POWER POINT

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BUDGET: CAN INDIA SWITCH TO A SINGLE INCOME TAX RATE

The tax slab rate system has been a cornerstone of India's tax framework since inception. Inspired by developed nations, this progressive tax system is designed to promote fairness by imposing incrementally higher tax rates on higher income brackets. For instance, an individual earning ₹5 lakh pays tax at 5%, while someone with an income of ₹7 lakh is taxed 5% on the first ₹5 lakh and 20% on the additional ₹2 lakh, ensuring a degree of equity as those with higher incomes contribute more in taxes.

However, the introduction of dual tax regimes—one catering to individuals who claim deductions and another for those opting out—has led to significant complexity. Besides, special tax rates from 12.5% to 30%, applicable to various income streams such as capital gains and cryptocurrencies, further complicate compliance, making the tax landscape more challenging for taxpayers.

While progressive taxation is common in developed countries like the USA and UK, it faces criticism. In India, issues like bracket creep, where inflation pushes individuals into higher tax slabs without a corresponding real income increase, and the complexity of compliance with multiple slabs and deductions, have led to dissatisfaction, particularly among salaried individuals.

Many perceive the system as a disincentive to earn more, as higher incomes are taxed at far higher rates, reducing motivation for increased productivity. Additionally, higher taxes on disposable income restrict consumption and savings, amplifying discontent. This raises a crucial question: can India transition to a single tax rate, and would it lead to a simpler, more equitable system?

Breaking down tax trends: A closer look at the income tax return statistics for AY 2022–23 reveals notable trends. Of the 6.9 crore individuals who filed returns, the gross total income reported was ₹53.7 trillion, while the total tax liability was ₹5.7 trillion—an effective tax rate of just 10.64%. This low rate is due to factors like deductions, slab rates, special tax treatments, and tax rebates. This trend is consistent with data from the previous three years, where the effective tax rate was around 9.5%. In contrast, companies face higher effective tax rates of 21% to 30%.

Ensure fairness by adjusting the tax-free income threshold periodically for inflation

What is more surprising is the average tax rate paid by ultra-high-net-worth individuals (UHNIs). While the highest slab rate for those earning over ₹5 crore is 39%, the reality is different. For AY23, the average tax liability to gross income ratio for these individuals was just 18.17%. This discrepancy arises because much of UHNIs' income is from capital gains, taxed at lower rates, typically 12.5% or 20%. This raises the question: are the complex slab rates and deductions really necessary?

For instance, an individual with a gross income of ₹15 lakh currently pays an average tax rate of 10%, while someone earning ₹25 lakh sees their average tax rate rise to 18%. By contrast, implementing a single tax rate of, say, 12.5% on income above ₹3 lakh could significantly simplify the tax structure while potentially yielding a similar overall tax collection.

To ensure fairness to the weaker sections of society, the minimum threshold limit for tax-free income (currently ₹3 lakh in this scenario) can be retained and periodically adjusted to account for inflation or other economic factors. This would ensure that lower-income groups remain exempt from taxation, allowing them greater disposable income to meet their daily needs. Such an approach would strike a balance between equity for the poor and simplicity in the overall tax structure.

A uniform tax rate for various types of investment income—such as interest, dividends, and capital gains—could further level the playing field. By eliminating preferential tax treatments, it would ensure that investment decisions are driven by financial goals rather than tax advantages, fostering a more equitable and transparent investment environment.

The concept of a single tax rate is not entirely new. In fact, companies and firms in India to a limited extent already follow a uniform tax rate on profits. Extending this principle to individual taxpayers could not only simplify compliance but also significantly reduce administrative burdens.

If implemented thoughtfully—ensuring measures to protect lower-income groups and maintain revenue neutrality—a single tax rate could serve as the much-needed reform to modernise India's taxation system. Such a shift could promote economic growth, enhance compliance, and reinforce equity in the system.

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(With inputs from Neetu Brahma, consultant, Nangia & Co LLP)