Chapter 2

Literature Review

1. The tax had been imposed since the time State or the Nation had been born. There are numerous types of taxes and there are as many methods of collection of these taxes. In fact, taxation has been one of the most discussed and debated subject since very long. The quest for the best taxation system has been continuing for time immemorial and would continue forever. The thinking on what constitutes the best tax system and an implementation strategy to achieve has undergone considerable change over the years, mainly because of the changing role of the state in development and internationalization of economic activities.

2. The theory of taxation will mainly deal with the question of what would be the best and proper way of taxes of the government and the major characteristic of any good system may have following ingredients[6]:

a. The tax system should be fair and equitable

b. It should cause least possible harmful effects to the economy and to promote the growth

c. Should be simple for administration and compliance

d. Should be income elastic

Equity and economic rationality are two important criteria of the taxation system and these criteria, limited by the requirement of simplicity and income elasticity. Taxes are unilateral payments for which there is no direct quid pro quo, citizen should be required to protect us from the basis of run of equity, and that the rule may be the principle of their ability to pay[7]. An individual's ability to pay can be measured on the basis of income or consumption, wealth. The main task of the Economist is to devise a system of taxation which

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[6] Chelliah & others(2001)

[7] Musgrave(1959)

would enable the government to reach the income and consumption of individuals without causing any, or more than minimum possible and worse effect upon the economy. It should also be ensured that the system is equitable to the extent that all equals pay equal tax and unequal will pay unequal tax, better off pay more tax than worst off. Designing tax policy and reforming an existing tax regime can be two distinctly different exercises, not always generating the same set of results. It is possible to argue that the objective of tax reform should be to chart the course for turning a given tax regime into one that has been "optimally" designed. It recognizes the difficulties of achieving the first-best solution and emphasizes the need to minimize the deadweight losses in exploring the second-best solutions[8].

3. The first ideology, based on the assumption that government is all-powerful, fully informed, benevolent and driven by efficiency considerations. It aims to minimize the excess burden of raising a given amount of revenue, consumption should be taxed and the optimal rate of tax on individual commodities should be related to the direct and cross-price elasticities of demand. In the special case when the compensated cross-price elasticities are zero, the optimal tax rate is inversely proportional to the direct, compensated price elasticity of demand (Ramsey rule). The lower the compensated price elasticity of demand, the smaller the movement away from the undistorted first-best optimum in response to the tax so that it pays to tax the lower-elasticity goods at higher rates. Since tax structures designed on these principles would involve taxing necessities, the need to address distributional concerns becomes paramount. Incorporating distributional considerations into this paradigm introduces discussions of optimal income tax, applications of which interestingly do not support sharply progressive tax structures.

[8] Rao M Govind and R Kavita Rao (2005-06)

4. The second ideology recognizes that the government typically lacks the information on elasticities and is subject to lobbying when it is willing to tax different goods at different rates. This ideology leans more heavily toward taxing consumption at uniform rates across goods[9]. According to this theory, while efficiency (and distribution weights) is clearly desirable in the design of tax policy, administrative capacity, attention to local institutions and political realities are equally, if not more, important. The principal concern is not to design a system that will be optimal, but to adopt a system that will minimize tax-induced distortions and at the same time, be administratively feasible and politically acceptable. The basic Harberger reform package for developing countries that are price takers in the international market consists, among other things, of uniform tariffs and a broad-based VAT. Panagariya and Rodrik[10] examine the rationale for uniformity in the context of import tariffs and argue that while the case for uniform tariffs is not watertight, uniformity minimizes the pressures for favorable (higher) rates on some goods over others. The commitment to a uniform tax rate introduces a free-rider problem for industries to lobby for lower rates for themselves (since such lower rates are then extended to everyone).

5. While the literature has focused more on the first theory described above, it is optimal taxation that has played only a limited role in the formulation of actual tax policy. The second theory, combined with administrative cost considerations, is a closer approximation of the approach of tax policy practitioners. The thrust of most tax policy advice within this approach is to enhance the ability of the tax system to raise revenue while minimizing relative price distortions. This involves efforts to broaden the tax base, lower the rates and reduce rate differentiation of both direct and indirect taxes. Adoption of uniform tax rates has been an important feature of

[9] Harberger (1990) and Hatta (1986)
[10] Panagariya and Rodrik (1991)

practical approaches to tax reform[11]. A broader base requires lower rates to be levied to generate a given amount of revenues. It also helps to ensure horizontal equity, and it is desirable from the political economy viewpoint because elimination of exemptions and concessions reduces administrative costs as well as the influence of special interest groups on tax policy. Lower marginal rates not only reduce disincentives to work, save, and invest, but also help to improve tax compliance. The preference for broad-based and uniform rates of taxation is thus guided by the need to eliminate an arbitrary array of tax differentials determined more by special interest group politics than pursuit of economic efficiency. Further, the limited infrastructure and capacity of tax administrations in developing countries constrain them from effectively administering complicated tax regimes. Broad-based systems of taxation applying uniform rates are a mechanism for providing stability and simplicity to the tax system.

6. The introduction of VAT is an important component of recent tax reform packages in many countries, especially in the context of declining emphasis on import tariffs. Keen and Ligthart[12] show that in small open economies, any revenue- neutral tariff cut accompanied by a price-neutral, destination-based VAT will enhance both net revenue and welfare. While this result is contested, especially in the context of developing economies with significant informal sectors, that debate does not extend to cases where a VAT seeks to replace a cascading type of sales tax or broad-based excise duty. In large economies, however, complete replacement of revenue from international trade taxes by a VAT may not be possible since it might be associated with unacceptably high tax rates; even if it were acceptable, the revenue might not accrue to the central government in a federal setup like India where the states have traditionally held

[11] Rao(1992)
[12] Keen and Ligthart(2002)

the power to levy sales taxes. There may thus be a need to explore all other alternatives.

7. Some economists have argued that because the VAT is a tax on the formal sector of the economy and is often combined with weak administration, it helped the informal economy to spread[13]. While this argument may be true to some extent, but it should be kept in mind that the same would apply to many other taxes levied in developing countries. It is very imperative that any taxation system should encourage honest tax compliance and should have very stringent penal provisions for tax violators. The extent to which a VAT encourages the informal sector also varies from country to country. This argument against the VAT also overlooks the dynamism created by the formal sector as it opens up avenues to expand businesses.

8. Another criticism of the appropriateness of the VAT in developing countries is based on market structures. Das Gupta[14] argues that under imperfect competition, since neither the gains from an input tax credit nor the entire tax burden need to be passed on to the consumer, a turnover tax may produce both more revenue and greater welfare than a VAT. This result, however, is based on a static framework. In a dynamic context, the taxpayers in a turnover-based tax system can integrate vertically, thereby avoiding taxes and potentially undermining production efficiency. Further, such a tax regime would perpetuate tax spillovers both across jurisdictions within the country and across international borders. These would undermine the competitiveness of the domestic industry and violate common market principles.

9. Tax policy has also often been guided by the need to pursue the

[13] Emran and Stiglitz(2004, 2005)
[14] Das Gupta (2004)

objective of redistribution. Most policy analysts in the 1950s and 1960s assigned redistribution a central focus in tax policies and considered that an ideal tax system should have a highly progressive personal income tax combined with a high corporate income tax. In fact, in the 1950s and 1960s, the marginal rates of personal income taxes were set at confiscatory levels in many countries. Redistribution was not merely an obsession in countries with interventionist strategies such as India but was fashionable even in countries such as the United States and Britain. In these countries, marginal income tax rates were set above 90 percent immediately after the Second World War.

10. Three important factors led to moderation in the pursuit of redistribution through tax policy. First, experience showed that highly progressive tax systems did little to reduce inequality in developing countries as they were neither progressive nor comprehensive. Em pirical studies in the United States and Chile showed that the income redistribution and reduction in inequality achieved by the tax systems were insignificant. Second, a redistributive tax system can impose additional costs on the economy, including administrative costs, compliance costs, economic efficiency costs, and political costs. Third, the focus of equity in fiscal policy itself has shifted from "reducing the incomes of the rich" to "increasing the incomes of the poor" and in this, the alternative approach of using expenditure programs for poverty alleviation has attracted greater attention.[15]

11. In theory the design of a tax system for developed countries today would rely largely on consumption taxes (VAT) on all goods and services applied at a more or less uniform rate. However, in the presence of large informal sector and constraints in implementing effective expenditure-based redistribution measures, it may be

necessary to have a combination of income and consumption taxes, the latter covering all goods and services, at fairly uniform rates. But such an option may not be easily available, with a tax system already in place. The task therefore is to reform the existing tax system so as to minimize the excess burden of taxation within the broad contours of the existing system. This involves reforms of all major taxes at the central, state, and local levels. The direction of reform as guided by the literature on tax reforms in developing countries includes:

- Scaling down of and possible elimination of trade taxes over time;
- Reform of existing domestic indirect taxes to transform them into comprehensive consumption taxes on goods and services: this should cover both national and sub-national taxes;
- A moderately progressive personal income tax;
- A corporate income tax at a rate equivalent to the highest marginal rate of the personal income tax.

12. Probably the most important aspect of the advice for developing countries in designing their tax systems is to keep the administrative dimension at the center rather than the periphery of reform efforts. Poor administrative capacity creates a wedge between the structure of the tax on paper and what actually works in practice. Apart from eroding revenue productivity, poor administration results in the perpetuation and even the spread of the informal economy, significant deadweight losses, and the violation of horizontal equity.

13. Tax policy, or for that matter any policy, stands on the tripod of architecture, engineering, and management[16]. Architecture provides the design of the tax system to be achieved, which is guided by the objectives of tax policy. Engineering provides the mechanics to achieve it, and these are provided by the nature of institutions and systems involved in tax collection. Management provides the implementation strategy and action, which, among others things,

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[15] Gurumurthi(2002)
[16] Bird and Zolt (2005)

depends on the political support and vision and the nature of administrative agencies and the information system. The three legs of the tripod are interdependent. A tax policy is only as good as it is administered; so it is important to design the tax system keeping the administrative capacity in mind. Similarly, the nature of tax institutions and systems will have to be adapted to conform to the design of the tax system and the implementation capacity. Further, administrative capacity should be continuously augmented to keep pace with changing requirements of tax policy. In other words, reform of the tax system involves both its structure and operations, is a continuous process, and has to be calibrated constantly. A complementary action in this regard is the building of proper information system.

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