

A CASE FOR COMPETITIVE TAX RATES

India's direct tax collections are booming. The Budget estimate of Rs 3-lakh crore for 2007-08 is likely to be surpassed. Corporate tax collections have registered a 41 per cent jump so far. Can this be attributed to the corporate tax rates? Are they at an optimum level? Or do they need to be revised?

The Laffer Curve Debate

Kevin Hassett, an economist with the American Enterprise Institute, has attributed US' low tax-GDP ratio of 2.5 per cent to the high 40 per cent corporate tax rate. According to him, "We could collect more revenues with lower corporate tax rates."

The American Congress is threatening to raise not only the tax rate on corporate dividends but also the taxes on foreign-sourced income of US companies. In a recent research article on the subject, The Wall Street Journal notes that the US now has the unenviable distinction of having the world's highest corporate tax rate of 39.3 per cent (35 per cent Federal plus a state average of 4.3 per cent).

The article has revived the old debate about the Laffer-curve effect of high tax rates. Tax receipts tend to fall below their optimum when corporate tax rates are high, as such high rates lead to the creation of loopholes and the incentive to move income to countries with a lower tax rate. The Journal indicates where different countries stand with reference to their taxes and revenue in 2004 as per the Laffer-curve.

Spree of tax cuts

It points out that 25 developed nations have adopted corporate income-tax rate cuts since 2001. The French President, Nicolas Sarkozy, has proposed to reduce the corporate tax rate to 25 per cent from 34.4 per cent. Germany's overall rate will fall to 29.8 per cent by 2008 from 38.7 per cent. The average in industrialised nations is 29 per cent.

There is a clear tendency among nations to attract investments and reduce their corporate tax rates. Average corporate tax rates, according to a KPMG International survey, moved down globally from 27.2 per cent to 26.8 per cent. The Asia-Pacific average is 30 per cent. In Malaysia it is 27 per cent, Singapore 18 per cent, Hong Kong 17.5 per cent, Thailand 30 per cent, Taiwan 25 per cent and Vietnam 28 per cent. Pakistan applies a rate of 35 per cent for big companies and 20 per cent for small companies. The UK has differential rates of 19 per cent and 30 per cent depending on the income slab.

Indian rates

India applies a corporate tax rate of 33.9 per cent with surcharge and cess. For foreign companies, the effective tax rate is 42.33 per cent. There is also the Dividend Distribution Tax (16.995 per cent), the Securities Transaction Tax (at varying rates) and Fringe Benefit Tax.

While over the past decade, the tax rates have been significantly reduced, the inclusion of FBT, STT and DDT has distorted an otherwise fair fiscal system. Even while attempting to remove exemptions and incentives from the tax code, the Government has been introducing them for Special Economic Zone, Software Technology Parks and the the hospitality industry in the National Capital Region; this is proposed to be extended to the rest of the country too.

At a meeting in July 2007, the OECD commented on these distortions: "A difficult domestic policy issue for India to resolve is the fate of the many incentives and exemptions in the tax system. These include Special Economic Zones, Export Processing Area and Software Technology Parks."

"The work undertaken by OECD suggests that such schemes generate very little new investments and that there are considerable advantages in ending such incentives and exemptions. It is not always clear that they achieve their policy objective. Also they have a tendency to distort the economy and do not result in sustainable tax revenues".

The OECD also notes that of the countries surveyed government subsidy relative to GDP was second highest in India and import tariffs, the highest. The OECD indicator of product-market regulation (that is, the extent of state ownership, the red tape involved in setting up a business, and barriers to international trade) again puts India at the bottom of the class.

As if these tax incentives are not enough to distort the system, fresh pleas have been raised to exempt profits made by foreign institutional investors (FIIs) from trading in derivatives. At present, the full income-tax rate applies even if the FII comes through the tax-free Mauritius route.

There can be no denying the fact that our tax rates are comparatively high and, therefore, affects our international tax competitiveness. If anything, the buoyancy in our tax collections dispels the Laffer-curve theory. Despite the higher tax rates, our collections continue to be high.

However, we need to reduce our tax rates for several reasons:

Tax rate cut will help boost foreign investments.

It is no longer true that the burden of direct taxes cannot be shifted. The cost of those taxes can be passed on by way of lower returns for shareholders.

Higher tax rates can also mean higher prices for customers and lower compensation for employees.

Every time the issue of high tax rates are brought up, the Government's typical response is that the effective tax rate is only 19.5 per cent owing to concessions and incentives. Not much attention is being paid to the surge in black money.

Curbing hot money

According to The Economist, about \$18 billion of foreign money has been invested in Indian shares this year. More than half of this has come in the form of Participatory Notes. These are sold to offshore investors by approved institutions. Foreign investors are able to trade in Indian stocks without disclosing their identity.

Fiscal authorities have not been able to keep track of the money flowing in through this channel. This is hot money and highly leveraged. The quality of these inflows will have to be closely monitored, notwithstanding the threat such scrutiny poses to the Sensex.

This is a challenge that our policymakers will have to tackle soon to avoid stock market shocks and promote a healthy fiscal system.