

## **It doesn't matter**

Taxes: Reality, Perception, and Ideology

By

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*Blurb: Sleepwalking ideology should not blind one to the reality – tax avoidance is the privilege of the “missing middle” and not the rich.*

It was just two years ago that there was a raging debate about the “low” tax/GDP ratio in India and that we needed to raise tax rates in order to increase the tax/GDP ratio to a respectable level of around 16-18 percent. Economic reforms, by definition, lower tax rates, and this was another argument offered by the sleepwalkers to increase personal income tax rates. Today, just two years later, when the tax/GDP ratio will be close to 20 percent of GDP, the talk of increasing tax rates has gone down (I hope!).

The new demand is for the rich to pay their fair share for the increased prosperity. It is alleged by many (too numerous to name) that tax compliance among the rich is very small. How often have we heard the argument that individuals earning more than Rs. 10 lacs a year have low tax compliance. As evidence, CAG data are trotted out to show that in 2004/5, there were only 122,000 taxpayers in the above 10 lacs category. [CAG, the Comptroller Auditor General of India is the official keeper of tax data). If one looks at car sales and other associated data, this does seem a shockingly low number. For example, just when 122,000 individuals were claiming to have incomes above 10 lacs, sales of new cars in India numbered over a million. If you add expenditure on golden marriages etc. it does seem that the analysts (and politicians) are right – the rich have been getting away with massive tax evasion.

Though the contenders for rich tax evasion are *seemingly* more in line with reality than the (erstwhile) sleepwalkers, they are also likely to be just as wrong. But if they are wrong, then how does one explain car sales? Over the last few years, I have asked several senior policymakers this question: how many > Rs. 10 lacs individuals are there in the economy? All of them, bar none, have answered in the several million plus range

i.e. a compliance rate of around 10 percent or so. All of them cannot be wrong, so how come they are?

For an answer to that question, a slight detour. First, personal income (the amount that accrues to households) is about 20 percent less than GDP, so individuals are only 80 percent rich as you thought they were. Second, as to how come out of a billion individuals only so few have high incomes [i.e. where is India shining?] two simple tax facts are useful: first, only 400 million individuals work, and only 20 percent of individuals in India have incomes high enough to be eligible to pay tax, any tax. So, from a billion we are left with 80 million potential taxpayers. And if, as is alleged, there are several million with such large earnings, then India has the most equal distribution of income in the world – even more than the welfare state of Sweden.

Third, and most importantly, the impression about car and house buying and gold marriages is from our perception of purchases done by *households*, not individuals. But taxes are paid by individuals. If there are joint earner families (in urban areas at least one in five households has two earners) then two individuals earning 5 lacs each can have household earnings above 10 lacs – and buy a luxury passenger car, or an upper class house.

NSS wage distribution data for 1999/00 indicates that the number of theoretical taxpayers numbered 84 million in 2004/5 – and only 250,000 were in the Rs. 10+ lacs category. This rich group appears to have the highest compliance rate of all groups – close to 50 percent. The national average is a third i.e. only one in three individuals filed tax return in 2004/5 [For the present year 2006/7, the average tax compliance rate appears to have doubled to 60 percent]. The largest amount of non-compliance provided by the “missing middle” – those earning between Rs. 2 and Rs. 10 lacs, but primarily those earning between Rs. 2 and Rs. 5 lacs.

The theoretical number of individuals earning Rs. 5 to 10 lacs in 2004/5 were 1.5 million. Marriages with richer individuals and labor force participation can mean that one can add about 200,000 such individuals to the perceived 10 lac plus camp. Since consumption comes from wealth, and tax avoidance increases wealth, then just two or three years of systematic tax avoidance can propel a large number of individuals, and households, into

the *perceived* category of rich 10 lac plus individuals. This number can become large quite quickly – hence, the success of schemes which attempt to unearth black money.

A good rule of thumb about car purchases is that one buys a car with value twice one's annual income. To finance about 350,000 car sales with value above Rs. 5 lacs, one would guessestimate that there are 700,000 such individuals. There are 250,000 with incomes above 10 lacs; add about 200,000 for those with joint, not individual, incomes above Rs. 10 lacs. Add about 200-400 thousand individuals who evaded taxes in the past and now have incomes to buy a Rs. 5 lac plus car. Total, about 700,000 to a million. Thus, the luxury car sales data are consistent with tax data, and earnings data i.e. there were only 250,000 individuals with earnings above Rs. 10 lacs in 2004/5, and not several million. [In 2006/7, this number has likely increased to 360,000].

It is important that any policy, especially tax policy, be made with the right facts. What will help tax collection the most is a lowering of tax rates for the “missing middle” and an elimination of tax exemptions. A flat tax rate of 15-18 percent for everyone with above Rs. 1.5 lac annual income does sound, and most likely is, an optimal policy.

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#### **Tax Returns in India in 2004/5: Actual vs. Potential**

<b>Income Range</b>	<b># of Tax Returns (in million)</b>		<b>Compliance %</b>
	<i>Actual</i>	<i>Theoretical</i>	
0 - 2 Lacs	24.36	67.59	36.0
2 - 5 Lacs	1.83	15.21	12.0
5 - 10 Lacs	0.47	1.45	32.2
>10 Lacs	0.12	0.25	49.1
<b>Total</b>	<b>26.78</b>	<b>84.50</b>	<b>31.7</b>

**New Car Sales (in millions) - 1.14; Luxury Car Sales (>Rs 5 Lacs) - 0.35**

*Source: C AG, Oxus Investment Database; for car sales: SIAM*