Fiscal Capacity for the 21st Century

07

CHAPTER

Fiscal capacity—spending and especially taxation—is key to long run economic development. Taxation is not just about financing spending, it is the economic glue that binds citizens to the state in a two-way accountability relationship. Against this background, we assess India's fiscal capacity. Simple tax-GDP and spending-GDP ratios suggest that India under-taxes and under-spends relative to comparable countries. But, controlling for the level of economic development, India neither under-taxes nor under-spends. India does tax and spend less than other politically developed nations, but given that most other democracies took time to strengthen tax capacity, perhaps India is not an outlier on this dimension, either. India does stand out in the number of individual income taxpayers, currently about 4 percent, far from our desirable estimate of about 23 percent. Building long-run fiscal capacity is vital. One low hanging fruit would be to refrain from raising exemption thresholds for the personal income tax, allowing natural growth in income to increase the number of taxpayers. Beyond that, building fiscal capacity is also about creating legitimacy in the state. This can be acquired by prioritizing improved delivery of essential services that all citizens consume.

Introduction

7.1 The Indian tax system is about to witness dramatic changes. Consider first the GST. Implementing a new tax, encompassing both goods and services, to be implemented by the Centre, 28 States and 7 Union Territories, in a large federal system, via a constitutional amendment requiring broad political consensus, affecting potentially 2-2.5 million excise and service taxpayers, and marshalling the latest technology to radically improve collection efficiency, is a reform perhaps unprecedented in modern global tax history.

7.2 Take next corporate taxes. The rate is scheduled to come down from 30 percent to 25 percent and a wide range of exemptions will be phased out in an orderly manner. In addition, the legacy of contentious, adversarial tax issues from the past is being cleaned up. Tax administration is being improved: now around 95 per cent of filings are electronic, tax refunds are now being issued in a record 7-8 days, and a new Tax Policy Council and Tax Research Unit are being created.

7.3 To be sure, a number of important issues in tax policy as well as in tax administration (as detailed for example, in the report of the Tax Administration Reforms Commission) need to be addressed. But ongoing developments warrant taking stock of a simple but fundamental question: *Given that state* *capacity and taxation are crucial determinants of long run development, how can India move from its current situation to one of increasing taxes and government spending as part of the process of building state capacity ?*[1]

7.4 The findings are nuanced but striking.

i. A simple comparison of aggregates with other countries indicates that India under-taxes and under-spends.

ii. Controlling for the level of economic development, India neither under-taxes nor under-spends.

iii. India does tax and spend less than other politically developed nations, but given that most other democracies took a long time to strengthen tax capacity, perhaps it is not an outlier on this dimension, either.

iv. Where India does stand out is in the number of individual income taxpayers. The ratio of taxpayers to voters is only about 4 percent, whereas it should be closer to 23 percent.

7.5 We explore the policy implications of these findings in the concluding section.

7.6 Consider first, *why taxation is key to long run political and economic development.* If spending is about the *entitlements* of citizenship in a democracy, taxation is about the *obligations* of citizenship. Taxation and military service (or some other form of compulsory national service) are two core elements of modern citizenship. India has chosen taxation as the key obligation that it can demand of its citizens. The obligations of citizenship are the foundations of nation building and democracy. Bringing more and more people into the tax net via some form of direct taxation, will help in realizing the promise of Indian democracy.

7.7 Democracy is a contract between the state and its citizens. This contract has a vital economic dimension: the state's role is to create the conditions for prosperity for all by providing essential services and protecting the less well-off via redistribution. The citizen's part of the contract is to hold the state accountable when it fails to honour the contract (Besley and Persson [2013][2]). But a citizen's stake in exercising accountability diminishes if he does not pay in a visible and direct way for the services the state commits to providing. If a citizen does not pay - through taxes or user fees - he either becomes a free rider (using the service without paying) or exits (not using the service at all). Both reduce the accountability of the state. Hence the expression: no representation without taxation. Taxation is not just about financing public spending, it is the economic glue that binds citizens to the state in a necessary two-way relationship.

7.8 One can think of tax paying and political participation as two important accountability mechanisms wielded by citizens. *The precocious India phenomenon is that economic development lags political development.* One can hypothesize that this difference in taxpaying and voting might explain the phenomenon in India of there being reasonably effective episodic accountability as opposed to ongoing accountability. Independent India has averted famines but chronic malnutrition is still a challenge. The Indian state can organize mega-events but routine safety for women has turned out to be more difficult to achieve. The Indian state responds effectively to floods and tsunamis but finds water and power metering more challenging.

7.9 Consider next the challenge of moving to a better equilibrium. There are no real low hanging fruit here because of two reasons: first, India is not really an outlier, contrary to much popular perception, in terms of its

[1] In this chapter, government spending, henceforth spending, and taxes, are for the general government unless mentioned otherwise.

[2] Besley, T. J. & T. Persson,2013, "Taxation and Development", *CEPR Discussion Paper* No. DP9307.

overall level of taxation and spending—facts that we establish unambiguously. It is easy to exhort the government to, say, increase spending on health and education or remove exemptions on the tax side. But it must be remembered that the ability to spend and tax is in part endogenous to the perceived legitimacy of the state. Citizens will be willing to pay their dues as taxes only if they feel that the state is adhering to its side of the contract by delivering essential services. In other words, tax and spending policy are related to actions by the state to increase its legitimacy. State and tax capacity are as much about state legitimacy as they are about technical details relating the design of policy and its implementation.

Cross-Country Taxation and Expenditure Patterns

7.10 In this chapter we assess, in a simple cross-country framework, whether India taxes and spends enough. How does India, a democracy with (PPP adjusted) per-capita GDP at about one-seventh of the OECD average compare internationally on spending and taxation patterns? A caveat: we do not consider property taxation not because it is unimportant. Rather, the omission owes to data challenges, stemming in part from the fact that property is taxed, albeit differently, at all three levels of government in India. This also means that the Centre has fewer policy levers at its disposal so that improving property taxation will require greater cooperation between all three levels of government. But given the extent to which property is a critical constituent of wealth and a potential source of local government revenues, property taxation reforms should be an important part of the country's tax reform agenda.

7.11 In the simple cross-section, India appears to be an outlier: it taxes and spends less than OECD countries and less than its emerging market peers (Table 1). India's spending to GDP ratio (as well as spending in human capital i.e. health and education) is lowest among BRICS and lower than both the OECD and EME averages. India's tax to GDP ratio at 16.6 per cent also is well below the EME and OECD averages of about 21 per cent and 34 per cent, respectively.

7.12 India's spending and tax ratios are the lowest even among economies with comparable (PPP adjusted) per-capita GDP e.g. Vietnam, Bolivia and Uzbekistan. The two ratios stand at 28 per cent and 22.2 per cent, 43.3 per cent and 25.5 per cent, 33.4 per cent and 25.6 per cent for Vietnam, Bolivia and Uzbekistan respectively for the latest year available. Table 1 also shows that India's share of income and property tax in GDP are also comparatively low (with the exception of China in case of direct taxation).

7.13 Over time too, it seems, India has made limited progress in increasing its tax and spending capacity. Besley and Persson (2013) document that rich countries have consistently invested in tax collection capacity and collect a larger share of income in taxes vis-à-vis poor nations (and much higher revenues vis-à-vis poor countries despite comparable tax rates).In comparison to the United States (which introduced income taxes over the first half of the 20th century) India's tax to GDP ratio has increased at a much slower pace over the comparable time period following the introduction of income taxation. India's tax to GDP ratio has increased by about 10 percentage points over the past six decades from about 6 per cent in 1950-51 to 16.6 per cent in 2013-14. Figure 1 shows ten-year snapshots of the trends in aggregate spending as well as the indirect and direct tax to GDP ratios for India starting 1960-61.

7.14 However, it may not be appropriate to make such simple cross-country comparisons since there is a strong relationship between a country's fiscal capacity and the level of economic development. The correct question to ask therefore is: *whether India's fiscal capacity is low given its level of economic*

Table 1: Share as per cent of GDP

Country	Total Tax	Total Expenditure	Expenditure in human capex*	Direct tax	Individual Income tax	Property tax	Indirect Tax
China	19.4	29.7	7.2	5.3	--	2.0	12.7
India	16.6	26.6	5.1	5.6	2.1	0.8	10.1
Brazil	35.6	40.2	11.0	7.3	2.3	2.0	15.7
Korea	24.3	20.0	8.4	7.1	3.7	2.5	7.5
Vietnam	22.2	28.0	8.8	8.4	--	--	--
South Africa	28.8	32.0	10.7	15.0	--	1.4	10.2
Turkey	29.3	37.3	7.2	5.9	4.1	1.4	13.5
Russia	23.0	38.7	7.2	7.2	--	1.1	7.1
UK	32.9	41.4	13.4	11.7	9.1	4.0	10.8
US	25.4	35.7	13.3	12.0	9.8	2.9	4.4
EMEs Avg	**21.4**	**30.9**	**7.5**	**7.4**	**2.2**	**1.0**	**10.8**
OECD Avg	**34.2**	**42.8**	**11.6**	**11.5**	**9.5**	**1.9**	**11.0**

Note: ***: Expenditure in health and education, --: Not available.** ***Source:*** **OECD, World Bank, IMF databases and Ministry of Education, People's Republic of China.**

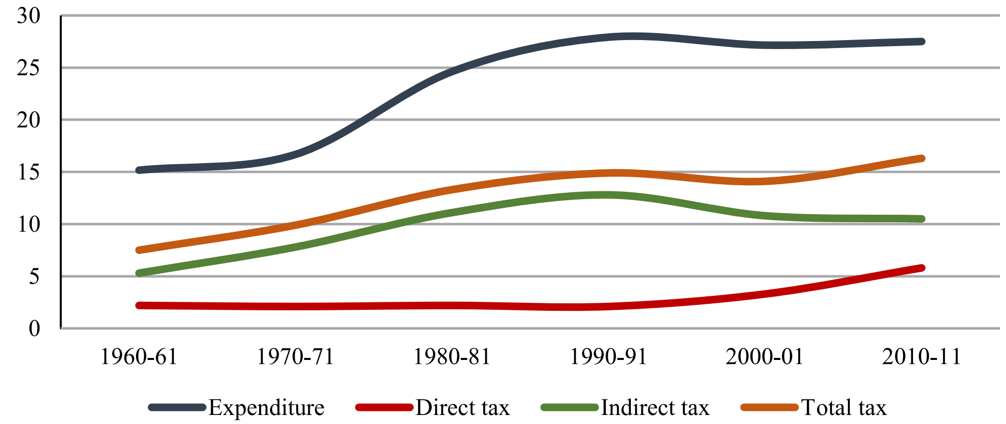
development (proxied by its PPP adjusted per capita GDP).

Analysis of Taxation and Expenditure Patterns: *Is India an outlier?*

7.15 One way to answer this question is simply to plot the relationship between various indicators of fiscal capacity and per capita GDP and see where India stands. In this section, we do this for five indicators—overall tax to GDP, direct tax to GDP, individual income tax to GDP, overall expenditure to GDP, and human capital expenditure to GDP.

7.16 To do this we collect consistent data for these indicators at the general government level from multiple sources viz. the OECD database, World Development Indicators (World Bank), Government Finance Statistics (IMF) and Fiscal Monitor (IMF). Our dataset[3] looks at variables including the total tax to

Figure 1: India's taxation and spending* trends (Per cent of GDP)(Per cent of GDP)



:** ***Source: **Various Economic Surveys and Indian Public Finance Statistics 2014-15.**

[3] The database also includes the number of taxpayers and voting age population for each country. Data on voting age population is from the International Institute for Democracy and Electoral Assistance (IDEA) based on the most recent elections held in these countries. Number of taxpayers are available for 56 countries and is taken from the OECD 2011 Report titled *"Tax Administration in OECD and Selected Non-OECD Countries: Comparative Information Series (2010)"*. Data on individual income taxes are for 54 countries.

Figure 2A: Tax to GDP (Per cent) and per-capita GDP

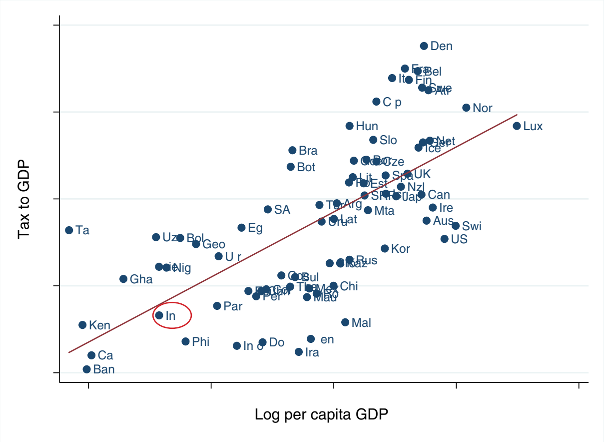


Figure 2B:Direct tax to GDP and per-capita GDP

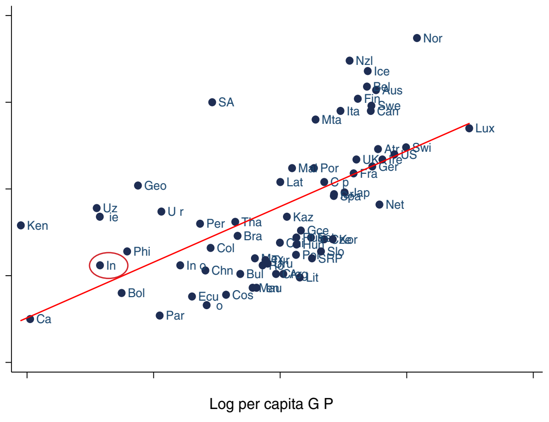


Figure 2C:Indiv. income tax to GDP and per-capita GDP

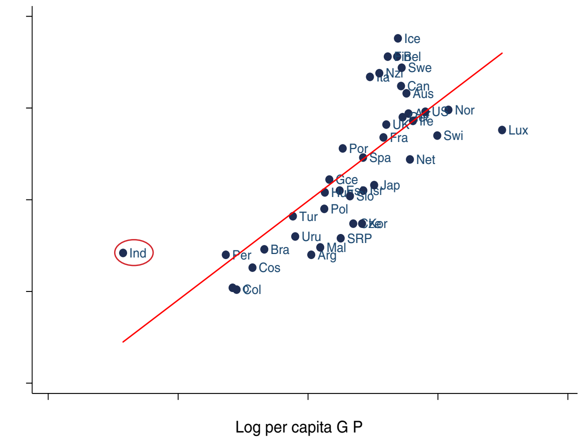


Figure 2D:Total expenditure to GDP and per-capita GDP

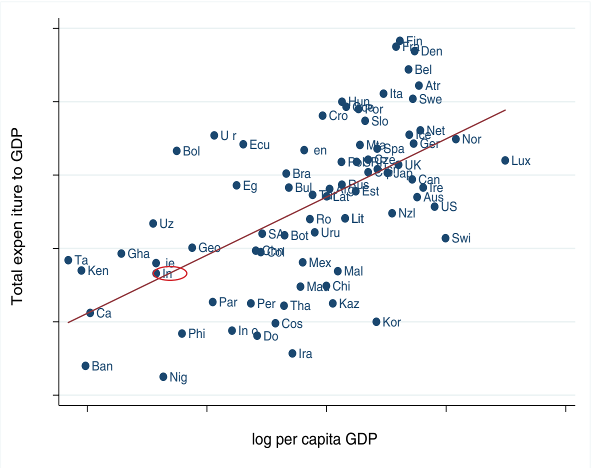
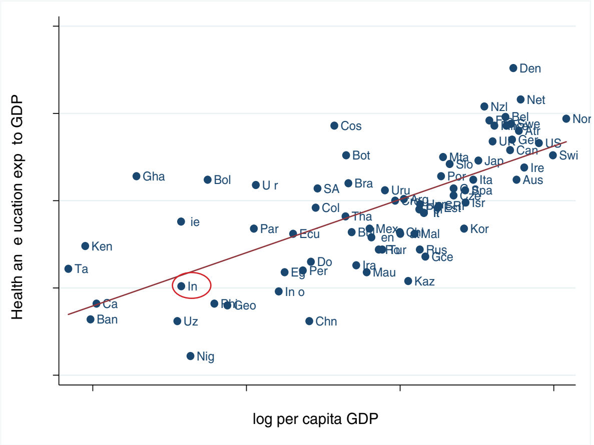


Figure 2E: Health & education expenditure to GDP and per-capita GDP



GDP, total general government expenditure as per cent of GDP and expenditures on education and health in a sample of 77 countries including all OECD countries and major EMEs for the latest available year. The results are shown in Figures 2A—2E.

7.17 The results are striking: *contrary to popular perception that India has low fiscal capacity, each of the charts show that India does not. It is close to the line of best fit (shown in red) in all the figures*[4]. In case of direct tax and personal income tax, counter to conventional wisdom, India's fiscal capacity seems to be significantly better than the average.

7.18 The response to this striking finding could be that it is not enough to control for lower levels of economic development. There is a well-known regularity that democracies tax and spend more, in part because they face greater pressures to redistribute. As is well known from the literature and more recently

[4] The regression results reported here are robust to outliers.

Acemoglu *et. al.* ("*Democracy, Redistribution and Inequality*", NBER, 2013), democracies by extending franchise often create pressures of redistribution. The appropriate question therefore is: *whether Indian fiscal capacity is weak controlling for both the level of economic and political development.*

7.19 We run regressions of each of the indicators of fiscal capacity on PPP adjusted per capita GDP and a measure of democracy[5] and plot the resulting relationship in Figures 3A—3E . The results are equally striking and unambiguous: *controlling for both India is a significant negative outlier when it comes to the tax to GDP ratio and significantly so with respect to expenditures on health and education.* In other words, controlling for democracy, India taxes less and spends less (especially on human capital) as can be clearly seen in figures 3A and 3E[6]. However, it is not an outlier, even controlling for democracy, with respect to collection of total direct taxes and, more specifically, individual income taxes.

Figure 3A: Tax to GDP (Per cent) and per-capita GDP controlling for democracy

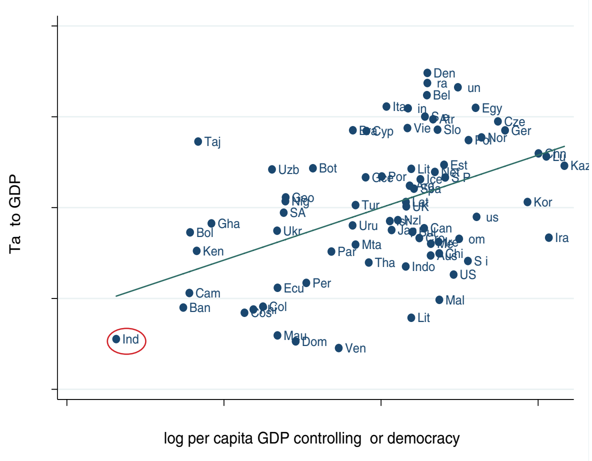


Figure 3B: Direct tax to GDP (Per cent) and per-capita GDP

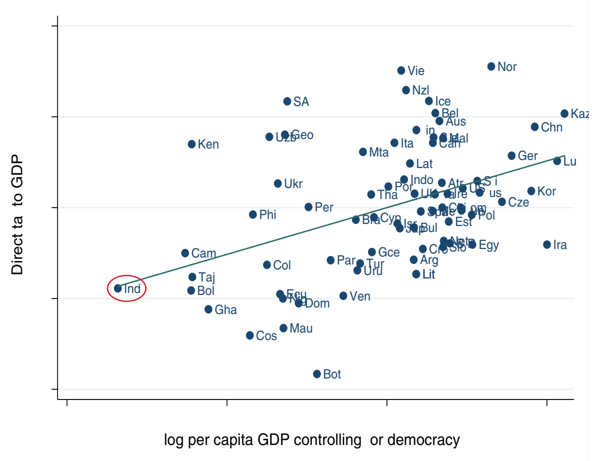


Figure 3C: Individual income tax to GDP (Per cent) and per-capita GDP

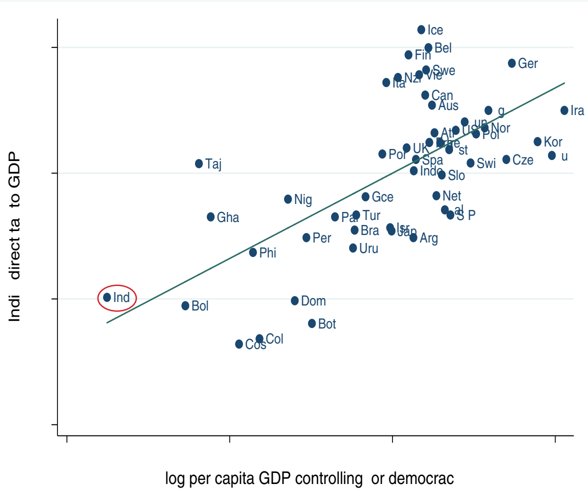
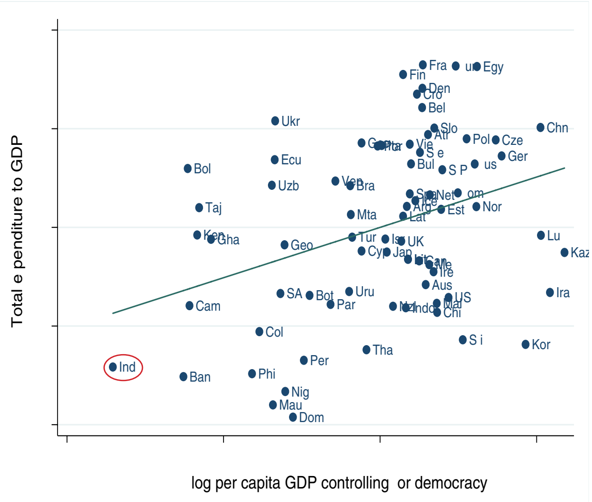


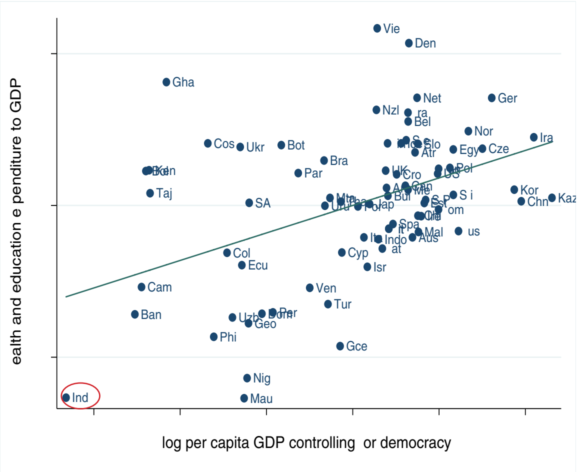
Figure 3D: Total expenditure to GDP (Per cent) and per-capita GDP



5 We construct an index of democracy using the PolityIV database for each of these countries that takes the average democracy scores of these countries for a period of 40 years (1974-2014).

6 These charts are partial correlation plots (referred to as 'avplots' in STATA) between the dependant and the independent variable controlling for a third independent variable.

Figure 3E: Health and education expenditure to GDP (Per cent) and per-capita GDP



7.20 To give a sense of the magnitudes, controlling for both the level of economic development and democracy, India's overall tax to GDP is about 5.4 percentage points less than that of comparable countries. India spends on average about 3.4 percentage points less vis-à-vis comparable countries on health and education (Table 2).

Table 2: How different is India?

Variable	Magnitude	t-statistic
1. Tax to GDP ratio	-5.41	-2.24
2. Direct taxes as share of GDP	-0.15	-0.11
3. Individual income tax as share of GDP	1.26	0.96
4. Total expenditure as share of GDP	-6.24	-1.75
5. Health & education expenditure as share of GDP	-3.44	-3.33

7.21 These stark findings can nevertheless be seen as an indictment of the Indian development experience since India has been a democracy for nearly 70 years and therefore should be judged by the standard of other democracies. By that standard India under-performs.

7.22 But this too is an inappropriate standard. In most of today's advanced democracies the big increases in fiscal capacity have been in response to wars (World Wars I and II), affirming the insight of Charles Tilly that "states make wars and wars make states." They also occurred in response to extreme crises (such as the Great Depression of the 1930s) which led to a sharp expansion of the welfare state and the need to finance it. Independent India has not experienced shocks of such large magnitudes that created pressures to enhance state capacity.

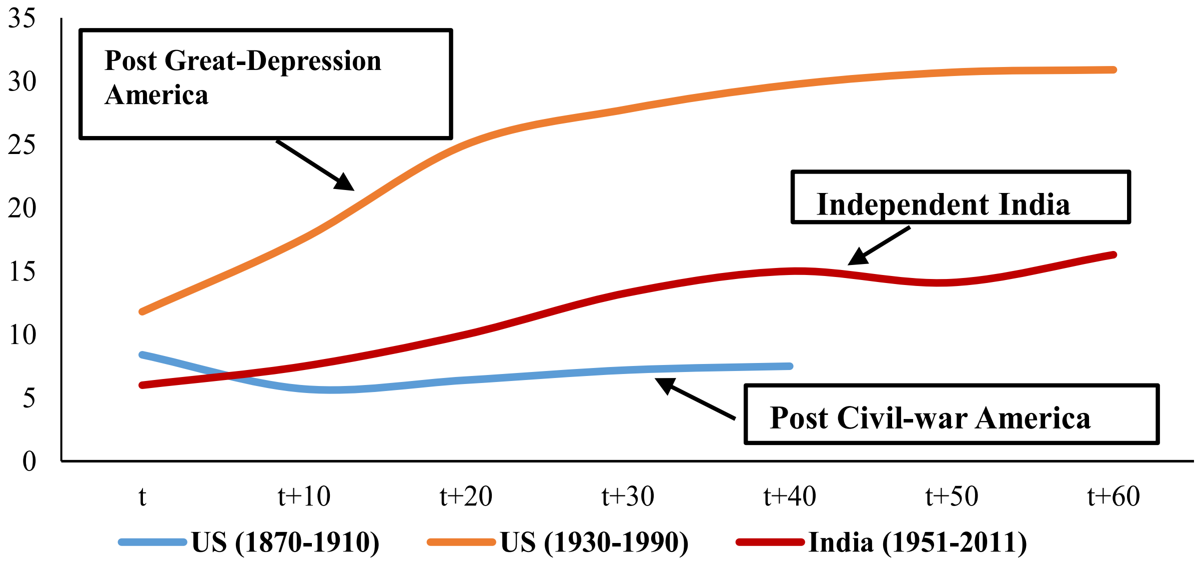
7.23 Figure 4 compares the taxation history of India vis-à-vis that of the US starting roughly from the year in which taxation picked-up in the two democracies. For the US two periods are shown – first, 1870-1910, the post-civil war period prior to the introduction of income taxation in 1913; and second, 1930-1990, after introduction of income taxation and capturing the boost to fiscal capacity brought about by the Second World War. These two periods are contrasted to taxation experience of independent India starting 1951. It is clear that even though India (middle line) has lagged behind the US in having a lower tax to GDP ratio when compared to the second period in US (1930-1990), India has done better than the US did in the initial stage (1870-1910).

7.24 Moreover, western democracies have had a much longer period of political evolution allowing them to build state capacity. This is important in assessing India's fiscal performance as highlighted by Professor Indira Rajaraman[7] .

7.25 The history of Europe and the US suggests that typically, states first provide essential services (physical security, health, education, infrastructure, etc.) *before* they take on their redistribution role. *That sequencing is not accidental.* Unless the middle class in society perceives that it derives some benefits from the state, it may be largely unwilling to finance redistribution. In other words, the

[7] Business Standard, "The Entitlement State", February, 2013.

Figure 4: Path of tax ratios-India and US (2 periods)



Source: **The World Wealth and Income Database, J. J. Wallis ('American Government Finance in the long Run: 1790-1990', JEP, 2000), and IPFS.**

legitimacy to redistribute is earned through a demonstrated record of effectiveness in delivering essential services.

7.26 A corollary is that if the state's role is predominantly redistribution, the middle class will seek - in Professor Albert Hirschman's famous terminology - *to exit from the state*. They will avoid or minimise paying taxes; they will cocoon themselves in gated communities; they will use diesel generators to obtain power; they will go to private hospitals and send their children to private education institutions. All these pathologies are evident in India. By reducing the pressure on the state, middle class exit will shrink it, eroding its legitimacy further, leading to more exit and so on. A state that prioritises or over-emphasises redistribution without providing basic public goods, risks unleashing this vicious spiral.

7.27 Therefore, any harsh judgement of India's performance must be tempered by these historical differences in the evolution of India compared with other democracies.

Number of Taxpayers: *Is India an outlier?*

7.28 Taxes and expenditures should be viewed not just from a fiscal but also an institutional perspective. It is well-known that citizenship and building the economic connection between citizens and the state happens more via direct rather than indirect taxes which do not affect taxpayers as immediately and saliently as direct taxes.[8] It appears that citizens feel the pinch of taxation most when their incomes or assets are taxed. Especially in a country like India, indirect taxes are not immediate or direct enough to be perceived by citizens as their contributions to the state. For that reason, the implementation of the GST - while highly desirable and necessary - will have a limited impact in furthering the broader objective of citizen participation, state building, and democratic accountability. As Besley and Persson (2013) show, countries with a higher share of income taxes in total tax collections tend to have more accountable governments.

7.29 This directly relates to the point noted

[8] In "The Pale King," David Foster Wallace's posthumously published 2011 novel, set in an I.R.S. office, a high-level agency official laments: "We've changed the way we think of ourselves as citizens. ... We think of ourselves now as eaters of the pie instead of as makers of the pie."

earlier, that accountability of citizens weaken if they do not pay directly for the services the state provides. This is likely to render citizens as free riders or compel them to exit thereby diluting the accountability of the state itself. Hence the number of taxpayers is a key indicator of fiscal capacity. *Does India have too few or approximately the right number of citizens paying taxes given its level of economic and political development?*

7.30 In India today, roughly 5.5 percent of earning individuals are in the tax net. This statistic gives an idea of the gap that India needs to cover to become a full tax-paying democracy. Based on recent tax data, and using the methodology in Banerjee and Piketty (2005), we estimate that about 15.5 percent of net national income excluding taxes (which is the national income accounts counterpart of the personal income accruing to households) was reported to the tax authorities as gross taxable income. In the late 1990s, this number was 8.3 percent. In other words, nearly 85 percent of the economy is outside the tax net.

7.31 Turn next to the cross-country

Figure 5a: Voting age population (million) & ratio of taxreturns to voting population (Per cent)

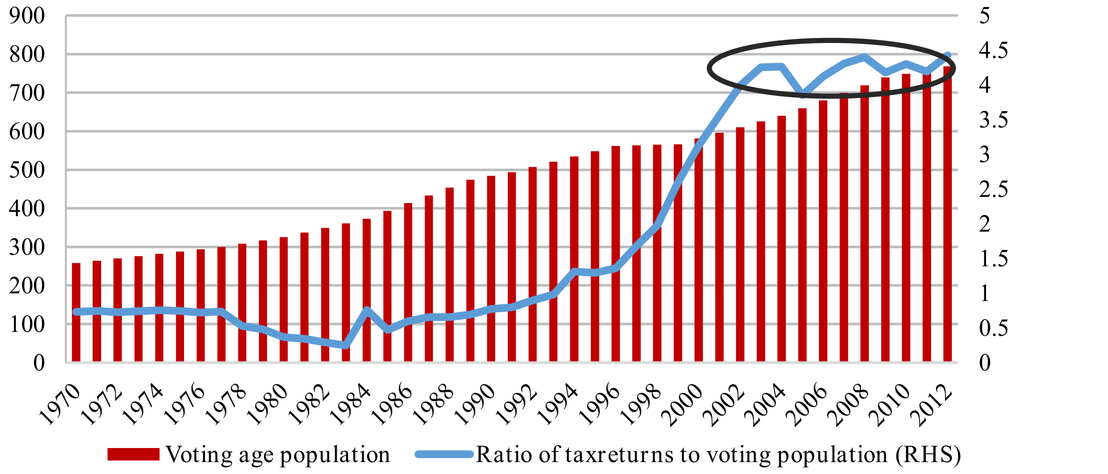
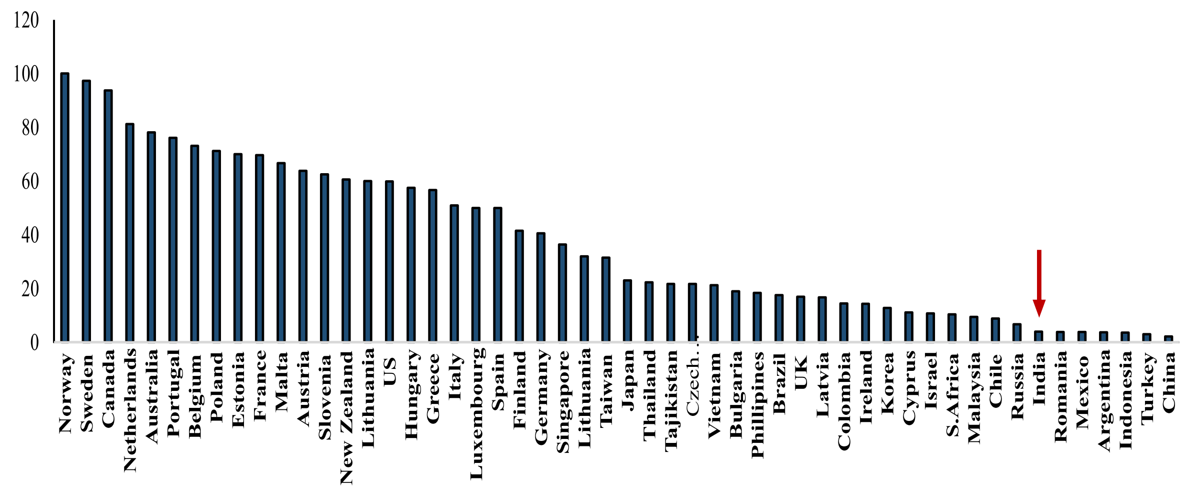


Figure 5b: Number of taxpayers to voting age population (Per cent)



Source: **Data on India's voting age population is from IDEA.**

comparisons. Here too at first blush India seems an outlier. As figures 5a and 5b show, despite the number of tax returns filed picking up from mid-1980 onwards, India currently has amongst the lowest number of taxpayers (as a ratio of voting age population).

7.32 However, a more rigorous cross-country analysis leads to interesting results. When we examine the number of taxpayers (as a ratio of voting age population) controlling for the level of economic development, India is not an outlier. It is only when we control for the level of political development (using the democracy index) does India turn out to be an outlier (Figures 6a and 6b). Controlling for the level of democracy, India's ratio of taxpayers to voting age population is significantly less than that of comparable countries. This implies that while at present about 4 per cent of citizens who vote pay taxes, the percentage should be about 23.

7.33 Piketty and Qian (2009)[9] compare China and India to argue that Chinese success in bringing more citizens into the individual income tax net owes to setting a reasonable threshold for paying taxes and not changing it unduly. In contrast, in India, exemption thresholds for income taxes have been consistently raised. In fact, as Figure 7 shows, thresholds have been raised much more rapidly than underlying income growth so that today, the wedge between average income and the threshold has widened.

7.34 We can calculate in some sense the "missing taxpayers" in India—not those who are evading taxes altogether or under-reporting taxes but those who have legitimately gone under the tax radar due to "generous" government policy. We ask how many taxpayers there would have been in 2012-13 if the threshold had been maintained at Rs. 1,50,000 (the threshold limit in 2008-09). We find that there would have been an additional 1.65 crore units incorporated within the taxation system (an addition of about 39.5 percent) and tax revenues would have been about ₹31,500 crores greater. India's tax-GDP would have increased by 0.32 per cent just by not having raised the threshold so generously.

Figure 6a: Taxpayers to voting age population and per-capita GDP

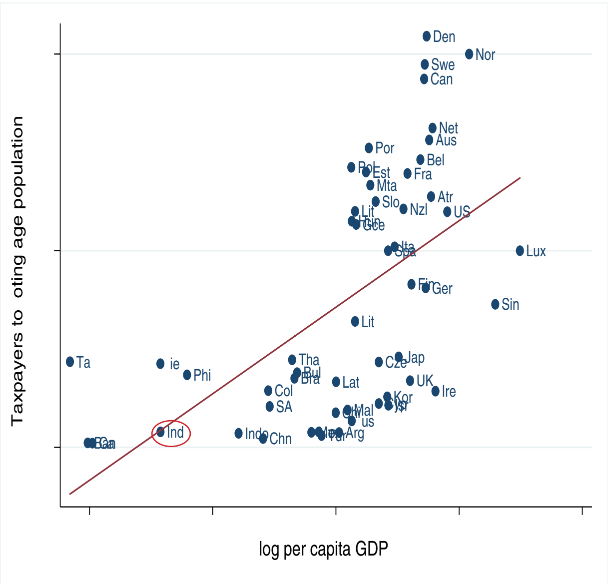
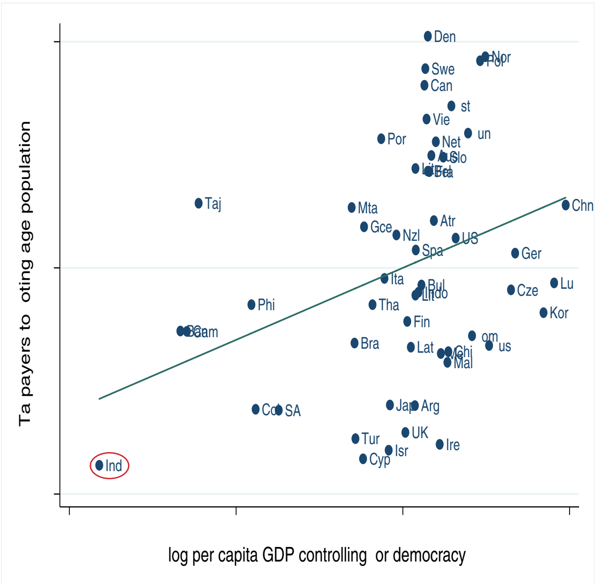
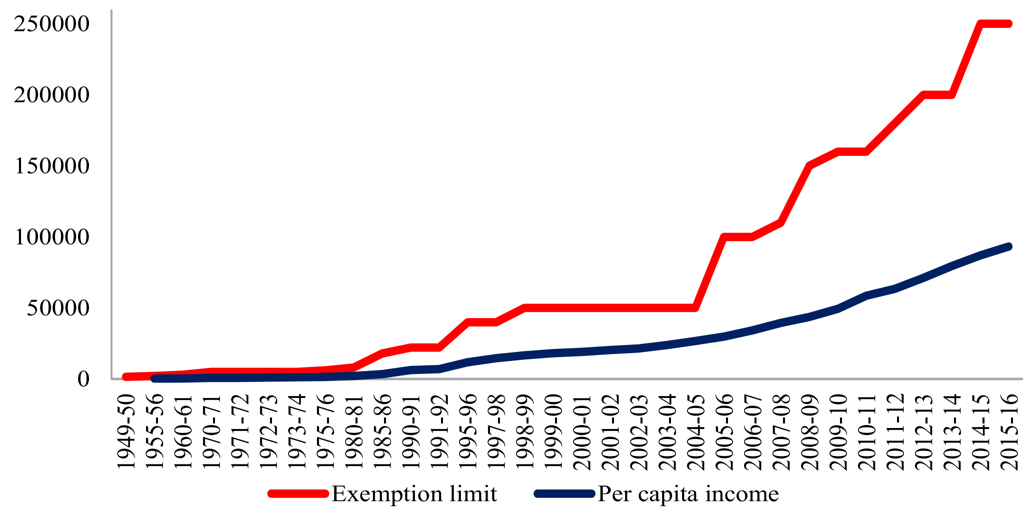


Figure 6b: Taxpayers to voting age population and per-capita GDP controlling for democracy



[9] Piketty, Thomas, & Nancy Qian, 2009. "Income Inequality and Progressive Income Taxation in China and India, 1986-2015." *American Economic Journal: Applied Economics*, 1(2): 53-63.

Figure 7: Exemption limit and per-capita income (Rs, current prices)

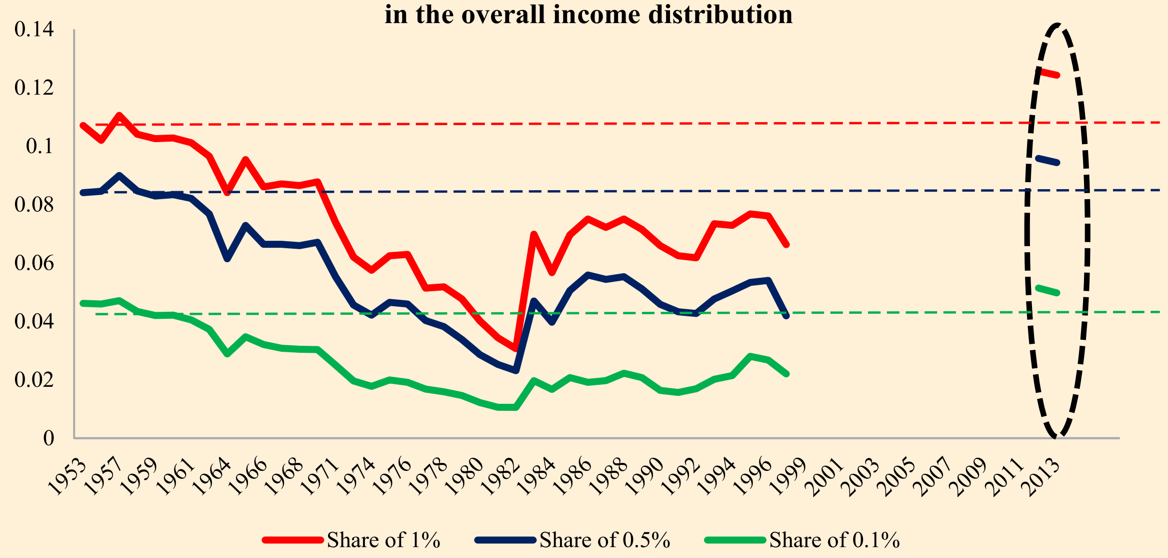


Box 7.1: Indian Top Personal Income Distribution

Recent work by Piketty[10] (2014) and his co-authors has raised a number of questions related to personal income distribution at the very top of the income spectrum. We are now able to provide some tentative estimates based on detailed tax data for the years 2012-13 and 2013-14 and compare them with the estimates produced by Piketty and Banerjee (2005)[11]. The methodology for computing these estimates is far from watertight and should hence be viewed with some circumspection.

We reproduce the methodology in Piketty and Banerjee (2005) and compare our estimates with theirs. The results are shown in Figure-2 for the share of the top 1 percent, top 0.5 percent and the top 0.1 per cent of the people in the overall income distribution. We do not have data for the intervening years (between 1999-2000 and 2011-12) and hence the blank spaces in the figure below.

Figure: Share of Top 1%, Top 0.5 % and Top 0.1% of people in the overall income distribution



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[10] Piketty, Thomas, 2014, "Capital in the Twenty-first Century", Harvard University Press.

[11] Banerjee, A., & T. Piketty, 2005, "Top Indian Incomes, 1922-2000", *World Bank Economic Review*. We have updated Piketty & Banerjee (2005) share of P99, P99.5, P99.9 & P99.99 using NSS net national income data at factor cost & population from same source. Thus our estimates may appear to be a little different from theirs even though we replicate their methodology.

As in many countries, there has been a growing concentration of income at the top: in 2013-14, these three groups accounted for 12.4 per cent, 9.4 per cent and 5.0 per cent[1] of the income of the entire Indian economy respectively. These numbers are close to comparable shares in the United Kingdom and a below those in the United States. But the change between the late 1990s and today in income shares is greater than the change in the UK and similar to that in the US (Piketty [2014]).

Table: Top Personal Income Distribution

	Share of top 1 percent		Share of top 0.5 percent		Share of top 0.1 percent	
	1998	2012	1998	2012	1998	2012
USA	15.2	18.9	11.6	14.7	6.2	8.4
UK	12.5	12.7	9.1	9.2	4.4	4.6
India	9.0	12.6	7.0	9.6	3.6	5.1

It seems that the fast growing years in the 2000s were in fact associated with rising inequality at the very top end of the Indian income distribution.

1. The presumption in these calculations, as in Banerjee and Piketty (2005), is that what has been measured is the actual income share of the rich. This may not be true given time-varying incidences of tax evasion which would imply that our estimates of income shares are prone to measurement error. Banerjee and Piketty (2005), and Atkinson, Piketty and Saez ("*Top Incomes in the Long Run of History*", Journal of Economic Literature, 2011) address the impacts of evasion on the income shares using wage data which is less prone to evasion. Such data however shows evasion to be insufficient in fully accounting for the rise in income shares over the years. In our updated data, we do not have wage data and therefore rely on earlier studies to address the issue of evasion.

Conclusion: Moving To A Better Equilibrium On Taxation And Spending

7.35 All that said, the foregoing analysis merely assessed the adequacy of India's tax base at a point in time, the present. Even today, it is evident from the analysis in this chapter that India has not fully translated its democratic vigour into commensurately strong fiscal capacity. In the long run, if India is to stay "on the line" as its per capita income grows, it will need to build fiscal capacity. One low hanging fruit that we suggested was to refrain from raising exemption thresholds and allowing natural growth in income to increase the number of taxpayers. In some ways, this would be reform through inaction.

7.36 Beyond that, what might be done, given that building fiscal capacity is essentially about creating legitimacy in the state? Four points seem relevant here.

7.37 First, the government's spending priorities must include essential services that all citizens consume: public infrastructure, law and order, less pollution and congestion, etc.

7.38 Second, reducing corruption—fiendishly difficult as it is—must be a high priority not just because of its economic costs but also because it undermines legitimacy. The more citizens believe that public resources are not wasted, the greater their willingness to pay taxes. In that sense, the government's efforts to improve transparency through transparent and efficient auctioning of public assets will help create legitimacy, and over time strengthen fiscal capacity.

7.39 Third, subsidies to the well-off (amounting to about ₹1 lakh crore as documented in Chapter 6) need to be scaled back. Regaining legitimacy must be as much about phasing down these bounties as it is about better targeting of subsidies for the poor. Similarly, the tax exemptions Raj which often amount to redistribution towards the richer private sector will also need to be reviewed and phased out. And, reasonable taxation of the better-off, regardless of where they get their income from—industry, services, real estate, or agriculture--will also help build legitimacy.

7.40 Fourth, property taxation needs to be developed. The very fact that systematic data on property taxation across the country is so sparse is a measure of just how little attention has been given to this tax. Property taxes are especially desirable because they are progressive, buoyant (at least in the Indian context), and difficult to evade, since they are imposed on a non-mobile good, which can with today's technologies, be relatively easily identified. Higher rates (with values updated periodically) can be the foundation of local government’s finances, which can thereby provide local public goods and strengthen democratic accountability and more effective decentralisation. Higher property tax rates would also put sand in the wheels of property speculation. Smart cities require smart public finance and a sound property taxation regime is vital to India's urban future.