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Expenditure-Based Income Taxation and Integration of Direct and Indirect Taxation in India

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Abstract
India's taxation landscape continues to be characterized by a pronounced disconnect between direct tax declarations and real economic activity. While the Goods and Services Tax (GST) provides a comprehensive digital trail of consumption, the income tax system continues to rely primarily on self-declared income, resulting in persistent underreporting, inequity, and administrative inefficiency.
This paper presents a novel expenditure-based model for computing income tax, grounded in the macroeconomic identity that income equals consumption plus savings. Unlike the traditional Indian income tax framework, which relies heavily on self-reported income, this model reconstructs taxable income by analysing indirect taxes paid on consumption and combining them with documented savings and investments. The model aims to integrate the direct tax structure with indirect taxes—primarily the Goods and Services Tax (GST). The indirect taxes serve as a verifiable proxy for personal expenditure, while savings reflect the unspent portion of income. A key feature of the model is an offset mechanism that allows taxpayers to deduct indirect taxes paid from their final income tax liability to prevent double taxation and promote fairness. The study outlines the conceptual underpinnings, computational pathways, administrative requirements, and policy implications of the model. It also addresses special considerations including cash transactions, cross-border spending, financed purchases, property investments, securities, insurance, and foreign assets. Additionally, it discusses data integration, compliance safeguards, and a phased implementation roadmap. Through this framework, the paper argues for an equitable, transparent, and technologically advanced tax system capable of broadening the taxpayer base, reducing evasion, and enhancing revenue efficiency in India.

Keywords
Expenditure-based taxation; GST; income reconstruction; savings and investments; indirect tax credit; tax evasion; digital tax administration; India; public finance; tax reform.

Introduction

India's direct tax system has long suffered from chronic underreporting, with only 6–7% of the population filing income tax returns and a significant portion of declared incomes diverging from observable economic behaviour. In contrast, indirect taxes—especially after the introduction of the Goods and Services Tax (GST)—capture a substantial share of the nation's consumption activity through invoice-level reporting. GSTN, PAN integration, digital payment systems, and Project Insight have created an unprecedented, verifiable trail of taxpayer expenditure. The evidence presented in the major research project indicates that indirect tax collections reveal a much higher level of consumption than what declared incomes would justify, exposing a structural "data asymmetry problem" at the heart of India's direct tax compliance gap.
The proposed expenditure-based model offers a significant departure from traditional methods by utilising indirect tax trails as the foundation for income estimation. The logic is grounded in the macroeconomic identity that income must ultimately be consumed or saved. Therefore, if personal consumption can be reconstructed accurately through indirect tax data—primarily GST—then income becomes a measurable function of verifiable data rather than self-declared figures. When combined with digitised reporting of savings and investments by financial institutions, this approach provides a comprehensive and objective method to approximate individual income more reliably. The model aims to expand the tax base, reduce manipulation of taxable income, and strengthen the integration between India's direct and indirect tax systems. The direct and indirect tax systems become mutually reinforcing: indirect taxes provide the input to

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estimate income, and direct taxes acknowledge the indirect-tax burden by permitting an offset. This integrated approach responds to longstanding inequities, broadens the tax base, reduces opportunities for evasion, and aligns tax liability with actual economic capacity.

Discussion

1. CONCEPTUAL FOUNDATION

The model adopts the national income identity—Income = Consumption + Savings—at the micro level. By reconstructing consumption from indirect tax flows and adding net savings, it derives an estimate of total income that is independent of a taxpayer's self-disclosure. The framework mirrors the expenditure method of GDP calculation and aligns with the Haig–Simons income concept, which conceives income as consumed resources plus additions to net worth. While this approach has traditionally been infeasible due to limited data, India's GST network, digital payments infrastructure, and expanded financial reporting systems now provide the necessary foundation to implement the model.

Computation of Income Using Expenditure and Savings

The model begins by gathering GST data from invoices, digital payments, excise duties, utilities, and sector-specific transactions. These indirect taxes are reverse calculated into total expenditure by identifying applicable GST rate slabs and reconstructing the pre-tax expenditure values. For cash transactions, which lack digital trails, various mechanisms—including reverse expenditure modelling, cash declarations, sectoral multipliers, and audit-based verification—are incorporated.

Savings and investments such as bank deposits, mutual funds, property purchases, gold, securities, insurance, and foreign currency assets are treated as net additions to wealth. Their values are captured through mandatory financial reporting, PAN/Aadhaar linkage, and real-time integration with financial institutions. The total income is computed as the sum of reconstructed expenditure and savings/investments. Standard deductions under Chapter VI-A are retained, although exemptions under Section 10 are discontinued to promote a more uniform tax base.

Indirect Tax Offset Mechanism

A key innovation of the model is the ability of taxpayers to deduct indirect taxes paid from their final income tax liability. This prevents double taxation on the same income and incentivizes individuals to record purchases accurately, thereby increasing indirect tax compliance. In cases where indirect taxes exceed the income tax liability, the model provides for automatic refunds, ensuring equity and safeguarding low-income or high-expenditure households.

Treatment of Special Scenarios

The model incorporates provisions for financed assets such as vehicles or property, where expenditure is recognised based on actual EMI payments rather than the full purchase amount. It also outlines extensive rules for handling securities transactions, mutual funds, insurance premiums, bonds, certificates of deposit, cryptocurrencies, precious metals, and foreign assets. Capital gains are treated using indexed cost principles, and cross-border expenditures are tracked through RBI, customs, financial institutions, and digital payment ecosystems. Clubbing provisions apply to spouses and minor children, requiring authenticated documentation. Non-GST items such as petroleum products, alcohol, and electricity are accounted for through supplementary indirect tax tracking.

Need for the Expenditure-Based Model

India's high levels of income inequality, widespread tax evasion, informal-sector dominance, and regressive effective tax rates create strong justification for this model. The fundamental gap between consumption and declared income—particularly among high-wealth individuals—suggests that traditional tax computation frameworks fail to capture true taxable capacity. In contrast, this model relies on verifiable economic activity rather than self-reporting, reducing opportunities for evasion. Additionally, by allowing indirect tax credits and simplifying income measurement, the model may encourage formalisation, strengthen digital payment adoption, and enhance progressive taxation.

Administrative Infrastructure and Data Integration

The proposed system relies on robust data integration among the GST Network (GSTN), income tax authorities, banks, mutual fund companies, insurance providers, and other financial intermediaries. A

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Centralized Tax Analytics Platform (CTAP) is recommended to ensure real-time interoperability, risk scoring using AI-based methods, and anomaly detection. These technological components must be supported by strict privacy safeguards, minimisation principles, and secure storage protocols. The phased rollout anticipates initial pilot testing in high-spending demographics, followed by national scale adoption.

Challenges and Mitigation Strategies

Potential challenges include privacy concerns, administrative complexity, system downtime, cybersecurity threats, cash-intensive markets, revenue volatility, and behavioural responses that may reduce reported spending. Mitigation strategies proposed in the model include incentivizing digital payments, enhancing third-party reporting, strengthening system resilience through cloud-based scalability, and maintaining clear compliance pathways. While the model may initially face resistance, strategic implementation and communication can facilitate adoption and long-term reform.

2. INTEGRATION OF DIRECT AND INDIRECT TAX

A persistent structural weakness of India's tax architecture has been the institutional and informational separation between direct and indirect tax systems. While both systems draw from the same underlying economic activity, they have historically operated in silos—direct taxes relying primarily on self-declared income and selective third-party reporting, and indirect taxes capturing transactional data without systematic feedback into income assessment. This disconnect has resulted in significant informational asymmetry, enabling taxpayers to simultaneously exhibit high consumption behaviour while declaring disproportionately low taxable income.

The proposed expenditure-based income tax model explicitly addresses this structural fragmentation by **institutionalising an integrated direct–indirect tax mechanism**, wherein indirect tax data becomes a foundational input for direct tax computation, and direct tax liability formally recognises the burden of indirect taxation already borne by the taxpayer. This bidirectional integration transforms the relationship between GST and income tax from a parallel coexistence into a **mutually reinforcing fiscal framework**.

Indirect Taxes as an Input to Direct Tax Computation

Under the proposed model, indirect taxes—primarily GST—serve as a **verifiable proxy for individual consumption expenditure**. Since GST is levied at the point of transaction and captured through invoice-level digital reporting, it offers a high degree of accuracy, coverage, and temporal granularity. By reverse-calculating GST paid across applicable rate slabs, the model reconstructs pre-tax expenditure at the individual level. This reconstructed consumption becomes a core determinant of taxable income when combined with documented savings and investments.

This approach represents a paradigm shift in income tax administration. Rather than using indirect tax data merely for post-facto scrutiny or risk profiling, the model embeds GST information directly into the **income estimation process itself**. As a result, indirect taxes no longer function solely as revenue instruments but also as **information instruments** that enhance the accuracy and integrity of direct tax assessment.

Direct Tax Recognition of Indirect Tax Burden

A defining feature of the integrated framework is the **statutory recognition of indirect taxes paid** through an offset mechanism against income tax liability. Traditional tax systems often subject the same income to multiple layers of taxation without explicit acknowledgement of cumulative tax incidence. In contrast, the proposed model permits taxpayers to deduct indirect taxes paid on personal consumption from their final income tax liability, thereby preventing double taxation and strengthening perceptions of fairness.

This mechanism not only enhances equity but also creates positive compliance incentives. When taxpayers are aware that GST paid will reduce their income tax burden, they are more likely to demand invoices, prefer formal transactions, and ensure accurate reporting of expenditure. Consequently, integration generates a virtuous cycle: improved indirect tax compliance strengthens expenditure data, which in turn improves income estimation and direct tax compliance.

Behavioural and Administrative Synergies

The integration of direct and indirect tax mechanisms yields significant behavioural and administrative synergies. From a behavioural perspective, the model aligns taxpayer incentives across tax regimes. Compliance with GST norms directly benefits taxpayers under the income tax system, thereby reducing

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adversarial attitudes and enhancing voluntary compliance. From an administrative standpoint, integration reduces duplication of enforcement efforts and shifts tax administration from discretionary scrutiny toward **system-generated reconciliation**.

Moreover, the integration framework allows tax authorities to identify structural inconsistencies—such as persistently high consumption coupled with low reported income—without relying on intrusive audits. Risk assessment becomes data-driven and proportional, improving efficiency and reducing compliance costs for honest taxpayers.

Institutional and Technological Integration

Operationalising this integrated framework requires seamless coordination between GSTN, income tax authorities, financial institutions, and digital payment platforms. The paper proposes a centralized analytics architecture capable of consolidating consumption, savings, and investment data while maintaining strict privacy safeguards. Such integration builds upon existing initiatives like PAN–GST linkage and Project Insight but extends them into a coherent computational framework rather than isolated compliance tools.

Importantly, the model does not seek to merge tax statutes but to **integrate information flows and fiscal logic**, preserving the legal distinctiveness of direct and indirect taxes while harmonising their functional roles.

Implications of Direct–Indirect Tax Integration

By integrating indirect tax trails into direct tax computation and acknowledging indirect tax incidence within income taxation, the proposed model advances three critical policy objectives:

(i) **equity**, by aligning tax liability with true economic capacity;
(ii) **efficiency**, by reducing evasion and administrative redundancy; and
(iii) **formalisation**, by incentivising invoice-based transactions and digital payments.

In this sense, the model repositions GST and income tax as complementary pillars of a unified fiscal system rather than independent revenue instruments. Such integration represents a foundational step toward modernising India's tax architecture in line with global best practices in data-driven taxation.

Conclusion

The expenditure-based income tax model provides a transformative approach to direct taxation in India by leveraging the country's extensive digitisation of financial and consumption activities. By reconstructing income from observable expenditure and savings, the model directly addresses longstanding challenges such as income underreporting, tax evasion, and economic informality. The built-in indirect tax deduction mechanism ensures fairness and prevents double taxation, while the model's comprehensive treatment of financial assets, cross-border transactions, and financed purchases enhances its applicability across diverse economic contexts. Although the model introduces significant administrative, technological, and policy challenges, the potential benefits—increased tax compliance, expanded tax base, reduced inequalities, and enhanced fiscal capacity—are substantial. Policymakers, therefore, must consider phased implementation, robust data safeguards, and extensive public communication to ensure a smooth transition. With careful design and execution, this expenditure-based model may serve as a cornerstone for modernising India's tax architecture and promoting a more transparent, efficient, and equitable fiscal system.

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