UNIT 10 DIRECT AND INDIRECT TAXATION

Structure

10.0 OBJECTIVES

After reading this unit, you will be able to:

- explain the various concepts under direct and indirect taxes;
- outline the rationale behind the concept of ‘optimal taxation’;
- describe the major types of direct taxes;
- delineate the evolution in indirect taxes converging towards the GST;
- discuss the impact of taxes on decision making; and
- critique the issues relating to ‘international taxation’ practices.

10.1 INTRODUCTION

Taxes are compulsory payments to the respective government in order to enable them to provide public goods, services and sometimes merit goods. It does not guarantee any '*quid pro quo*'. This means, there is no direct mapping between the taxes one paid and public welfare services received. The taxes collected from an individual can be used for any purpose which maximises the social welfare, rather than providing private benefit to the tax payer. Some view transfers as negative taxes. However, transfers try to achieve distributional goals (i.e. they achieve specific objectives like reducing malnutrition) for targeted people. Such transfers include social welfare payments, unemployment stipend, etc. They may also influence consumption, investment and work effort, just like taxes. There may therefore be multiple objectives of taxation: from revenue raising, production and distribution to bringing about behavioural changes in consumption. According to Musgrave (1959), taxes could be classified into different categories like: (i) taxes imposed in the product or factor markets; (ii) taxes imposed on the sellers or buyers; (iii) taxes imposed on households or firms; and (iv) taxes imposed on the sources or users side of the taxpayer's account. Among all the classifications, the one as 'direct and indirect taxes' is used commonly in the official tax data systems. Income, property and professional taxes are the main direct taxes and GST (goods and services tax), customs, stamp duty and registration fees are the main indirect taxes.

10.2 DIRECT AND INDIRECT TAXES: CONCEPTS

A tax is said to be direct when both the impact and incidence fall on the same tax unit. In case of indirect tax, the impact and incidence fall on different tax units. In other words, when tax is imposed on a unit, the one whose income and welfare is reduced due to the tax, becomes the basis for distinction. The feasibility to shift the tax burden depends on the elasticity of demand and supply of the taxed unit (or commodity). In reality, this direct and indirect distinction become blur in many cases since it is difficult to ascertain the tax burden and incidence. Direct taxes mostly comprise of income and capital taxes, which may be further divided into taxes imposed on households, firms and property. Indirect taxes are broadly on sales and purchases.

There are certain merits and demerits in both the direct and indirect taxes. Direct taxes are equitable, economic, certain and accurate. Its demerits are: they are inconvenient and prone to evasion. On the other hand, indirect taxes are convenient and sumptuary i.e. they are taxes imposed to discourage consumption rather than for generating revenue (e.g. tobacco taxes). They are difficult to evade and cover a wide range of items. But, indirect taxes are regressive, uncertain and may increase inequalities, affect consumption and production decisions and hence not neutral.

Taxation have far reaching effects, at individual as well as macro level. For instance, income tax may impact after tax returns of education, which in turn may determine the years of schooling of an individual. If there are tax sops to certain kind of jobs with untaxed benefits, people's job choices may be influenced. The classic wage and work trade off may operate with people deciding their labour participation (i.e. whether they should remain in work force or not) and retirement age (i.e. whether taking voluntary retirement is beneficial to them). When tax incentives in certain goods or regions are announced, new investments may prefer to flow in those areas. On the whole, tax structure determines tax culture of the society and reveals the path of economic development in the economy.

10.2.1 Progressive, Proportional and Regressive Taxation

A tax is said to be progressive when tax rate rises with the rise in tax payer's incomes. A tax is proportional when tax rate is fixed at some rate irrespective of the level of tax payer's income. A tax is regressive when tax rate does not decrease with decrease in taxpayer's income. Many of the direct taxes follow the progressivity principle. The rationale for progressivity is that tax should impose relatively larger burden on the wealthy. Unfortunately, in reality, the degree of tax progressivity is difficult to measure. Progressivity is also time related in the sense that some tax may be regressive when imposed on annual basis but they may become progressive when the time frame is increased to lifetime (e.g. social security taxes in USA; even though wage earners pay good amount of their wage as tax in the short run, they get benefits for the entire lifetime, off-setting their sacrifice). The response of the taxpayers to tax changes may be asymmetrical and will vary depending on the economic class and command over wealth. On the other hand, taxing 'sin goods' (i.e. taxes which discourage the consumption of goods such as tobacco and alcohol) with highly progressive rates are justified and there is common consensus on this across the countries.

10.2.2 Specific Vs Ad Valorem Taxes

A specific tax is levied on the goods and services on per unit basis. It is an '*ad valorem*' tax when the tax imposed is as a percentage of the value of the product. The choice between specific and ad valorem is debatable. Specific taxes do not automatically respond to changes in inflation and therefore reduce the incidence of a tax on the price of the goods imposed. Most broad based taxes are imposed as ad valorem taxes which can be single stage or multi stage. When it is multistage, it is primarily on value added [e.g. value added tax (VAT) and GST]. But there are cases where the combination of both are used to tax a product (e.g. in the new GST regime in India, tobacco taxes are imposed as a combination of both specific plus ad valorem).

As the economy moves from traditional to transitional to modern stages of development, the nature of the tax revenue structure also change from traditional taxes such as land based taxes to indirect taxes and then to direct taxes. In the traditional economy, mostly taxes on property, land, import and export dominate as the economy is predominantly agriculture and engage in raw material exports or imports. In transitional stage, manufacturing and trade dominates and the phase of indirect taxes like excise and sales taxes along with trade tax dominates. In modern economy with full-fledged services sector, the revenue profile is expected to shift in favour of income taxes with a smaller role to be played by commodity taxes.

10.2.3 Tax-GDP Ratios

Tax-GDP ratio is a widely used measure of tax productivity. The ratio is used for inter-country comparison with higher tax-GDP ratio indicating the government's capacity to provide public goods and visa-versa. The tax-GDP ratio for India is far below other countries (Table 10.1). But the ratio has been gradually increasing (it has increased from 14 percent in 2000 to 17.6 percent in 2015). For all other counties, the tax-GDP ratio has declined during the period of global financial crisis i.e. from 2005 to 2010 and revived again by 2015. For India, there is a steady increase over the period of 2000-2015.

Table 10.1: Tax-GDP Ratios

Country	2000	2005	2010	2015
India	14.02	15.91	16.34	17.57
Australia	30.38	29.92	25.42	28.22
Canada	34.77	32.22	30.65	32.02
France	43.05	42.78	41.97	45.22
Germany	36.24	33.87	35.01	37.07
United Kingdom	33.17	32.89	32.59	32.53
United States	28.20	25.93	23.49	26.23
OECD – Average	33.91	33.49	32.45	33.99

Source: OECD (2018), Indian Public Finance Statistics, MoF.
Note: The ratios are at market prices.

Check Your Progress 1 [answer within the given space in about 50-100 words]

1) Distinguish between direct and indirect taxes with illustrations.

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2) What is the basic principle followed in determining direct taxes?

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3) How is tax-productivity measured? How is it useful?

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10.3 DIRECT TAXES

As mentioned above, taxes on income form a major part of direct taxes. But the concept of Income has certain issues associated with it. First, what is income? How is it conceptualised and measured for tax purposes? Hicks (1939) defines income as: 'the maximum value which a man can consume during a week and still be as well off at the end of the week as he was at the beginning'. Simons (1938) proposed a definition of income called 'comprehensive income'. According to this definition, personal income is the sum of: the market value of rights exercised in consumption and the change in its value between the beginning and end of the period.

Generally, income from salary, house property, business or profession, capital gains are taken as constituents of income. Some of these incomes are straight forward to compute but some incomes need to be imputed (e.g. rental income from owner occupied house). Sometimes, people may accumulate income from non-market activities (e.g. working in family farm or helping family activities/business). Another issue is realised and unrealised incomes. Generally, unrealised incomes are excluded (e.g. capital gains of land or assets). Finally, we should not forget that illegal activities also generate incomes. How to treat them? The answer is straight forward: when an economic activity is illegal, then the proceeds generated from that act is also illegal.

10.3.1 Income Tax

Once income has been defined, the next question is: at what rate should it be taxed? Differentiation between types of personal income is major issue. Should we consider all incomes equally irrespective of how and from which activity it is accumulated? There are no fixed rules on the rate of income tax and there is no optimal rate. Income tax rate is always a contested issue in all countries. In India, income tax rates were historically high (e.g. the marginal income tax rate i.e. the tax rate on the highest income slab was as high as 97.5 percent at one time). Over the years, the highest income tax rate is brought down to around 30 percent.

In general, governments differentiate between the incomes on certain grounds and allow for tax relief in the form of standard deduction or itemised deductions or exemptions. Such standard income tax exemptions include: leave travel concession, death-cum-retirement gratuity, leave encashment, retrenchment compensation, compensation received at time of voluntary retirement, tax on perquisites paid by employer, amount received from superannuation fund to legal heirs of employee, house rent allowance, etc. Mirrless (1971) applied Ramsey model to labour market and found that when government uses distortionary instruments of taxation (e.g. labour income tax), even at optimal level, it cannot achieve ideal redistribution outcomes.

Arthur Laffer put forward the argument that when government increases tax rates beyond a certain point, it will be counterproductive and tax revenues start declining. High tax rate, disincentivises and demotivates people to work to their fullest of productive levels. Unfortunately, there is no consensus on the maximum upper bound of tax rate beyond which this negativity kicks in. The Laffer curve effect depends on the existing tax structure and tax rates. When government increase tax rates and tax administration is fragile it leads to tax evasion. At low rates, people's incentive to evade tax remains unprofitable and hence keeps the tax compliance high.

10.3.2 Corporate Income Tax

The word corporation originates from the Latin word '*corporare*' which means 'to form into a body'. Corporation tax is a tax on the incomes of corporations. What justifies corporate income taxation? According to privilege argument, a corporation should pay the tax for the privilege of being allowed to exist and function which entitles it to a set of unique legal provisions in terms of savings, debt rising, etc. The social cost view argues that since the corporations consume public services of the state, a tax is justified. The ethical argument put forwards the view that it corporate tax could be used to reduce inequalities in wealth distribution.

While it is clear that incomes should not be subject to tax more than once, some difficulties arise in applying this concept to corporate incomes and dividends. Dividends are payments made by corporations to shareholders out of profits earned by the corporation. If the corporation is a separate legal entity, then it is appropriate that the profits of the corporation should be taxed followed by the incomes of the earners of dividends. However, if corporations are not considered as separate legal entities, then taxation of both would result in double taxation, which in turn can lead to reduced incentives to invest in corporations. One way of addressing the issue of double taxation is to offer a variety of tax incentives focused on chosen specific issues so as to reduce the overall tax liability of the sector.

10.3.3 Wealth and Property Tax

Wealth taxes are one of the oldest forms of taxation. It can be imposed as an annual fee based on property valuation or fixed amount. It is imposed on estates and inheritance wealth. There are four main type of wealth taxes imposed historically: property tax, estate and inheritance tax, net worth tax and capital levies. Property taxation is one of the main source of revenue for local governments. This is primarily imposed on residential and non-residential land and structures. The main criteria is ownership of the property. There is a debate on how to tax property separating this from the capital portion of the wealth. Estate and inheritance tax is slightly different from property tax in the sense that the assessment happens only once at the time of death. This is applicable to most of the asset classes of estates and inheritance wealth. Since imposition and collection of estate taxes are complicated, they are not successful in implementation as well as in generating revenues to the treasury. Net worth tax is one of the rare taxes imposed in the world and also very complex to implement. Net worth tax is primarily on capital income and assets which does not generate current realised income. This tax is not imposed in India. Capital levies are mostly one-time tax levies to meet the exigencies of war and calamity. Many countries used this levy during world wars.

10.4 INDIRECT TAXES

The 'excise tax' is the most common of all the indirect taxes. It taxes 'the act of production or use of specific goods and services'. Most popular excise tax include taxes on tobacco, alcohol and petroleum products. Excise taxes can be imposed as specific or ad valorem. Apart from revenue generating, excise taxes can be used to address the problem of externalities like pollution and can also be used to deter the people from using harmful goods. Pigovian taxes on externalities are primarily imposed in the form of excise duties.

Generally, majority of the excise tax incidence fall on ultimate consumers and sometimes to the fullest (e.g. alcohol and tobacco). But, the tax burden is regressive since both the poor and the rich use these products (e.g. petroleum products) and the poor will be relatively paying higher percentage of their total incomes as these taxes. The higher excise taxes on essential goods usually leads to illicit trade and smuggling. In India, some of the excise taxes are subsumed with GST but taxes on alcohol and petroleum duties are not yet combined.

10.4.1 Value Added Tax (VAT)

Over the years, tax authorities have identified many problems with commodity taxes. Most of these taxes are regressive and iniquitous. Due to the ambiguity and loopholes in tax laws, and also due to differences of opinion on taxable event and amount, there are many inter-jurisdictional conflicts. Historically, commodity taxes are very complex with multiple rate structures. There is also high compliance costs involved. Additionally, due to lack of coordination between different tax authorities at central level and between centre and state tax authorities, there is high level of tax cascading. As a solution to all these problems, a new variant of indirect tax called 'value added tax' (VAT) was proposed. VAT is a form of indirect tax levied on the value added and collected at various stages of production and distribution. It ideally rationalises the indirect tax system. It is superior and also self-enforcing due to invoice based tax credit system. It eliminates cascading and pyramiding. It a 'good best' for tax authorities due to high revenue potential. However, despite its merits, VAT is not a simple tax. Administration of VAT is difficult.

There are three types of VAT: gross product VAT, income VAT and consumption VAT. Gross product VAT includes all capital goods. Income VAT taxes only the final goods excluding depreciation of the capital goods. Consumption VAT neither tax capital goods nor depreciation of capital. It only taxes the final stages of consumption. Consumption VAT is the most popular of VATs across the world. Keen (2013) defined 'C-efficiency' as 'the VAT productive performance measure'. It is an indicator of the departure of the VAT from a perfectly enforced tax levied at a uniform rate on all consumption. 'C-efficiency' is defined as:

C-efficiency = (VAT Revenue)/(Tax Rate * Consumption Expenditure) (10.1)

Or, Tax Rate = (VAT Revenue)/(C-efficiency * Consumption Expenditure) (10.2)

10.4.2 Goods and Services Tax (GST)

Even though, the implementation of VAT solved some of the problems, the integration of goods and services taxes were still not achieved. The problems with the pre-GST tax system were as follows.

- Cascading and High Tax Rates: In addition to 'central excise' and VAT, central sales tax (CST) was collected on inter-state sale of goods.
- Input Tax Credit (ITC): The central government allowed selective cross credits across CENVAT (i.e. central VAT) and service tax providing an assessee to fall either under 'central excise' or under 'service tax' assessment. VAT was levied on intra-state sale of goods where input tax credit (on inputs and capital goods) was available only for intra-state purchases of goods.

- Entry Tax: States where 'entry tax' was collected on behalf of local governments and the revenue was passed on to them, entry tax remained a stranded cost for these states (e.g. Karnataka, Odisha) as no Input Tax Credit (ITC) against 'entry tax' was allowed.

Given this background, GST is expected to solve these issues, broaden the base, lower and simplify the rate structure and streamline the administration and enforcement. World over, there have been mixed experiences of impacts and GST on inflation. Canada, Singapore, Australia and New Zealand faced inflation pressure but UK, Germany and Malaysia did not face inflation problem. In India, GST has not created inflation pressure as a low percentage of WPI basket is affected by GST.

Check Your Progress 2 [answer within the given space in about 50-100 words]

1) Why is income tax a contentious issue in all the countries?

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2) What is Arthur Laffer's point on income tax? Why is it not practically useful?

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3) Why is Corporate Tax declining in all the countries over time?

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4) State the advantages and disadvantages of VAT.

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5) What has been the experience of GST world over on inflation? Why has it not affected inflation in India?

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10.5 IMPACT OF TAXES ON FACTORS OF PRODUCTION

All taxes are expected to alter decision making impacting both the supply and the demand side of the economy. In other words, if one compares the decisions of a taxpaying unit before and after imposition of tax, it is expected that the decisions would be different. Since taxation takes away some percentage of household's economic resources (income or wealth), the impact on household decisions needs to be examined. In case of income tax, tax is applied on incomes earned by both the factors of production viz. labour and capital. A tax on labour income would change the choice of the worker between working and enjoying leisure. Likewise, a tax on interest income or on capital gains would influence the decision on savings. On the other hand, if one considers indirect taxes, tax on a commodity could reduce the demand for the commodity.

10.5.1 Impact of Direct Taxes on Labour

Individual's labour supply is a function of 'after tax wage' and 'income'. When wages are low, for any increase in wage, individual responds with increased labour supply. But, after certain level, any further increase in wage results in the withdrawal, of labour supply. In other words, the labour supply curve turns 'backwards' after a level.

To explain this further, let us consider a representative individual willing to maximise his utility which is a function of his net income (Y) and leisure. L is the number of labour hours spent and Lo is the total number of labour hours available. The utility function is assumed to be convex to the origin. It is continuous, strictly increasing in Y and strictly decreasing in L. In the absence of a tax, budget constrain is:

$$Y = wL + I \tag{10.3}$$

where I denotes 'other income'.After imposing a proportional income tax at a rate equal to t_i, the budget constraint changes to:

$$Y = (wL+I)\ (l–t_i) = w_1L + M \tag{10.4}$$

where, w_1 is after tax wage rate and M is after tax other income. The effect of the imposition of a tax is shown in Fig. 10.1 where P is the before tax equilibrium and P^1s the after tax equilibrium P^1. In the figure, the sub-script 'i' is not shown as we are not considering different tax rates over time or across agents when tax is imposed, the pre-tax equilibrium P is moved to new post-tax equilibrium. The tax not only reduces the post-tax wage rate, but the amount of labour the individual chooses to supply is also reduced. The exact impact will depend on the nature of the utility function and the resulting elasticity of supply of labour with respect to wages. In other words, a tax on wages could influence the choice of how much labour an individual would like to supply in the labour market.

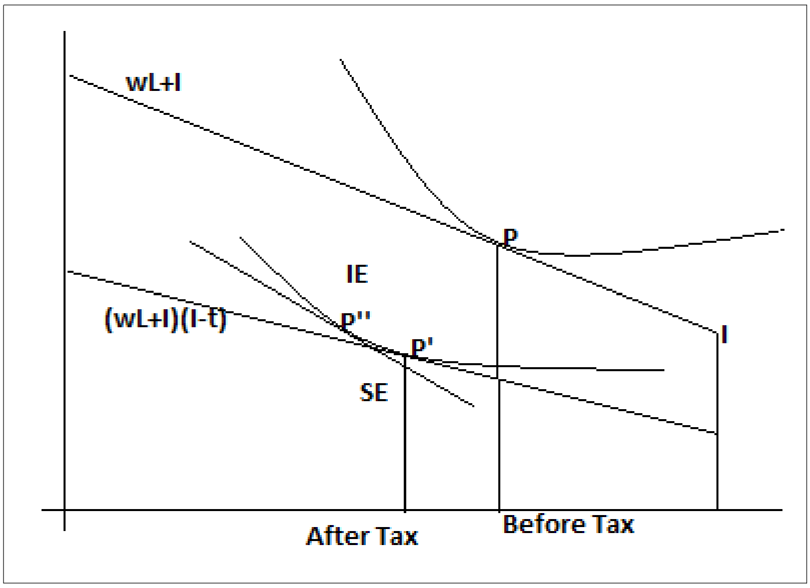

Fig. 10.1: Before and After Imposition of Tax on Income

10.5.2 Impact of Direct Taxes on Capital

Interest and dividends are incomes earned on capital. Capital, in turn, is redeployment of savings in the form of investment. Savings arise primarily due to the postponement of present consumption. One form of reward for saving is interest. Hence, theoretically, taxing interest income has the same effect as reducing pre-tax interest rate. Hence, taxation of saving results in a decline in savings. The exact quantum of decline depends on the 'interest elasticity of savings'.

Likewise, taxation of dividend income too generates changes in investment decisions. A company may choose to pay dividends to its shareholders or retain the profits for future investment. In the former case, tax on dividend would apply. However, if there is no equivalent tax on capital gains (i.e. tax on gains from buying and selling of shares of a company), the company might choose not to pay dividends and let the investor benefit from higher capital gains. To counter such effects, income tax regimes bring such accruals to investors under tax.

10.5.3 Impact of Indirect Taxes

Imposition of tax on commodities (i.e. by increasing the price of the commodity), can result in a decline in demand for the commodity. The extent of impact would depend on the elasticities of demand with respect to price. A similar tax on different commodities can result in widely different effects. Using a partial equilibrium approach, Fig. 10.2 shows the impact of a tax on the price and quantity of the commodity consumed. The figure highlights the fact that the entire increase in price may not be passed on to the consumer. Hence, the result is a smaller decline in demand and a smaller increase in price. The initial equilibrium price was at P^* but after the tax is imposed the new price is reached at P which is lower than the 'after-tax price'. If we use a general equilibrium framework, there would be change in demand not just for the commodity for which tax is levied but for a number of other commodities as well. For instance, demand for a substitute commodity could increase while that for a complementary commodity could decline.

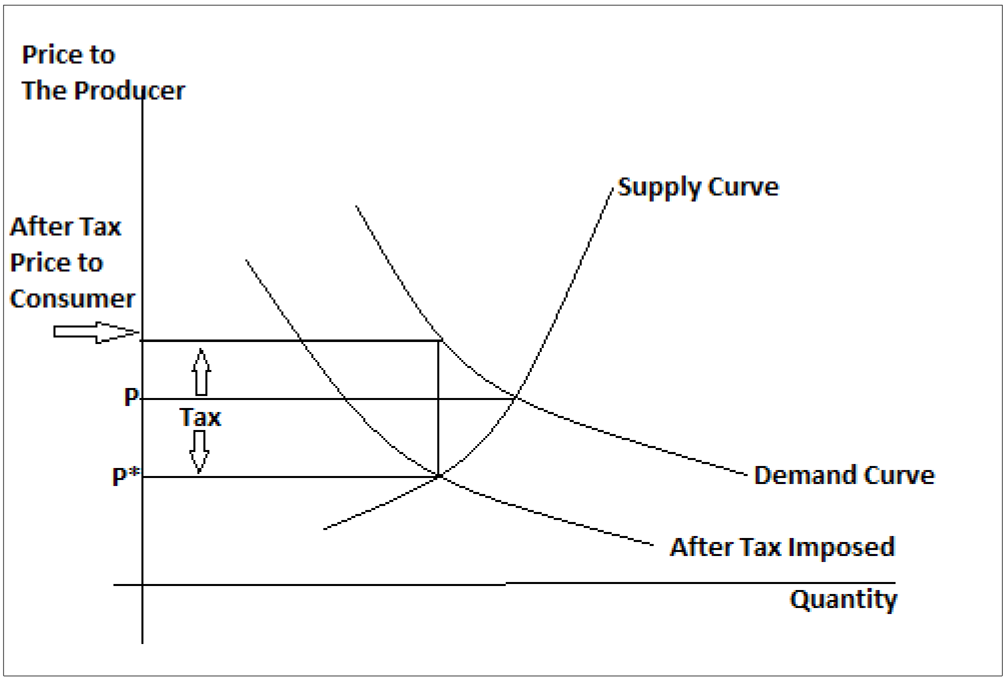

Fig. 10.2: Tax Incidence – Partial Equilibrium

Given that taxes have a wide range of effects on the economy and on economic agents, one of the objectives of a government should be to design taxes in such a way that they maximise social welfare. Such an optimal taxation is an extension of the Ramsey's commodity taxation problem (1927) where the issue was how to set/fix commodity taxes on a population of identical individuals to meet revenue adequacy. Ramsey argued that the problem will be solved if the tax levied on commodities is inversely proportional to the elasticity of demand. Since, Ramsey assumed people to be identical, distributional issues did not arise. Later contributors [e.g. Diamond and Mirrlees (1971), Atkinson and Stiglitz (1976, 1980)] relaxed the Ramsey assumption of identical population. The distributional effects then became prominent and more taxes were levied on luxury goods and less taxes levied on essentials. They further argued that if the tax imposed is a lump-sum tax then it does not need any assumptions on individual types or distributional aspects.

10.6 INTERNATIONAL TAXATION

The world has witnessed rapid integration of countries, especially after the Second World War. The free movement of capital (in the form of foreign direct investment - FDI) and labour, movement of manufacturing bases from high tax to low tax locations, removal of trade barriers, ICT technological developments, exploitation of intellectual property rights, etc. have all contributed to a new way of cross border activities. Globalisation has boosted trade and increased foreign direct investments in many countries. Traditionally, public economics and taxation studies remain confined to closed economy framework. But, due to the international factor mobility and rapid globalisation, taxation policies need to be looked at in an open economy framework. International taxation is concerned with the issues arising from the interaction of tax systems across countries when factors are mobile across their borders.

10.6.1 Double Taxation

Countries tax that aspect of economic value which arise due to different forms of transactions done (or holdings held) by different factors of production. In the process, many issues arise. There are certain transactions and incomes generated in one economy by individuals and corporations belonging to other countries. In the same way, individuals and corporations belonging to a mother country (say India), generate incomes in different tax jurisdictions. How to treat these incomes and transactions and how to tax them thus becomes an issue. Many countries tax all the incomes of their nationals irrespective of domestic or foreign incomes. When both the countries tax the incomes then there is a case of double taxation. For instance, when a firm invests in overseas country (called as host or source country), the home country (called as resident country) may wish to tax profits from this cross-border activity. The host country will also exercise the right to tax, since the profits are generated within its jurisdiction. This leads to double taxation. With such double taxation, factor mobility gets seriously affected.

Companies are considered for residence purposes based on incorporation of company situated in a country. When a company is incorporated in their jurisdiction, then it is considered a 'resident' company by many countries. Effective management control is another criterion. Here, what is considered is whether the company holds board meetings and/or whether day-to-day operations are run from this country or not? But, it is difficult to assess the degree of operations for each firm. In India, a company incorporated in India is considered its ordinary resident [as per section 6(3) of Income-tax Act, 1961]. A second concept that is applied in India is based on 'permanent establishment' (PE). This depends on whether the management and control of the entity is wholly situated in India during any year. Under this, if the foreign company has some place of relative permanence (which is used to operate or carry on business activities in the source country), then it is considered as resident. There is no PE concept in the Income Tax Act 1961. Hence, based on past conventions, the PE is determined.

In a globalised world, companies can earn overseas income through various means. Some potential avenues are: foreign collaborations, royalties, technical fees, license fees for patents, copyrights or trademarks, profits, dividends, interest and capital gains. Many tax authorities have found that firms evade taxes with aggressive tax planning by: (i) reallocating taxable income, (ii) showing intra-firm sales or showing some kind of corporate borrowing from a high taxed country to low tax country, (iii) showing interest deduction on the borrowing, etc. The firms thus manage to show low profit in high tax country and high profits in low tax country.

Many governments enter into bilateral and multilateral tax treaties for formulation of standard taxation procedure on foreign incomes and profits. Most tax treaties aim at 'double taxation avoidance agreements' (DTAAs) and sharing of tax revenues in a mutually beneficial way. Tax treaties award and assign primary and secondary taxation powers to involved parties. Generally, the source countries are given primary right to tax business income from direct investments and resident country gets the primary right to tax in other forms (e.g. taxing foreign institutional investments and portfolio investments). But, the definitional and permanent establishment issues with respect to electronic commerce firms has been a controversial issue between the countries. Interestingly, even the rigorous tax treaties are leaving some loopholes which are giving rise to a concept called 'treaty shopping'. Under this, the MNCs just go on establishing subsidiaries or shops in a country just to evade taxes on profits. There are different types of DTAAs: some are comprehensive and others are limited. But there are broadly two models of DTAAs: the OECD model and the UN model. India has entered into more than 100 DTAAs. Section 90 and 90A of the Income Tax Act forms the basis for the tax treaty. Most of the Indian tax treaties have followed the UN model. In the long run, the business unit or source will yield more revenue to the public treasury than the individual and the place where the income is earned will derive larger revenues than the jurisdiction of the person (T S Adams).

10.6.2 Tax Competition and Tax Havens

Two questions have arisen surrounding tax competition in recent years: (i) is tax competition a good thing? and (ii) can countries derive benefits by resorting to tax competition? Tax competition refers to strategic tax-setting by different tax jurisdictions by taking into consideration the actions of other tax authorities. Countries can engage in tax competition in all of the taxes or specific taxes (e.g. on profits). In the modern setting, competition is mainly focused on how capital is taxed in the country and whether it is taxed on the basis of source or residence basis? Countries where liberal taxation policies exist for foreign entities are called 'tax havens'. Among the rules identified by countries to recognise countries as tax havens are: (i) secrecy and reluctance to share information and (ii) allowing fake firms which do not do any real commercial activity to exist (called 'ring fencing'). General characteristics of tax havens are that they are small countries, commonly below a million population but affluent with good governance structure. Examples of tax havens with 'no tax' are Bahamas, Bermuda, and Cayman Islands. Tax havens with 'low tax' are Mauritius, Hong Kong, British Virgin Islands, Isle of Man and Channel Islands. Switzerland is a special country which offers special facilities from banking secrecy to investments. There are also some disadvantage for investors in a tax haven. While profits earned in tax haven are subject to low local tax, when they try to repatriate those profits to the home country, they attract very high taxes. It is obvious that no country allows a double taxation treaty with tax havens. Still, MNCs are trying to find loopholes in DTAAs and use them for 'round tripping'. Classic examples are, India-Maturities and India-Singapore DTAAs.

10.6.3 Base Erosion and Profit Shifting (BEPS)

Over the years, it is observed that many individual and multinational companies take advantage of DTAAs, disguising their operations and inversing the situation from double taxation to zero taxation at both the ends. OECD estimates a annual revenue loss of 100 to 240 billion USD due to 'base erosion and profit shifting' (BEPS) across the globe. In 2013, G20 and OECD took joint action to address the flaws within the international tax system that create opportunities for BEPS. The BEPS package developed, over a wide range of 15 action plans, has a wide variety of measures like new minimum standards, revision of existing standards and common approaches. These tools help and facilitate to achieve convergence in national practices.

In 2010, USA enacted a law known as 'Foreign Account Tax Compliance Act' (FATCA) with the objective of tackling tax evasion through obtaining information in respect of offshore financial accounts maintained by USA residents and citizens. India and USA signed an agreement which facilitates the exchange of information. The G20 and OECD countries are also working together to develop a Common Reporting Standard (CRS) on Automatic Exchange of Information (AEOI).

Check Your Progress 3 [answer within the given space in about 50-100 words]

1) How do firms generally manage to avoid taxes in a globalised situation?

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2) What does the term 'treaty shopping' mean?

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3) What is meant by 'tax competition'?

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10.7 LET US SUM UP

Both direct and indirect taxes are governed by their respective advantages and disadvantages. There is no criteria developed for striking a fine balance between the two. But with matured institutions and the country reaching a stage of development wherein the contribution of services sector predominates, countries graduate to adopting the GST which subsumes many forms of indirect taxes into one comprehensive tax system. The experience of countries with GST on inflation is mixed. India has managed to keep its inflation under control during its limited phase of GST's experience. With globalisation, tax havens i.e. countries with low or nil taxation have become important for corporations to help avoid taxes. DTAAs have come to play a role in dealing with this type of tax evasion practices.

10.8 KEY WORDS

Ad Valorem Tax : Tax imposed as a percentage of the value of the good.

Optimal Taxation : Refers to design of taxes (or a certain 'tax design') which optimise both efficiency and distribution.

VAT : This is a form of indirect tax levied on the value added and collected at various stages of production and distribution.

Tax Competition : Refers to strategic tax-setting by different tax jurisdictions by taking into consideration other tax authorities.

Tax Haven : Are small countries, commonly below a million population but affluent with good governance structure and follow liberal taxation policies.

10.9 SOME USEFUL BOOKS

1) Atkinson, A.B. and J.E. Stiglitz (1980). *Lectures on Public Economics*, New York: McGraw-Hill.

2) Hindriks and Myles (2003). *Intermediate Public Economics*.

3) Kaplow, L (2008). *The theory of taxation and public economics*. Princeton: Princeton University Press.

10.10 ANSWERS OR HINTS TO CHECK YOUR PROGRESS EXERCISES

Check Your Progress 1

1) Direct tax is marked for both the impact and incident to fall on the same taxed entity (e.g. income tax). They aim at equity (those who can pay more are taxed more and vice versa) and are progressive (more income, more tax). In case of indirect taxes, the impact and incidence falls on different entities and are regressive (i.e. tax rate or incidence of tax does not alter depending on increase or decrease in income).

2) Progressivity principle. This means that tax imposes relatively larger burden on the wealthy.

3) Tax-productivity is measured by tax-GDP ratio. It is useful for inter-country comparison. A higher tax-GDP ration indicates higher capacity to provide public goods and vice versa.

Check Your Progress 2

1) There is no fixed rule on the rate of income tax and an optimal rate.

2) When government increases tax rates beyond a certain point, the actual tax revenue starts declining. There is no consensus on the optimal rate and the point on which Laffer's rule starts operating cannot be easily determined as it depends on existing tax structure and tax rates.

3) Due to shifts in business activities, more aggressive tax planning, increasing tax competition and transfer pricing.

4) It rationalises the indirect tax system by eliminating cascading and pyramiding. It has high revenue potential and is administratively difficult.

5) Experience has been mixed. In India, GST's effect on inflation has been minimum because 'less percentage of WPI basket is affected by GST'.

Check Your Progress 3

1) (i) by reallocating taxable income, (ii) by showing intra-firm sales or borrowing from a high taxed country to low tax country, (iii) by showing interest deduction on the borrowing, etc.

2) Under this, the MNCs establish subsidiaries or shops in a country just to evade taxes on profits.

3) Tax competition refers to strategic tax-setting by different tax jurisdictions by taking into consideration other tax authorities.