Reworking on Personal Income Tax Rates

Why in news?

Finance Minister recently said that the government was considering lowering and rationalising personal income tax (I-T) rates.

What is the announcement?

- Budget 2020-21 will make changes to the personal income tax rates for the salaried in lower and middle income groups.
- This may be done through changes in the tax slabs.
- Accordingly, those having annual income between Rs. 2.5-10 lakh may be taxed at the rate of 10%.
- On the other hand, individuals earning between Rs. 10-20 lakh may get to pay tax at a rate of 20%.
- The tax exemption limit may, however, remain unchanged at Rs. 2.5 lakh.
- The announcement was among other measures to boost economic growth.
- Notably, the economic growth slowed to 4.5% in the second quarter of the current fiscal year.

What is the rationale?

- There are various reasons why the government should revisit and rationalise income tax in the forthcoming Union Budget.
- Primarily, it would be a logical step after the reduction in corporate tax rates earlier in 2019.
- It would also help take the process of direct tax reforms forward.
- The simplification of the tax structure has a better chance of improving collections in the medium- to long-run.
- The move will also provide an opportunity to rationalise taxes for different category of taxpayers and remove distortions.
- [E.g. It was highlighted in the 2018 Budget speech that in 2016-17, salaried individuals on an average paid Rs 76,306 as income tax.
- On the other hand, the average for individual business taxpayers, including professionals, was Rs 25,753.]

- Also, lowering tax rates for individual taxpayers is expected to increase their disposable income and help boost consumption.
- This is despite the fact that the impact on the overall economic activity could be limited because of the small taxpayer base.

What is the need for caution?

- The idea of rationalising individual income tax rates needs to be welcomed.
- However, it is important to note that the government is in a difficult position in terms of revenue collection.
- Given this, it will need to strike a fine balance.
- A sharp reduction in rates can adversely affect revenues and further weaken the government's fiscal position.
- It is almost impossible for the government to contain the fiscal deficit under the target of 3.3% of GDP in the current year.
- The economy is also unlikely to witness a sharp recovery in the near term.
- Given these, revenue collection in the next financial year could also remain under pressure.

What could be done?

- The focus should be on removing distortions and rationalising exemptions, along with tax rates, to minimise the impact on revenue mobilisation.
- E.g. in the July 2019 Budget, the government raised the surcharge for "super-rich" taxpayers, which further complicated the I-T structure
- Such measures should be avoided.
- A significant increase in tax rates, even for a small group of individual taxpayers, raises the possibility of evasion.
- There is also no certainty of an income tax cut translating into more spending as during tough times the tendency is to save more.
- So, a simpler regime with reasonable tax rates can be expected to help improve compliance and increase the base.
- Meanwhile, the government should also work on building institutional capacity in the tax department with better technology use to check evasion.
- This will help improve revenue mobilisation and reduce the burden on honest taxpayers in a more sustainable manner.

Source: Livemint, Business Standard

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