Addressing the **'tax gap'** in India

A cooperative compliance framework programme can help build mutual trust and a strong continuing relationship between the taxpayer and the tax department, leading to sustainable compliance and revenue growth

By Akhilesh Ranjan and S. Ramesh

In October 2020, Prime Minister Narendra Modi said that he is optimistic about India becoming a USD 5 trillion economy by 2024. India's gross domestic product (GDP) in 2020 was USD 2.66 trillion.[55] Though there was a decline in GDP of 7.3% from 2019 primarily on account of the pandemic, the economy has since shown remarkable resilience and the GDP growth has picked up pace over the last year and a half. However, the target of a USD 5 trillion economy is still some distance away. Clearly, continued and sustained high growth would be required, not only for reaching the USD 5 trillion dollar goal within a few years, but also for coming out of the COVID-19-induced disruption and achieving the Sustainable Development Goals (SDGs) set out under the United Nations (UN) agenda for emerging and developing economies. Since such growth would need substantial government spending, a sustained growth in tax revenues would also be required.

Tax reforms over the years

Over the past few years, the Central Government has introduced several far-reaching tax reforms. Some of the major steps taken on the direct taxes side were:

- the rationalisation of the corporate tax structure, including dividend taxation
- the deepening and broadening of the tax base by phasing out various profit-linked income tax deductions and introduction of new levies to meet the challenges of e-commerce and highly digitalised business models

55 GDP (current US$) - India, World Bank, 2020

- the implementation of the recommendations of the G20/ Organisation for Economic Co-operation and Development (OECD) Base Erosion and Profit Shifting project and modification of India's tax treaties through ratification of the multilateral instrument.

Measures have also been taken to modernise the tax administration by:

- leveraging information and digital technology for ease of filing
- faster processing of returns
- data analytics and faceless assessments.

Further, specific measures such as the Vivad se Vishwas scheme and the repealing of the retrospective taxation of offshore indirect transfers have been directed towards building trust between taxpayers and the tax administration. All these reforms have together contributed, at least in part, to direct tax collections in FY 2021–22 reaching unprecedented levels of more than INR 14 trillion (USD 180,000 million).

The launch of the Goods and Services Tax (GST) in India was a momentous indirect tax reform in the country. By subsuming all the indirect taxes at the federal and sub-national level (such as value added tax, service tax, central excise tax) into GST, several issues such as multiplicity of taxes, cascading effect of taxation and minor constraints such as physical check-posts at the inter-state borders were resolved to a great extent. By aligning GST laws and procedures across the states and introducing a single IT portal, the GSTN, the GST Council has ensured a smoother indirect tax regime.

Effective data-sharing between direct and indirect tax authorities as well as tightened compliance monitoring have contributed to robust monthly GST collections to the tune of over INR 1 trillion (USD 12,820 million) for over ten months in a row. Moreover, improvements in the customs law and procedures such as faceless assessments in a digitised environment, simplification of import-export procedures in terms of the World Trade Organization (WTO) Trade Facilitation Agreement have pushed India's ease of doing business ranking upwards.

All these initiatives have had tangible outcomes. However, to achieve sustained revenue growth that is needed to fuel the country's progress towards a USD 5 trillion economy and towards achieving the climate goals that it has set out for itself, it is important to:

- identify the strengths and shortfalls
- address areas of concern in a targeted manner.

The current strategy of ensuring predictability and stability needs to be extended to cover sustainability to optimise the collection of tax revenues required for achieving the SDGs.

India's significantly lower tax-to-GDP ratio

It is to be noted that notwithstanding the unprecedented tax collections in FY 2021–22, India's tax-to-GDP ratio stands at just 11.7%[56] in regard to federal taxes, with direct taxes contributing 6.1% and indirect taxes, the remaining 5.6%. In comparison, for similar sized economies (in terms of GDP) such as the United Kingdom, France and Italy, the tax-to-GDP ratio[57] is 24.9%, 24.6% and 24.6% respectively which are much higher. Even South Africa, which is a relatively smaller economy, has a tax-to-GDP ratio of 24.2%.

There appears to be scope for significantly increasing this ratio for India (even after factoring in the tax exemption currently allowed to agricultural income). Further, only about 5% of the population actually files tax returns (about 71.4 million returns were filed during FY 2021–22), with a large proportion of filers declaring income levels that are not subject to tax or that are just marginally so. The varied reasons for non-compliance in the Indian context need to be identified and examined, and appropriate policy measures as well as key administrative initiatives need to be analysed and implemented.

56 Press Information Bureau, Ministry of Finance, 2022

57 Tax revenue (% of GDP), World Bank, 2019

Select reasons for the ‘tax gap’

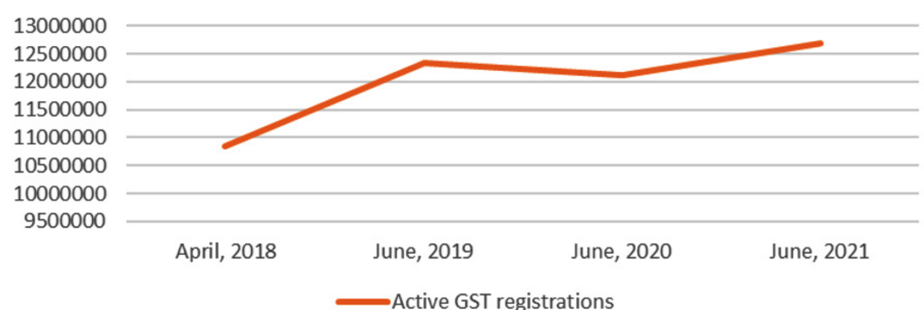
1. Informal sector

One of the major reasons for this ‘tax gap’ is the relatively lower level of compliance among people in the informal sector of the economy. A study conducted by the International Monetary Fund[58] (IMF) found that the informal sector, while shrinking, still represents up to a third of the economic activity in low- and middle-income countries. For the period 2010–2017, the study found that this sector accounts for about 30% of the economy (in terms of GDP) in South Asia and around 28% in emerging market economies.

The informal sector largely remains outside the tax net due to non-registration under any law. It is very difficult to monitor compliance from this sector since it mostly comprises the self-employed and small businesses. As per a study[59] carried out on the informal economy in India, about 86% of the trade, repair, accommodation, and food services industry is unorganised and part of the informal economy. While the withholding tax provisions play a significant role in preserving and preventing erosion of the tax base, bringing the informal sector to the formal/organised sector is key to widening this base. While measures taken for presumptive taxation of small businesses have resulted in a significant number of returns being filed by them, a large proportion of such returns declare incomes that are not subject to tax.

- GST policies have, to a large extent, brought about greater formalisation of the economy. Some of the features of GST that helped this trend are e-invoicing, e-way bills and reverse charge payments by the service recipients in sectors such as goods transport, where smaller service providers are predominant. Lowering of GST registration thresholds, especially in smaller states and invocation of ‘deemed supplier responsibility’ on e-commerce operators in some sectors such as food delivery and cab aggregator services have heightened the pace of formalisation. Withholding taxes such as taxes deducted at source and taxes collected at source in GST have also cast a wider net to bring more players under the formal tax net. Despite this, out of 63 million enterprises (as per the latest data available from National Sample Survey Organisation 2015-16), only 13.4 million[60] have joined the GST network. There was a dip in the number of GST registrations post April 2019 when the thresholds for suppliers of goods was raised to INR 4 million per annum (USD 0.05 million per annum) from INR 2 million earlier (USD 0.025 million) as seen in the graph below. After June 2020, the number of GST registrations has gradually risen, given the post-pandemic economic recovery as well as closer compliance monitoring, based on e-invoices and e-way bills as well as returns. Policy interventions to sustain and enhance the tax base continue to be a top priority under GST.

Active GST registrations



Source: https://tutorial.gst.gov.in/offlineutilities/gst_statistics/4YearReport.pdf

58 Medina, L., and F. Schneider. Forthcoming. International Monetary Fund, Washington, DC, 2020

59 Measuring Informal Economy in India _ Indian Experience, By S V Ramana Murthy (Source - Computed from National Accounts Statistics, 2019),

60 How GST is killing small business.

2. Revenue leakage

Another area of concern is the leakage of revenue, particularly in the micro, small and medium enterprises (MSME) sector, caused by the blurring of the distinction between personal and business expenses. This leads to claims of excess deductions, as also the tendency to leverage the continued prevalence of cash transactions by falsely claiming tax-deductible payments where the money is brought back in cash. These leakages are largely going unchecked due to inefficient administrative processes of verification.

The problem of revenue leakage is not confined to direct taxes but also pervades the domain of indirect taxes. According to official data, in FY 2019–20 alone, the government detected fraud of about INR 408,530 million (USD 5,237 million), out of which only INR 184,640 million (USD 2,367 million) could be recovered.[61]

3. Incentives and concessions

Over the years, while a number of existing tax incentives have been phased out, a large number of new incentives and exemptions have been introduced in an uncoordinated manner. As per the Statement of Revenue Impact of Tax Incentives published as part of the Receipt Budget 2022-23, the total estimated tax revenue foregone[62] for FY 2020–21 due to various deductions, rebates and special exemptions is INR 1,032,850 million (USD 13,242 million) for corporate taxpayers, INR 88,270 million (USD 1,132 million) for non-corporate taxpayers (firm/association of persons/body of individuals) and INR 1,705,830 million (USD 21870 million) for individual/ Hindu undivided family. Likewise, for the year 2020–21, the total revenue impact of tax concessions (exemptions as well as export promotion schemes) on account of basic customs duty is INR 2,348,130 million (USD 30,104 million).

A report[63] published in 2015 by the IMF, OECD, UN and the World Bank, which was submitted to the G-20 Development Working Group, stated that there is often ample room for more effective and efficient use of investment tax incentives in low-income countries. It also mentioned that tax incentives are often found to be redundant, meaning that the same investments would have come in even if no incentives were provided. As per the report, a good revenue system adopts taxes that are simple, fair and efficient. Tax incentives risk compromising these principles as they complicate the tax system.

On the flip side, such tax expenditure could be seen as targeted expenditure for the development of specific sectors or as incentivising certain social and economic activities.

It must also be recognised that given the paucity of adequate infrastructure and other resources in developing countries, the use of tax incentives in these countries is a necessary component of the right to development. However, the continued relevance of these incentives, particularly those that have been in operation for a period of time, needs to be analysed.

It is noted that in order to encourage the 'Make in India' agenda as well as to prune outdated customs exemptions, the government has withdrawn around 350[64] customs exemptions in the Budget 2022. Moreover, a new provision has been introduced under the customs law which provides that any new customs duty exemption shall be valid for only two years, unless specifically extended. On the GST side, the GST Council has constituted a Group of Ministers to look into the multiple tax rates as well as review the numerous GST exemptions to ensure higher revenue mobilisation in the coming years.

Undeniably, some targeted incentives and exemptions that are critical for the development of the specific sectors would always be required in an emerging economy like India. For tax collections to go up substantially, however, a well-designed scheme of tax exemptions as well as incentives need to be put in place.

61 GST officers detect Rs 7,421 crore tax evasion in April-June; recover Rs 1,920 crore

62 Receipt Budget 2022-23, Ministry of Finance, Budget Division, 2022

63 Options for Low Income Countries – Effective and Efficient use of Tax Incentives for Investment, IMF 2015

64 Customs duty exemptions on 350 items withdrawn to push 'Make in India'

Impact of trade policies and targeted exemptions

It is quite revealing to study the revenue impact of tax concessions due to the preferential rate of customs duty as part of sovereign commitments under various Free Trade Agreements (FTAs) which India has signed over the last few decades. The revenue outgo on this count rose steeply from INR 217,800 million (USD 2,792 million) in FY18 to INR 688,510 million (USD 8,827 million) in FY22, as per the Budget documents. Despite this steep tax expenditure, there does not seem to be any commensurate benefit for India in terms of increased exports with the major FTA partners such as Japan, South Korea or the ASEAN countries. Of late, a revamped trade policy has been put in place to leverage the FTAs for better global access for Indian exporters.

The modern FTAs which India has recently inked with the UAE and Australia have given substantial tariff and non-tariff advantages to labour-intensive and other sectors to enhance their exports from India in the coming years. India has also not shied away from engaging with developed countries to explore new frontiers in areas such as sustainable trade, intellectual property, government procurement and digital trade as part of the 'new age' FTAs. This evolution of trade policy in the recent FTA negotiations underscores the importance of using tax expenditure as a bargaining chip for deeper global integration. A case in point is the huge outgo on account of zero-duty concessions for import of gold from the UAE and coal from Australia. These concessions have in turn yielded substantial gains for India's exports to those countries in sectors such as gems and jewellery, pharma and textiles.

On a related note, India has also been consistently advocating the lifting of the moratorium on customs duties on electronic transmissions for the last several years. Estimates indicate potential revenue losses of about INR 4,368,000 million (USD 56,000 million) for developing and least developed countries, given that the global 'online' imports of such digital products have increased from INR 10,842,000 million (USD 1,39,000 million) in 2017 to INR 15,912,000 million (USD 204,000 million) in 2020. The potential tariff revenue loss (using bound duties) for India would have exceeded INR 312,000 million (USD 4,000 million) during the period 2017–20 alone.[65] Any decision of the WTO to remove this moratorium would be a major inflexion point for policymakers in India to regain to some extent the fiscal space lost during the pandemic.

Another major issue impacting the Indian tax system is the high level of litigation and resultant blocked tax revenue. According to figures published by the Central Board of Direct Taxes, the number of appeals pending with the Commissioner of Income Tax (Appeals) was 5,00,030, as of 1 April 2021. Another 53,000 appeals were pending in 63 Tribunal benches located at 30 places across India. Such high levels of litigation have an adverse impact on tax certainty, which is of fundamental importance for any tax system.

Litigation management – addressing the trust deficit

Another major issue impacting the Indian tax system is the high level of litigation and resultant blocked tax revenue. According to figures published by the Central Board of Direct Taxes (CBDT), the number of appeals pending with the Commissioner of Income Tax (Appeals)[66] was 5,00,030 as on 1 April 2021. Further, 53,000 appeals were pending in 63 Tribunal benches located at 30 places across India.[67] Such high levels of litigation have an adverse impact on tax certainty, which is of fundamental importance for any tax system. Moreover, it is now well accepted that the evaluation of tax risks is an important factor in making investment decisions, and a competitive tax regime must offer a high level of tax certainty.

65 How much tariff revenue have developing countries lost

66 Central Action Plan 2021-22, CBDT, Ministry of Finance, 2021

67 Tax Tribunal chief wants policy level intervention to reduce tax litigation

Various dispute resolution schemes (such as the Vivad se Vishwas scheme in 2020) have succeeded only to some extent in reducing the quantum of litigation and amount in dispute. Further, the Central Government has tried to settle certain long pending issues by bringing in amendments to the law through the budget. However, the overall level of litigation continues to increase and the revenue blocked in appeals has assumed humongous proportions (the statement of tax revenues raised but not realised published as part of the Receipt Budget 2022-23 shows an amount of INR 10,576,390 million [USD 135,595 million] as disputed corporate and income tax as at the end of 2020–21). In addition, increasing costs of litigation for taxpayers and higher administrative costs for the Revenue have increased the perception of tax uncertainty and widened the trust deficit between taxpayers and the Revenue.

Litigation abounds also in the sphere of indirect taxation. According to the Economic Survey 2018, nearly INR 7,580,000 million (USD 97,179 million) of tax (including direct as well as indirect tax), which was about 4.7% of the total Indian GDP, was involved in litigation at all levels of judiciary (i.e. Appellate Tribunal and above).

Despite being a nascent law, GST has had more than its fair share of disputes relating to issues such as transitional credit, input credit matching and supply between distinct persons. The conflicting rulings by different Advance Ruling Authorities as well as the non-constitution of the GST Tribunal have overburdened the High Courts with avoidable litigation.

There is a dire need to curtail wasteful expenditure on litigations, especially by the tax departments, while streamlining the entire dispute resolution process.

On the Customs front, the newly set up Advance Ruling Authority has been successful in delivering prompt and effective rulings to applicants. This facility is widely recognised as an important trade facilitation measure which results in predictability in taxation, mitigates disputes and engenders mutual trust in the system.

There is a need to introduce robust and efficient dispute prevention and resolution mechanisms. A cooperative compliance framework programme can help build mutual trust and a strong continuing relationship between the taxpayer and the tax department, leading to sustainable compliance and growth in revenue.

On the aspect of tax administration, the faceless assessment scheme was intended to strengthen the deterrence against tax avoidance and evasion by enhancing the quality and accountability of the assessment function. However, the manner in which it has been implemented appears to have actually worsened matters. There have been several instances of assessments being quashed or set aside by the courts, including awarding of costs to taxpayers and passing of strictures accompanied with adverse and sometimes harsh observations from the judiciary. The scheme needs to be reappraised and possibly redesigned so as to be able to fulfil its intended objectives.

Assimilating global tax policy developments

Developments in global tax policy are also likely to have an impact on the domestic tax environment. In October 2021, the G20 leaders endorsed a multilateral political agreement worked out by the Inclusive Framework on BEPS, outlining a two-pillar plan to address the tax challenges of a digitalised global economy. The plan, agreed to by 137 of the 141 member countries including India, provides for the reallocation of part of the residual profits of large multinational enterprises (MNEs) to ‘market countries’ even in the absence of their physical presence in those countries (Pillar 1) and a global minimum tax at an effective rate of 15% having to be paid by MNEs in every jurisdiction that they operate in (Pillar 2).

The agreement is to be implemented through a multilateral convention and agreements, together with domestic legislation to be enacted by countries in accordance with model rules. The new rules are supposed to become effective globally by 2023. But going by the observations made by the Secretary General, OECD, at the recent meeting of the World Economic Forum in Davos, the drafting of the model rules and convention is facing complexities and the implementation of the agreements on both Pillars may get pushed to 2024.

The implementation of these agreements in India would not only require ratification of the multilateral convention and enactment of domestic legislation, but would also require allocation of additional administrative resources that would put a strain on the revenue authorities considering the complexity involved in administering the new rules. A separate and specialised unit may have to be tasked with the administrative responsibility along with ensuring necessary training of resources to enable proper monitoring and implementation. It would also be imperative to review the compatibility of the current tax regime with the requirements of implementing Pillar 2 through, e.g. reviewing the existing tax incentives and ascertaining the interplay of the global minimum tax with the Minimum Alternate Tax (MAT) provisions including availing of eligible MAT credits.

Tax policy and the ESG agenda

Last but not the least, tax policy in India will have to be aligned with the Environment, Social and Governance (ESG) agenda and will be expected to contribute to the achieving of the climate-related goals that it has set for itself. India has officially committed to achieving net zero emission status by 2070, and also has several ambitious objectives to fulfill by 2030.

Several developed countries have re-calibrated their tax rates on electric vehicles and circular economy products in view of the decline in tax revenues from gas-guzzling cars and fossil fuels.

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Indian tax policy makers would also likewise have to strategise for future-proofing revenue streams as we move towards net zero. Further, India is now negotiating several 'new age' FTAs having several provisions to enhance the SDGs. Indian policymakers have to be cognisant, in particular, of the areas around sustainability in the entire supply chain and the social and governance issues of the supply chain partners.

The tax system can also act as an effective means to incentivise organisational behaviour towards adoption of ESG factors. The necessary reporting and disclosure requirements are being introduced in India and there are also several global agencies that provide ratings on ESG. However, the lack of mandatory standards and increasingly highlighted instances of greenwashing make these mechanisms unreliable.

Tax reforms such as the introduction of environmental taxes, targeted incentives and disclosure requirements are much needed to ensure that businesses commit towards India's ESG goals. It goes without saying that any taxes and disclosure requirements that are considered should be well thought out and implemented in a well-coordinated manner.

Public policy and much less tax policy cannot be cast in stone. These must proactively strategise, respond, and adapt to the dynamically changing global and domestic landscape. Tax policy reforms, while ensuring a sustainable and resilient revenue stream, should pave the way for achieving the SDG goals planned by India in the most efficient and effective manner in its journey towards achieving a USD 5 trillion economy and beyond.

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