How to pay more taxes

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The European rich now wish to pay more taxes. What about the Indian rich?

Startling news: the rich in many European nations have asked their governments to tax them more. This follows the call made by Warren Buffet in the United States that the rich should pay more taxes. The motive is self-interest: to save their economies from sliding further and going into a double-dip recession, and preventing the kind of youth violence that has been witnessed in many countries in Europe. The recession looming on the horizon (if the world is not already in it) will be more difficult to deal with than in the earlier rounds since this time the cause is political rather than financial, as the case was with the global recession that started in late-2007.

In 2007-08, the experts and the analysts were 'behind the curve' and in a state of denial about the start of the recession. The International Monetary Fund did not acknowledge the recession till late-2008, almost a year after it had started. Ben Bernanke, the head of the U.S. Federal Reserve, only admitted problems in February 2008 when the first stimulus tranche of $160 billion was announced. The U.S. Treasury Secretary did not admit of basic problems in the financial sector even in July 2008 when Freddie Mac and Fannie Mae faced imminent collapse.

Beyond salvage

By the time Lehman Brothers collapsed and AIG was on the verge of collapse in September 2008, things had gone out of control. The situation could not be salvaged even with the announcement by the U.S. government of a bailout package involving $750 billion. In order to keep AIG afloat, $350 billion was pumped into it.

Globally, an unprecedented amount of liquidity was released by central banks. In normal times that would have led to hyper-inflation, but in 2008 there was a fear of deflation. The problem had originated with the sub-prime crisis in the housing mortgage market, and that spread like a contagion to all financial institutions due to the interlocked nature of balance sheets.

There was a crisis of trust. The financial system had got linked to the shadow-banking that was highly leveraged and unstable. It meant that even a small decline in the value of the assets of a company led to a big fall in profits and valuation. With the accounting practice of 'marked to market,' these losses came on to the balance sheet and the company was in danger of losing its entire capital. Thus, as the stock markets and other markets collapsed, most financial sector companies lost their capital, and with that their viability. Governments had to step in and bail out these companies.

In the financial markets, where borrowing and lending is the name of the game, trust was evaporating. Since it was not clear which company would go under next, none could be trusted and lending ceased. Entities that were considered to be 'too big to fail' were failing, or showing signs of failure, one by one — Bear Stern, Freddie Mac, Fannie Mae, Lehman Brothers, AIG, Citibank and so on. No amount of liquidity was enough to revive the financial markets, until the situation stabilised with the stoppage of the practice of 'marked to market.' There was fraud: the major financial entities were not telling their customers the entire truth about the products they were selling. The U.S. government has just launched investigations into this fraud.

Globally, governments boosted demand following the Keynesian device of creating deficits. The U.S. budget deficit went from 3 per cent of GDP to 12 per cent. The same thing happened in India. China provided a $600-billion boost to infrastructure. Japan and much of Europe went in for budget deficits to boost demand in their economies. Nonetheless, unemployment rose sharply everywhere. In the U.S., it reached the level of 9.6 per cent. In India, exports which were growing at 35 per cent started plummeting at 35 per cent, leading to large-scale unemployment in labour-intensive sectors such as textiles, gem and jewellery and leather goods. Many industries and services such as transportation, finance and real estate went into a tailspin.

Worker versus economy

The International Labour Organisation estimated that 60 million jobs were lost in spite of attempts by various governments to boost their economies. The workers and the poor bore the brunt. Not that the dollar billionaires did not lose: their wealth declined sharply. But they had the cushion of their hundreds of millions and billions worth of assets still intact.

The reason for the anaemic recovery was that the stimulus was nowhere as big as was needed to boost employment and revive economies in a strong manner. So, when the big economies started climbing out of the recession in early-2010, employment hardly rose in the major economies.

Enter, politics

Politics entered the picture globally soon thereafter. The conservatives started pushing the neo-classical paradigm of tax cuts for the rich and balancing the budget. The anaemic recovery was used as an excuse to argue that the Keynesian prescription to boost the economy does not work. The implication of the conservatives' programme of cutting taxes on the rich leads to a decline in tax revenue so that the deficit tends to grow. But since the budget has to be balanced, expenditures have to be curtailed — the opposite of what the economy needs. In Britain, the new Conservative government cut back the budget and reduced public sector employment by half a million.

In the U.S., after the Democrats' big losses in the 2010 elections, President Barack Obama could not push his expenditure programme and had to reach a compromise with the Republicans. At the beginning of August 2011, the U.S. government almost came to a grinding halt due to the logjam between the two political forces. This left the markets in panic.

The euro zone had its own problems of coordination amongst its disparate constituents. One after the other, Greece, Ireland and Portugal teetered under debt and had to be bailed out by others — but on condition that they implement austerity packages. This led to revolts by workers and youth facing unemployment. The possibility of default meant that they had to borrow at higher cost; that worsened their debt situation. When the contagion spread to Spain and Italy, matters became difficult for the euro zone because it was hardly feasible to bail out those economies. The possibility of sovereign default has increased, and that has added to the difficulties of the financial entities that have lent to these nations.

The world economy faces a deep crisis for political reasons. This is not palatable to the conservatives, who once again have a grip on power in the major economies of the world. India is no exception to this conservative mood with the government talking about balancing the budget in stages.

The rich, starting with Mr. Buffet, have realised that in their own interest they have to accept higher taxes so that governments can boost demand. In the pessimistic scenario that now prevails across the globe, the private sector on its own is unlikely to boost investment. Sensing trouble ahead, citizens are saving more for the rainy day, and so consumption demand remains weak. Globally exports growth is weakening. Thus the only source of boosting demand can be government expenditure.

In France, Mr. Levy, the president of the French association of private enterprises, supported Mr. Buffet's idea. Sixteen of the wealthiest people in France signed a petition urging their government to tax them more. A group of 50 wealthy Germans backed the petition. In Italy, the chief of Ferrari weighed in with support.

Manipulators

The well-off in India avoid paying taxes through both legal and illegal means. They manipulate things to get themselves huge tax concessions and then make even bigger sums through black incomes. The more property one owns the more tax concessions one gets. For instance, income from dividend on shares in companies is exempt. Thus, if the managing director of a big company gets Rs.30 crore as salary, bonuses and so on, but gets Rs.1,000 crore as dividend, the tax liability is only Rs.10 crore. That amounts to a tax rate of 1 per cent of the total income. No wonder, less than 3 per cent of the citizens file income tax returns, and India has one of the lowest ratio of direct tax to GDP in the world.

Today, Indian corporates (less than 0.1 per cent of the population) control 20 per cent of the national income, much more than what the 50 per cent of the population that is dependent on agriculture make. The legal exemptions they enjoy, called 'tax expenditures,' amount to over Rs.5 lakh crore. Add to this the black incomes these corporates generate annually, and their incomes turn out to be astronomical. The corporates pay an average tax of 23 per cent of their legally declared taxable incomes, whereas they should be paying about 33 per cent.

So the Indian rich need not ask for a tax rate increase. They only have to allow the government to eliminate 'tax expenditures' and to voluntarily stop generating black incomes. This will more than double tax collections, which could give a big boost to the slowing Indian economy.

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