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Impact of Tax Avoidance on Indian Economy

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ABSTRACT

Tax evasion and tax avoidance are serious issues that negatively impact India's economic growth. Because of these problems, the government is less able to collect taxes, which limits its ability to fund public spending that is necessary for economic growth. Tax avoidance is the use of legal methods to lower tax obligations, whereas tax evasion is the wilful failure to pay taxes or the underreporting of taxes. Government revenue, investment, and economic growth are all negatively impacted by these activities. The study examines how these behaviours affect important economic metrics including GDP growth, investment, and government revenue using secondary data from multiple sources. The results show that tax avoidance and evasion have a major detrimental effect on economic growth. Because tax evasion lowers government revenue, there are fewer public funds available for investments in vital areas like infrastructure, healthcare, and education. On the other hand, tax evasion discourages foreign investment and skews resource allocation, which slows down economic growth overall. The study emphasizes how tax fraud and avoidance have a major detrimental effect on India's economic growth. In order to encourage sustainable economic development in India, it offers evidence in favour of the adoption of effective policies to counteract these behaviours.

Keywords*: Taxation, Tax Evasion, Tax Avoidance, Indian Economy.*

I. INTRODUCTION

Tax evasion is the unlawful practice of purposefully avoiding paying taxes by hiding assets, exaggerating expenses, or underreporting income. It covers deliberate acts taken by people or organizations to evade tax liabilities, lowering the amount of money owed to the government. Avoiding taxes is not the same as evading taxes. Tax avoidance is a legitimate way to lower taxes.

The techniques used to evade taxes include straightforward underreporting of income, intricate schemes involving offshore accounts, shell corporations, and fraudulent activities, and more. Tax evasion undermines the integrity of the tax system, erodes public confidence, and denies governments the funding they need to maintain infrastructure and other necessities. Considered

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a serious offense, tax evasion carries fines, penalties, prosecution, and jail time.

II. History of tax evasion

Contrary to popular assumption, which holds that wealth and income taxes are relatively new, there is ample evidence that income taxes in one form or another were in place even in prehistoric and primitive societies. Taxation (an estimate) is where the term tax originates. These were occasionally collected in an ad hoc fashion and were imposed on the sale and purchase of goods or livestock. Caesar Augustus issued an edict around two millennia ago stating that taxes should be levied worldwide. Taxes were also imposed in the Greek, German, and Roman Empires, sometimes based on occupations and other times on turnover. The Monarch received tax revenue for many centuries. Land and movable property, including the Saladin title in 1188, were subject to taxes in Northern England. Poll taxes and indirect taxes known as Ancient Customs, which included levies on wool, leather, and hides, were later added to these. These levies and taxes, in a variety of forms, on a range of goods and occupations, were put in place to help governments pay for their civil and military expenses. They were also put in place to ensure public safety as well as to meet the needs of the general populace, such as road maintenance, the administration of justice, and other state functions[2].

But it was Kautilya's Arthasastra that addresses the tax system in a very thorough and organized way. This well-known work on state crafts, which was written around 300 B.C., when the Mauryan Empire was on its glorious ascent, is truly remarkable for its in-depth analysis of the civilization of the era and its recommendations that ought to direct a monarch in the most effective and profitable way possible. Kautilya devotes a significant amount of Arthasastra to business-related topics, such as financial management. In terms of agriculture, the Mauryan system was a form of state landlordism, according to well-known statesmen, and the state derived a significant portion of its revenue from the sale of land. Along with collecting a portion of the agricultural produce typically one-sixth the State also imposed taxes on water rates, octroi fees, tolls, and customs duties. In addition, taxes were collected on forest products, metal mining, etc. A significant source of income was the salt tax, which was collected at the location of extraction[3].

Historians have examined tax evasion in a number of ways, including by examining historical

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[2] Meghna Sherman *The debate between artificial intelligence and human rights (July 01 2024, 10.11. p.m.)* https://www.legalserviceindia.com/legal/article-8831-the-debate-between-artificial-intelligence-and-human-rights.html

[3] Financial Inclusion Available at https://eastasiaforum.org/2023/05/18/the-g20-can-bridge-indias-digital-financial-service-gap/. (last viewed on 11.3.2024 at 3.24 p.m.)

tax resistance groups. Famous examples include the Boston Tea Party in 1773, French poujadism in the 1950s, and the California property tax protest in the late 1970s. Historians can more easily locate pertinent sources since organized tax revolts and anti-tax opposition are typically well-publicized and amenable to thorough analysis. Historical studies have also been conducted on black markets. Another area that has garnered significant historical attention is tax havens as a transnational institution for tax avoidance and profit shifting. However, historical studies have rarely examined other silent types of tax evasion and avoidance. The fact that tax evasion and avoidance from the viewpoint of the ‘offenders, that is, those who are responsible for paying taxes is inherently underrepresented in sources, both in terms of the behaviours, processes, and tactics as well as the underlying motives, may be one explanation for this study gap[4].

India's high level of tax delinquency today can be explained by their tax history, which began when the British imposed income taxes in 1922. The General Anti-avoidance Rules were created by the Income-tax Act of 1961 and went into effect on April 1, 2017. When an arrangement or transaction has a tax impact of more than INR three crores in a given fiscal year, the purpose of the aforementioned regulations is to prevent tax malpractice by taxpayers and tax professionals who aid taxpayers in evading taxes. Tax farming has long been a method of raising money. A private company paid governments a one-time payment in advance, collected and kept the money, and took on the risk of taxpayer evasion. Tax farming has been proposed as a way to lessen tax evasion in developing nations.

(A) Tax Avoidance

The lawful practice of taking advantage of loopholes and/or contradictions in tax legislation in order to minimize or completely avoid paying taxes is known as tax avoidance. Since it is carried out within the bounds of the law, it is not unlawful, but occasionally it may be regarded as unethical. In order to avoid paying taxes in their home countries, businesses have historically turned to tax avoidance by transferring funds through offshore entities.

(B) Tax Evasion

Tax evasion is an illegal attempt to reduce one's tax burden by using fraudulent methods, such as purposefully understating taxable income or inflating expenses. The goal of tax evasion is to show fewer profits in order to avoid paying taxes, and it involves illegal practices like making false statements, hiding relevant documents, not keeping complete records of

[4] Harnessing trade for sustainable development Available at https://www.wto.org/english/res_e/publications_e/brochure_rio_20_e.pdf (last seen at 16.3.24 at 3.14 p.m.)

transactions, concealing income, overstating tax credit, or presenting personal expenses as business expenses. Tax evasion is a crime for which the assesse may face legal consequences[5].

(C) Tax Planning

The process of efficiently assessing one's financial status is known as tax planning. One can lower their tax liability by using tax planning. It entails legally organizing one's income in order to take advantage of numerous exemptions and deductions. A tax deduction of up to Rs 1,50,000 can be obtained under Section 80C if certain investments are made for a specified amount of time. Investing in PPF accounts, National Saving Certificates, Fixed Deposits, Mutual Funds, and Provident Funds are the most common ways to save taxes. Applying a number of beneficial, lawful laws that allow the assessee to take advantage of deductions, credits, concessions, refunds, and exemptions is known as tax planning. Alternatively, tax planning can be defined as the art of rationally organizing one's financial affairs to take advantage of all applicable tax law provisions for the assessee. Tax planning is a sincere method of implementing the rules found in the tax law framework[6].

III. VARIOUS METHODS OF TAX EVASION

(A) Under reporting of income

The goal of tax evasion is to unlawfully minimize or evade tax obligations through a variety of strategies. The strategies for tax avoidance are as follows:

Income underreporting: Taxpayers frequently avoid paying taxes by reporting their income insufficiently or not at all. Wages, business income, rent, interest, dividends, and capital gains are among the types of revenue that are frequently underreported.

(B) Inflating expenses or deductions

By exaggerating expenses or deductions to lower taxable income, one can also avoid paying taxes. It can be accomplished by overstating deductions for charitable contributions or medical bills, misclassifying personal spending as company expenses, or inflating business expenses.

a. Offshore tax havens:

Businesses and individuals frequently use offshore bank accounts, trusts, and companies in low-tax or no-tax jurisdictions to conceal assets and income from tax authorities. Additionally, they manipulate the true ownership of assets and revenue by utilizing intricate offshore

[5] Harnessing trade for sustainable development Available at https://www.wto.org/english/res_e/publications_e/brochure_rio_20_e.pdf (last seen at 16.3.24 at 3.14 p.m.)
[6] Financial Inclusion Available at https://eastasiaforum.org/2023/05/18/the-g20-can-bridge-indias-digital-financial-service-gap/. (last viewed on 11.3.2024 at 3.24 p.m.)

arrangements.

b. Transfer pricing manipulation

By altering transfer prices on goods and services traded amongst their affiliated businesses, multinational firms avoid paying taxes. Profits are transferred to organizations in jurisdictions with lower tax rates as a result. Selling goods at higher prices to companies in higher-tax jurisdictions and purchasing goods at lower prices from entities in lower-tax jurisdictions are two ways that transfer pricing manipulation is carried out[7].

c. Shell companies and nominees

Shell corporations and nominees are often created in order to conceal the true ownership of assets. In order to hide the identities of the beneficial owners, these corporations are set up in jurisdictions with stringent confidentiality rules.

d. False invoicing and billing

By creating fictitious invoices and bills for which there would be no actual transaction, businesses may attempt to avoid paying taxes. These fictitious invoices are sent out in an attempt to inflate costs and alter revenue and expense data[8].

e. Cash transactions and informal economy

Businesses operating in the informal economy typically do not register with the tax authorities, therefore they do not disclose sales or income for taxes reasons. In this situation, taxpayers may use cash for commercial activities, leaving no evidence of the transactions they have made. Therefore, in an informal economy, a taxpayer can use cash transactions to avoid paying taxes.

f. Late filing of income tax returns:

if the taxpayer does not submit the claim, in full compliance with the appropriate standards of the 1961 income tax return. An INR 5,000 fine could be imposed by the evaluating officer[9].

g. Misuse of tax treaties:

In order to lower the tax burden, taxpayers take advantage of gaps in international tax treaties and inadequacies in tax legislation. This is done in order to avoid taxes and obtain favourable tax treatment.

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[7] Harnessing trade for sustainable development Available at https://www.wto.org/english/res_e/publications_e/brochure_rio_20_e.pdf (last seen at 16.3.24 at 3.14 p.m.)

[8] Financial Inclusion Available at https://eastasiaforum.org/2023/05/18/the-g20-can-bridge-indias-digital-financial-service-gap/. (last viewed on 11.3.2024 at 3.24 p.m.)

[9] Digital Financing Technology, Anjali Mandal, October 2023, Imperial Publications

h. Fraudulent tax returns

In order to lower their tax obligations, taxpayers frequently file tax returns with fraudulent information, such as stating bogus income, expenses, or deductions. This is accomplished by creating fake documents, making up transactions, or utilizing identities that have been stolen.

IV. Impact of tax evasion

Tax avoidance strategies have a detrimental effect on the nation, as we have already witnessed. These are harmful to the long-term advancement of civilization and the nation as a whole. The rich have gotten richer as a result of tax evasion, which encourages the growth of illicit gains that people try to conceal or avoid paying taxes. Meanwhile, the poor are suffering greatly because the government is unable to provide enough funds to help those in need because it is not collecting the right taxes.

The nation's most vulnerable residents seem to be suffering more harm as long as the government does nothing to stop such misconduct. Because tax evasion results in a lack of income and enough funding, the government is forced to stop development projects that were started to help people and communities. Evasion distorts the management plan by preventing the project's core resources from being available, and it infiltrates government programs for society.

The effects of tax avoidance are extensive. It has an impact on many facets of the economy, society, and government. Some of the main effects of tax evasion include the following:

- **Loss of revenue**: Government revenue is frequently lost as a result of tax evasion. impacting the government's capacity to provide the general people with basic services like social welfare, healthcare, education, and infrastructure. Budget deficits brought on by tax evasion frequently force the government to borrow funds or reduce expenditure on critical services. Only the citizens' standard of living is impacted by this[10].
- **Social justice and inequality**: By allowing affluent people and businesses to avoid paying their fair share of taxes, tax evasion exacerbates economic inequality. As a result, the wealth disparity widens, which impacts both honest taxpayers and those with lower incomes. Furthermore, when resources are taken away from people who need them, social inequality rises. hence promoting inequality and poverty.

[10] Digital Financing Technology, Anjali Mandal, October 2023, Imperial Publications

- **Deterioration of institutional trust**: Tax evasion causes the tax system and other governmental institutions to lose their credibility. The belief that few people and companies can avoid paying taxes without suffering any repercussions can have an impact on public confidence in the rule of law and the efficiency of government. The honest taxpayers will become more dissatisfied as a result[11].
- **Distorted economic incentives**: Tax evasion frequently benefits illicit or covert business ventures, which hinders economic expansion and productivity. As a result, resources are allocated inefficiently, and real investment and entrepreneurship are discouraged. Sincere taxpayers who follow the tax code may experience unfair competition, which could lead to market distortions and a decline in competitiveness.
- **Underinvestment in public goods**: The government will be unable to invest the money it receives from tax evasion in services and public goods that will benefit society. Underdevelopment and inequality result from this impact on long-term economic growth, innovation, and social advancement.
- **Increased tax burden on honest taxpayers**: As a result of tax evasion, law-abiding individuals and enterprises are frequently penalized and must pay a higher tax burden. Economic activity and incentives to work, save, and invest are impacted by this.
- **Weakened Rule of law**: Tax evasion shows that the rule of law is eroded, which in turn undermines democratic governance. Additionally, it can erode the authority of the organizations in charge of upholding tax rules and combating financial crimes, as well as contribute to a rise in corruption in the nation.

V. Legal provisions

In order to guarantee that taxpayers pay their fair share of taxes, the Income Tax Act of 1961 contains rules pertaining to tax avoidance. They give the tax authorities the authority they need to look into and prosecute tax evasion instances. arrangement was entered with the main purpose of obtaining a tax benefit. The tax authorities may then disregard such arrangement and assess tax as if the arrangement had not been entered into.

- Transfer Pricing Rules: The Income Tax Act of 1961's Section 92 addresses transfer pricing rules. It mandates that related-party transactions be carried out at arm's length rates, or the amount that would have been paid in the event that the parties were

[11] Financial Inclusion Available at https://eastasiaforum.org/2023/05/18/the-g20-can-bridge-indias-digital-financial-service-gap/. (last viewed on 11.3.2024 at 3.24 p.m.)

unrelated. The tax authorities may change the price to the arm's length price and levy taxes in accordance with that adjustment if the transaction price is not at arm's length[12].

- Thin Capitalization requirements: The Income Tax Act of 1961's Section 94B addresses thin capitalization requirements. It prevents interest paid on excessive debt from being deducted from taxes. Debt that surpasses double the company's equity capital is considered excessive debt.
- Tax Avoidance plans: The Income Tax Act of 1961's Section 97 addresses tax avoidance plans. It enables the tax authorities to ignore any arrangement or transaction that is made just for the purpose of receiving a tax benefit and lacks any commercial substance.
- Section 271H: This section addresses late filing of income tax returns, which is a form of tax evasion and is penalized under the Income Tax Act of 1961. The assessee may be fined between Rs. 10,000 and Rs. 1,00,000.
- Section 270A: This section addresses the very serious problem of tax evasion, which is the hiding of income from the income tax department. The assessing officer must be persuaded that the assessee has concealed any income in this case[13].
- provision 271B: This provision addresses an individual who fails to get his accounts audited in accordance with section 44AB of the Income Tax Act of 1961.
- Section 234E: Addresses the assessee's failure to comply with the TDS regulations. A company or organization is required to pay a penalty of Rs 200 per day if they do not timely file their tax deducted at source (TDS) or tax collected at source (TCS) returns. The total TDS cannot be exceeded by the penalty.
- Section 276C: A person who wilfully attempts to avoid taxes or understates their revenue by more than Rs 25 lakh suffers a minimum of six months in jail and a maximum of seven years in prison, in addition to a fine. False information, including PAN data, is prohibited when filing an ITR.
- Section 139A: Giving incorrect information, including PAN data, on an ITR is prohibited. Employers and all other tax deductors demand PAN card IDs. TDS is collected from payments using this information.

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[12] Financial Inclusion Available at https://eastasiaforum.org/2023/05/18/the-g20-can-bridge-indias-digital-financial-service-gap/. (last viewed on 11.3.2024 at 3.24 p.m.)

[13] Digital Financing Technology, Anjali Mandal, October 2023, Imperial Publications

(A) Government Measures to Reduce Tax Evasion

The Indian government has taken numerous measures to curb tax evasion, which has been a problem since the country's independence. In the present day, the government has taken even more measures to curb tax evasion.

- **Implementation of GST:** A comprehensive, multi-stage, destination-based tax system, the Goods and Services Tax (GST) incorporates a number of indirect taxes, including value-added tax (VAT), service tax, and excise duty. With the introduction of a transparent, technologically advanced structure, the GST has significantly altered the tax system. This method makes it more difficult for tax evaders to manipulate the system by lowering the cascading effect of taxes, streamlining the tax filing procedure, and facilitating improved transaction tracking.
- **PAN-Aadhaar linking**: In order to file income tax returns, the government has required that the Permanent Account Number (PAN) be linked to the unique identification number (Aadhaar). By establishing a thorough financial profile of people and companies, this connection helps the government keep a closer eye on revenue streams, financial dealings, and tax obligations. It assists in discovering disparities and underreporting of earnings[14].
- **Income Disclosure Programs**: The government has implemented a number of voluntary disclosure programs, including the Pradhan Mantri Garib Kalyan Yojana (PMGKY) and the Income Declaration Scheme (IDS). These plans enable people to pay the necessary taxes and penalties, declare assets and income that have not been reported, and stay out of trouble. These programs aid in bringing unreported wealth into the official economy and boosting tax compliance.

In an effort to decrease cash transactions, the government has been pushing digital payment options such as the Immediate Payment Service (IMPS), National Electronic Funds Transfer (NEFT), and Unified Payments Interface (UPI). Authorities can track revenue sources and identify tax evasion thanks to the trail left by digital transactions. To promote digital payments, incentives such as tax breaks, rebates, and discounts are offered.

In an effort to combat tax evasion, counterfeiting, and black money, the Indian government demonetized high-denomination currency notes (₹500 and ₹1,000) in 2016. This action made unaccounted-for funds traceable and taxable by forcing people to deposit them in banks.15.

[14] Financial Inclusion Available at https://eastasiaforum.org/2023/05/18/the-g20-can-bridge-indias-digital-financial-service-gap/. (last viewed on 11.3.2024 at 3.24 p.m.)

Long-term advantages were higher tax compliance and a move toward digital payments, while the short-term effects included cash shortages and economic disruptions.

- **Tax information exchange agreements**: India has bilaterally and multilaterally signed agreements with a number of nations to share tax-related data, including the Double (AEOI). These agreements make it possible to work together across borders to find tax evaders and retrieve assets and income that have been hidden. Automatic Information Sharing and Tax Avoidance Agreements (DTAA).
- **E-assessment**: To reduce corruption, discretion, and taxpayer harassment during income tax inspection, the Indian government implemented a faceless e-assessment system. To choose cases for examination, this method uses data analytics and artificial intelligence, guaranteeing an impartial and open procedure. By removing direct communication between taxpayers and tax authorities, e-assessment lowers the possibility of corruption and fosters a more effective tax administration system.

The Income Tax Department launched Project Insight, which uses sophisticated data mining and analytics techniques to analyze taxpayer data, find tax evaders, and find inconsistencies in income statements. The project assists the government in tracking high-value transactions, identifying tax evasion trends, and implementing corrective measures. Project improves the efficacy and efficiency of tax administration by utilizing big data[15].

- **Sanctions:** The Indian government has imposed severe sanctions for tax evasion, which include jail time and hefty fines. with serving as a deterrent, these fines motivate taxpayers to abide with tax laws and rules. For instance, tax evasion is punishable by up to seven years in prison and a fine under the Income Tax Act of 1961. Even harsher penalties, such as up to 10 years in prison and a fine of up to 300% of the value of the undeclared foreign income or asset, are imposed under the Black Money (undeclared Foreign Income and Assets) and Imposition of Tax Act, 2015. These strict regulations are meant to deter tax evasion and encourage a tax-compliant culture. As a result, people were compelled to deposit unaccounted-for funds in banks, which made them taxable and traceable. Increased tax compliance and a move toward digital payments were among the long-term advantages.

VI. Conclusion

Tax-related offenses are like a deadly sickness that gradually eats away at the nation's revenue

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[15] Financial Inclusion Available at https://eastasiaforum.org/2023/05/18/the-g20-can-bridge-indias-digital-financial-service-gap/. (last viewed on 11.3.2024 at 3.24 p.m.)

and is difficult to stop with ineffectual legislation. In a similar vein, citizens are crucial since these crimes may be easily stopped and destroyed if they are aware of them and value the government and the law. It is a curse that encourages the growth of illicit money. Although it is impossible to completely eradicate these crimes in a short amount of time, they can be decreased in frequency by merely improving the efficiency of the government system and establishing more organizations that finally succeed in lowering tax fraud and related crimes.

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