TAX COMPLIANCE AND REFORM IN INDIA: THE ROLE OF SIMPLIFICATION, TECHNOLOGY, AND POLICY DESIGN

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ABSTRACT

Taxation increases government revenue which could be utilized to fund certain essential services and social goods that the mercantile world would never have provided if they had to operate solely on profits. Given that taxes are obligatory contributions levied on income, it is paramount to put the right tax system in place, one that encourages compliance, while at the same time remains fair to all taxpayers. Tax compliance depends critically on three things: the rate of taxation, the perceived threat of detection, and the penalties for failing to pay taxes.

Tax policy is best formulated when the system has a broad base with a low and simple rate. Simplifying tax laws allows taxpayers to easily understand and comply with their obligations, as well as to minimize the cost of taxation. This denotes the costs of collection for the government, the costs of compliance for the taxpayer, and the cost of output as impacted by taxation.

Encouraging compliance and ensuring that tax systems work fairly for all citizens consist of a straightforward system to collect taxes, which also affords lower tax rates while generating the necessary revenue for public services. In addition, by administrating taxes with modern technologies, it becomes considerably easier to increase detection rates of any refusal to comply and thus encourage voluntary tax compliance.

This paper attempts to develop those design aspects of tax compliance in a way that underlines the contribution of technology in effective tax administration in the Indian context.

Keywords: Tax compliance, Tax administration, Tax rate.

ANALYSIS

Only the functioning tax demands that a rational Taxation system collects revenue on behalf of the State, which is to be effectively used to create various goods and services. While the market may be unable to supply, public goods are characterized as unsatisfactory due to their nature as non-rival and non-excludable. Neither a given person's use of a public good decreases the amount available to others, nor is it easy to exclude a user from the good without charging. In making people pay, however, in big communities, a system of voluntary payments leads to thin contributions because people's true preferences for public goods cannot be gauged properly without effective charges.

Also, there is a group of services that the market is capable of providing but does so on an alternate basis which results in less than optimal potential. Public goods aimed at overall social benefit are inevitably made accessible to all and at least at a minimum; therefore, either the government goes on to provide them or subsidizes private supply.

A tax system is designed to ensure resource collection that would allow governments to deliver functions of public and merit goods and ensure their service provision to races and eventually deliver utility on an external basis for

the populace. Therefore, care is taken that it causes no disincentive impact upon its introduction and is put forth as efficient to serve as a business-enabling framework that reconciles with market functions while extracting fiscal revenues in the process.

When people can clearly see effective governance and public services have many benefits, as they are more willing to pay taxes. This is why, at the local level, it is often easier to connect revenue generation with spending decisions, leading to higher tax compliance. However, in India, cycle of low tax collection and poor public services reinforcement of each other is the result of the lack of decentralization. When citizens observe that their tax payments lead to improved access to services and that tax revenues are not squandered, they are more likely to comply voluntarily.

Tax compliance is influenced by three key factors: the tax rate, the likelihood of detection, and the penalty for non-compliance. High tax rates can discourage compliance because they increase the incentive to avoid or evade taxes. For example, in the fiscal year 1973-74, India had a complex income tax system with 11 brackets where rates escalated from 10% to 85%, and for those earning over Rs. 20 lakh, the effective marginal rate reached an astonishing 97.5%. This structure, compounded by a wealth tax, meant that high-net-worth individuals faced tax liabilities exceeding their income, which discouraged earning and paying taxes altogether. Consequently, tax evasion became widespread, with less than 1% of the population paying income taxes and revenue from individual income tax constituting only about 0.8% of GDP.

Significant reforms began in 1986-87 when the number of income tax brackets was reduced from 11 to 4, and the highest marginal rate was lowered to 50%. The recommendations from the Committee chaired by Raja Chelliah led to further simplifications in 1992, rationalizing brackets and reducing the top rate to 40%. In the budget for 1996-97 under Finance Minister

Mr. Chidambaram, additional simplifications were made, limiting rate categories to three and lowering the highest marginal rate to 30%. These changes resulted in increased tax compliance and improved revenue productivity.In subsequent years, cesses were introduced on high-income earners to fund specific programs like education and healthcare. According to Arthur Laffer's principles, raising tax rates beyond a certain point can actually decrease revenue collections due to increased evasion incentives and adverse effects on work, savings, and investment behaviors. After reaching this inflection point, reducing tax rates can lead to higher revenue collections. Notably, India's income tax revenue productivity improved following the reforms implemented after 1996-97.

To collect a specified amount of tax, maintaining low tax rates is only feasible with a broader tax base. Therefore, expanding the base by minimizing exemptions and eliminating various incentives and concessions in the tax structure is essential. Pursuing multiple objectives when designing a tax system can erode the tax base, complicate the system, and create opportunities for tax evasion and avoidance. A complex tax system increases compliance costs and causes unintended distortions in resource allocation.

In India, the Constitution's allocation of taxes on agricultural income and wealth to the States and non-agricultural income and wealth taxes to the Union government has resulted in a significant anomaly.This division provides a convenient avenue for income misclassification, tax evasion, and reduction of compliance. Many non-agricultural high-net-worth individuals own big farms or farmhouses for the very purpose of misclassifying their incomes.

These recent changes in tax laws are quite a milestone in their implementation with an uncommon viewpoint. In 2019-20, corporate income tax rates were reduced to 22% for domestic companies that do not avail of

exemptions and concessions. Including the 10% surcharge and the 4% cess, this brought the effective tax rate down to 25.17%, which is lower than the older system of 34.2% with preferences. . The minimum alternative tax (MAT) rate was lowered to 15% (17.16% with surcharge and cess), and new companies were taxed at 15%. In personal income tax, an option was introduced to forgo exemptions and deductions like those for savings, insurance premiums, and home loans in exchange for lower rates. Functional and graceful at last, the new regime converts the erstwhile three slabs into seven, each slab being comprehensive enough to accommodate taxable income levels aggregating up to ₹15 lakh.This division provides a convenient avenue for income misclassification, tax evasion, and reduction of compliance. Many non-agricultural high-net-worth individuals own big farms or farmhouses for the very purpose of misclassifying their incomes.

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Taxes should always widen and rates lowered, but simplification through minimal brackets is also necessary to streamline it all. Significant rate differences between brackets may lead to income manipulation to exploit lower rates. Furthermore, offering taxpayers two separate systems—one with a narrow base and high rates, and another with a broad base and lower rates—complicates the system and does little to enhance compliance. The government would benefit from redesigning the tax system with fewer brackets, lower rates, and no exemptions for both corporate and personal income taxes.

The current Finance Minister's initiatives to do away with exemptions and reduce rates are commendable; however, the opting system should not be retained in future budgets, and tax brackets must be limited to three.

GST is a fine example of how compliance can be improved with self-patrolling mechanisms. Claiming input tax credit from the GST necessitates that a taxpayer declares its

turnover, hence promoting voluntary compliance among taxpayers. A self-policing compliance model is being implemented all over the world: since 2000, 166 of the 193 member states of the United Nations have adopted some form of VAT. An uncomplicated structure will be essential for the efficacy of GST, wherein large exemption lists and multiple rates narrow the base and motivate evasion with misclassification. The point is that multiple rates generate incentives for misclassification and complication. Most countries that have implemented VAT since the year 2000 generally adopt single-rate structures. On the other hand, several rates are utilized for the GST in India, thereby creating a structure of inverted duty when input tax exceeds output tax, leading to difficulties and claims for refunds.

According to the economists of the time, equity in tax should be achieved by keeping the thresholds high to focus on "whales" instead of "minnows" and focus on poverty mitigation through expenditure programs instead of income inequality. Income inequality has never decreased convincingly with an upwardly segmented tax structure as income spread across tiered marginal rates. Initial reductions in rates incentivized people to evade taxes and enhanced voluntary compliance. India's GST, which has several rates with a peak of 28%, promotes a grey market and einerodes the chain of taxes. The high rates on goods and services like motor cars and building materials with crucial forward linkages bring on bothersome consequences for downstream labor-intensive industries. The design of rates in a multiple-rate system is best undertaken with economic impact assessment as a simple-sounding rule of thumb for installments.

The complex structure of GST in India, with separate central and state-level taxes, multiple rates, and exemptions, has compromised the self-policing advantages of GST. The system failed to address petroleum products and electricity, amounting to 40% of consumption, due to cascading impacts. Compliance was maintained by integrating some standard

identification method through a standard numbering system for traceability and detection. Linking the GST registration numbers to the PAN will ensure better matching of taxes and would point out any discrepancies, contributing towards better compliance.

The crucial aspect of tax administration and compliance is technology. The India experience in income tax and GST endorses this view. The introduction of the Tax Identification Number in 2002 resulted in tremendous improvement in compliance in income tax. GST compliance has improved considerably with the help of a very strong technology backbone for tracking inter-state transactions, for invoices verification, and for input tax credit processing. The initial experience of India in implementing GST faced many challenges as regard the technology front. Compliance was hampered, and her eventual growth of revenue had been affected by issues such as returns that appeared delayed, non-functioning compliance systems, and flawed input tax credit claims based on false invoices. These shortcomings were thrown into focus by the Comptroller and Auditor General in its 2019 report when its technical glitches and absence of suitable verification were highlighted.

Nevertheless, notwithstanding the challenges, compliance of GST is much better now, with technology stabilized.An adequate use of technology is still mandatory to improve tax compliance and fully realize GST revenue potential in India.

CONCLUSION

Tax compliance is a very crucial aspect of a functioning taxation system. Achieving compliance by design is feasible only when the tax structure is kept straightforward and equitable. It is equally essential to ensure that paying taxes is simple, supported by efficient administration, advanced technology for enforcement and management, and taxpayer-friendly services. While their fundamental objective is to generate revenue, resorting to tax design for multiple purposes often erodes their

efficacy such that revenue generation loses focus as a primary objective.

Given the inherent self-enforcing characteristics of the Goods and Services Tax (GST), along with proper structuring, it can be transformed into what one might call a "money machine." For this reason, the success of GST-dependent countries relies on setting up a strong and efficient technological infrastructure that is vital for seamless administration and greater compliance for all nations adopting GST on a resounding subnational level.

Tax reforms ought to upgrade such a system that regenerates encouragement towards self-compliance, and elicits simplicity, equity, and efficiency in its design and execution.

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