Reduce high incidence of direct taxation to reap benefit of rationalized tax structure

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An efficient taxation system is an instrument of social and economic engineering for any economy due to its significant contribution to the national exchequer and overall development of different sectors of the economy. Therefore, the system of direct taxation has a major impact on economic policies, creation of savings, trend of investments and fiscal health of the economy.

Our taxation system has undergone reforms over the years with rationalisation of tax rates, simplification of tax laws, better compliance mechanisms, ease of tax payment and improved enforcement. These reforms were focused broadly on widening of the tax base, reduction in tax rates and lowering the rate differentiation to incentivise work, savings and investments.

The direct tax structure of our economy has experienced significant transformation in the past years. In 1970-71, the personal income tax had 11 tax brackets with the peak tax rate of 93.5%, which has presently reached down to 3 tax brackets with 30% peak tax rate, indicating a shift from the narrow based, complicated and confiscatory tax structure to the one that is far more better.

Individual income tax rates

Year	Exemption Limit (Rs.)	No. of rates	Entry rate (%)	Peak rate (%)	Income at which the peak rate applies (Rs.)
FY2001	50,000	3	10	35.1	1,50,000
FY2002	50,000	3	10	30.6	1,50,000
FY2003	50,000	3	10	31.5	1,50,000
FY2004	50,000	3	10	33	1,50,000
FY2005	50,000	3	10	33.66	1,50,000
FY2006	1,00,000	3	10	33.66	2,50,000
FY2007	1,00,000	3	10	33.66	2,50,000
FY2008	1,10,000	3	10	33.99	2,50,000
FY2009	1,50,000	3	10	33.99	5,00,000
FY2010	1,60,000	3	10	30.9	5,00,000
FY2011	1,60,000	3	10	30.9	8,00,000
FY2012	1,80,000	3	10	30.9	8,00,000
FY2013	2,00,000	3	10	30.9	10,00,000
FY2014	2,00,000	3	10	30.9	10,00,000
FY2015	2,50,000	3	10	30	10,00,000

FY2016	2,50,000	3	10	30	10,00,000

Source: Ministry of Finance, Government of India and Budget Documents.

Incidence of direct taxation is high

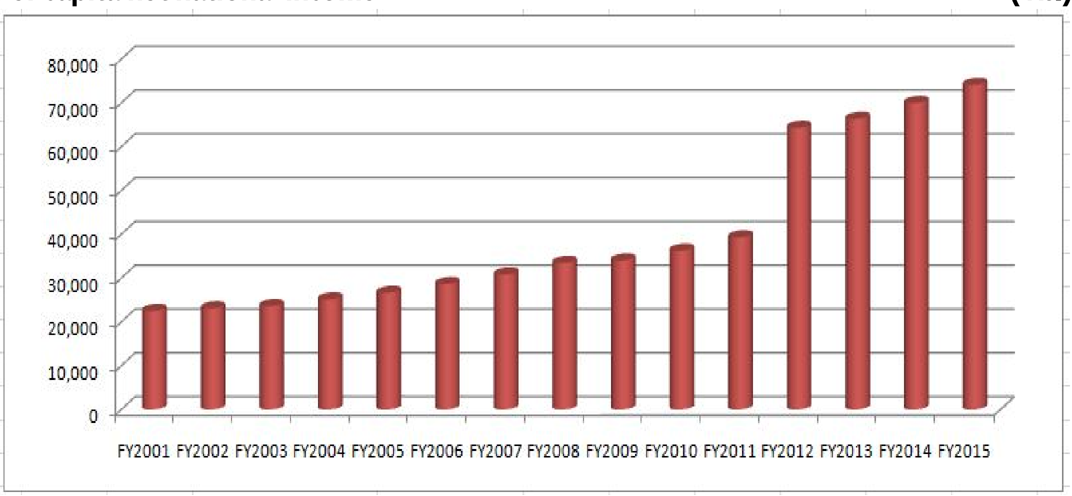
Although, our direct tax system has been on the path of rationalisation over the years, incidence of direct taxation is still high as compared with some major emerging markets and developing economies. Presently, India's personal income tax rate stands high at 34% as compared with other countries such as Brazil (27.5%), Malaysia (26%), Bangladesh (25%), Sri Lanka (24%), Russia (13%) and Mauritius (15%).

Tax policies in terms of reduction in individual income tax rates and income tax reforms by broadening the income tax base hold an influence on economic choices. The high rates of personal income tax can influence the choice between work and leisure, between savings and consumption and between risky and safe investments. Therefore, the incidence of direct taxation should be reduced to enhance savings in the economy, which will further help India's growth story by enhancing investments in various sectors of the economy.

Per capita income rises

At income front, per capita income of our economy has increased by more than 200% from Rs. 22,491 in FY2001 to Rs.74,104 during FY2015, which creates larger room for more savings and encourages investments in the economy. Therefore, to convert the rising income of our economy into higher savings and investments, it is required that higher direct tax rates should be brought down to widen base of tax payers in the coming times. At present, the number of tax payers is less than 3% of the total population in our country, which reflects that large part of the population falls below the basic income tax threshold; yet huge potential remains to be realized in terms of expansion of tax base, going ahead.

Per capita net national income **(Rs.)**



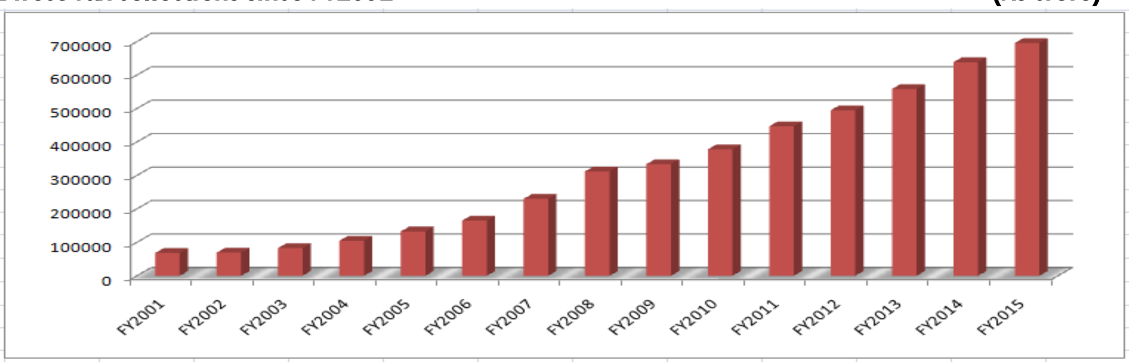
Source: PHD Research Bureau compiled from Economic Survey 2014-15, Government of India and MOSPI.
Note: Data onwards 2011-12 are based on New series estimates by CSO. Data pertains to Per capita net national income at market prices at constant prices

Rise in direct tax collections

The gross fiscal deficit as a % of GDP of our country[1] for the year 2014-15 has been contained at 4.1% and is estimated to reach at 3.9% in 2015-16, 3.5% in 2016-17 and 3% in 2017-18. Further, the revenue deficit of our economy is at 2.9% for 2014-15 and is estimated to reach at 2.8% in 2015-16. Hence, in order to reduce the fiscal imbalance in our country and overcome the deficit concerns, it is necessary that equity, efficiency and effectiveness of the tax structure must be promoted for widening tax revenue collections.

The government's revenue collections from direct taxes have increased by more than tenfold since FY2001. The direct tax collections have scaled up from Rs. 68,305 crore in FY2001 to Rs. 6,95,988 crore in FY2015.

Direct Tax collections since FY2001 **(Rs crore)**



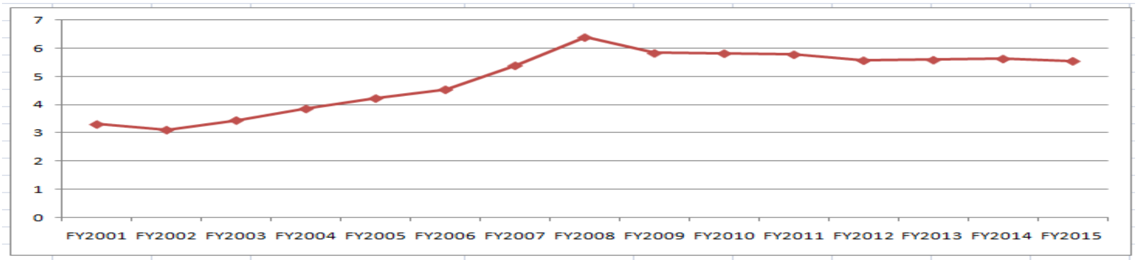
Source: PHD Research Bureau compiled from Ministry of Finance, Government of India, Note data for 2014-15 are provisional/unaudited

Rise in Tax to GDP ratio

To promote inclusive and sustainable development, garnering of adequate resources must be at the top priority which would result from higher tax to GDP ratio for any economy. According to the latest available data, our direct tax to GDP ratio has scaled up by 1.7 times from 3.31% in FY2001 to 5.55% in FY2015. Going ahead, the proposed introduction of GST will definitely help to boost India's tax to GDP ratio and promote sustainable development in the coming times.

Tax to GDP ratio since FY2001 **(%)**

[1] Budget Document 2015-16, Ministry of Finance, Government of India



Source: PHD Research Bureau compiled from Indian Public Finance Statistics 2013-14,Ministry of Finance, Government of India
Note: The ratios to GDP at market prices are based on CSO's National Accounts 2004-05 series and from 2012-13 onwards ratios to GDP at market prices are based on CSO's National Accounts 2011-12 series.

Low incidence of taxation, wider tax base and large number of tax payers to reap benefit of rationalized tax system

As taxes are important for every economy to fund Government expenditure on security and welfare of its people, low incidence of taxation, wider tax base and large net of tax payers plays a critical role in contributing to large tax revenue collections for meeting various developmental expenditures of the economy. However, yet huge potential remains to be realised in terms of reaping the benefits of rationalised tax structure.

Going ahead, moderate tax rates, institution of a simple and transparent system, alignment of incentives of taxpayers, reduction of transactions costs of tax revenue collection and tax administration would help in overcoming fiscal imbalances to a larger extent in the coming times.

In addition, introduction of more tax incentives, availability of information and infrastructure would also result in increasing large base of tax payers, which is critical to achieve fiscal consolidation, minimise distortions in the economy and to create stable and predictable environment for the markets to function, going forward.

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