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Can AI Reinvent India's Tax System?

Muskan Malhotra

Abstract

Economic development is severely hampered by tax evasion, particularly in developing nations like India. Further, India's tax structure and the country's high rate of informal economic activity makes the Enforcement and compliance more difficult. The potential of artificial intelligence (AI) technologies, including machine learning, data analytics, and natural language processing, to revolutionize tax administration is examined in this study which can help in overcoming the problem of tax evasion. The potential of AI to increase transparency, automate anomaly detection, and develop effective tax compliance systems is emphasized. This article outlines the prospects and problems associated with the deployment of AI for tax governance in India, drawing on both international case studies and domestic initiatives like the Goods and Services Tax Network (GSTN) pilot programs.

Keywords

Artificial Intelligence, Tax Transparency, Tax Evasion, India, Machine Learning, GSTN, Tax Compliance

Introduction

Tax evasion undermines the social contract between the people and the government, distorts economic policy, and reduces government revenue. The informal sector in India accounts for around 40% of the country's GDP. (Kumar & Mitra, 2022), complicating the effective enforcement of tax laws. Tax evasion persists despite reforms like the Goods and Services Tax (GST) being implemented in 2017, in part due to the rigidity of existing enforcement systems and their heavy reliance on manual audit procedures. (NIPFP, 2021).

Artificial Intelligence (AI), the simulation of human intelligence via machines, offers transformative potential in tax administration by enabling automated data processing, identifying hidden patterns of tax evasion, and providing predictive insights for compliance targeting (OECD, 2020). Through an analytical examination of current applications and case studies, this study investigates how AI might improve tax transparency in India. It concludes with policy recommendations.

Literature Review

Research on the use of artificial intelligence (AI) to tax administration has become increasingly important, especially when it comes to improving tax compliance and decreasing tax evasion. The main conclusions from numerous studies are summarized in this review of the literature, underscoring the possible advantages, difficulties, and moral dilemmas of using AI in tax systems.

A foundational aspect of the literature is the exploration of AI's capabilities in processing large datasets. Bhatia and Singh (2021) emphasize that AI can analyze complex financial data to identify patterns of non-compliance that traditional methods may overlook. Their research shows that large volumes of transactional data may be efficiently processed by machine learning algorithms, resulting in more precise risk evaluations and focused audits. In a nation like India, where the informal economy makes tax compliance extremely difficult, this capacity is especially important.

Apart from data processing, AI's potential to enhance taxpayer involvement and education has drawn interest. Patel and Kumar (2022) has highlighted the significance of AI-driven chatbots and virtual assistants in providing real-time assistance to taxpayers. According to their research, by making information more easily accessible, these solutions not only improve the taxpayer's experience but also improve tax compliance. The authors contend that more voluntary tax compliance rates can result from proactive engagement with AI, especially for small and medium-sized businesses (SMEs) that do not have the funds for availing high end tax advisory services. This also aligns with findings from other studies that suggest that personalized communication can significantly improve taxpayer compliance (Baker & Smith, 2020).

As AI is often questioned to overpower humans, the ethical implications of AI in tax administration have also been a focal point in the literature. Verma and Joshi (2023) discussed the potential biases inherent in AI algorithms, specifically related to socio-economic factors. There lies apprehensions that without careful oversight, AI systems could inadvertently perpetuate existing inequalities in tax enforcement. This not only highlights the significance of transparency and accountability in AI applications, but are also expected to promote fairness and equity in tax administration. The authors advocate for the development of ethical guidelines and frameworks to govern the use of AI in public sector applications, emphasizing the importance of stakeholder engagement in the development of these regulatory guidelines.

Moreover, the literature also addresses the challenges of implementing AI in tax systems, particularly in developing countries. Choudhury and Mehta (2022) identified infrastructural bottlenecks and a dearth of skilled human resource as significant barriers to AI adoption in India. Their study emphasized that it must be one of the top priorities of government to investmen in technology and training programs to build the capacity needed for effective AI integration. This is coherent with findings from international context, where successful AI execution have often been backed by robust infrastructure and training initiatives (OECD, 2020). Few authors also suggest to start with pilot projects as a phased approach to AI integration which could help reduce risks and boost confidence among tax authorities and other stakeholders.

It is also crucial to investigate how AI can improve fraud detection systems. According to a PwC (2023) study, AI-driven data analytics can examine big datasets and spot differences in reported income and lifestyle indicators, possibly demonstrating instances of tax evasion. The study described the effectiveness of AI in processing vast amounts of transactional data, enabling tax authorities to uncover hidden patterns of non-compliance. Furthermore, According to OECD (2020) publications on the effective use of AI in several nations, data analytics has significantly increased the rate of fraud detection and total tax compliance. These results highlight how AI has the potential to revolutionize tax administration by enhancing detection systems and expediting compliance procedures.

International viewpoints offer important insights into how AI is being used in tax administration. The United States Internal Revenue Service (IRS) has adopted AI technologies to enhance its fraud detection capabilities. The IRS (2022) claims that machine learning models have been crucial in spotting fraudulent tax returns, which has improved audit effectiveness and revenue recovery. Similar to this, the Australian Taxation Office (ATO) has significantly increased tax compliance by using AI to examine data from various sources. (ATO, 2021). These case studies underscore the potential of AI to transform tax administration by improving detection mechanisms and streamlining compliance processes.

The literature also highlights the importance of collaboration between tax authorities and technology providers. Sharma et al. (2023) advocate for public-private partnerships to facilitate the development and deployment of AI solutions in tax administration. They contend that such partnerships can leverage the expertise of technology firms while ensuring that solutions are customized to the specific requirements of tax authorities. This collaborative approach can enhance the effectiveness of AI applications and foster innovation in tax compliance strategies.

Despite the promising potential of AI, several challenges hinder its effective implementation in tax administration. NASSCOM (2023) states the need for robust IT infrastructure and skilled human resource as crucial factors for successful AI integration. Public sector capacity building and continuous training are necessary to adapt to emerging AI technologies. Furthermore, Raj and Singh (2023) highlight the resistance to change among tax officials and taxpayers, suggesting that widespread awareness campaigns and stakeholder involvement are crucial for fostering acceptance of AI-enhanced tax procedures.

The Landscape of Tax Transparency and Evasion in India

India’s tax system consists of direct and indirect taxes, with GST streamlining indirect taxation into a unified framework (Central Board of Indirect Taxes and Customs [CBIC], 2023). However, high levels of underreporting, cash-based transactions, and complex compliance requirements have hindered transparency (KPMG, 2022).

Significant tax revenue leakage from tax evasion and avoidance was highlighted in a 2021 research by the National Institute of Public Finance and Policy (NIPFP), which assessed India's tax-to-GDP ratio at about 11.7%, below the OECD average of 33.8%. Efforts to address this include digitization initiatives like the GSTN portal and electronic invoicing; yet, manual processes and human adjudication remain resource-intensive and prone to inefficiencies.

AI Technologies in Tax Administration

1. Data Analytics and Anomaly Detection

Processing large amounts of transactional and third-party data to find irregularities suggestive of tax evasion is made possible by AI-powered data analytics. (PwC, 2023). Revenue inconsistencies occur, for instance, when taxpayer-reported incomes do not match asset ownership or banking transactions.

"AI models leveraging big data can flag suspicious transactions in real-time, allowing tax officials to prioritize investigations." (OECD, 2020, p. 82)

In a vast and diverse economy like India, artificial intelligence (AI) improves transparency and lessens information asymmetry by integrating multiple data sources.

2. Machine Learning for Predictive Risk Modeling

To predict evasion risks, machine learning (ML) algorithms create prediction models using taxpayer profiles and past audit outcomes. (Kiran & Rao, 2023). These models improve over time through supervised learning, adapting to evolving tax evasion techniques.

Automation of routine compliance checks using AI enables tax authorities to optimize resource allocation, focusing scrutiny on high-risk taxpayers (Lin & Chen, 2022). Furthermore, unsupervised learning facilitates the detection of novel evasion schemes undetectable by predefined rules.

3. Natural Language Processing to Analyze Unstructured Data

Natural Language Processing (NLP) enables the analysis of textual data—news media, social networks, judicial rulings—to detect tax evasion signals (Singh, 2023). Real-time online monitoring can be used by tax authorities to find new cases of tax fraud or compliance issues.

Additionally, by answering questions and offering clear information, chatbots with NLP capabilities enhance taxpayer engagement and increase voluntary compliance.

Case Studies Demonstrating AI Application in Tax Systems

1. Indian Context: Goods and Services Tax Network (GSTN)

Leading India's digital tax infrastructure, the GSTN is creating artificial intelligence (AI) solutions for fraud prevention and transactional analytics. In order to detect questionable tax credits, GSTN introduced an AI-powered risk management system in 2021 that examines e-way bill data in conjunction with GST returns (GSTN Annual Report, 2022). According to preliminary findings, audit efficiency increased by 17%, and significant quantities of tax evasion were recovered.

In order to detect fraudulent input tax credit claims, a different pilot project used machine learning algorithms to examine differences between reported inputs and business-to-business invoices (CBIC, 2023).

2. International Case: United States Internal Revenue Service (IRS)

AI and data analytics have long been used by the IRS to enhance fraud detection. To forecast the possibility of evasion, its fraud detection system uses machine learning models that have been trained on a large amount of taxpayer data (IRS, 2022). The yield has increased and the burden on taxpayers has decreased as a result of this focused audit approach.

By examining irregularities in tax return trends, the IRS expanded its systems in 2020 with AI-driven identity theft detection, which reduced false refund claims (IRS, 2022).

3. Australia Taxation Office's (ATO) AI-driven Compliance

To assess compliance risk, the ATO uses AI to examine data from taxpayers, banks, and government organizations. Advanced frauds involving offshore accounts or asset concealment are detected by machine learning models (ATO, 2021). An estimated A$1 billion in taxes are reclaimed each year as a result of improved automation (ATO, 2021).

4. The United Kingdom's HM Revenue and Customs (HMRC)

HMRC uses social media surveillance and natural language processing to identify new patterns of tax evasion. In order to improve compliance, the authority also uses chatbots with AI capabilities to help taxpayers comprehend complicated tax laws (HMRC, 2023). It also demonstrated that demographics targeted by AI-powered communication tools saw a 10% increase in voluntary compliance.

Challenges and Considerations in AI Integration

Data Privacy and Security

Access to vast amounts of transactional and personal data is necessary for AI to function. To preserve citizens' privacy, it is crucial to make sure that India's changing data protection laws—such as the proposed Personal Data Protection Bill—are followed. (Sharma & Gupta, 2023).

Infrastructure and Capacity Building

Sophisticated computing resources, a strong IT infrastructure, and knowledgeable staff are necessary for the successful deployment of AI. To adjust to new AI technologies, the public sector must increase its capability and provide ongoing training. (NASSCOM, 2023).

Ethical and Legal Frameworks

To preserve public confidence and avoid algorithmic biases, it is imperative to establish explicit regulations for AI openness, accountability, and fairness. (Kumar & Das, 2023).

Public Acceptance and Change Management

Due to their inexperience with AI tools, tax officials and taxpayers oppose widespread implementation; for this reason, intensive awareness efforts and stakeholder involvement are essential. (Raj & Singh, 2023).

6. Policy Recommendations

- Implement a gradual approach to AI integration strategy in tax administration with pilot testing and continuous assessment.
- Invest in training tax officials in AI and data science to gain institutional expertise.
- Create a legal framework regulating the use of AI in tax systems while emphasizing transparency, privacy protection, and anti-discrimination.
- Encourage public awareness initiatives to increase trust and voluntary collaboration with AI-enhanced tax procedures.
- Collaborate with international tax administrations to exchange AI insights and fraud detection strategies.

Conclusion

In India, artificial intelligence has the revolutionary potential to significantly lower tax evasion and improve tax transparency. Advanced data analytics, machine learning, and natural language processing give tax authorities unprecedented powers to identify and stop fraud, maximize compliance initiatives, and foster taxpayer trust. Despite obstacles pertaining to infrastructure, privacy, and change management, India's tax system can be set up for future resilience and efficiency with a well-thought-out plan that combines technical advancement with legislative protections. Therefore, adopting AI is both necessary and an excellent opportunity to protect India's financial stability and advance fair economic development.

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