Improving tax compliance in India

In the recent Union budget, the focus on tax proposals was prominent. There was the introduction of the long-term capital gains (LTCG) tax, as well as significant tax breaks for senior citizens who earn interest income from fixed deposits. However, there is one aspect of taxation reform that often goes underreported despite its central presence in every Union budget—measures related to tax compliance.

Economic theory (for example, Yale economist T.N. Srinivasan in the *Journal Of Public Economics*, 1973) on tax evasion argues that for a given rate of taxation, an individual decides whether or not to truthfully report her income (and subsequently, how much of it to report) in income tax returns on the basis of the likelihood of getting audited, as well as the penalties/costs associated with being caught. Studies by the National Institute of Public Finance and Policy (NIPFP) explore other factors such as liquidity constraints on the taxpayer, the demand for cash in an economy, and the timing of tax liabilities.

While useful in explaining simplistic tax evasion behaviour, the model does not account for behavioural factors that influence the tax compliance decision, which have been the focus of more recent studies in this area. Some of the behavioural factors considered include the complexity of tax filing mechanisms, social status and lie aversion. This article seeks to explore tax compliance policies in the context of such behavioural factors and understand their effects.

The 2018-19 budget did not change the tax rate for individual taxpayers, but tax rationalization measures show a drive to endow enforcement agencies with more power and autonomy in scrutinizing returns.

First, the provision that allowed tax officials to enter any premise and seek information has been extended to charitable organizations (p48, 2.33). This is perhaps due to reports that unreported cash was being hoarded at non-governmental organizations in light of demonetisation. Furthermore, the budget also gives autonomy to senior tax officials: “(authorises the) Joint Director, Deputy Director or the Assistant Director of Income Tax to call for information for the purpose of any enquiry without seeking approval of the higher authority. (p 48; 2.32)”. Such measures are meant to increase the likelihood of tax evaders getting caught and therefore increase the cost of compliance for those reporting false information in tax returns.

The finance minister (FM) rightly claims that the rate of tax compliance is low in India, with 36% of all individual taxpayers in the organized and unorganized sector filing tax returns. However, a closer look at recently released data suggests that tax compliance among individual taxpayers is at 11.6%. This, coupled with the low tax-to-GDP (gross domestic product) ratio, suggests that there is still much the government can do to widen the tax base. Recent events suggest that tax authorities have stepped up checks on irregularities in financial dealings by scrutinizing bank deposits post-demonetisation. Such measures increase the likelihood of being caught, but could be construed as a means of coercive power. Research shows that this tends to reduce trust in the tax authorities despite resulting in more enforced compliance.

Studies in social psychology and behavioural economics suggest that lower trust levels in turn result in dishonesty. Thus, with an increase in enforcement powers, trust in government and tax authorities goes down, and there is a conducive environment for individuals to be dishonest in reporting their income on tax returns.

One solution is to employ social norms in priming individuals to pay their taxes; this has been successful in nudging individuals in countries such as the UK, Norway and Guatemala, to name a few. For example, priming social norms such as, “Nine out of ten people pay their tax on time” (basic norm); “Nine out of ten people in India (or city) pay their tax on time” (country/local norm); “Nine out of ten people in India pay their tax on time. You are currently in the very small minority of people who have not paid us yet” (minority norm) have been effective in raising compliance rates. The local norm, in particular, triggered significant changes in tax compliance behaviour.

Furthermore, large-scale Central Board of Direct Taxes (CBDT) campaigns in recent years priming public goods and rewards for timely compliance can now be targeted to individual taxpayers by highlighting the salience of their value for public goods contribution (e.g.“Paying tax means we all gain from vital public services like hospitals, roads, and schools”). Specific targeting through pilot experiments could show the interaction of such norms with tax compliance behaviour, given that there exists very little evidence that taxpayers would respond to such nudges.

Lastly, there is a rich sociocultural context in India that the CBDT can harness in attempting to nudge taxpayers. In his budget speech, the FM invoked M.K. Gandhi to argue the merits of demonetisation. In line with the use of Gandhi’s image to influence citizen behaviour in the Swachh Bharat Abhiyan programme, targeted behavioural interventions could make use of his likeness to nudge people towards honest behaviour. Such interventions are low cost, especially since the CBDT already has in place an email reminder system to communicate with taxpayers using the e-filing system. The government’s recent efforts at setting up a nudge unit could also be involved in such a policy intervention.

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