Dissertation – Economics of tax collection

Executive Summary

"When there is an income tax, the just man will pay more and the unjust less on the same amount of income." – Plato

It is estimated that the number of personal income tax payers in India is around 2 crore, which forms just about 2% of our population. In the year 2005-2006, the personal income tax collection amounted to 50,929 crore. This forms slightly lesser than 2% of our annual GDP. As per Income tax department's statistic, in 2002, the number of individuals declaring annual income of Rs 10 lacs and above was a paltry 85,000. Enforcing this tax collection mechanism is the mammoth income tax department with a sanctioned manpower of 59,682 personnel.

The above statistics give a glimpse of the monetary costs that are involved in enforcing administrative machinery that would arguably yield a measly sum (less than 2% of our GDP). That is not all, when we take into account the economic costs in terms of transaction and compliance costs involved in activities such as filing returns, costs of hiring professional help to file returns, amount paid in the form of bribes, cost incurred due to time lost in harassment, delayed payment of refunds etc, the costs reach alarming proportions.

In this dissertation, the analysis of the "costs" involved in personal income tax collection, would go beyond just the monetary costs incurred by the government in administering the tax collection mechanism, but would also include the costs incurred by both collector and the income tax payer due to the systemic inefficiencies and high economic costs in terms of lost productivity. The thrust of the argument is that the current system propagates large scale inefficiencies which in turn lead to distrust between the agent and the tax payer.

The initial part of the dissertation looks into these systemic inefficiencies and tries to quantify the costs incurred to the society with the help of established research studies. Following this, alternatives to the existing structure of tax collection are studied, including the question of whether personal income tax collection, as it exists today, be scrapped and alternative forms of revenue collection be adopted as proposed by academicians, research scholars from across the world.

Finally, based on the study of these models, an attempt is made to develop a workable India specific consumption based tax collection model using the VAT system as the foundation. The objective of this exercise is to evolve a model that is effective, equitable, leads to higher revenue collections at the same time reducing the economic costs arising out of inefficiency in the system.

Inefficiencies plaguing the Personal Income tax system

The findings of a survey and research study conducted in 2002 by Chattopadhyay and Das Gupta of the planning commission throws the following startling results:-

Administrative costs in collecting taxes

- As per the survey, the cost of collection of income tax for the year 2000-01 was approximately Rs.759 crore. This includes costs incurred by department of revenue, CBDT, The finance, law and home ministries, the comptroller and auditor general, public account committee of parliament etc

Saral?

"The hardest thing in the world to understand is income tax." − Albert Einstein.

This has been proved right, at least in India with its Byzantine income tax laws, which is further compounded by the administrative hassles of paying taxes, a task for which most of the salaried class employ professional help.

Costs of hiring advisors

- Two thirds of all salary earners consulted tax advisors for the job of filing tax returns
- Chartered accountancy firms charge on an average Rs. 500 to Rs. 1000 and non-salary earners Rs. 1000 to Rs. 5000
- Third party costs of unpaid assistance from friends to help others comply has been valued at Rs. 399 per salaried tax payer and Rs. 405 per non-salaried taxpayer as per their opportunity costs of time

Monetary and time compliance costs

- On an average, non-salaried tax payers spent 88 hours per year complying with tax obligations of which the bulk was spent in keeping records. In contrast, salaried earners spent 28 hours in complying with tax obligations
- These costs are estimated at a staggering Rs. 27,000 per annum for non-salaried tax payers and Rs 2,100 per annum for salaried tax payers.

Table 9: Average Value of Components of Monetary Compliance Costs (in Rs.)

Activities	Non-salary	Salary	All
Record keeping	6605	95	1620
Tax planning and research	429	189	245
Filing of tax return	960	176	359
Obtaining PAN	60	62	62
Fees paid to the advisor	5575	459	2275
Other monetary costs [1]	1534	60	122
Total monetary cost (excl advisor fees)	**9588**	**581**	**2408**
Total monetary cost	**15163**	**921**	**4683**
% on Tax planning and research	*2.83*	*18.14*	*5.24*

Note: 1 Scrutiny, tax refund, in appeal and litigation, and others.

Cost of bribes / harassment

- On an average 23% of salaried respondents and 42 % of non-salaried respondents in the research survey admitted to paying bribe
- The survey estimates that the average bribe cost for salaried taxpayers is around Rs 200, while for the non-salaried it is around Rs 4000.
- Costs involved in harassment by tax officers, delayed PAN card, late IT refunds etc, that are difficult to quantify but are highly prevalent

Cost of TDS

- TDS is an important source of third party compliance costs. Collections through TDS constituted 53% of total collection of income taxes and 60% of non-company income taxes during FY 2000.
- The survey identifies three main types of compliance costs a) External costs including fees paid to an external chartered accountant b) Staff costs c) Overhead administrative expenses
- For the year 2000-01 total cost of compliance is estimated at 11.81% of taxes deducted at source

Cost of collecting taxes through public sector banks

- The survey estimates total cost incurred by public sector banks to collect and remit taxes to the government at Rs 22-23 per thousand rupees, out of which the government reimbursed Rs11.18 per thousand collected, which amounted to Rs. 334 crore during 2000-01, and the banks themselves spent Rs. 363 crore for this purpose out of their own pockets

Putting it all together

To sum it all up, the survey tries to estimate the gross operating costs i.e. total social costs involved in tax collection which includes administrative costs, TDS, banks, legal costs, appeals, cost of hiring advisors etc but excluding bribes. This figure comes out to a staggering 60% of tax revenues collected!

Although, the survey has shortcomings in terms of limited sample size, so far no other satisfactory study has been conducted to quantify the economic costs involved in enforcing and paying personal income tax. Thus the authors of the study conclude that
"In the event that findings of this study cannot be refuted by a more satisfactory study with an adequate sample, then no government in the world has the right to burden its citizens with such a costly source of finance for government expenditure. Compliance costs should either be lowered or high compliance cost groups – which may include the majority of taxpayers – should be exempted from the personal income tax."

Table 28: Aggregate Costs of Collecting the Individual Income Tax:Compliance and Administrative Costs (Percentages of Individual Income Tax Collected in 2000-01)

Item		Estimates with sample averages
Total compliance cost of taxpayers (excluding litigation costs)		49.01
of which legal compliance cost		*46.61*
Add estimated cost of representation in appeals cases	Rs. 78.59 crore	0.25
Non-filer costs (Chattopadhyay and Das-Gupta, 2002b)	Rs. 1089 crore	3.40
Cost of collecting taxes through banks	Rs. 363 crore	1.15
Cost of tax deduction at source		5.68
Total private compliance costs		**59.49**
Government cost of collecting taxes – Income-tax department	Rs. 759 crore	2.40
Government cost of collecting taxes – other (ITAT, settlement Commission, etc.)	Rs. 27.28 crore	0.09
Total direct cost of collecting personal income taxes		**61.98**
Total social cost (deducting bribes)		**59.58**

Income or Consumption?

Income can be divided into two main components, viz consumption and savings. The personal income tax system currently in place taxes the entire income i.e. both savings and the consumption, while giving arbitrary relief in tax to certain forms of savings and investments. The models that we study below revolve around the idea of taxing only the consumption while exempting savings and investments, which are channeled into the productive economy, altogether from taxes. Consumption taxes are taxes on movement of goods i.e. when the item changes hands, the seller or buyer pays a tax. Money is taxed if it is spent and is not taxed if it is saved and re-invested

Alternative models of revenue collection

Some alternative models that have been advocated by economists and experts and / or are being followed in other parts of the world are discussed below:

Fair tax

The Fair tax act 2005 is a bill pending with the U.S. senate. Fair tax is a proposal to change the US tax laws to replace federal personal income taxes and corporate taxes with a single national consumption based retail sales tax. The fair tax would be levied at the point of purchase of new goods and services.

The proponents of the fair tax system cite the following advantages:

Reduction of tax burden visibility: In the fair tax system the tax would be highly visible as the consumer would see most of the cost in a single tax paid every time he purchases a good or service

Reduction of compliance costs: The efficiency costs of the current tax system in the U.S i.e. the output lost over and above the tax itself is to the tune of $ 240 - $ 600 billion as per a 2005 report by the U.S. government accountability office. It is envisaged that the fair tax system would reduce compliance and efficiency costs by over 90% and return a large share of that money to the productive economy.

VAT based consumption tax

This is a modification to the retail sales tax system suggested above, where instead of taxing at a retail level; the tax would be levied at every intermediate step of production where value is added. Here, the producers at every level have an incentive to maintain records and pay taxes on value added, as this would entitle them to rebates on the value that has already been taxed at the previous stages of the value chain.. India has already moved to a VAT regime in many states in 2005 but it is still supplementary to state level sales tax and personal income tax thus involving multiple levels of taxation.

Savings Exempt Income tax (SEI tax)

This idea is essentially a type of consumption tax but differs from the earlier models in the mechanics of its implementation. This idea is associated with the British Nobel prize winning economist Professor James E. Meade. A savings-exempt income tax, as the name suggests, is a form of income tax where a progressive tax is levied only on that part of income that is spent, exempting the part that is saved.

But unlike the Goods and Service taxes (GST) described above, the SEI shifts the point at which the government collects revenue from the seller to the buyer. Rather than attempting to keep track of billions of individual tiny transactions, it uses a far more effective measure of a person's personal consumption expenditure: it simply measures the difference between his income and his net savings. Thus, each taxpayer would be required to provide a careful year-to-year record of his income and consumption. This could again increase compliance costs.

An India specific model

The challenge is to evolve an India specific model that reduces the tax enforcement and compliance costs and at the same time increase savings and channelize funds into the productive economy. With these objectives in mind, the following proposal is put forth:

- Abolish the personal income tax system as it exists currently and move to a consumption based tax system on goods and services.
- Eliminate disparate taxes such as central excise, state level sales tax, service tax, income tax etc and move to a all encompassing value added tax that includes taxing every level of value addition
- Charge a revenue neutral VAT rate that would not provide a loss in revenue to the government.
- The premium that the customer would pay as consumption tax in lieu of the gains realized in not paying personal income taxes, would be spread across the value chain at all levels right from the first level of supplier to the retailer
- The tax would be a progressive tax based on the level and the items of consumption. Basic food items and medicines would be exempt from VAT and the other items and services would be categorized into bands ranging from necessities to day to day utility items to super luxury items / services.
- Dismantle the current income tax apparatus and mould it into a Revenue collection department segregated on the basis of consumption items and services.
- All savings and investments including in banks, stock markets, mutual funds etc would be fully exempt from tax

Benefits of proposed model

Some of the benefits envisaged through the proposed model are:

- All the unproductive money that has been floating around in the parallel economy (which is estimated to be as big as the national GDP) can be unearthed and channelized into productive avenues. Now, the concept of black money would cease to exist
- From the revenue collection point of view, it is much easier to track the supply chain of goods and services including the network of sellers and service providers

than to track each and every individual liable to pay income taxes. Furthermore, the VAT system provides incentives for producers at every level to pay their taxes and claim rebates on taxes that have already been paid.

- There is a feeling of inequity and alienation among the middle class salaried tax payers and the self employed, who, generally feel are the primary victims of high compliance costs and feel squeezed out as they have no alternative but to comply in the form of TDS while the government efforts at expanding the tax base and bringing the defaulters to book has been far from satisfactory. Added to this are schemes such as the VDS (Voluntary disclosure of income scheme) that sought to pardon the guilty and dis-incentivize honest tax payers. The proposed model seeks to eliminate such inequities.

Conclusion

The irony of the Indian tax system is that one pays taxes even on the compliance costs incurred while paying taxes. This can be seen from the real life scenario where one pays a service tax even for hiring a chartered accountant who is essentially helping out in filing personal income tax returns!!

India has already tried to bring in a consumption based tax system, but it failed to take off because the consumption tax was made supplementary to the personal income tax system. Now, India is witnessing unprecedented GDP growth rates of 8% or more for three years in a row. Aspiration levels of people has increased and we are witnessing a consumption led boom be it retail stores, malls, luxury items, cars, consumer durables, Indians are lapping it all up. In this context, a consumption based tax can yield much higher revenues compared to the measly personal income tax collections and at much lower enforcement and tracking costs. At the same time, the tax payer is better off as his compliance costs are drastically reduced and he need not hire advisors or face harassment in myriad forms.

Money that has been locked up for many decades would enter the productive economy and provide much needed funds for public spending on education and infrastructure creation. The only ones to lose are the tax defaulters and the corrupt officers who extracted huge sums of money in the form of bribes. There is overwhelming consensus even among economists and policy makers across the world on the effectiveness of a consumption based tax system. It would political will and innovation to implement it, but the benefits outweigh the costs of transitioning into the new system

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