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# Freedom Team of India

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# Come on, liberals: Let's change India!

## A liberal perspective on taxes – Part II

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Last month, in the first part of this article I made the comment that internally consistent theories of public finance simply don't exist. I then went on to (bravely!) propose an internally consistent theory derived from the basic social contact. The following principles resulted from that analysis, that (a) citizens (and not companies) should pay taxes; (b) paying taxes must be mandatory unless someone is simply unable to pay; (c) taxes should be based on the annual average of the lifetime worth of an individual; and (d) taxes must price-discriminate with a modest level of progression: the marginal rates approximating the overall share of taxes in GDP.

According to the fourth principle, the middle class should pay an income tax at a marginal rate approximately equal to the proportion of overall taxes to GDP; the rich should pay at a rate slightly above this; and those below the poverty line should not pay taxes, receiving a negative income tax as part of the social insurance scheme, instead.

### The *right* level of taxation

A fifth principle suggests itself: the total amount of tax collected should be neither too much nor too little, being just enough to ensure *effective* delivery of necessary government services. The liberal believes that when governments are restricted to their proper role they provide us with a crucially needed service. In this regard it may be noted that a society comprising a larger share of honest people (like Japan) will need less policing and hence lower taxation. Corrupt societies will need higher levels of taxation.

In any event, the liberal is not smitten by the mindless fascination of some alleged 'liberals' for low taxation. It is crucial to have the right size of government with right services and functions. That is the only correct determinant of the right level of taxation. Today, India's socialist government imposes an extremely low overall tax burden but then it *squanders* these precious revenues on totally unnecessary activities. The consequent under-supply of basic public goods like defence, police and justice – including the defence of property rights – has led to significant crime and poverty in India.

### The ever-present specter of regressive taxation

Theoretical models of public taxation are extremely difficult to translate into practice. We noted last month how regressive taxation is the norm across the world. The rich pay proportionately less as they get richer. At the same time, the poor (who, we have noted, should not have to pay taxes) fork out heavy consumption and indirect taxes. The most progressive taxes of all are reserved for the salaried upper middle class, which carries the world on its shoulders.

The rich benefit most from any number of exemptions, including a regressive capital gains tax regime. Assume that A and B have the same level of assets today and that they invest equally in, say, land. Now assume that A receives a windfall gain with his land tripling in value while B's stagnates. Most tax systems will treat A's windfall gains very lightly, even though A is now considerably richer than B. It is improper for windfall gains to be taxed proportionately less than income from ordinary hard work.

The reality is that even as the rich continue to influence politicians to give them more and more exemptions, they end up suffering from the effects of the consequent regressive taxation regime. While they can own the best Mercedes, they must then hire heavily armed security guards and drive through sludgy, potholed roads. The quality of life is very low in societies that depend on regressive taxation.

**Some other principles of taxation**

Other principles of taxation include:

- No taxation without representation (i.e. democratically determined taxes).
- Inflation is the most regressive form of taxation. The liberal therefore opposes deficit financing except in the rarest circumstances (like war).
- Taxes must be levied by that tier of government which administers the relevant service (principle of subsidiarity).
- Since it is citizens who must be taxed, taxation of goods must be avoided, being limited to Pigovian taxes to facilitate the internalizing of negative externalities. Where possible, market-based instruments should be used to control negative externalities.
- The variable cost of a government service to an individual or industry, such as the cost of processing a license, should be recovered from that individual or industry (cost recovery principle).
- The government should not own land except for roads, common infrastructure, Parliament, courts, basic defence establishments, and police stations. This will allow land to be put to its most productive use. The government should therefore sell land and use these revenues to keep taxes low.
- Transfers of assets from one generation to another should be treated seamlessly, thus ruling out inheritance taxes.

Clearly, the liberal is not utopian. He realizes that practical matters related to the ease of collection of taxes will influence the real tax system, even though unavoidable distortions will result. Thing like a mix of indirect and direct taxes; or the use of visible and not discounted *future* income and wealth; will therefore be unavoidable.

**Implications for India**

What does this mean for India? A few thoughts are outlined below.

1. India must raise its overall tax level from the current tax share currently of around 16 to 18 per cent of GDP to 25 per cent of GDP (compared with 33-50 per cent of GDP in the West). Note that merely raising taxes without reforming India's governance model will not improve much. Therefore governance reforms of the sort advocated in my book, *Breaking Free of Nehru* (http://bfn.sabhlokcity.com/) must form the bedrock of reform in public finance.

2. The only defensible way to increase taxes is to broaden the base by requiring all Indian families to lodge annual income and wealth tax returns. Poverty elimination, a vitally necessary part of the liberal agenda, also depends critically on the information received from such returns (see my article in *Freedom First*, August 2009). The result would be to increase the base of tax returns in India from 3 crores to around 67 crores.

3. Since abolishing company taxes will be impractical and create many complications, an alternative is to reduce company tax level in India to 25 per cent while requiring dividends paid to Indian investors to be franked through an imputation system: thus defaulting to an income tax system.

4. Apart from eliminating indirect taxes (already touched upon) most excise duties and taxes on products will, in due course, need to be abolished. Pigovian taxes, however, may well be needed on a few products.

5. Given that increases in asset prices continuously transfer significant amounts of wealth to the rich relative to the poor, land and capital gains taxes would need to be increased, aiming at the end of all these reforms for a (broadly) *overall* flat tax system in India from the current regressive one.

Given space constraints I have been able to present only a sketch of a theory of liberal taxation, but I trust that these two articles of mine will be found broadly reasonable by liberals everywhere.

**Freedom Team of India**
Once again I'd like to remind that FTI (http://freedomteam.in/) continues to look for leaders and seeks your active involvement and support.

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