Exploring ArthaKranti - A Path to Fiscal Consolidation

1 Fiscal and Socio-economic Conditions in India

Fiscal deficits are like obesity. You can see your weight rising on the scale and your clothing size increasing, but there is no sense of urgency in dealing with the problem.

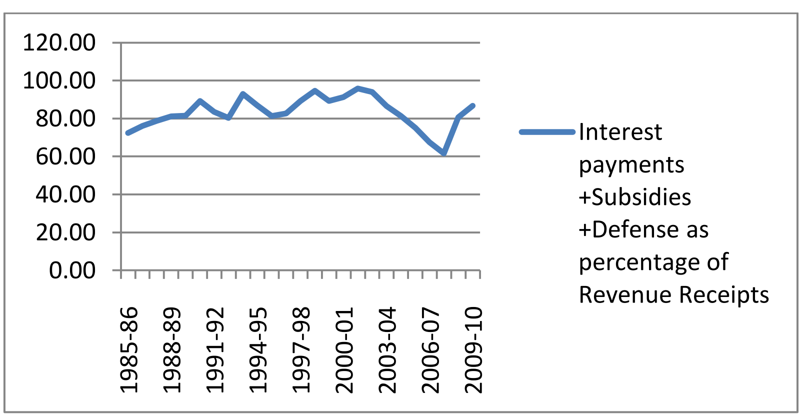
Martin Feldstein – Professor of economics at Harvard University - Address to RBI, Jan, 2004

In this section we explore the prevalent fiscal conditions and their effects on macro-economic and socio-economic conditions in India. This helps in establishing the pressing need for fiscal consolidation.

1.1 Fiscal Conditions

India has faced persistent fiscal problems for over a decade with high level of revenue and fiscal deficits (5.25 %, 9.4 % respectively in 2009-10). This had led to higher Debt to GDP ratio. High level of Debt to GDP ratio affects investment as well as the ability to deal with financial turbulences like the global financial crisis in 2008. With high level of revenue deficit and high Debt to GDP ratio, increasing portion of the revenue receipts (26 % in 2009-10) is spent on interest payments. Equally significantly a major portion of the revenue receipts (86.63 % in 2009-10) is spent on non-developmental activities (interest payments, defence expenditure, subsidies) resulting in inadequate spending on developmental activities (human and infrastructure development).

Figure 1: Trend of interest payment + subsidies + defence expenditure (as percentage of revenue receipts) of central government [1]



[1] RBI Database - TABLE 101: CENTRAL GOVERNMENT RECEIPTS - MAJOR COMPONENTS, TABLE 103: MAJOR HEADS OF EXPENDITURE OF THE CENTRAL GOVERNMENT

1.2 Macro-economic Consequences of the Fiscal Situation

Due to this high level of fiscal deficit, government borrows heavily from the market. Government schemes to attract savings to finance government debt, increase the interest rates and distort the lending and borrowing behaviour in the banking sector. The private sector thus becomes credit constrained. The large cash economy in India and the inadequate use of banking combine to limit the formation of bank money thus further reducing the credit availability. The high fiscal deficit, increasing interest rates, and the inadequate expenditure on infrastructure development leading to supply side bottlenecks combine to compromise government's ability to combat inflation. The dominant cash economy worsens the situation by reducing the tax revenues as well as the effectiveness of monetary measures. All these factors together adversely affect growth.

1.3 Socio-economic Conditions

Slow reduction in poverty, inadequate rate of employment generation, increasing disparity, low access to credit, poor infrastructure, and lack of access to healthcare and education systems are adversely affecting social capital of India. Since India is the home to approximately one sixth of human population in the world, it is especially important to effectively address these socio-economic challenges.

1.4 Need for Fiscal Consolidation

Considering all these current and future challenges, there is an urgent need for fiscal consolidation. However, a mechanical reduction in fiscal and revenue deficits would lead to an unacceptable lower level of fiscal activity. In India we have to maintain an appropriate level of fiscal activity particularly because public goods have to be provided. Thus fiscal policy needs to be designed by keeping into consideration the need of structural transformation as well as that of investment in social and financial infrastructure. [2]

2 Key Contributing Factors – Tax Systems, Cash Economy and Black Money

The three key factors contributing to the fiscal and socio-economic conditions are the current tax system, the cash economy and the black money (and corruption).

2.1 Current Tax System

FRBM Act Implementation Task Force Report states that the **current tax system is distortionary, fragmented between centre and state, has a narrow tax-base, is difficult to administer – partly due to the many exemptions, prompting and enabling many to evade the taxes**. Three key findings from this report are [3]

- The revenue base has been considerably diminished through exemptions

[2] Page 14, Fiscal Policy and Economic Reforms, by Dr. Y.V.Reddy, Working Paper 2008-53, NIPFP, May 2008
[3] Page 16-23 Chapter 2, Report of Task Force on Implementation of the FRBM Act, 16 July 2004

- Manufacturing has been the focus of indirect taxation. The service sector is now larger than 50 % of GDP. While taxation of services has commenced, the service tax accounts for less than 0.5 % of GDP. (*Service Tax Revenue as percentage of Total Tax Revenue has increased from 2.6 % in 2002-03 to 12.77 % in 2009-10*)
- Tax compliance is expensive, for honest citizens, and the probability of getting caught is low, for violators. This has led to an endemic culture of tax avoidance

Some of the observations reported by FRBM Act Implementation Task Force about the problems created by tax exemptions and incentives are given as follows [4]

- A **crucial consideration** that bears on the decision **to grant tax incentives** should be their **cost-effectiveness**. Granting tax incentives entails four types of costs: (1) **distortions** between investments granted incentives and those without incentives; (2) **forgone revenue** (3) **administrative resources** and (4) **the social costs of corruption** and/or rent-seeking activities connected with abuse of tax incentive provisions. While these **costs could be substantial, the benefits** to the economy that could be attributed solely to tax incentives **are less clear** and **not easily quantifiable.** Hence, the **cost-effectiveness of tax incentives is often questionable**.
- **Abuse and leakage** are perennial problems with tax incentives, and their effective prevention can often absorb a substantial amount of quality administrative resources – a scarce commodity in most developing countries.
- **Tax incentives** are, therefore, **inefficient, iniquitous, impose greater taxpayer compliance burden** and **administrative burden, result in revenue loss** and **complexity of the tax laws**, and **encourage tax avoidance** and **rent seeking behaviour**. It is best that they are fully eliminated from the tax statute.
- The **mounting appeals at all levels** are an **eloquent testimony** to the **complexity** and the **ambiguity** in the tax law on account of the various incentives

Table 1: Trends of Tax Expenditure, Total Tax Revenue Collected and Revenue Deficit [5]

Year	Total Tax Expenditure (Crore Rupees)	Total Tax Revenue collected (Crore Rupees)	Revenue Deficit (Crore Rupees)
2007-08	2,85,052	4,39,547	52,569
2008-09	4,14,099	4,43,319	2,53,539
2009-10	4,82,432	4,56,536	3,38,998
2010-11	4,59,705	5,69,869	2,52,252
2011-12	5,29,432	6,42,252	3,94,951
Note - Data for 2011-12 is Revised Estimate			

[4] Page 112-113 Chapter 5, Report of Task Force on Implementation of the FRBM Act, 16 July 2004

[5] Budget documents from site - http://indiabudget.nic.in/index.asp

The key take-away from **Table 1** is that the amount of tax expenditures exceeds the revenue deficits! Hence there are two possible inferences:

1. If the tax expenditures are required genuinely to assist growth etc., it implies that the tax system needs a serious overhaul so as to ensure adequate revenues.
2. If the tax system is ideal then it implies that there are vested interests which force the Government to give such huge tax exemptions and incentives even in the face of rising deficits.

Since tax expenditures lead to more complicated tax systems, there is a concern that tax expenditures might encourage tax avoidance and tax evasion. Adverse impact of exemptions, incentives, and special treatment to some sectors is reflected / expressed in Personal Income Tax System, Central Excise, Taxation for small scale industries and Taxation on immovable properties. Another important source of distortion and leakage of revenue is the **location based exemption**. Some states have been complaining of deindustrialisation i.e. Firms being shifted out to neighbouring states enjoying location based exemption. Tax administration has found growing instances of shell companies leading to **fraudulent exemption** claims and **loss of revenue without any commensurate social benefit**.

Tax-evasion practices "force" otherwise honest taxpayers who operate in cash-sector activities to misreport their income to align with market practices or to seek different employment opportunities where they can compete without evasion. [6] Increased currency use in a fast growing economy is inevitable yet **facilitates tax evasion.** [7]

2.2 Cash Economy

Prof. Edgar Feige, acknowledged Global authority on Underground Economy, is precise in his views about significant role cash plays in aiding and abetting tax evasion [8]

> All tax systems are vulnerable to evasion when currency is made freely available to the tax-paying public. Currency is the preferred medium of exchange for illegal activities because it does not leave a paper audit trail. **It is ironic, that government provides, virtually free of charge, the instrument most widely used to subvert both its revenue collection efforts and its laws defining prohibited economic activities**. What is needed is a means of eliminating the incentive to use the state's own creation, currency, to thwart the state's fiscal objectives.

[6] TAXING CASH by Prof. Ilan Benshalom, 2012
[7] Measures to Tackle Black Money in India and Abroad - Report of the Committee Headed by Chairman, CBDT Parts - I and II – 2012; Government of India; Ministry of Finance ; http://www.itatonline.org
[8] Taxation for the 21ST Century: the automated payment transaction (APT) tax, October 2000, Edgar L. Feige

The RBI in its latest annual report has attributed the growth and strength in the cash economy to factors like acceleration in per capita real GDP growth, commercialization of agriculture, urbanization and availability of higher denomination notes.. [9]

In India the easy availability of high denomination notes (81 % of currency-in-circulation is in 500 and 1000 rupee notes in 2011 - 12) facilitates large valued cash transactions. If we compare the percentage of currency money in circulation to GDP, India with value of 12.04 stands fourth among countries (Brazil, Australia, China, Euro Zone, Japan, Mexico, Russia, South Africa, Sweden, UK, US) having high values. Only China, Japan, and Russia have higher values than India. In the case of value of the ratio of currency money to narrow money, India has the highest ratio (i.e. 59.58 %) amongst abovementioned countries. [10] Given the fact that Indian currency is not a global currency (like say the US dollar), both these values together indicate that a large portion of the money in India is in currency form and consequently there is relatively less formation of bank money (credit money) as compared to currency money.

The Indian economy predominantly operates on cash today. … More so, there is no traceability and accountability for cash transactions, which leads to problems of bribery, corruption, and black money. [11] Equally seriously high denomination notes end-up encouraging creation and circulation of fake-currency notes. This poses a major threat to the economy and has grave consequences for the security and stability of the nation. [12]

2.3 Black Money and Corruption

If money breaks laws in its origin, movement or use, and is not reported for tax purposes, then it would fall within the meaning of black money. There are three sources of black money – crime, corruption and business.

- The 'criminal' component of black money would normally include proceeds from a range of activities including racketeering, trafficking in counterfeit and contraband goods, forgery, securities fraud, embezzlement, sexual exploitation and prostitution, drug money, bank frauds and illegal trade in arms.
- The 'corrupt' component of such money would stem from bribery and theft by those holding public office – such as by grant of business, bribes to alter land use or to regularize unauthorized construction, leakages from government social spending programmes, speed money to circumvent or fast-track procedures, black marketing of price controlled services, etc.
- The 'commercial' limb of black money usually results from tax evasion by attempting to hide transactions and any audit trail relating thereto, leading to evasion of one or more

[9] Measures to Tackle Black Money in India and Abroad – Report, 2012
[10] Statistics on payment clearing and settlement systems in the CPSS countries_2010_cpss99.pdf http://www.bis.org/publ/cpss99.pdf
[11] Report of the Task Force on an Aadhaar-Enabled Unified Payment Infrastructure - February, 2012 – Submitted to Finance Minister GoI
[12] Measures to Tackle Black Money in India and Abroad – Report, 2012

taxes. The main reason for such black economy is underreporting revenues / receipts / production, inflating expenses, not correctly reporting workers employed to avoid statutory obligations for their welfare.

- Opening of the economy permits contracts of all kinds – particularly for allocation of scarce resources such as mineral and spectrum – which, in the absence of transparent rules and procedures for licenses and noncompliance of contractual obligations of the persons concerned, leads to increased generation of black money.
- In all the three forms of black money – 'criminal', 'corrupt' and 'commercial' – subterfuges are created which include false documentation, sham transactions, benami entities, mispricing and collusion. This is often done by layering transactions to hide their origin.
- Level of development affects extent of black economy in another way. Developing countries have large parts of their economy in the informal sector, which is difficult to regulate. Further, cash component of the economy is usually higher and leads to problems of monitoring. Lack of regulation and monitoring reinforces the black economy and also helps its expansion. Opportunities for leakages increase. Low level of literacy reduces penetration of the banking sector resulting in a large cash economy.
- Generally, rising burden of taxation, both actual and perceived, provides a strong temptation to participate in the black economy. Increasing burden of compliance also gives a strong reason to enter the black economy. Lack of tax morality, or non-compliant attitude of the citizenry towards tax laws, also tends to increase the size of the black economy.

It is widely believed that the election process requires considerable funds and is believed to be funded also through black money. Further electoral reforms are also required to reduce election costs. Social sector schemes involving huge public expenditure reportedly suffer from possible manipulations and leakages due to lack of regulatory institutions with best international practices of transparent processes.

In India, it is widely reported that corruption is pervasive and appears impossible to eliminate. At the grass root level, corruption is practiced in millions of exchanges that ordinary people have at lower levels of bureaucracy – for licenses, procuring services, etc. – as part of government's delivery mechanism. Cumulatively a punitive cost is imposed on the poor and lower middle classes. In contrast, instances of large-scale corruption at the national and regional scale though distant from petty instances of everyday life, have a shock and awe effect and tends to provide a rationalization for lower level corruption. [13]

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[13] Measures to Tackle Black Money in India and Abroad - Report of the Committee Headed by Chairman, CBDT Parts - I and II – 2012; Government of India; Ministry of Finance ; http://www.itatonline.org

3 Structural Challenges of Prevalent Tax Systems and Goals for Tax Reforms

Here we attempt to identify the challenges of the prevalent tax systems and goals of an ideal tax system specific to India but also applicable worldwide.

3.1 Challenges

According to Prof. Marcos Cintra, Economist and Parliamentarian from Brazil, there are two preliminary problems that, if not addressed properly, will make any tax reform become a mere attempt at "perfecting of the obsolete": [14]

- The first is to improve the pattern of tax incidence. **"A fair tax is one you can collect"**, Contrario sensu, the worst tax is one that can be evaded**.**
- The second is the high cost of the current tax system.

3.1.1 Operating Costs

Society bears heavy operating costs in the form of costs for maintaining gigantic tax collection mechanism, administrative and compliance costs of individuals and corporations, operating costs of legislative and judiciary branches and psychological cost that is induced by the operation of the tax system. According to findings of Prof. Evans[15], compliance costs are high, significant, and regressive and are not reducing over time. Prof. Marcos Cintra emphasises the operating costs of taxation as follows: [16]

- Compliance and administrative costs are high and they reduce international competitiveness
- Compliance costs have undesirable redistributive effects, are highly regressive, and severely burden small businesses
- High compliance costs create resentment and stimulate tax avoidance
- The high costs generated by the creation of VATs in several countries have led to protests and dissatisfaction on the part of small business
- In the early 1980s, some governments reduced their administrative costs, shifting them onto the taxpayer and increasing compliance costs; they soon discovered that the social tax cost had increased in their economy as a whole.

The report by NIPFP on Compliance costs related to personal income tax in India has the following relevant observations: [17]

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[14] Page 204-205, Bank transactions: pathway to the single tax ideal A modern tax technology; the Brazilian experience with a bank transactions tax (1993-2007), by Cintra, Marcos, July 2009

[15] Counting the costs of taxation: an exploration of recent developments, October 2006, by Prof. Chris Evans

[16] Page 163-164, Bank transactions: pathway to the single tax ideal A modern tax technology; the Brazilian experience with a bank transactions tax (1993-2007), by Cintra, Marcos, July 2009

[17] The Compliance Cost of the Personal Income Tax and its Determinants – NIPFP – December 2002, Saumen Chattopadhyay and Arindam Das-Gupta

- Overall, despite the personal income tax being limited to only around 20 million taxpayers, costs directly borne by tax-payers amount to over 0.8 percent of GDP or 49 percent of personal income tax collections.
- The overall social cost of the personal income tax, adding administration costs and subtracting bribes is 60 % of tax revenue.

Classical taxes force the taxpayer to submit tax returns and the revenue agency to assess and audit taxpayers. The compliance and auditing costs are enormous and assessment involves subjectivity, making the temptation to evade almost irresistible. [18]

3.1.2 Incremental Changes and Resultant Complexity of Prevalent Tax Systems

Let us now turn our attention to the complexity of these systems. These are a direct result of the on-going attempts of the Government to improve its revenue. NIPFP studies on Income tax compliance costs of Corporations observe: [19]

> Possibly more important are costs imposed on society by business uncertainty due to frequent changes in tax provisions and tax administration procedures. These costs are only partly reflected in measurable compliance costs. Costs of a complex tax code and a related but distinct aspect, ambiguity in tax provisions or discretionary elements in both the tax code and administration powers, are likely to be more completely reflected in measurable costs.

As the earlier quoted NIPFP studies on compliance costs of personal and income tax reports observe: [20]

> Complexity of the tax system possibly has adverse effects on tax administration, compliance and compliance costs. Complexity is caused by factors ranging from complex tax laws or administrative procedures to discretionary provisions, tax concessions and poorly drafted laws.

Avoidance and evasion is an acknowledged outcome of this complexity and those who do not evade continue to suffer! Complexity and resultant evasion spurs the Government to take more action to tighten controls leading to even more complexity. In order to improve revenues, governments resort to making feasible adjustments to rates and slabs or introduce taxes on different services / goods.

[18] Page 201-202, Bank transactions: pathway to the single tax ideal A modern tax technology; the Brazilian experience with a bank transactions tax (1993-2007), by Cintra, Marcos, July 2009

[19] THE INCOME TAX COMPLIANCE COST OF INDIAN CORPORATIONS, CHATTOPADHYAY AND DAS-GUPTA, December 2002

[20] The Compliance Cost of the Personal Income Tax and its Determinants, Chattopadhyay and Das-Gupta, December 2002

Unfortunately, the continued story of deficits in India tells us that these changes have not succeeded in raising the revenues to the required levels. Tragically, these incremental and ad-hoc changes definitely increase the complexity of the existing tax system.

3.1.3 Challenges of implementing VAT in Developing Countries

Shahe Emran and Joseph Stiglitz, highlight the challenges of VAT in a developing country by pointing out two elements – informal economy and literacy: [21]

- An important structural feature of a developing country that militates against the desirability of VAT: the existence of a **large informal sector** that escapes the VAT net.
- The informational and compliance costs of VAT are likely to be high, especially in developing countries, because of high rates of illiteracy and scant written record-keeping. The recent evidence from cross-country regressions shows that, "...all else equal, **the VAT yields less revenue in less literate economies**.

Prof. Marcos Cintra has the following observations about evasion of VAT [22]

> The most common types of VAT evasion parallel those associated with traditional sales taxes—non-registration of businesses, underreporting of gross receipts, abuse of multiple rates, and non-remittance of tax collected to the tax authorities—but there are additional types of evasions arising from the nature of the VAT. These include the use of fake invoices and the claiming of VAT credits for non-creditable purchases. Perhaps most important, and distinguishing the VAT from other types of general sales taxes, is the relationship of an effective audit to the ability to administer an appropriate refund system.

In the Indian context, while VAT / GST is a much anticipated improvement over the current taxation, the drawbacks and challenges highlighted in this section imply that the promised benefits are neither guaranteed nor easily achievable, especially given the current level of literacy as well as the large informal economy.

3.1.4 Challenges Inherent in the Prevalent Declaratory Tax Systems

Prof. Patrick R Colabella and Prof. Richard J Coppinger highlight a significant flaw in the existing declaratory tax systems: [23]

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[21] On selective Indirect Tax Reform in Developing Countries - June, 2002, M. Shahe Emran and Joseph E. Stiglitz

[22] "THE VALUE ADDED TAX - EXPERIENCES AND ISSUES", prepared by staff of the IMF, OECD, and World Bank, 2005

[23] The Withdrawals Tax - St. John's University, New York, Prof. Patrick R Colabella and Prof. Richard J Coppinger, 1999

> As non-integrated systems, income, sales and estate taxes are natural adversaries to each other. This means that, in their coexistent operation, evasion of one always ricochets to one or both of the other systems thus defeating one another.

Prof. Cintra's description of this crisis is as follows: [24]

> Tax collection, assessment, and control functions now demand operations on a scale wholly incompatible with the declaratory, bureaucratic, paper filing systems typical of the traditional tax method of "self-assessment, self-levying, self-collection, and public audits," which typify conventional declaratory tax systems.

3.2 Goals for Tax Reform

The Task Force on Implementation of FRBM Act had clearly documented the underlying strategy while proposing the specific reforms for indirect taxes (i.e. GST), personal and corporate income taxation as well as customs duty. The original strategy is worth re-visiting in detail. [25]

- An enhanced tax-GDP ratio should be achieved through policies which are compatible with the **core economic policy goals of promoting efficiency, equity and high quality growth**. This implies that additional resources should be obtained through **a non-distortionary tax regime supportive of saving and entrepreneurship**.
- We may sketch the elements of a reform strategy which would achieve these goals as follows:
  - *Widening the tax base.*
  - *Low rates; few rates.*
  - *Enhancing equity of the tax system.*
  - *Shift to non-distortionary consumption taxes*
  - *Enhancing the neutrality between present consumption and future consumption.*
  - *Enhancing neutrality of the tax system to the form of organisation.*
  - *Enhancing the neutrality of the tax system to sources of finance.*
  - *Establishing an effective and efficient compliance system.*
  - *Focus on buoyancy rather than immediate sources of tax revenue.*

The strategy elements captured here are quite aligned with suggestions given by other international experts like Prof Richard Bird [26], Jorge Martinez-Vasquez [27], Prof. Cintra [28] .

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[24] Page 11-23, Bank transactions: pathway to the single tax ideal A modern tax technology; the Brazilian experience with a bank transactions tax (1993-2007), by Cintra, Marcos, July 2009

[25] Page 49-50 Chapter 5, Report of Task Force on Implementation of the FRBM Act, 16 July 2004

[26] Taxation in Latin America: Reflections on Sustainability and the Balance between Equity and Efficiency, Richard M. Bird, June 2003

[27] Taxation in Asia– Asian Development Bank – 2011, Jorge Martinez-Vazquez:

[28] Page 203, Bank transactions: pathway to the single tax ideal A modern tax technology; the Brazilian experience with a bank transactions tax (1993-2007), by Cintra, Marcos, July 2009

Essentially the strategy proposed by the FRBM Act Implementation Task Force is indeed a valid one. However we differ in the means proposed to operationalize the strategy.

One of the best descriptions of what to avoid during any tax reform effort is given by Roberto Campos (as quoted by Prof. Cintra in his paper). It applies to the Indian context verbatim.[29]

The five effects to be avoided are

- The underground economy effect – non-registered payments (for example, fiscal blackmail and tax evasion);
- The government corruption effect – corruption in intermediation of public funds;
- The "Tanzi" effect – inflationary corrosion of revenue between time of collection and actual availability of funds;
- The "papyrus" effect – the proliferation of documents and tax books;
- The "toga" effect – when tax cases logjam the judiciary branch.

So this is a clear description of the challenge we face in coming up with a better tax system that works for the whole of India – citizens, corporates and governments.

4 ArthaKranti Banking Transaction Tax as the possible solution

The situation where the rich get richer and the poor become even worse off is socially and politically untenable. At the same time we can't create a situation where we hold back the genuine, healthy aspiration of the capable to strive and to achieve more. These twin challenges are tough to handle in the best of times and for a government in fiscal stress virtually impossible to tackle.

The economic disparity in India eventually leads to social unrest, which in turn places severe demands on the law and order machinery. Basic dignity, basic livelihood is a mandatory pre-condition for genuine financial inclusion and reversal of alienation that results out of such exclusion / disparity. The principle to be followed is dignified existence as a birth-right and further progress will come out of genuine efforts of the individual. Let us remember that economic demand is a combination of need and purchasing power. We have to accept that in a monetized world, credit availability is as much a need as say, oxygen and pure water.

The world is increasingly and unrelentingly a global market place. Post-2008 strong domestic demand has become the more important consideration in these changed and uncertain times. India, thanks to its huge population, has a huge potential for strong domestic demand. This is especially so when we look at the basic needs to be fulfilled for large sections of the population. Ensuring financial inclusion via easy access to credit, and may be, initial assistance to acquire

[29] Page 203, Bank transactions: pathway to the single tax ideal A modern tax technology; the Brazilian experience with a bank transactions tax (1993-2007), by Cintra, Marcos, July 2009

basic amenities like food, clothing, shelter, health, education will ensure dignified existence for the weaker sections.

Government's financial strength, via improved revenue can directly address the existential needs of the weaker sections via direct, targeted subsidies. But as many have said before, this government supported existence is not a permanent solution. The safest route to genuine participation in the market today is by becoming a valued customer first. This will over-a-period of time enable their participation in economic, value creating activities and thereby widen the base of the economy further making it truly inclusive, resilient and robust. This is how we can fundamentally address the challenge of inequity and resultant social distress.
Wealth generation and wealth distribution are currently accidental adversaries. These words of **Jorge Martinez Vazquez** from his **paper on Taxation in Asia** point out the nature of this adversarial relationship: [30]

> Tax systems—the combination of tax policy and tax administration—are central to successful fiscal policy and the overall management of the public sector. Too little tax revenue can make it difficult for governments to spend adequately in critical areas for economic growth, including public infrastructure and investment in human capital creation through education and health services. But tax burdens that are too high can also be detrimental to economic growth; these decrease private investment and discourage savings and work effort. In addition, tax revenues can be raised with a minimum of distortions in the economy, or else can carry significant excess welfare losses due to poor design and disincentives to economic activity.

We need to create a way where wealth creation and distribution work together all the way as genuine partners / collaborators. To start this journey, let us remove hurdles and distortions created by the current taxation system. We need to find ways to remove the unnecessary complexity that exists. We need to create a set of systems such that we reverse the trends of evasion, corruption and cynicism.

In the world-of-today, Global financial flows are a reality. So is Global production. Multi-National Corporations (MNCs) tend to minimize their tax burden through many routes – including transfer pricing and tax havens. The rest evade by taking the cash route to non-traceability. The few who can't evade carry an even greater burden. Significant many, if not all, end up losing one way or another and almost everyone is stressed out and unhappy. Most of us try to fulfil our aspirations in whichever way it is feasible in a given system. If morals / ethics are taking a beating today, then it is a result of a combined effect of individual values, social norms as well as the prevalent systems. The prevalent systems often tempt or force unethical behaviour.

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[30] Taxation in Asia– Asian Development Bank – 2011, Jorge Martinez-Vazquez (Professor, Andrew Young School of Policy Studies, Georgia State University)

We need to ensure that the key mechanism for healthy circulation of capital, i.e. banking, affordable credit, is available to all. Let us ensure that the government revenues are aligned to genuine all-round economic growth. Let us find ways in which banks stay focused on their primary role of ensuring robust flow of credit to the last citizen! Creating systems / conditions such that the greatest good of most (if not all) is the stated and practiced objective i.e. the true measure of success.

If we can look at the logic of "Tax all consumption" in light of the fact that today we live in a monetized world, a new base will become visible. Why not look at taxing banking transactions alone? All taxation can be justified as a "fee" which ensures that the public goods in a democratic society are available to all. In a monetized and well-banked economy, voluntary bank transactions constitute the broadest possible base for a simple and small tax. Ideally, there are no exemptions, no special rules.

Use of Information technology for taxation mostly has been an exercise in improving speed, removing unnecessary paper handling and possibly improving co-ordination between different agencies to trap tax avoiders / evaders. In our proposal, Information Technology, brings the taxation systems in-tune with the times and actually enables creation of a non-evadable, painless taxation on the widest possible tax base.

To capture concisely the taxation related changes, let us once again turn to the words of **Roberto Campos** as quoted by **Prof. Cintra** in his paper. He states [31]

- If it is true that mankind cannot coexist without abiding by a "Social Contract", then each of us should genuinely desire that any necessary contribution to the Common Good be as painless as possible, that it require of us little or no effort, that it not incite competition with our peers, and that it protect us from the anxieties associated with investigative and prosecutorial actions of the State.
- Thus, one can see clearly that the call for a light tax system that is simple, automatic, universal, paperless, non-declaratory, moderate, equitable, difficult to defraud, rests on solid foundations of tax psychology. These are the good foundations of the tax's legitimacy, which ensure consent, a subjective presupposition that is indispensable to effective fiscal institutions

With this context let us look at the **ArthaKranti BTT Proposal**

- **Withdrawal of Existing Taxation System Completely (**except Customs/Import Duties - Customs duties perform an important role of ensuring a genuine level playing field in a globalized world. Hence they will continue, may be, with the many improvements already suggested by the FRBM Act Implementation Task Force and other committees**.)**

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[31] Page_177-178, Bank transactions: pathway to the single tax ideal A modern tax technology; the Brazilian experience with a bank transactions tax (1993-2007), by Cintra, Marcos, July 2009

- **Every Transaction routed through a bank will attract a certain deduction in appropriate percentage as Bank Transaction Tax i.e. Single Point Tax Deducted at Source (say 2 %)**
    - **This deduction is to be effected on receiving/credit account only**
    - **This deducted amount will be credited to different Government Levels like Central, State and Local (as say 0.7 %, 0.6 % and 0.35 % respectively)**
    - **Transacting Bank will also have its share in this deducted amount (say 0.35 %) as the Bank has a key role to perform**
- **Withdrawal of High Denomination Currency (say above Rs. 50)**
- **Cash Transactions will not attract any tax**
- **There will be no legal protection for cash transactions having a value of more than Rs. 2000.**

The systemic challenges highlighted previously are adequately addressed as the underlying structural flaws are removed. Thus implementation of ArthaKranti BTT Proposal would start creating conditions to move towards a principled, prosperous and peaceful living for all. Of course, other changes are also required to get to this desired state.

In this context, the ArthaKranti BTT Proposal can be seen to be a way to remove distortions and ensure a principled wealth-creation process which is tied to mechanisms for wealth distribution (by ensuring that governments at all levels have adequate revenue to finance required programs and investments in infrastructure and other development efforts including education and health) thereby creating a path to genuine prosperity for all!

5 Key Characteristics of AK-BTT and typical objections

Now we will explore the key features of the proposed reform and also delve into some of the known as well as possible objections and our current responses to these objections.

5.1 Key Features

5.1.1 Revenue function of taxation

The more important message is probably that the best tax system is the one that produces the most revenue in the least costly and distorting way. – *Richard Bird (Global Expert in Taxation)* [32]

[32] Taxation in Latin America: Reflections on Sustainability and the Balance between Equity and Efficiency, Richard M. Bird, June 2003

Thus it is safe to say that the most important function that taxation serves is collecting adequate revenue for the various expenditures of the government. If it gets additionally loaded with other purposes then the global as well as Indian experience shows that even the primary purpose is not accomplished, let alone the additional ones!

5.1.2 Bank transaction as the tax base

Globally bank transactions are not a commonly used base for taxation. Its appropriateness as the base of choice needs to be established. We explore the views of various authorities on possible tax bases. The **FRBM Act Implementation Task Force** observes that [33]

> It can be argued that the returns to all factors of production should be taxed equally. A tax on expenditure alone is equivalent to a tax on wages alone with no tax on returns to capital. Hence a tax on labour distorts the work/leisure decision in the same way that a tax on capital distorts the save/consume decision. To tax returns to labour but exclude returns to capital, encourages those engaged in production to use less labour and more capital. It would seem reasonable, looking only at these economic arguments, **to tax the return to all factors of production.**

This statement indicates the desirability of having the widest possible tax base which includes every aspect of economic activity. We also explore the views of other experts from across the globe like, **Prof. Bird, Prof. Feige, Prof. Patrick R Colabella and Prof. Richard J Coppinger. Prof. Cintra's observations** are most lucid in the current context [34]

> Bank Transaction Tax … could be conceptually justified as being the payment for the supply of public services and for the public cost of making possible the circulation of money without physical handling. It is a tax on a social service that creates value, reduces transaction costs, and which society makes available through the banking services. Such a service would not be possible without institutions that guarantee its safety and reliability.
>
> Different tax bases – income, consumption, production, and labour use – are replaced by a single bank transaction tax collected through the banking system. This tax would be exogenous, automatic, and evasion-proof. It would be exogenous because it would not depend on returns filled out by the taxpayer. It would be automatic in that it would be a simple charge against use of banking services. It would be evasion-proof, because in a modern economy banks are indispensable, financial supermarkets that offer diverse services.[35]

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[33] Page 90, Chapter 5, Report of Task Force on Implementation of the FRBM Act, 16 July 2004

[34] Page 160-161, Bank transactions: pathway to the single tax ideal A modern tax technology; the Brazilian experience with a bank transactions tax (1993-2007), by Cintra, Marcos, July 2009

[35] Page_202, Bank transactions: pathway to the single tax ideal A modern tax technology; the Brazilian experience with a bank transactions tax (1993-2007), by Cintra, Marcos, July 2009

The proposed tax system is evaluated against the frequently used **Canons of Taxation**, like equity, certainty, productivity, variety, etc. This logically establishes the desirability and workability of the ArthaKranti Banking Transaction Tax (AK-BTT). The ease of enforcement and virtually zero-cost of compliance of the AK-BTT are significant advantages. Essentially the simplicity of the automated mechanism leads to all round improvement in terms of cost reduction as well ensuring required revenue collection. The low-rate and automatic collection also make this tax virtually evasion-proof – no motivation to evade and cost of evasion would be far greater than compliance costs! A significant benefit is the removal of most tax-induced distortions in the economic behaviour of individuals and corporates.

A key innovation of ArthaKranti BTT Proposal is the provision to share a portion of the tax revenues with the collecting bank. This additional revenue for banks enables availability of affordable credit to all sectors of society. It could also play a significant role in helping banks realign their priorities to genuinely serve the interests of the society as a whole.

In the detailed research report, we have addressed the significant objections raised about AK-BTT as well as those related to BTT in general. . In addressing each objection we leverage the work of global experts and give detailed responses which establish the true nature of the AK-BTT. The alleged regressive nature, the possible cascading, empirically observed erosion of tax base (Latin American experience), the workability of demonetization and questions about banking are all addressed in the required detail

As a representative example, we share here some excerpts from the response to objection related to possible cascading and cumulativeness. **Prof. Patrick R Colabella** and **Prof. Richard J Coppinger** write thus about this **objection about cascading**: [36]

> Cascading refers to the repeated taxation of the same items as they are sold and resold at successive stages of production causing the ultimate price of the completed product to include all the taxes paid in the stages of production and the related costs of sales and administration. Sales, excise and property taxes cascade and we haven't sent the world into turmoil yet. In reality, all taxes paid by business cascade into the price of goods.

To consider effect of cascading in case of transaction tax vis-à-vis ideal Goods and Service Tax (GST) regime on prices of goods and services we have done some simple estimations as under:

- If we consider GST at flat rate 'g' and if total 'x' value is added in value chain output cost would be $x * (1 + g)$

[36] The Withdrawals Tax - St. John's University, New York, Prof. Patrick R Colabella (Associate Professor of Accounting and Taxation, St. John's University, New York, Chairman, Global Institute for Taxation (GIFT)) and Prof. Richard J Coppinger (Professor, St. John's University, New York, Vice Chairman, Global Institute for Taxation), 1999

- Considering total value added as Rs. 100 and GST flat rate as 12 %. The output cost after applying GST would be Rs. 112.
- Assuming that 'x' value is added in 'n' steps in a manner that equal value is added in each step i.e. 'x/n'. Considering the rate of transaction tax as 'r', price of the goods / service at nth step is calculated as shown in the Table titled Indicative Calculations of BTT and price of commodity including BTT in generic manner.
- Output cost at n^{th} step in BTT method $= (x/n)((1+r) + (1+r)^2 + (1+r)^3 +\ldots+\ldots+ (1+r)^n)$
$$= (x/n) * ((1+r)/r) * ((1+r)^n -1)$$
- If we consider Bank Transaction Tax Rate as 2 %, to reach to equivalent output cost the number of transaction steps required will be 11. At 10th step the output cost would be Rs. 111.687 and at 11th step it would be Rs. 112.83.
- If 1 % BTT rate is sufficient then number of steps required for getting value equivalent to flat GST will be 22.

We have not considered here the reduction in the interest rate at which credit will be available. Also we have not considered the compliance cost, administration cost and evasion which are significant at each step even for GST. Eliminating all the other taxes means eliminating the compliance and collection costs as well as the distortions caused by tax evasion. And unless cascading is significant the net effect would be positive in the BTT case. Our simple modelling above indeed demonstrates this to be the case.

Concluding his arguments about the **allocative efficiency and distortionary effect on prices**, **Professor Cintra** refers to work done by **Prof. Yitzhaki** and shows conclusively that **BTT** has a **healthier effect on prices**. [37]

- Yitzhaki has suggested that "*in the extreme case where all commodities are taxed, they can all be taxed at the same rate, so that relative prices do not change and we end up with a zero deadweight loss*." Thus, a tax system with lower rates, and more widespread universal incidence across all commodities should imply a smaller impact on relative prices, and therefore, have smaller substitution effects and cause less allocative distortions on the economy. There are two reasons for expecting that bank transaction taxes conform more closely to these requirements of absolute generality stated by Yitzhaki.
    - First, bank transaction taxes have a single uniform rate, universally applied to all commodities. VATs, on the other hand, usually have multiple rates.
    - Second, rates of bank transaction taxes are lower than those required from VATs to achieve given revenue target: the tax base is broader, and evasion potential is more limited.

[37] Page 110, Bank transactions: pathway to the single tax ideal A modern tax technology; the Brazilian experience with a bank transactions tax (1993-2007), by Cintra, Marcos, July 2009

- Thus, it is expected that bank transaction taxes imply lower and more homogeneous tax burdens on commodity prices than VATs, thus being closer to a situation of relative price neutrality, as stated by Yitzhaki.

6 Revenue Projections and Other Benefits of the ArthaKranti BTT Proposal

Staying focussed on fiscal consolidation, we present the benefits of the ArthaKranti BTT Proposal in quantitative as well as the qualitative terms. Thus we primarily look at

- The transaction tax rate required to ensure adequate revenue for the Government (so as to initiate and achieve fiscal consolidation). We have defined adequate government revenue as that required to initiate and achieve fiscal consolidation.
- Impact of the changed taxation policy on the prices of some of the commodities
- Impact of the changed taxation policy on the tax paid by individuals and organizations (Indicative Sector-wise analysis)

Post ArthaKranti BTT Proposal implementation, high denomination currency money will not be available. Instead banking and electronic payments are promoted. Hence majority of the transactions will be carried out through banks and the cash economy would be significantly reduced in volume. In essence, all money credited to bank account will be taxed at a low rate. The basic guidelines are

- No differentiation in taxation (irrespective of reason for transaction or location)
- Handle exceptions by refunding via direct payment route
- Increase in tax base and with appropriate rate, required tax will be collected at each level of Government.

The only exceptions to these generic guidelines are

- Transfer of money between different bank accounts of the same person / legal entity.
- BTT collection accounts of government (all levels)

Different possible methods to estimate the required transaction tax rate are explored in the detailed research report. These methods are identical in the required revenue estimation -- current tax revenues (central, state and local government bodies) and the known revenue deficit. They only differ in the way the tax base (taxable transactions) is estimated. We are presenting here the first method as an example

- As per RBI database Tax revenue collected for all state and central governments combined together for 2009-10 was 9,87,771 Crore Rupees.[38]

[38] TABLE 115 : RECEIPTS AND DISBURSEMENTS OF CENTRAL AND STATE GOVERNMENTS, RBI Database

- Revenue deficit for central and state governments combined for 2009-10 was 3, 70,015 Crore Rupees as per RBI Database. [39]
- To arrive at the revenue requirement for local bodies (rural and urban) we consider revenue under the head "own revenue" (includes tax and non-tax revenue) from the available data on the Central Finance Commission site [40]
    - Grand consolidated revenue for PRI (Panchayat Raj Institutes) was 2,736.39 Crore Rupees for 2007-08
    - Grand consolidated revenue for ULBs (Urban Local Bodies) was 23,521.38 Crore Rupees for 2007-08
    - Based on the data available for 5 years prior to 2007-08, the average growth rate of total expenditure carried out by PRIs and ULBs works out to be approximately 17 %.
    - Assuming the same growth rate till date, we can extrapolate the requirement of revenue in year 2009-10. It is equal to Grand consolidated own revenue for PRIs and ULBs combined multiplied by Extrapolation factor (considering 2007-08 as the base year) i.e. 26,257.77 * 1.17 * 1.17 = 35,944.26 Crore Rupees
- Combining the entire revenue requirement i.e. Tax revenue for Central and state governments together (9, 87,771), revenue deficit for central and state governments considered together (3, 70,015) and extrapolated revenue for all local bodies (rural + urban) (35,944.26), total revenue requirement comes out to be 13, 93,730.26 Crore Rupees.
- If we look at RBI Annual report 2010-11 [41] "Payment System Indicators – Annual Turnover", we get some indicative numbers. Grand total of transactions under different heads for 2009-10 comes out as 8, 92, 87,769 Crore Rupees.
- Hence the revenue equivalent transaction tax rate can be calculated as follows
  Reqd. Transaction tax rate = (Revenue required to be collected / Total Transactions) * 100
  = (13, 93,730.26 / 8, 92, 87,769) * 100
  = 1.561 %
- If we consider the collection costs for banks as 2 % of the revenue collected = 0.031 % (**Saumen Chattopadhyay** and **Arindam Das-Gupta** in their paper [42] state that government compensate banks for collecting taxes by giving around 1 % of the revenue collected and banks are asking for compensation around 2% of the revenue collected)
    - We may adjust the collection costs share that is to be given to banks by considering
        - the one-time costs for building new technological infrastructure by Government and private partners together and

[39] TABLE 114: COMBINED DEFICITS OF CENTRAL AND STATE GOVERNMENTS, RBI Database
[40] Tier Wise Revenue and Expenditure of PRIs and ULBs in Rs Crores, http://fincomindia.nic.in/
[41] Table IX.1: Payment System Indicators - Annual Turnover, Page 128, RBI Annual report, 2010-11
[42] The Compliance Cost of the Personal Income Tax and its Determinants, Chattopadhyay (Senior Economist, NIPFP) and Das-Gupta (Visiting Professor, Indira Gandhi Institute of Development Research, Mumbai), December 2002

  - the cost to banks for infrastructure upgrades and spread across the interiors of India
- Thus Total transaction tax rate comes out to be 1.592 % i.e. ~ 2 %

We have not considered here the inevitable increase in bank transactions as a result of the withdrawal of higher denomination currency (Highest denomination note being Rs. 50). "**Mobile payments in India**", a **report** by **Deloitte** in association with **ASSOCHAM**, **highlights** the **huge size of the cash economy** as follows: [43]

> "However, India remains predominantly a cash economy due to high prevalence of cash in day-to-day transactions. Overall, 67 % of transactions are carried out in cash, while only 33 % are done through electronic means."

This implies that the actual transactions in banks, post ArthaKranti BTT Proposal implementation would be substantially greater and thus the effective revenue neutral BTT rate could be lower.

As per the ArthaKranti BTT Proposal, due to the wider tax base the tax rate is low and the compliance costs are negligible (non-declaratory, automatic collection system), hence there is less incentive for tax evasion. This tax will be automatically deducted and distributed appropriately to the different levels of government (central, state and local) reducing the administration costs as-well. Demonetization of the high denomination notes and sharing a portion of the tax revenues with banks helps in widening and deepening of banking system as well as shrinking cash economy. The proposed system is more traceable, accountable, simpler to administer while generating required revenue for governance in a decentralized manner and with minimum distortion.

Government will get the required revenue, at significantly low rates of tax, by ensuring the continued presence of a socio-politico-economic environment that encourages and sustains higher economic activity. (The increased economic activity results in higher volume of bank transactions and hence higher revenue for government and banks). There is adequate financial strength at each level of government. This will enable local governance, which is the best way to ensure meaningful response to local aspirations. Simultaneously, financially strong central government is also assured and hence (eventually) improved infrastructure. Robust and inclusive social institutions will also be a reality. This in turn would lead to restoration in confidence in government. This in-turn would increase the willingness to participate in the virtuous spiral and contribute genuinely and fully.

This change thus helps in achieving the desired fiscal consolidation. This fiscal consolidation enables better credit availability to private sector. Public investment in infrastructure will crowd

[43] Mobile Payments in India New frontiers of growth. Deloitte and ASSOCHAM India, April 2011

in private investment leading to adequate infrastructural development. This will help in reducing supply side bottlenecks. All these changes combine with the reduction in cash economy to improve the ability of the government to combat inflation.

All of these factors will create more conducive economic environment for sustainable growth. This growth-friendly environment will boost employment generation and contribute significantly to the efforts of poverty reduction. Available revenues for infrastructural development could be used for reducing regional disparities.

Post implementation of the ArthaKranti BTT Proposal informal economy will substantially merge with the formal economy. Hence the abuse of the informal economy by anti-social and anti-national elements would be effectively checked. Improved fiscal conditions of the country could be used to provide assistance for socio-economic development of neighbouring countries and thereby could create conditions for more effective international diplomacy.

7 Next steps – Research Areas, Transition Plan, Global Consortium

We have presented here our current understanding about the next steps required to move AK-BTT from being an Innovative Proposal to an Implemented Tax System.

The change proposed by ArthaKranti is significant. To ensure a successful change-over, a smooth transition plan is an absolute necessity. Withdrawal of higher denominations, removal of existing taxes and introduction of the BTT will take place according to an appropriate program designed by Competent Authorities. It could be on the following lines:

a. Fake Currency will not be entertained
b. Cash deposited will attract certain rate of BTT, as well as above specific amount, deposited cash will be redirected for infrastructure development through mechanisms like infrastructure bonds.
c. Certain taxes of Central Government could be withdrawn first and a BTT at the required rate introduced to ensure appropriate revenue.
d. Agreement based on actual revenue can then be initiated with states / local bodies to ensure a smooth switchover

Globalization is reality, especially so in the field of economics. The 2008 financial crisis and the subsequent sovereign-debt crisis in Europe make this reality undeniable. Post 2008, there is a deep concern about the stability of the global financial system, especially due to excessive speculative activity in the equity and debt markets as well in foreign currency trading. The most visible formal response to the crisis thus far has been the monetary quantitative easing by central banks across the globe. Another response has been a **growing acceptance of FTT** (Financial Transaction Tax), at least in Europe. **Eleven European countries** (**Austria, Belgium, Estonia, France, Germany, Greece, Italy, Portugal, Slovakia, Slovenia and Spain**) and the

European parliament have agreed to introduction of a FTT (at different rates) on equities and derivatives trading. The current motivation is to use the collections as a reserve fund in case of a similar break-down / crisis in the financial sector, instead of using the average tax-payer's money.

As evidenced by the material researched, such a time for major change is indeed here for all the countries across the globe. Reproduced below is a brief sampling of the material about economists and thinkers from the across the globe who share a similar vision:

- **Prof. Marcos Cintra, economist, educated at Harvard**, and an **active politician** as well as a **professor in Brazil** proposed a banking transaction tax (BTT) in Brazil, way back in 1990. In fact, BTT had been in use in Brazil as an additional tax from 1993 to 2007. (http://www.marcoscintra.org/)

- **Prof. Edgar Feige, an international authority on Underground economies**, proposed in the late 1990s, a radically different tax system - a tax on all Automatic Payment Transactions to replace the prevalent tax system (http://www.thetransactiontax.org/).

- In 1996, **Prof. Patrick R Colabella** and **Prof. Richard J Coppinger** from **USA** had proposed a bank withdrawal tax as a single tax to replace all existing taxes.

- **Peter Scott Willans of University of Tasmania** has proposed a global FTT and recommends the use of the proceeds to strengthen national social policy commitments. (http://eprints.utas.edu.au/9764/)

- Taking the basic idea of FTT forward, **Simon Thorpe** (a **Research Director with the French National Centre for Scientific Research**) has proposed a Flat Rate Financial Transaction Tax to replace all taxes. (http://simonthorpesideas.blogspot.in/).

All we want to say about AK-BTT is nicely captured by **Prof. Edgar Feige** in his paper "**The Automated Payment Transaction Tax - Taxation for the 21ST Century**": [44]

> The APT tax proposal embodies the normative principles that have guided all successful tax reform proposals: **simplicity, equity, efficiency and reduced costs of administration and compliance.** To achieve these ends it contemplates revenue neutrality, base broadening, the reduction of marginal tax rates, a single flat tax rate, the elimination of tax loopholes, the end of tax returns and information returns and the **automatic electronic assessment and collection of taxes**. All in all, it looks like a proposal worthy of serious consideration.

[44] Taxation for the 21ST Century: the automated payment transaction (APT) tax, October 2000, Edgar L. Feige (Professor of Economic Emeritus, University of Wisconsin-Madison) (http://wisc.academia.edu/EdgarFeige/Papers and http://www.apttax.com/)

Given the change from current practices, we believe that a global consortium of the authors quoted above and may be more such individuals, would indeed consolidate the necessary knowledge-base (fundamental theory, modelling rigour and detailed argumentation) to bring about this much needed and hugely beneficial reform.

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