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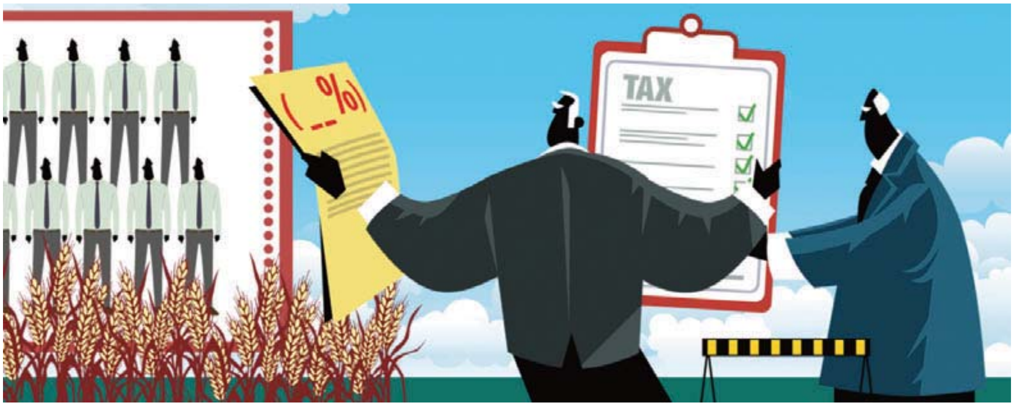


# Tax reform dilemmas

## For a fairer, more inclusive tax system, taxing agriculture and adjusting exemptions are essential

Discussions on enhancing economic growth in the country, as well as those on fiscal sustainability, zero-in on the need to raise the tax-to-gross domestic product (GDP) ratio for India. This is based on the premise that governments need to — and can— play a larger role for the country to achieve its aspirational goals. Reduction in subsidies and the rationalisation of expenditures, too, find mention, but the political economy challenges in undertaking these changes are well recognised.

Two important tax bases to examine are: Personal income and land and property. Two contentious issues to consider in taxation of personal income are — taxation of agricultural income and effective exemptions under personal income tax. There is a need to re-examine the taxation paradigm in both these cases to effectively expand the tax base.

Consider the taxation of agricultural income. The constitutional assignment of taxation places the responsibility for taxing agricultural income in the hands of state governments. Over the years, states have not been able or willing to tax this component of their base. Arguments for not taxing agriculture can be classified into two broad categories: First, the average size of holding and, therefore, average incomes generated in the sector are small, and hence should not be subject to the fiscal and compliance cost of taxation. Second, agriculture is considered a difficult sector to tax, with limited returns for the administrative effort required.

A closer examination of these arguments reveals a few fallacies. The existing income tax regime, as it applies to non-agricultural income, includes an exemption threshold. For farmers with income below the threshold — the small farmers — there would be no liability of tax. Given the voluntary nature of tax-return filing, there is no compliance cost either. For those with annual income above the exemption threshold, it is only fair that they be treated on a par with other tax-paying sectors in the country. Further, exemption in agriculture can create opportunities for evasion in other sectors, where incomes can be misrepresented as agricultural income. It should be mentioned that bringing agricultural income under taxation would also contribute to expanding the number of taxpayers in the country, making the income tax regime more representative of the nation's citizens.

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This reform however, might be difficult to operationalise — an agreement between the Centre and the states could be discussed. States could choose to either collect the revenues themselves or arrive at an arrangement with the central administration to collect the revenues and transfer them to the states. This could be a useful tool to expand the tax base and the taxation autonomy of the states.

Turning to the other contentious issue — effective exemption under personal income tax. The income tax regime for non-corporate taxpayers includes an exemption threshold. Individuals with incomes less than the threshold are not liable to pay tax. The exemption threshold in India has been periodically raised. In addition, the government chooses to provide a rebate to people in the lowest tax slab, effectively raising the exemption threshold and thereby reducing the number of potential taxpayers in the country.

Taking a few selective years, the ratio of effective exemption threshold as a percentage of per capita income has remained between 200 and 300 per cent. For financial year (FY) 2000-01, it was 238 per cent. It increased to 335 per cent in 2008-09, dropped to 251 per cent in 2015-16, and in 2023-24, it stands at 236 per cent. Assuming an 8.2 per cent growth in per capita income, the ratio for 2024-25 would be 305 per cent. These ratios indicate that the proportion of individuals potentially liable for tax remains low.

The only way to reduce the ratio of exemption threshold to per capita income is by keeping the exemption levels inclusive of rebate unchanged for the foreseeable future. The challenge however, is to convince the "tax paying" citizens that the system remains fair. The small number of taxpaying citizens — 1-2 per cent according to data presented in Parliament —f eel aggrieved by the diminishing real value of exemptions over the years. Balancing these alternative concerns drives some of the decisions regarding income tax today. Incorporating an inflation adjustment for exemption threshold could reduce these pressures.

Apart from the need to raise additional taxes, increasing the number of taxpayers would make the tax regime fairer, both in perception and in reality. As a result, the attitude towards tax payment could receive a nudge in the right direction.

Major taxes on property include property tax collected by local bodies, applicable on ownership and use of land and buildings, as well as stamp duty and registration fees on transactions involving sale and purchase of land and building. Digitalisation of land records is a very useful step towards bringing on record all potential taxpayers. To make these taxes a buoyant source of revenue, the corresponding tax structure needs to be understood. Both property tax and circle rates for stamp duties are usually fixed in nominal terms. Changes in property prices or rentals, therefore, do not get captured unless these are revised regularly. However, such changes meet with clear resistance. Perceptions of inadequate civic services make increases in property tax seem unacceptable. Institutionalising inflation correction could be one way to move away from negotiated arrangements for rate increases. In addition to the above, there is a need to revisit land revenue as a source of revenue. Barely five states collect more than 2 per cent of own tax revenue through land revenue.

High density of population in urban and peri-urban areas, along with high dependence on agriculture for livelihood, has made reform in land-related issues highly contentious. The reallocation of land use from agriculture to other uses is constrained by the high dependence on agriculture. Changes in taxation regimes alone may not be enough to alter the structure of the economy, which is crucial for generating sustainable revenues to meet developmental needs of people. Any proposed reforms, therefore, need to be analysed from this perspective as well.

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