Source : www.livemint.com Date : 2019-10-23

WHY HIGHER TAXES ARE NOT THE WAY TO BETTER WELFARE IN INDIA

Relevant for: Indian Economy | Topic: Issues relating to Growth & Development - Public Finance, Taxation & Black Money incl. Government Budgeting

Unlike in the West, conditions in the country are not suitable for soak-the-rich policies to succeed

Abhijit Banerjee, winner of the 2019 Economics Nobel along with Esther Duflo and Michael Kremer, has been talking up the idea of high and rising marginal tax rates for the rich. He has also criticized the Narendra Modi government's recent corporate rate cut and said the money would have been better spent on the poor, which would have helped revive demand. He argues that there is no evidence that high tax rates deter investment or growth.

One need not quarrel with the idea of putting more money in the pockets of the poor, provided it can be funded appropriately and without setting off high inflation. But it is surprising that he should be advocating soak-the-rich policies in a country which is estimated to have lost around 5,000 millionaires in 2018 alone, according to an AfrAsia Bank-New World Wealth report. While the rich may be leaving India for reasons other than just high tax rates, surely, hiking marginal taxes will hardly convince them to return and invest in this country. Jobs and growth are created by boosting investment and entrepreneurship, not just consumption.

There have been studies to suggest that high marginal tax rates do not endanger growth, and the Eisenhower era US top rate of 91% is often cited as evidence that one should indeed fleece the rich to fund welfare. A research study by Peter Diamond and Emmanuel Saez of MIT and University of California at Berkeley, respectively, has even recommended that the US raise its top marginal tax rate to 73%.

Evidence from Europe, especially Scandinavia, where the top marginal rates are usually in the 40-50%-plus range, also suggests that the rich do not flee high-tax jurisdictions.

The problem with these arguments is that they are being universalized without context. If the US and Europe can raise taxes without investors voting with their feet, it is because they are globally powerful and their governments can impose their laws on smaller countries and tax havens. Consider how easily Indians have been forced to comply with the US Foreign Account Tax Compliance Act, though the US has no jurisdiction over Indian citizens. Equally, totalitarian countries can enforce high rates. Consider the case of China, where financial repression is the norm and the state can commandeer resources from anyone with its ability to track almost every citizen in every activity.

Monocultural countries also find it easier to tax their citizens at a high rate; acquiescence is aided by the public knowledge that these taxes will serve to benefit someone we can identify with in terms of race or kinship. Once countries become diverse and culturally divergent, this willingness to pay high taxes reduces—as is the case with India.

To repeat, high tax rates are likely to work if a country offers huge economic opportunities, can enforce compliance even outside its sovereign jurisdiction, is largely homogeneous and mono-cultural, makes a reasonable assurance that the money will be put to good use, and its economy is largely free of corruption and the legal system is capable of punishing violations.

Almost none of these conditions are true in India at this stage of its development, and even small efforts to enforce better tax compliance attract the charge of tax terrorism, which may be partially true, given the venal nature of our bureaucracy and the legal system's endless delays. As for corporate taxes, even the US finds it tough to prevent corporations from keeping their profits abroad in tax havens. Competitive tax rates are thus crucial till we reach a global understanding that countries must not compete on tax rates.

But beyond the simple ability to impose high marginal tax rates on individuals, there is the question of desirability. Despite high state capacity in advanced countries, few people would argue that states can spend money more efficiently than private parties. In India, this is even more true. In these circumstances, a rupee left in the hands of private individuals and companies may be put to better use than if handed over to politicians and bureaucrats.

It is also time to question the basic hypothesis that states can deliver welfare better to the poor, and that higher taxation is the way to fund this munificence. The marginal utility of higher incomes reduces as one moves up the income scale. This implies that beyond a certain level of income, wealth and personal consumption, the rich work largely to earn psychological rewards—by winning against competitors, taking on new challenges, earning plaudits from peers, and contributing to society. This may sound like an argument for higher taxation, but it is actually an argument to incentivize the rich to do more for society.

Ask yourself: If toilets have to be built for the poor, is it more likely that the Tatas would do it well or the government? So, rather than tax the Tatas and get the government to spend money on building poor quality toilets, wouldn't it make more sense to incentivize the Tatas (or Birlas, or Ambanis or Shiv Nadars and Azim Premjis) to promote social entrepreneurship and investment in human capital?

Companies and individuals are more primed to deliver better outcomes. It is time to let go of the idea that higher taxes are the way to better welfare.

R. Jagannathan, is editorial director, 'Swarajya' magazine

END