20TH Annual Oration on Taxation

Faculty of Taxation

INSTITUTE OF CHARTERED ACCOUNTANTS OF SRI LANKA

“The Challenge of Tax Policy and Tax Administration in a Developing Country”

Hon. Shri P. Chidambaram
Former Minister of Finance and Home
Government of India

22 October 2015

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I am pleased to accept the invitation of the Institute of Chartered Accountants of Sri Lanka to deliver the 20th Oration on Taxation. It is an honour that you have bestowed upon a citizen of your closest neighbour and I accept it with deep gratitude.

Over the last 48 hours I have enjoyed the celebrated hospitality of Sri Lanka, your food and fruit and fish, and your famous King coconut. I have no words to thank you for your extraordinary kindness.

In the early years of my career, I was a lawyer. For many years thereafter I was a law maker. Lawyers and chartered accountants are usually reckoned as natural allies, but I am not sure the same can be said about law makers and chartered accountants or, for that matter, law makers and lawyers. I suppose the law maker looks upon lawyers and chartered accountants as his natural adversaries, and I would not blame him for that. We – chartered accountants and lawyers -- are, after all, the cause of much grief to governments and law makers! Hence, I am glad you have invited me when I am no longer a law maker and I am back to being a lawyer.

II

Governments are elected on the basis of promises, but no government can run on promissory notes. Government needs money in cash. Government needs money for its expenditure which includes both consumption and investment.

There are only five types of resources for a government.

Firstly, a sovereign government can create i.e. print money, but there are limits to printing money. Beyond a point, the currency will lose its value, inflation will rear its head, prices will rise, and there will be general unrest.

The second option is to borrow money. A government can borrow from its own people or banks or foreigners or friendly foreign governments or international financial institutions. Even if a government has the capacity to borrow, there may not be many willing lenders. Also, every borrowing comes with a cost. The more a government will borrow, the higher will be the cost. Hence, there are limits to borrowing.

The third option is to invite capital investments. Production of public goods can be funded by private capital if the gains are shared with the private investors. The ability to attract investments is however affected by external and internal factors, and these factors are not always economic. Besides, several countries will compete

for the same investment. While investment is a valuable source of money it is beset with uncertainty. Another disadvantage is that such resources cannot be used for consumption expenditure.

The fourth option is the gains from investments made in the past. However, not many developing countries would have a portfolio of investments that will yield a steady stream of income. Some gains can be made through disinvestment, but that will not be a perpetual source.

The fifth option is tax revenues. A sovereign government loves taxes because it can levy taxes. Tax resources are usually free resources without the burden of any obligation. Hence governments prefer to raise resources through taxation. Locating the power to tax is the simplest of the steps. What to tax, whom to tax, when to tax, the rate of tax, and how to collect the tax are the difficult steps.

III

Developing countries face the difficult problem of tax base. In a poor country, most people will have neither sufficient wealth nor sufficient income that can be taxed directly. Most people will also consume a limited quantity of goods and services and heavy taxes on goods and services may actually depress consumption. Besides, indirect taxation is regressive. These are the reasons why the tax base in developing countries is narrow and the tax to GDP ratio is low. I am informed that the tax to GDP ratio of Sri Lanka is about 16 percent and the worry is it has been declining since 1990. I am informed that during this period, in most years, actual revenue collections were lower than the budget estimates.

The Asian Development Bank’s Development Outlook 2013 mentions that the main cause of your low tax ratio has been VAT. VAT was introduced in Sri Lanka in 2002. It accounts for about one-fourth of Sri Lanka’s revenues. VAT collections have declined from 5.8 percent of GDP in 2004 to 2.7 percent of GDP in 2012. It is believed that VAT collections have continued to decline because of exemptions, poor import performance since 2009, and unification of rates at 12 percent in 2011. The report also says that faster growth in the post conflict period and rise in per capita income have not resulted in boosting revenue generation. Tax buoyancy in Sri Lanka has been estimated to be about 0.78 percent in the five year period till 2013, meaning that tax collection has not been responsive to the pace of economic growth. I can understand your concerns because all developing countries, including India, have experienced the challenges of low tax to GDP ratio and low tax buoyancy. The answer lies in expanding the tax base – that is bringing more people into the tax net without violating the principle of equity and promoting a culture of voluntary tax compliance.

IV

A finance minister's prime worry is how to protect the tax base and grow it. The challenges are both domestic and external.

The internal challenges are formidable. There are legacy issues like archaic tax laws, outdated technology, high tax rates, chronic tax evasion or avoidance, an adversarial tax administration, an ineffective dispute resolution system, an overburdened judiciary and corruption at many levels. These have made tax enforcement and tax collection herculean tasks.

A Finance Minister is not only the minister in charge of revenues. He is also the minister in charge of expenditure and has the responsibility of allocating resources. While everyone will say "we must live within our means", few really believe in that, and nobody will actually support a finance minister when he attempts to put that principle to practice. Our experience is that the Expenditure budget will be determined first and raising revenues to fund that expenditure will be left to the lonely finance minister. Tax policies and tax collection practices are distorted by the unreasonable demands for funds.

The external challenges are equally strong. No economy can be insulated from what is happening around the world, especially in the United States and China. The financial crisis that hit the US in September 2008 scarred all countries. The unconventional remedy of Quantitative Easing adopted by the US caused a rush of money into developing countries. The opposite happened at the hint of withdrawal from Quantitative Easing. There was an outflow of money, and the exchange rates of many currencies were affected. Even as they are coping with the after-effects of the US' actions (taken obviously in its self interest), developing countries are now faced with a slowing of growth of the world's economy caused mainly by the sharp slowdown in China.

The other big external challenge is the phenomenon of multinational or global corporations. Many developing countries are yet to get the measure of such companies and devise a comprehensive strategy to deal with them. Developing countries need them because they bring investments and create jobs. Developing countries are wary of them because, with their vast resources and extraordinary access, they can overwhelm tax administrations and deprive the country of its legitimate revenues. Love them or hate them, we have to live with multinational corporations.

V

That takes me to the next and more important question of protecting the tax base and expanding it as a county's economy grows and is able to attract new

investments. Corporate taxes constitute a major chunk of the tax revenues earned by a country. I have already referred to the size and scale of the businesses of modern corporations. Because of their size and scale they are able to locate themselves in multiple jurisdictions. The concept of a ‘home’ country of a corporation is vanishing: at best one can identify a country as the place where the corporation has its headquarters. Its profits are routed through several jurisdictions among which may be no-tax or low-tax countries. This problem is described as Base Erosion and Profit Shifting (BEPS).

At the request of the G20 countries, the Organization for Economic Co-operation and Development (OECD) launched a project to study the problem. In July 2013, the OECD published an Action Plan on Base Erosion and Profit Shifting. The Plan described the problem thus:

> “Tax Planning by multinational Enterprises (MNEs) that makes use of gaps in the interaction of different tax systems to artificially reduce taxable income or shift profits to low-tax jurisdictions in which little or no economic activity is performed.”

The Action Plan has identified 15 Actions, and each one of them will be a challenge to the tax administrations of developing countries. Some of the issues are familiar to tax administrations and chartered accountants: the emergence of the digital economy; the role of Controlled Foreign Companies; inappropriate treaty benefits; artificial avoidance of permanent establishment status; and transfer pricing issues. No developing country can ignore these issues. There are no globally accepted standards or rules to tackle these issues. How well a developing country is equipped to tackle these issues will determine how well it can guard against the erosion of its tax base and the avoidance of taxes due the country.

VI

There was a time when volumes were low, profits were modest and the stakes were low. Times have changed with globalization and multinational corporations. The size and scale are staggering, the stakes are giddily high, and the rewards of successful tax evasion are too tempting. Technology, communication and profit-shifting have made the situation more challenging for the tax collector.

Our experience shows that simple and clearly-worded tax laws, moderate rates of taxes, low compliance costs, a non-adversarial tax administration, and a fair and impartial dispute resolution mechanism will enlarge the tax base and boost revenue collection. Each one of the five elements that I have listed seems to be a fair and easy goal to be achieved but, in the real world, it is not so.

The draftsmen somehow seem unable to express their intention in simple, clear and uncomplicated words. The style of drafting also leaves much to be desired. I yearn for a tax law that has sections (with a few sub-sections in each section) and no provisos or explanations or illustrations! Tax rates in developing countries are still too high and the task of moderation has become more difficult with even developed countries cutting tax rates aggressively. Compliance costs are high, and corruption adds to compliance costs for the honest tax payer. A non-adversarial tax administration is the taxpayer's dream, but that will require a massive effort to educate, re-train and motivate both the tax collector and the tax payer. Fair and quick dispute resolution is easier said than done, and that goal cannot be achieved unless we overhaul the entire adjudicatory system starting from the tax payer at the bottom to the judge at the top of the system.

Nevertheless, I would plead in favour of voluntary compliance and a non-adversarial approach towards the vast majority of tax payers. Here I would like to commend the example of India's Central Processing Centre for income tax located in Bengaluru. A little over 98 percent of income tax returns are processed electronically, accepted, assessed and tax refunds made without human intervention. Even the refund order is printed and placed in an envelope, addressed and handed over to the post office by machines. The sad part of the story is that it is the 2 percent or less cases that are scrutinized which make news (or noise, if you wish) and it is that 2 percent of cases that is used to rate the tax administration of the country.

VII

There are two parts to tax administration and tax collection. The first is tax policies. Tax policies are devised by the government of the day having regard to the political and economic context of the country. Increasingly, tax policies are also influenced by what are called "global standards", although I am somewhat skeptical about the relevance or efficacy of such standards. In my view, tax policies have to be country-specific and autonomous, and it would not be wise to copy or imitate the tax policies of another country. The only precept a country can follow is that some policies have failed and some have succeeded elsewhere. To the extent that a country is willing to learn from others' failures and successes, it may be useful to study those policies.

However, tax administration is part of management science. There are some lessons in management that are applicable in most situations and circumstances. Tax administration can be divided into philosophy and application. Some countries believe in too many taxes, some in a small number of taxes. Some swear by

encouraging voluntary compliance, some have a deep-rooted suspicion of the tax payers' ethics and morality. Some think that every drop of juice must be squeezed from the fruit, some weigh the cost and benefit of such an approach and are content with an optimum level of tax compliance. Some countries have a compulsion to maximize tax revenues, some have adequate non-tax revenues and can therefore afford a light-touch to tax enforcement. You are the best judge of what is appropriate for your country.

I am not an expert on your tax laws or practices, but I have acquainted myself with some of the challenges that you face. It appears that, like in India, you have a plethora of taxes: some major taxes and several minor levies and cesses. Some taxes yield a significant sum while others earn miniscule amounts even as they make the tax structure complicated. A large proportion of your total tax revenues is collected from international trade. A study made some years ago had concluded that your corporate tax performance was quite poor in terms of both tax revenues and tax efficiency, attributing the outcome to the wide ranging tax holidays and incentives that you had offered to companies. It appears that such exemptions and concessions were continued in the Budgets of 2012 and 2013 to both domestic and foreign investments in the desired sectors. I also gather from a recent study by ADB that your government has brought the Board of Investment under the Inland Revenue Act in an effort to limit tax holidays and tax exemptions and that many exemptions are slated to end in the near future.

Here, I would like to say a few words about offering tax incentives or concessions in order to attract foreign investment. Some of the incentives and concessions are embedded in Bilateral Investment Treaties. I am told that Sri Lanka has signed 24 such treaties beginning with the first treaty in 1980. While the intent is clear, there is a growing body of evidence that has called into question the effectiveness of offering tax incentives to promote investment including, in particular, tax holidays and tax free zones. Such incentives are not an alternative to a poor investment climate and may actually damage a developing country's tax base. The real drivers of investment are infrastructure, education and security.

VIII

The big question before developing countries, especially low income countries, is why do the Governments of low income countries not raise more tax revenues and how can they improve their performance? A working paper published in December 2013 by the International Centre for Tax and Development, Geneva suggested two different but complementary approaches to answer the question. The first approach leads to the traditional and conservative answer pointing to the "sticky" nature of taxation. "Stickiness" is measured by the tax to GDP ratio which remains stubbornly low in developing countries. The "stickiness" is attributed to the

structure of the national economies of developing countries. The first approach therefore recommends major structural reforms in the economy.

The second approach is a more optimistic one and suggests that reforms in tax policy and administration are the answer to the question how to raise more tax revenues. The working paper highlights three reform issues:

(i) Scope for the Government to raise more resources by better taxing transnational economic transactions;

(ii) Adoption of advanced tax administration practices; and

(iii) Policy reforms, particularly tackling the problem of gross under-taxation of land and property.

As I mentioned, both approaches are complementary and should be adopted simultaneously.

IX

Let me conclude by narrating two major exercises undertaken by India in recent years.

The first was an ambitious effort started in 2007 to rewrite the laws on direct taxes, mainly income tax and corporation tax. The thrust of the proposed Direct Taxes Code was to improve the efficiency and equity of the tax system by eliminating distortions in the tax structure, introducing moderate levels of taxation and expanding the tax base. It was based on well accepted principles of taxation and the best international practices. I would like to refer to a few features of the proposed Direct Taxes Code. In the case of income tax, the principle will be 'tax liability should be according to the ability to pay' – those with equal abilities would pay equal taxes and those with higher abilities will pay proportionately large amounts. The total income of a person or a corporation will be the measure of ability to pay. The definition of income will be comprehensive enough to include all accruals. In the case of corporation tax, all profits will be taxed.

Another lesson learnt was that owing to tax incentives given to corporations and widespread tax evasion, the total income reported by a company could be extremely low. Therefore, in order to extract some tax from such companies, the

Code proposed to adopt the concept of minimum alternate tax. Such minimum alternate tax will be calculated with reference to the value of the gross assets.

The third important feature of the Code was the manner of taxation of non-profit organizations and other trusts. The principle adopted was that the tax liability of a non-profit organization should be no more than 15 percent, but it should be made mandatory for every non-profit organization to pay 15 percent and acquire the freedom and autonomy to operate in India.

Another major aspect dealt with by the Code was tax administration. The proposed Code envisaged the creation of a modern tax payer information system. The principle underlying the system is that information will be collected about the tax payer in an organized and non-invasive manner. The object was to create a 360 degree profile of the tax payer using the Permanent Account Number, storing the information in electronic form and sharing information on a need to know basis.

The proposed Code also addressed issues such as relief from double taxation and the general anti-avoidance rules (GAAR).

The second major exercise undertaken by the Government of India was to set up the Tax Administration Reform Commission (TARC). The Commission concluded – and I share the view – that "public institutions need fundamental reform at least every decade, if not more frequently." Tax administration is one such institution. The Tax Administration Reform Commission has submitted four reports and has made comprehensive and wide ranging recommendations to do a complete overhaul of the tax administration.

I may now add a note of disappointment. The Direct Taxes Code, although given final shape in 2008 and placed in the public domain for discussion in August 2009, has not yet been introduced in the form of a Bill in Parliament. Similarly, while the core of the recommendations of the Tax Administration Reform Commission has been accepted, no major recommendation has yet been incorporated in the extant laws.

I am aware that it will not be an easy task to put in place a brand new Direct Taxes Code; nor can the government easily overcome the opposition to the radical recommendations made by the Tax Administration Reform Commission. Nevertheless, there is no escape for a country that aspires to take its place among the advanced countries. In a growing economy, direct taxes are the best and surest way of raising resources. They are also the most equitable taxes. It is, therefore, imperative that no hurdles are placed in the way of evolving suitable tax policies and making drastic changes in the tax administration.

Perhaps, there are lessons to be learnt by other developing countries from the two major efforts that I have just described, notwithstanding the fact that, in either case, the outcome has not yet been satisfactory.

X

As practitioners of an ancient craft – keeping the books of account – you have an important stake in the formulation of tax policies and in the fairness of the tax administration. It was therefore a great privilege to address your Institute on an important day of your annual calendar. I thank you for your kindness and patience and I wish you the very best in your endeavours.