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OECD releases Economic Survey of India

On 28 February 2017, the Organisation for Economic Co-operation and Development (OECD) released the Economic Survey of India[1]. OECD identifies priority areas for future action, including continuing plans to maintain macroeconomic stability and further reduce poverty, additional comprehensive tax reforms and new efforts to boost productivity and reduce disparities between India's various regions. Key takeaways from the survey relating to Indian taxation are as follows:

- Goods and Services Tax (GST) will replace a large number of taxes on goods and services which currently account for the bulk of the total tax intake. It will contribute to make India a single market and, by spurring competition, it will promote productivity gains. By reducing tax cascading, it will support the manufacturing sector and investment. It is however designed to be revenue-neutral and thus does not provide an avenue for raising more revenue at least in the medium-term. A comprehensive reform of property, personal and corporate taxes is needed to complement GST reform. It should aim at raising more revenue to fund social and physical infrastructure in a way that support economic growth, promote social justice and empower sub-national governments to better respond to local needs.

- India should raise more and better tax revenue to finance large spending needs for social and economic infrastructure.

Reforming company taxation to support investment by reducing distortions and improving certainty

- Creating a business-friendly tax environment is key to promoting investment, to raising India's competitiveness and to creating more jobs. The statutory corporate income tax rate is 30 per cent plus surcharges resulted into 34.6 per cent for resident companies. It is high by international standards. The survey suggest that the high corporate income tax rate is a major obstacle to business development.

- Tax concessions lower effective tax rates (to 23 per cent in Financial Year (FY) 2013-14) but create large variations across enterprises by size, sector and ownership. Tax concessions also raise uncertainty for investors, as tax law is often unclear and audits can be aggressive.

- Further the number of tax disputes is large and about 40 per cent of them go through the court system, resulting in delays and further uncertainty. Recent efforts to improve clarity in tax laws and their interpretation (e.g. on retrospective taxation) should continue so as to build a more predictable environment for investors.

- The government plans an ambitious base-broadening and rate-reducing tax reform i.e. the corporate income tax rate for resident companies will be lowered to 25 per cent over a five-year period and most tax concessions will be phased out as suggested in the past OECD Economic Survey of India. The Union Budget 2016

[1] http://www.oecd.org/eco/surveys/INDIA-2017-OECD-economic-survey-overview.pdf

introduced a reduced statutory rate for small and new manufacturing companies, but such targeted reductions should be temporary steps on the way to a single 25 per cent rate and the elimination of most concessions (including overly generous depreciation allowances). This reform should be implemented as soon as possible.

- The relatively high corporate income tax rate makes it difficult to attract more foreign investment, as the statutory rate on foreign dividends is quite high. To increase India's attractiveness, the distribution dividend tax should be replaced by a traditional withholding tax system, which may be reduced by tax treaties, and the non-resident corporate income tax rate should be lowered to the resident rate.

- Increasing the capacity and expertise of tax administration and improving its management could help raising more revenue while making the system fairer. Many commendable measures have recently been taken to reduce the cash transactions, combat tax evasion and improve the ease of paying taxes. The government is also making efforts to clarify tax legislation and reduce the very high number of tax litigations. Still, the 2017 edition of the World Bank's 'Ease of doing business survey' indicates that India ranked 172nd out of 190 countries on the ease of paying taxes. Government's efforts should thus be pursued to help boosting investment and growth. In particular, the audit process should be improved to reduce the number and length of tax disputes while the number of tax employees and their training should be lifted.

Using personal income and property taxes to raise more revenue and promote inclusiveness

- Personal income tax revenue is low and its redistributive impact is limited. As in many emerging economies, the low level of income of most people and a large informal sector pose challenges to raising revenue from this source. Some countries, in particular South Africa, have however been more successful in engaging their population in the tax system. In India, only 53 million individuals paid personal income tax in 2014-15, i.e. about 5.6 per cent of the population, reflecting the very large zero rate tax bracket and the exemption for agricultural income.

- A host of specific tax expenditures further reduces tax liabilities of the well-off, such as tax allowance for repayment of mortgage principal and interests. The taxation of capital income is low, even zero, in most cases. In addition, the Hindu Undivided Family (HUF) offers those with substantial property income an avenue to reduce their tax liabilities and complicates the implementation of an inheritance tax.

- The personal income tax could raise more revenue and better contribute to horizontal and vertical equity. Accordingly following steps should be taken:

  - Efforts to promote tax compliance and improve the ease of paying taxes should be strengthened. Tax compliance could be incentivised, e.g. by securing access to services (such as life insurance) to those filing a tax return for the first time.

  - Agricultural income of rich farmers should be brought under the personal income tax ambit so as to promote vertical equity and avoid tax evasion with non-agricultural income re-categorised as agricultural income.

  - Most tax expenditures should be abolished since they benefit mostly the rich (e.g. tax allowance for the principal and interests of housing loans).

  - Personal income tax schedule (in particular income thresholds) could be brought more into line with other emerging economies, with more people paying taxes and top rates kicking in at a lower income level. Simulations by the OECD suggest that bringing the personal income tax schedule more into line with other emerging economies and abolishing tax expenditures would raise personal income tax revenue by at least 50 per cent.

- There is also scope to raise more revenue by less distortive property taxes. Wealth in India is extremely concentrated and real estate accounts for the bulk of household assets. States levy stamp duties and registration charges on the sale of real estate, and municipalities levy some recurrent taxes. Raising more revenue from recurrent property taxes would require granting municipalities more power to implement them and set tax rates, and establishing up-to-date property values.

- In addition, India could introduce an inheritance tax, starting with a relatively high exemption threshold and low rates, since this would help promoting equal opportunity and inter-generational mobility.

Our comments

The OECD survey highlights the growth story of India. It also provides the key areas where India needs to work to sustain its growth rate. As per survey, economic growth of around 7.5 makes India the fastest-growing G20 economy. The acceleration of structural reforms, the move towards a rule-based policy framework and low commodity prices have provided a strong growth impetus. Recent deregulation measures and efforts to improve the ease of doing business have boosted foreign investment. However, government still needs to pay attention to certain areas such as high corporate income tax rates, a slow land acquisition process, regulations which remain stringent in some areas, high non-performing loans which weigh on banks' lending, and infrastructure bottlenecks, etc.

The survey suggests that a comprehensive tax reform would promote inclusive growth. Timely and effective implementation of GST would support competitiveness, investment and economic growth. Government's plans to reduce the corporate income tax rate and broaden the base will also serve the same objectives. Property and personal income taxes, which are paid by very few people, could be reformed to raise more revenue, promote social justice and empower government to better respond to local needs.

The survey also suggests certain tax reforms such as the dividend distribution tax should be replaced by a tax deduction at source, introduction of inheritance tax, abolition of HUF status, income tax on agriculture income of rich farmers, etc.

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