

5 ways to change the 'P' in Personal Income Tax

By Jitamitra Desai | Jun 29, 2023

Why do we have such a limited number of tax filers in the country and how we draw them into the formal economy? Here are five ways we can change the tax code to ensure inclusion



[CAPTION]As per the latest statistics available on the Income Tax Department website, around 5.5 crore individuals filed their ITRs in FY2018-19 (other sources indicate that this number has risen to 6.85 crores in FY2021-22) Image: Shutterstock[/CAPTION]

It's that time of the year when crores of Indians get ready to go through an annual ritual: Filing their income tax return (ITR), which computes the personal income tax (PIT) that must be paid for the most recently concluded financial year. As per the latest statistics available on the Income Tax Department website, around 5.5 crore individuals filed their ITRs in FY2018-19 (other sources

indicate that this number has risen to 6.85 crores in FY2021-22), leading to a total collection of Rs6,96,604 crores, which is nearly three percent of India's GDP. Given the country's population of ~140 crores, and after excluding the elderly, children, and low-income households (which altogether account for 70 percent of the population), the number of ITRs filed is still a fairly small percentage (< 10 percent) of the taxpayer base, which then leads to many important questions regarding PITs and whether citizens are indeed following the requirements.

There have been many debates and discussions on whether the PIT has been effective in:

1. ensuring that citizens contribute their due for the development of the nation and;
2. whether it has been uniformly applied across all types of employment.

RSS For example, paying their share of salaried income tax is fairly straightforward for employed/salaried professionals, with tax deduction at source (TDS) being applied. However, for self-employed business owners and even more so for the large swathe of low-wage workers (comprising maids, cooks, drivers, daily wage labourers, and so on) that exist in our country, the filing of an ITR remains a far-fetched notion. According to the FY2018-19 data, the number of taxpayers in the Rs2.5-3.5 lakh income range and the Rs5.5-9.5 lakh income range is dubiously large, and it is not hard to figure out why this is the case. (These individuals fall into a no- or significantly- lower tax bracket after applying the standard deductions.)

The government has taken various measures at central, state, and local levels to improve tax compliance. Still, these have been primarily restricted to educating the workforce on filing ITRs or informing them of penalties relating to the non-filing of ITRs. Despite these efforts, a large section of the workforce still does not file an ITR (the "informal economy", so to speak) and is not included in the "formal economy". Having a differentiated tax structure where the economically weaker sections of society pay little- to no- income tax and the tax burden climbs with rising income levels has also not helped curb this problem. In urban India, where the income levels of a majority of even low-wage workers exceed the tax threshold (currently at Rs3 lakhs per annum), it is worth asking why we have such a limited number of tax filers in the country and how we draw them into the formal economy. How do we ensure taxpayers across all brackets pay their fair share and not conceal part of their income?

The short answer is: It must become more lucrative for people to be part of the formal economy than remaining outside its purview. This seems counter-intuitive as paying taxes implies a reduction in an individual's wealth; so, how can it become more lucrative for anyone to pay taxes? To achieve this, we need to make significant changes to our existing tax code as outlined below:

1) Cap on Income Tax:

The personal income tax to be paid by an individual must be capped at a reasonable amount. (I would suggest something around Rs12 lakhs per annum.) How did I arrive at this number? If the cap is too low, the government will lose too much revenue; if the cap is too high, the individuals

benefiting from this will be too few, and the cap becomes inconsequential. There are many reasons why this is useful.

1. First, if an individual contributes Rs1 lakh per month for nation-building (Rs3,000 per day), we must recognise that they are doing their fair share. A PIT cap makes participating in nation-building more equitable. Someone cannot be held responsible for Rs20 lakhs of tax while another pays little to nothing. One of the goals must be to ensure that the judicious taxpayer does not feel aggravated and develop a mindset that the government is taking a significant chunk of their hard-earned money.
2. Second, once an individual has paid this cap amount, it is evident that no further checks will then need to be conducted by tax officials on their income to determine if they have short-changed the system, thereby freeing up resources. In today's environment, it is not uncommon for a taxpayer to receive notice of unpaid dues of a few thousand or a few hundred rupees after they have already paid several thousand in taxes. It is a complete waste of time for a tax official to pursue such measly amounts from an already existing taxpayer (already a part of the formal economy) instead of focusing on bringing the vast segment of non-taxpayers into the formal tax bracketing system.
3. Third, take the example of an individual who perhaps is liable to pay a large tax in the current system and therefore avoids paying taxes entirely by hiding part or all sources of income. The cap would ensure that such individuals would comply with the law as paying the cap amount may be palatable, and therefore there is no need for them to be outside the formal system. (The FY2018-19 data shows that only ~ 5 lakh taxpayers are above the Rs50 lakh threshold, which seems unusually low for a large country like ours.)
4. Fourth, the tax laws must work for all sections of society, including the elite. As the old saying goes, "You cannot legislate the poor into prosperity by legislating the wealthy out of prosperity", and a PIT cap ensures that such a thing does not occur. If the elite begins to feel that the government only cares about the poor, and the poor begin to realize that the government will always take care of them irrespective of whether they put in their fair share of work, this will lead to a complete breakdown of our tax and societal norms.

2) No Capital Gains Tax:

This is not a new idea and already exists in many other countries such as Singapore. It is a worthwhile idea because it will pull individuals into investing (out-of-sight) money into FDs, stocks, and so on, for which, once again, they must engage with the formal economy. It improves transparency in the system, provides visibility to the government on actual savings, will skyrocket the banking and financial systems upwards (which in turn will bring in more people to invest as they will make huge profits), and thereby making it more attractive to be part of the formal economy. This is where being part of the formal economy becomes lucrative even after applying PIT.

3) Improve Reward/Risk Ratio:

The government must start thinking like corporates and act accordingly. So, how does a company attract non-customers (who are either not interested in the product or are buying from a competitor)? Well, they use a variety of mechanisms, and one such lever is to entice (potential and existing) customers with "reward/loyalty points". How do we apply this in the tax context? Thinking

aloud, let's say that if an individual pays the maximum cap amount continuously for five years, then the taxpayer will be exempted from all income tax in the 6th year (or some such clever idea). Conversely, the penalties for egregious non-compliance must be very high, and we must put IT officers to track and prosecute individuals who are not filing taxes despite these proposed advantages; in tandem, this reward/risk ratio will funnel everyone into the formal tax architecture. This also sets priorities for IT officials to engage with only serious offenders and ignore the pittance collections.

4) Territorial Tax Structure:

India is one of those countries with a large, well-qualified, highly professional workforce based overseas. Many of these individuals continue to be Indian citizens. They may be assigned internationally for some time and then return to India. (With a changing global economy, it is not uncommon for many of them to also have several stints abroad.) In such instances, they set down roots in a foreign land (buy a home, grow savings, make long-term investments for their children, and so on), and some of their wealth will likely remain there when they relocate back home. They have paid their fair share of taxes when living abroad, and we must respect the tax laws of that country, be it for savings or investments (which may accrue after they return to India). In a country where a significant percentage of the population does not pay tax, applying "global tax" on the very few once again penalises the ones who already exist in the formal economy instead of focusing resources on the bigger problem.

5) Technology for Tax Compliance:

Technological advancements—such as AI/ML improving audit and tax compliance—are forever growing, but having so much data, information, and insights is useless if we have poor priorities. After all, sophisticated algorithms can only track transactions of the ones already in the formal economy and provide no visibility towards those avoiding the formal route. The Income Tax department will likely end up burrowing into low-hanging, low-impact rabbit holes instead of focusing on real game changers that will upend the tax system that we know today and set us on a path towards becoming a truly developed nation.

In conclusion, one might think that in every one of these suggestions, I am advocating lesser personal income taxes to be levied, and therefore, why should the government think along these lines? I say again that the government must think like a multinational corporation: Why do companies routinely offer discounted sales? How do they make money by reducing prices? It is a "volume game": The perceived loss of revenue for the government from the existing taxpayer base will be more than adequately compensated by an increased share of taxpayers in the system. This is perhaps the defining reason for setting these rules in place: There must be no incentive for people to be outside the formal economy; on the contrary, we need to create a tax structure that will get buy-in from across all sections of society and bring in a large swathe of taxpayers into the formal economy.

Such structural changes to our tax code will also pivot us from pinching pennies to pocketing pounds: it's time to change the 'P': move from "personal" to "prioritized" income tax and set the agenda for a progressive taxation policy that will benefit the nation for years to come.

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