FIRSTPOST.

History lesson: Mr FM, when it comes to taxes, less is more

By: FP Staff – January 13, 2013

The UPA 2 government has developed itchy fingers, and is looking to dip its hands into the pockets of the 'super-rich' in order to mop up revenue to lower its deficits and provide enough for the spending binge that it hopes will return it to power.

Ever since C Rangarajan, chairman of the Prime Minister's Economic Advisory Council, first went public with his view that the income tax rate on the rich be raised from the current 30 per cent in order to meet the growing expenditure requirements, there's been ceaseless speculation that the government proposes to wallop the well-heeled.

At their pre-budget meeting with Finance Minister P Chidambaram on Wednesday, captains of Indian industry, however, argued against a 'special tax' on high networth individuals or, as has alternatively been suggested, an estate duty tax.

CII president Adi Godjrej is believed to have "strongly advised" Chidambaram that any move to raise taxes on the rich would prove counter-productive at a time when the compelling need is to revive the economy through higher corporate investments.

FICCI president Naina Lal Kidwai pointed out that a tax rate that was disproportionately high would potentially trigger an exodus of top-dollar professionals to low-tax jurisdictions such as Singapore. The case of France, where the socialist government of Francois Hollande levied a "millionaire tax" - at the top rate of 75 percent - only to see millionaires like actor Gerard Depardieu go into tax exile, is illustrative. The 75 percent tax rate was subsequently ruled "unconstitutional", but the French case study offers a compelling lesson in how not to go about raising tax revenue.

India's own experience of taxation proposal over the decades points to the folly of having peak tax rates at very high levels. In Indira Gandhi's time, for instance, the peak tax rate was 97.5 percent, which meant that beyond a certain income threshold, the government took away every rupee of your earnings. Such a high tax rate provides very little incentive for people to disclose their earnings - or even to be industrious and work hard and earn well - since they never got to enjoy the fruits of their labour.

On the other hand, India's experience of lowering peak tax rates progressively in the two decades since the economic reforms of 1991 has validated the wisdom of the Laffer Curve model, which established the relationship between possible rates of taxation and the resulting levels of government revenue.

For instance, as The Times of India notes in an editorial, reducing tax rates and expanding the tax base has reaped rich dividends in recent times. "Though peak income tax rates have been sharply reduced from 56% in the early 1990s to 30.9% in recent years, income tax collections have gone up from Rs 5,371 crore (1990-91) to Rs 1,66,679 crore (2011-12). More importantly, the share of income tax in total tax collections of the central government has doubled from around 9% to about 18% now."

In other words, as the Laffer Curve model illustrates, lowering tax rates to reasonable levels incentivises growth and leads to more transparent income disclosure - both of which serve to enhance tax revenues for the government.

The theory was propounded by US economist Art Laffer, who postulated that there is an optimal tax rate at which the government can maximise tax revenue. For instance, if the tax rate was zero, the government gets no revenue. Likewise, if the tax rate were 100 percent, the government would still earn no revenue because there would be no incentive for anyone to earn anything at all.

Tax revenue is maximised at some point between 0 percent and 100 percent, but beyond the optimal rate of tax, Laffer established that the tax revenue actually begins to decline with higher rates. That optimal rate, of course, varies across different economies - and in any case isn't a constant. (This video, prepared by the Cato Institute, explains the theory of the Laffer Curve model.)

In other words, Chidambaram could end up laughing all the way to the bank - having mopped up optimal tax revenue - if he were to keep tax rates at reasonable levels. But if he were to get overambitious and decides to bean high networth individuals with a special rate of taxation, it could have a negative influence on taxpayer dynamics, changing their behaviour in a manner that actually lowers tax revenues.