoretically speaking, growth in the GDP indicates an increase in the total quantum of goods and services produced in an economy as compared to the previous year. Therefore, other things remaining constant, tax revenues from goods and services i.e. indirect tax collections should increase in the same proportion. However, in practice the above linkage is not so obvious as indirect taxes are one of the principal tools in the government’s fiscal toolkit to influence consumption patterns and give impetus to industrial
growth and development.

In Figure 5 below, the total indirect tax collections in India have been plotted against the GDP at Current Market Prices (CMP). The period covered in this analysis is from 1990-91, when structural reforms were introduced in the indirect tax system of the country in response to the economic crises, till 2014-15. The Pearson’s Co-efficient from this analysis is 0.99 which shows a strong co-relation between the increase/growth in indirect taxes to increase/growth in GDP at CMP. The trendline incorporated in the scatter plot has been derived from the trends in indirect tax collection till 2007-08 which has then been forecasted to cover the period till 2014-15. This methodology has been adopted as indirect tax collections had shown a steady growth with growth in GDP till the 2008 Financial Crises and the consequent economic stimulus in the form of indirect tax concessions to boost economic growth to pre-crises levels. By adopting this methodology, this paper intends to analyse the stagnation of the indirect tax collections consequent to the economic stimulus package of 2008-09.

![Figure 5](image)

**Figure 5**

*Scatter Plot of Total Indirect Tax Collections along with GDP at CMP*

As can be seen from the scatter plot, the indirect tax collections for the period 2008-09 till 2014-15 do not follow the trends as were seen in the high economic growth period from 2001-02 to 2007-08. Thus indirect tax collections in India, though linked to GDP growth, are more dependent on the fiscal policy of the government keeping in context the broader economic and political goals to be achieved through the policy.

4. **Trends in collections of various components of Indirect Taxes of the Union**

On the indirect taxes front, the revenues from both excise and customs have shown a declining trend since 2007-08, both as percentage of GDP as well as percentage of gross tax revenues of the Union Government. The share of revenue from service tax in total indirect tax revenues has shown a steady increase on account of expansion in the tax base as well as the adoption of the “negative” list approach in 2012-13.
a. Customs

Tariff reductions across rate categories, including peak rates, has caused a decline in the revenue collection from customs duties even in nominal terms during 2008-09 and 2009-10, compared to 2007-08. After a brief recovery in 2010-11, the growth of customs duties has continued to show a downward trend, indicating a fairly entrenched impact of the economic downturn on imports. The share of customs duty was 15.1 per cent of gross tax revenues in 2013-14 and 2014-15.

Customs duty is collected on imports of goods but there are number of exemptions to the application of the statutory rate. Therefore, increase in the value of imports does not necessarily imply similar change in customs duty collection. Figure 4 below shows the Customs duty collection viz a viz the total imports into the country.
The collection rate is an indicator of overall incidence of customs duty and is computed as the ratio of total customs revenue collection to the value of imports in the fiscal year. The trend in these ratios for important commodity groups as well as for all commodities taken together over the years is depicted in Table 2. A major reason for the decline in collection rates has been a reduction in duties on many items which have significant import value, including petroleum, oil, and lubricants (POL), some of which continued until the recent hike, and of course the impact of various exemptions.

Table 2
Collection Rates for Selected Import Groups

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Food Products</td>
<td>4.2</td>
<td>2.5</td>
<td>3.1</td>
<td>2.9</td>
<td>3.2</td>
<td>5.3</td>
</tr>
<tr>
<td>2</td>
<td>POL</td>
<td>2.7</td>
<td>1.9</td>
<td>5.6</td>
<td>2.8</td>
<td>1.5</td>
<td>1.6</td>
</tr>
<tr>
<td>3</td>
<td>Chemicals</td>
<td>16.4</td>
<td>13.9</td>
<td>16.9</td>
<td>14.0</td>
<td>16.3</td>
<td>16.3</td>
</tr>
<tr>
<td>4</td>
<td>Man-made Fibre</td>
<td>17.0</td>
<td>22.0</td>
<td>29.6</td>
<td>21.9</td>
<td>31.3</td>
<td>29.5</td>
</tr>
<tr>
<td>5</td>
<td>Paper and newsprint</td>
<td>8.4</td>
<td>7.7</td>
<td>7.9</td>
<td>7.0</td>
<td>7.3</td>
<td>7.3</td>
</tr>
<tr>
<td>6</td>
<td>Natural Fibre</td>
<td>5.6</td>
<td>4.3</td>
<td>4.6</td>
<td>3.3</td>
<td>4.5</td>
<td>5.6</td>
</tr>
<tr>
<td>7</td>
<td>Metals</td>
<td>16.8</td>
<td>17.4</td>
<td>22.0</td>
<td>19.7</td>
<td>22.7</td>
<td>22.9</td>
</tr>
<tr>
<td>8</td>
<td>Capital Goods</td>
<td>12.5</td>
<td>11.3</td>
<td>12.9</td>
<td>11.5</td>
<td>11.7</td>
<td>11.9</td>
</tr>
<tr>
<td>9</td>
<td>Others</td>
<td>4.0</td>
<td>3.8</td>
<td>3.9</td>
<td>3.7</td>
<td>4.7</td>
<td>5.4</td>
</tr>
<tr>
<td>10</td>
<td>Non Pol</td>
<td>8.7</td>
<td>7.6</td>
<td>8.5</td>
<td>7.4</td>
<td>8.2</td>
<td>8.8</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td></td>
<td><strong>6.9</strong></td>
<td><strong>5.9</strong></td>
<td><strong>7.7</strong></td>
<td><strong>6.0</strong></td>
<td><strong>6.0</strong></td>
<td><strong>6.2</strong></td>
</tr>
</tbody>
</table>

Source: Economic Survey 2014-15

b. Central Excise

In 2007-08, Union excise duties constituted the largest share of indirect taxes, at 20.8 per cent of gross tax revenues. The impact of economic slowdown and introduction of stimulus measures by way of across the board reduction in excise duty rates (by 6 percentage points from 14 per cent to 8 per cent) saw revenue collections from the tax
falling even in nominal terms in 2008-09 and 2009-10. The rate reduction was partially rolled back in 2010-11 with general excise rates increasing from 8 per cent to 10 per cent, followed by a further increase to 12 per cent in 2012-13. However, growths of revenue from excise duties have fluctuated considerably since 2010-11. Year-on-year growth went up to 34 per cent that year, then dropped to 5.2 per cent in 2011-12 and again accelerated to over 22 per cent in 2012-13. As a ratio of GDP, revenue from excise duties has shown a steady decline from around 3.1 per cent in 2001-02 to 2.5 per cent in 2007-08 and to 1.51 in 2014-15.

**Figure 8**
Central Excise Collections along with Manufacturing Sector in total GDP

![Graph showing excise collections and manufacturing sector](source: Public Finance Statistics 2014-15, CSO)

c. **Service Tax**

The share of revenue from service tax in total indirect tax revenues has shown a steady increase on account of expansion in the tax base as well as the adoption of the “negative” list approach in 2012-13.

**Figure 9**
Service Tax Collections along with Services Sector in total GDP

![Graph showing service tax collections and services sector](source: Public Finance Statistics 2014-15, CSO)
5. **Trends in Revenue Foregone**

Revenue foregone as estimated by the Union Government reached a peak of 8.1 per cent of GDP in 2008-09 and as a percentage of gross tax revenue; it was the highest (77.3 per cent) in 2009-10. Since 2004-05, revenue foregone has always been in excess of 5 per cent of GDP. In nominal terms, the estimated revenue foregone for 2013-14 (RE) stands at Rs.5,72,923 crore. This accounts for a little over 5 per cent of estimated GDP of 2013-14 and about a half of the total tax collections estimated during the year.

The revenue foregone under excise duties includes general exemptions, which largely reflect the fiscal policy of the Union Government, as well as area-based exemptions. Area-based exemptions are of two types - refund-based exemptions determined on the aggregate refunds sanctioned (for the North-eastern States and Jammu & Kashmir) and outright exemptions, where revenue foregone is calculated using the difference between the general effective rate and the duty actually paid (in Himachal Pradesh and Uttarakhand). On customs duties, the revenue foregone is shown under ten broad commodity groups based on the difference between the tariff rates and effective rates.

As can be seen in Table 3, in the Indian indirect tax structure, the revenue foregone in customs and excise is more than the amount that is collected. If for theoretical understanding, it is assumed that no revenue concessions are given, then the total indirect tax to GDP ratio will double to around 8.5 to 9 percent as compared to 4 to 4.5 percent at present.

<table>
<thead>
<tr>
<th>Year</th>
<th>Customs</th>
<th>Central Excise</th>
<th>Service Tax</th>
<th>Total Indirect Tax Foregone</th>
<th>Total Indirect Tax as % of GDP</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Revenue (in Rs. Crores)</td>
<td>Revenue Foregone (in Rs. Crores)</td>
<td>Revenue (in Rs. Crores)</td>
<td>Revenue Foregone (in Rs. Crores)</td>
<td>Total Indirect Tax Revenue Foregone (in Rs. Crores)</td>
</tr>
<tr>
<td>2010-11</td>
<td>135813</td>
<td>172740</td>
<td>137701</td>
<td>192227</td>
<td>71016</td>
</tr>
<tr>
<td>2011-12</td>
<td>149328</td>
<td>236852</td>
<td>144901</td>
<td>195590</td>
<td>97509</td>
</tr>
<tr>
<td>2012-13</td>
<td>165346</td>
<td>254039</td>
<td>175845</td>
<td>209940</td>
<td>132601</td>
</tr>
<tr>
<td>2013-14</td>
<td>172085</td>
<td>260714</td>
<td>170198</td>
<td>196223</td>
<td>154778</td>
</tr>
<tr>
<td>2014-15</td>
<td>188013</td>
<td>301688</td>
<td>189040</td>
<td>184764</td>
<td>167990</td>
</tr>
</tbody>
</table>

Typically, there is an overstatement of Revenue Foregone as most emerging markets have high rates of their statutory schedule of taxes and effectively tax collections at much lower rates systematically for a number of years. For example, the effective rates of customs as well as excise duties on many commodities have been less than the tariff rates. Though termed as Revenue Foregone, it does not imply that the government has waived this quantum of revenue. Rather, in some cases, this could be seen as targeted incentives for the promotion of certain sectors that may not otherwise, in the absence of such incentives, have come up. Further, the positive externalities by the way of ancillary economic gains due to the progress of any sector are also not factored in the determination of revenue.
foregone of any sector. However, in spite of these benefits accruing, there is a case of rationalizing some of these exemptions so as to increase the overall Tax-to-GDP ratio.

6. Area Based Exemptions – A Case Study.

Area-based exemptions are of two types - refund-based exemptions determined on the aggregate refunds sanctioned (for the North-eastern States and Jammu & Kashmir) and outright exemptions (in Himachal Pradesh and Uttarakhand). This paper examines one such area-based exemption in Himachal Pradesh to see if the same has been able to achieve the desired objectives.

In brief, the Government of India, Ministry of Commerce & Industry (Department of Industrial Policy & Promotion) issued a New Industrial Policy dated 07.01.2003 providing fiscal incentives to new industrial units and to existing units on their substantial expansion. The policy provided that new industrial units and existing industrial units on their substantial expansion which are set up in the growth centres, industrial estates and other areas as notified from time to time by the Central Government would be entitled to 100% excise duty exemption for 10 years, etc. Pursuant to the aforesaid policy, the Central Government, in public interest, issued notifications Nos. 49/2003 & 50/2003 dated 10.06.2003 under Section 5A of the Central Excise Act, 1944 granting exemption of excise duty on certain kinds of goods cleared from a unit located in an area specified therein. Such new industrial units or expanded existing units were eligible for excise duty exemptions for a period of ten years from the date of commercial production. Subsequently, a cut off date of 31.03.2010 was prescribed in the notification for availing the exemption benefit.

The total number of declarants that availed the area-based exemption in the state of Himachal Pradesh along with the duty foregone pertaining to such units is shown in Table 4. As can be seen, there was a substantial jump in the new industrial units that were set up in the state in the year 2009-10, just before the cut-off date of the notification.

<table>
<thead>
<tr>
<th>Year</th>
<th>No. of Units availing exemption</th>
<th>Duty Foregone (in Rs.Crores)</th>
</tr>
</thead>
<tbody>
<tr>
<td>2007-08</td>
<td>1994</td>
<td>2153.41</td>
</tr>
<tr>
<td>2008-09</td>
<td>2260</td>
<td>4727.86</td>
</tr>
<tr>
<td>2009-10</td>
<td>3517</td>
<td>3856.42</td>
</tr>
<tr>
<td>2010-11</td>
<td>3517</td>
<td>6274.58</td>
</tr>
<tr>
<td>2011-12</td>
<td>3517</td>
<td>7312.00</td>
</tr>
<tr>
<td>2012-13</td>
<td>3517</td>
<td>8370.64</td>
</tr>
<tr>
<td>2013-14</td>
<td>3476</td>
<td>9288.47</td>
</tr>
<tr>
<td>2014-15 (upto 09/2014)</td>
<td>3412</td>
<td>4060.70</td>
</tr>
</tbody>
</table>

Source: Central Excise & Service Tax Division, Shimla

The area-based exemption provided an excise exemption for a period of 10 years from the date of commencement of commercial production by the unit. As a consequence, from 2013-14 onwards i.e. 10 years from notification date, the excise exemption for the units which commenced commercial production in 2003-04 lapses and these units were normally expected to become duty paying units. Similarly, for the subsequent years more
such units are expected to become duty-paying units depicting the industrial development of the state due to the area based exemption.

However, on the contrary, as per data compiled till 2014-15, the number of units that have closed down on completion of the excise exemption far exceeds the number of units that have continued commercial production after the completion of excise exemption. Table 5 below, shows the number of Units that have closed down after the completion of exemption vis. a vis. the number of units which have continued industrial production raising doubts as to whether the area based exemptions have been able to meet the desired objective to ensure long term industrialization of the state.

Table 5
No. of units availing area-bases exemption in Himachal Pradesh which have closed down upon expiry of the excise exemption

<table>
<thead>
<tr>
<th>Number of Units Closed Down from 2013-14 till 2014-15 after expiry of excise exemption</th>
<th>Number of Units Continuing Commercial Production after expiry of excise exemption</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>141</td>
<td>43</td>
<td>184</td>
</tr>
</tbody>
</table>

Source: Central Excise & Service Tax Division, Shimla

From the above it is seen that, as per data available, the majority of units set up in such area based exemption jurisdiction have opted not to continue production after the expiry of exemption. This may either be as the products being manufactured by such units no longer remain competitive on removal of excise exemption or such units were set up only as a proxy to show clearance of goods which were actually produced in a taxable jurisdiction. Either way, the benefit of industrialization accruing to the state is limited. One of the main reasons for such flight of industrial units (into the state during the exemption period and out of the state after expiry of exemption) is that there is no minimum investment criteria (based on value of investment or capacity of machinery) to avail such area based exemptions. As a result, apart from a few big industrial units, the majority of the units set up in the state were low capital and labor intensive which are since closing down on the expiry of the exemption, thus leading to skewed industrial development in the state. This trend is expected to magnify further as majority of units in the state were set up close to the cut off date in 2010 and will complete the exemption period by 2020.

Thus, it is seen that providing such area based tax exemptions have limited role in promoting industrialization in the area and therefore need to be looked into afresh. Further, if such schemes are to be resorted to for political and other reasons, a minimum investment criteria must be prescribed within the notification to ensure continuity in production even when the exemption is withdrawn, ensuring long term industrial development of the state.

7. Challenges and Recommendations

The analysis of the Indian tax system underlines the need for the reform of the indirect tax system. Increase in revenue productivity in the least distortionary manner requires expansion in the tax base, rationalization of rates to levy the tax at reasonable rates, simplifying the tax system and reforming the administration.
As seen above, there is a need to relook into the various exemptions especially the area-based exemptions as to whether these have been able to achieve the desired objectives. Such exemptions are distortionary in nature as they tend to promote a shift of industries from neighboring states to exempted areas. This results in the industrial development of one state at the cost of its neighbors. Further, such exemptions increase the tax gap due to the large amount of revenue foregone and reduction in tax base. Ideally, such exemptions must be avoided so that the tax base can be expanded and the tax rates can be kept low and optimum. However, if these are to be resorted to due to political and other exigencies, these must be linked to a minimum investment criteria, as suggested above, so as to ensure long-term interests of the industries that are setup in the targeted areas. Similarly, for threshold-based exemptions, the threshold levels can be reduced and brought to the same level for both goods and services.

The major item in the reform agenda comprises of the introduction of GST at Union and State levels. The government has shown keenness to implement the reform and has brought in the 122nd Constitution Amendment Bill to hasten the process. GST is expected to improve the ease of doing businesses, enhance efficiency in the supply chain by obviating the need to have branch offices (created to avoid the inter-states sales tax), reduce transaction costs by ensuring seamless trade in commodities and services across the country and improve export competitiveness by providing comprehensive relief from domestic taxes.

The other major challenge is to tap the informal sector of the economy to increase tax revenues. India is essentially a cash economy, which imposes a challenge in achieving universal tax coverage. There is a need to encourage cashless transactions and to shift to other modes of payments other than cash. Further, methods need to be explored for bring cash transactions into the formal sector. In this regard, lessons can be learnt from the Korean system of Cash Receipt System (CRS). In the CRS, for every transaction involving cash, a Cash Receipt is required to be issued by the seller or supplier of service to the customer. This Cash Receipt is issued by a terminal, which is linked to the central database of the National Tax Service of Korea. To incentivize the issuance of Cash Receipts, tax credits are give to the customer receiving the receipt at the time of filing of his tax returns, thus promoting a demand for such Cash Receipts. To ease identification of the customer, each citizen is assigned a unique number, which is required to be mentioned on the Cash Receipts so as to facilitate tax credits at a later stage. To simplify the process further, the Korean National Tax Service has introduced Smart Cards and mobile apps that are used to input the customer’s unique number into the Cash Receipt issuing terminal. There were also periodical lottery distributions (now discontinued in Korea) based on the Cash Receipt Numbers as available in the National Tax Service Servers to promote use of the CRS.

The other reform, which can be implemented within a short span of time, is the pruning of the Negative list in Service Tax. The taxation of services provided by the Government to Business entities, though has been proposed in the Budget 2015-16, but not yet notified, can be brought into the tax net in the immediate future. Further, Private health care may be brought under service tax net by removing from exemption notification. Also, the Swach Bharat Cess as proposed in this year’s Budget must also be notified immediately to mobilize more revenue.

There is also a need to minimize the misuse of input tax credit and to check tax
evasion. The use of technology to facilitate invoice and tax credit matching online can prevent fraudulent availment of input tax credits. Further, simplification of tax laws, procedures and reducing cost of tax compliance will address non-compliance and motivate genuine and willing taxpayers. This will reduce the tax gap – the difference between tax that is legally due and the actual tax collected.

There is also a need to address the organizational shortcomings of the Tax administration. It is well known that ultimately ‘Tax administration is Tax Policy’. Therefore to have an effective tax system the organizational shortcomings such as human resource development, training, functional reorganization of the field formations instead of the geographic organization at present, increased use of Information Communication Technology, strengthening the risk based compliance verification and enhancing focus on risk management by deploying more resources to it.

The Information Dissymmetry in Tax administration also needs to be addressed to ensure tax productivity. This dissymmetry is in the form of a data gap where the tax administration does not have the entire information, which an assessee may have. In this regard, all statutory and other returns may be designed to collect maximum information without increasing compliance costs. Third Parties such as credit card companies, foreign exchange dealers, banks, etc. have loads of information, which is very useful for ensuring effective tax compliance. There is also a need for information sharing between various agencies of the government. In this regard, Memorandum of Understandings (MoU) can be signed between various departments charting out specific details of mechanism, limitations and conditions for exchange of information between the departments. There is also a need to encourage and protect whistleblowers by ensuring timely disbursal of rewards and protection of the identity of the whistleblower. There is also a need to adopt a global approach by increased information sharing with foreign Customs administrations.

Ultimately, as emphasized by Johnson and Myles (2011; p.323), “In the real world, proposals for tax reform are constrained by politics – Those who lose from tax reforms tend to be vengeful while those who gain from them tend to be ungrateful. This can lead in tax policy, perhaps more than in any other areas of public policy, to a ‘tyranny of the status quo’. There is always a tension between what is economically desirable and what is politically practical.” Thus, the major precondition for successful tax reforms is political aptitude to such reforms.5

8. Study of Tax Systems in Korea and Singapore

**Tax System in South Korea:**

National Tax Service, a single authority, is responsible to collect all direct, indirect and special purpose taxes as part of Korean National Taxes. Customs is administered by Korean Customs separately.

Korean National Taxation is based on the annual business income. Since most of the foreign investors are corporations and thus liable to pay it, corporate tax makes up the largest portion of the total taxes related to foreign investment. Under the tax agreement, only the income from the permanent establishment of a foreign company is taxable. Permanent establishments here refer to branches, warehouses, stores, or other establishments for installment or construction projects. A company which has a right to sign a contract or which conducts its business and trade through an agent who on behalf of
the company buys or sells its stocks is also subject to tax.

Foreign corporations with a permanent establishment in Korea are required to pay corporate income tax on income from Korean sources in the same manner as that applied to a domestic corporation. In case of a branch in Korea, there may be a branch profit tax (BPT), depending on tax treaties. The BPT is imposed on the adjusted taxable income of the Korean branch of the foreign corporation. This branch profit tax is levied in addition to the regular corporation tax under the Corporation Tax Law. The standard rate of BPT is 25%, although reduced rates of between 5% and 15% apply where provided for by a tax treaty.

The national internal taxes consist of direct and indirect taxes and each consists of five internal taxes. Of these ten taxes, Income Tax, Corporation Tax, and Value Added Tax make up the bulk of Korean tax revenue. There also exist three national earmarked taxes, namely the Transportation, Energy, Environment Tax, Education Tax, and Special Tax for Rural Development; the revenues from these sources go directly to pre-designated government programs.

There are eleven local taxes, and they are divided into province and city & county taxes. At the province level, there are four ordinary taxes and two earmarked taxes. At the city & county level, there are five ordinary taxes. In the six large specially designated cities that are run as autonomous local administrative units (independent of the provinces they appertain to), the tax composition is slightly different from that of the provinces and cities or counties, although the residents are required to pay the same taxes.

The Value Added Tax (VAT) was introduced in South Korea in 1976 combining all indirect taxes on goods and service tax. VAT is levied on the supply of all goods and services and the importation into South Korea of all goods. Goods include all tangible and intangible properties that have values. Tangible properties include commodities, products, raw materials, machinery, buildings and other properties having a tangible form. Intangible properties include power, heat, and other properties (including “rights”) that do not have a tangible form.

For VAT purposes, the term “supply of services” refers to the provision of services for consideration pursuant to law or contract, except for services provided by an employee to his employer. The importation of goods from outside Korea or from a bonded area is taxable under the Korean Value Added Tax Law (VATL). The standard VAT rate is 10 percent. There is no applicable provision of reduced rates under the Korean tax law. The treatment of zero-rate VAT and exemptions are available as described below. The following categories of transactions are zero rated:

- the export of goods
- the supply of services outside Korea
- the supply of international transportation services by vessel or aircraft
- the supply of certain goods or services the compensation for which is received in foreign exchange.

Korean national tax system has also introduced simplified VAT which eliminated the invoice method. A single VAT rate for each type of business is applied instead of
deducting input VAT from output VAT.

**Important features of Korean National Tax System:-**

1. Taxation based on VAT Invoice – It makes all the transactions accounted for, prevents misuse of input VAT which is not available without an authorized invoice and evasion of duty and enhances tax base.

2. A flat rate of VAT is applied to all transactions of goods and services which eliminates progressive taxation. The VAT system improves neutrality of taxation as well as helps enhancing market functions through stabilizing tax administration.

3. Exports are zero rated and capital investment is not subjected to tax which promotes the environment for investment, setting up of new units and export.

4. Simplified VAT is very trade friendly reduces compliance cost and tax administration cost. But, it does not require issue of tax invoices making difficult to substantiate transactions. It can increase the tax avoidance of VAT and also personal and corporate income tax.

5. Growing number of VAT exemptions adding towards cascading effect.

**Tax System in Singapore:-**

Inland Revenue Authority of Singapore (IRAS) is a statutory board under the Ministry of Finance of Singapore, which is responsible for collecting personal income tax, corporate tax, property tax, goods & services tax, betting taxes, withholding tax and stamp duty.

*The Inland Revenue Authority of Singapore (IRAS)*, was formed in 1960 and was formerly known as the Inland Revenue Department. It integrated all the key revenue collection agencies into one body, enabling the administration and collection processes to become more streamlined and better managed. IRAS has also made its mark as an efficient tax administrator and a service-friendly tax collector.

The IRAS is responsible for collecting income tax, property tax, goods & services tax, estate duty (abolished since 15 Feb, 2008), betting taxes and stamp duties. As the main tax administrator for the Ministry of Finance, IRAS plays a role in tax policy formulation by providing policy inputs, as well as the technical and administrative implications of each policy. IRAS also actively monitors developments in external economic and tax environment to identify areas for policy review and changes. It aims to foster a competitive tax environment that encourages enterprise and growth. The other non-revenue functions performed by IRAS include representing the government in tax treaty negotiations, providing advice on property valuation and drafting of tax legislation.

The commissioner of Inland Revenue administers the whole tax structure of Singapore under supervision of IRAS board. Further the work of policy formulation, enforcement and investigation and tax collection of various taxes like personal income tax, corporate tax, property tax, goods & services tax, betting taxes, withholding tax and stamp duty has been divided into divisions headed by Assistant Commissioner or Deputy Commissioner.

- Singapore follows a territorial basis of taxation. In other words, companies and
individuals are taxed mainly on Singapore sourced income. Foreign sourced income (branch profits, dividends, service income, etc.) will be taxed when it is remitted or deemed remitted into Singapore unless the income was already subjected to taxes in a jurisdiction with headline tax rates of at least 15%. Although the concept of locality of the source of income seems simple, in reality its application often can be complex and contentious. No universal rule can apply to every scenario. Whether profits arise in or are derived from Singapore depends on the nature of the profits and of the transactions which give rise to such profits.

- Singapore corporate tax rate is capped at 17%. By keeping corporate rates competitive, Singapore continues to attract a good share of foreign investment. Singapore follows a single-tier corporate tax system, where tax paid by a company on its profits is not imputed to the shareholders (i.e. dividends are tax free).
- Singapore corporate tax rate start at 0% and are capped at 20% (above S$320,000) for residents and a flat rate of 15% for non-residents.
- To increase the resilience of taxes as a source of government revenue, Goods and Services Tax (GST) was introduced in 1994. The current GST rate is 7%. The balanced mix of tax on consumption and income reduces the vulnerability of revenue intake to adverse changes in economic conditions and strengthens the resilience of Singapore’s fiscal position.
- Interest, royalties, rentals from movable properties, management and technical fees, and director’s fees paid to non-residents (individuals or companies) are subject to withholding tax in Singapore.
- For personal taxes, the tax year is the normal calendar year i.e. January 1 – December 31. Deadline for filing personal tax return is April 15. For corporate taxes, a company is free to decide on its financial year. Deadline for filing corporate tax return is November 30. Taxes are paid on a preceding year basis.
- Singapore has no capital gains tax. Capital loss expenses are correspondingly not allowed as deductions.
- Singapore has concluded more than 50 bilateral comprehensive tax treaties to help Singapore companies minimize their tax burden.

Goods & Services Tax (GST) is a broad-based consumption tax levied on the import of goods (collected by Singapore Customs), as well as nearly all supplies of goods and services in Singapore. However, some items are specifically exempt from GST include financial services and the sale or lease of residential properties. A company must be registered to collect GST if its annual turnover exceeds or is likely to exceed S$1 million from the sale of taxable goods and services. This requirement may be waived if most of the goods or services are exported or supplied internationally (“zero-rated supplies”). The current rate for GST in Singapore is 7%.

The work related to border protection and management is being looked after by immigration authority. Singapore Customs looks after economic security and collects customs duty on only few commodities like cigarette, alcohol and petroleum and remaining commodities are traded freely.
**Bibliography**


**Data Sources**

2. Planning Commission Data Tables
3. Economic Surveys
4. Union Budget Documents
5. Central Excise Division, Shimla for area based exemptions.

**Annexures**

1. Taxation System in Korea and Singapore