Tax revamp: Incentives vs broader base

The govt aims to make the new regime more attractive, but this raises questions about long-term revenue stability

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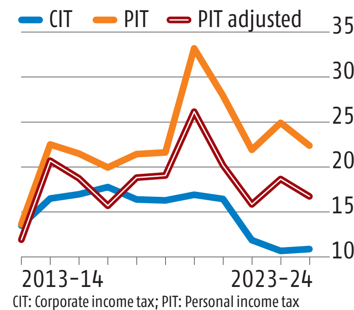

CIT: Corporate income tax; PIT: Personal income tax

The reform agenda in taxation — both for income taxes and indirect taxes — has advocated for a broad-based regime with low tax rates. Through this reform process, the income tax structure in India witnessed a significant reduction in the number of slabs, stabilising at three by the late 1990s. Another critical element of this agenda was to reduce the extent of incentives built into the regime. The introduction of sunset clauses for some major incentive regimes was a step in this direction. More recently, the government has attempted another push in this direction by offering a lower rate regime with no exemptions and incentives, available to both corporations and individuals.

In order to bring in an element of transparency and to support discussions on the merits of various exemptions, the Government of India has been publishing a revenue foregone statement since the 2006-07 Budget. These documents provide some interesting insights into the evolution of incentive regimes and taxpayer decision-making.

At the aggregate, the ratio of revenue foregone to total revenue collected has declined for corporate tax, especially in the last three years for which data is available. Between 2016-17 and 2020-21, the ratio remained stable, and, thereafter, there is a decline. This is also the period when the alternative tax regime kicked in, under which businesses could opt for a lower rate regime with no exemptions. These trends suggest that considerable progress has been made in reigning in exemptions and concessions within the tax regime — a commendable achievement.

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In terms of the choice of regime among corporate taxpayers, information is currently available only till 2022-23 and suggests that 41 per cent of the total income reported is under the old regime, modestly lower than 43 per cent reported in 2021-22. If the commitment to transition to a no-exemption regime is sacrosanct, there is still some way to go.

Personal income tax (PIT) is a little more complex. During the entire period, the ratio for PIT is higher than that for corporate income tax (CIT). Given that PIT revenue collections have exceeded revenue from CIT in recent years, higher ratios suggest that the role of incentives remains significant. In terms of trends, the ratio increases sharply in 2019-20 before declining. Since 2019-20 was the year of the Covid-19 pandemic and the lockdown, revenue collection growth was moderated, and incentives were provided to support citizens. The ratio, however, remains above 20 per cent even in 2023-24.

The composition of revenue foregone for individuals throws up some interesting trends. First, section 80C remains the largest contributor to revenue foregone, though the share of these savings incentives has declined from 82 per cent in 2013-14 to 52 per cent in 2022-23. Apart from contributions to pension schemes and medical insurance, another important component is the rebates under section 87A. These are rebates given to taxpayers in the lower tax brackets to reduce effective liability. These concessions can be viewed as an alternative to raising the exemption threshold. Excluding these from the revenue foregone, the ratio drops considerably, yet remains above 15 per cent. It should, however, be kept in mind that the lower rates of tax built into the new regime under section 115BAC are not factored into the reporting of revenue foregone.

Should we view incentives in personal income tax in the same light as those for corporate tax? Should reforms focus on reducing the incentives available or the incentives availed of? There are two ways to imagine such a transition. One, to reduce and phase out these incentives over time. This option would expand the tax base and keep existing taxpayers within the tax net. The other option is to make the alternative regime more attractive by increasing the implied tax benefit. This would reduce the number of taxpayers in the regime and at the same time reduce the tax liability for most taxpayers.

The Union Budget 2025-26 chose the latter approach. It introduced a significant change in the income tax regime for individuals with changes in the rate slabs as well as a sharp increase in the effective exemption threshold from ₹7 lakh to ₹12 lakh. Individuals with incomes less than ₹12 lakh can now choose the new tax regime and not be liable for any taxes. Further, even for taxpayers with income above the ₹12 lakh threshold, the regime offers lower tax rates in comparison to the old regime. For a broad range of taxpayers who are not availing of large deductions under the old regime through housing and savings provisions, the new regime might prove more attractive.

The question that remains, however, is how these changes can be used to construct a more robust income-tax regime in the country. The need to bring in more people in the tax regime remains an important concern for ensuring long-term stability in revenue collections. Can we phase out the "old regime" at some point in time? If the income tax regime is not broad-based, the pressure to "support the middle class" will remain.

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