CHAPTER 4

PERSONAL INCOME TAX REFORM

Ramifications of Tax Policy for Tax Administration[19]

4.1 By the late 1960s and early 1970s, Scandinavia, the United Kingdom and other developed countries, as well as many developing nations, had legislated multiple and high individual income tax rates. Among the highest was India's, where it was well over 95 per cent. Such high and multiple rates not only made tax administration very difficult, but also led to a state, especially in developed countries, where income tax evasion became widely accepted as standard behaviour. During this era, corporate income tax rates were also very high — with most countries legislating rates between 50 per cent and 60 per cent.

4.2 The expected negative ramification of such high marginal tax rates was that income tax became replete with exemptions, allowances, deductions and incentives. What started as sectoral and specific reliefs from high taxes were soon extended to facilitate and accommodate social or development goals. It was rarely analysed whether such tax exemptions actually achieved the desired objectives. But these developed lives of their own and, in most countries, inevitably multiplied over time — driven by interests of specific power groups at different points of time. India was no exception.

4.3 Thus, over and above the personal exemption or threshold, the individual income tax base became eroded by explicit deductions for household size (which has been used both as an allowance in some countries and as a disincentive in others), education expenses and loans (as social objective), life insurance (both for social security and saving objectives), and particular saving instruments such as government securities or small banks such as post-office saving banks. It also excluded implicit income from owner occupied housing, sometimes pecuniary income from second homes, agriculture income and so on, across the world. In some Asian and Latin American countries, certain sources of income such as interest, dividends, and gains from capital were exempted altogether. Understandably,

[19] This section is heavily drawn from Parthasarathi Shome, *India's Fiscal Matters*, Oxford University Press, New Delhi (2002).

in not a few countries including some developed ones, individual income tax came to be popularly known as a 'voluntary tax'.

4.4 The corporate income tax base also became analogously eroded. Accelerated depreciation for select activities, tax incentives for employment generation or capital equipment, tax holidays for export-oriented industry, breaks for backward region development, small-scale industry and environmental investment, and the like — all these became a part of the fiscal landscape of India. Often, these exemptions led to inequitable taxation. For example, the jewellery industry produced very large incomes, but contributed to little revenue. In other instances, it led to excessive imports of unused accessories such as windmills or solar energy panels. Such examples can be multiplied.

4.5 While some countries attempted to narrow the scope of incentives over time, many failed to carry out comprehensive reform in tax policy and concomitant tax administration. In most part, this reflected the power of lobbies and political economy constraints associated with removing a vast spectrum of incentives in one go. However, the incremental approach to reform is also fraught with dangers. The electoral cycle of democracies make it very difficult for even reformist governments to credibly pre-commit to a time-table and schedule of reforms. More often than not, this has resulted in the original objectives being diluted — only to recreate new opacity in the 'reformed' tax system.

4.6 A few facts need to be stated at this stage — facts that are common knowledge to most experts in fiscal policy.

- First, there is hardly any evidence to prove that tax incentives have, *per se*, increased investment or saving — for which these incentives were devised.

- Second, the corollary has been proven very often — namely, that scaling back of tax incentives and exemptions have almost always had a positive effect on tax policy, tax revenue, tax compliance and tax administration.

- Third, decreasing the intensity of tax incentives automatically translates to a tax expenditure. Thus, even if gross tax revenues remained the same, the net tax revenue would necessarily be higher.

- Fourth, the other important implication of "exemption raj" tax regime is the loss of effective parliamentary oversight as the resultant "tax expenditure" are not transparent and not amenable to the C&AG audit ; a clear loss to democratic governance.

- Fifth, the tax incentives create antagonistic tension between the tax administrator and the taxpayer as the tax system is being asked to meet multiple objectives such as support to R&D, development of backward area etc. This becomes a source of litigation.

- Sixth, fewer the tax incentives, the less is the discretionary space available to tax administrators to interpret the law or executive statutes. It has been repeatedly emphasised to this Task Force that the 'control over the provision of tax incentives to a particular investor' by 'government officials' is a 'major instrument that makes corruption possible' — which often results in unwarranted discretion in the hands of officials, and militates against arm's length transactions.

4.7 The results of the income tax laws due to the "exemption raj", comprising of complex, allowance and exemption, are two-fold. For honest taxpayers, on the one hand, filing the income tax return continues to be an annual exercise in complexity, and an uncomfortable fear of the assessment by the tax administrator that is to follow. On the other, a direct result of the complexity in the tax structure is the difficulty faced by tax administrators in carrying out initial assessments, as well as to execute selective audit functions.

4.8 By the beginning of the 1980s, things had begun to change — starting with developed countries and then spreading to globalising developing nations. By the mid-1990s, the structure, design and enforcement of both individual and corporate income taxes underwent major changes. Earlier ideological objectives were substituted by considerations of incentive compatibility, reasonableness, administrative feasibility, stability and the credibility of fair enforcement.

4.9 The first step in reforming the income tax structure was reducing the number of as well as the level of rates. By the mid-1990s, many developing countries had emerged from the reform process having legislated individual income tax structures with significantly

lower and fewer rates — typically 15-25-35 per cent. Even India legislated comparable rates in 1997. Similarly the corporate income tax rates were slashed — sometimes halved from the prevailing rate — driven by the twin objectives of administrative feasibility and better tax compliance.

4.10 Forces of globalisation also played a major role in the international convergence of tax rates and structures. In a world on increasingly mobile and frictionless international flow of capital, outward looking national governments soon realised that getting a share of competitive global capital necessitated keeping the tax rates low and tax rules simple — in line with global trends.

4.11 The global experience is with lower tax rates and fewer opaque exemptions, the administration of income tax became much simpler. The administration's resources was better spent on alternative investments — such as modernising the tax administration through widespread computerisation, including electronic filing, better data processing and mining, and production of far better statistical output. These resources and inputs, in turn, were more usefully employed both in formulating future tax policy, as well as in better enforcement, through more transparent and finer tax audit selection.

4.12 **At the beginning of the 21st century, some truths about taxation have become self-evident. Even so, they bear repetition.**

- **First, the design of tax policy is of paramount importance for tax administration.**

- **Second, if the objective is to have a transparent, efficient and feasible tax administration, then the structure of all taxes should comprise common elements. These are low rates, few nominal rates, a broad base, few exemptions, few incentives, few surcharges, few temporary measures. And in the rare instances where there are exceptions, there should be clear guidelines.**

4.13 **The Task Force is unanimously in favour of these overarching fiscal principles. And the recommendations that follow in this chapter and the next derive from these objectives.**

Personal Income Tax Rates

4.14 It is well recognised that the rates of tax affect economic behaviour of taxpayers i.e. choice between work and leisure, the choice between consumption and savings, and also the compliance behaviour of taxpayers. The design of a personal income tax rate schedule must therefore be equitable and efficient — which are potentially conflicting objectives. A highly progressive tax rate schedule, while meeting the ends of vertical equity, causes higher distortion in the economic behaviour of taxpayers and therefore promotes inefficiency. Further, high rates of taxes induce tax evasion, thereby undermining the effective impact on equity. **The Report of the Advisory Group on Tax Policy and Tax Administration for the Tenth Plan has enumerated the following principles for designing the rate schedule:**

- **The basic exemption limit must be at a moderate level — an appropriate balance between the tax liability at the lowest levels, administrative cost of collection and compliance burden of the smallest taxpayers. The ability of the tax administration to render quality services to taxpayers will also significantly affect the choice of the exemption limit.**

- **The number of tax slabs should be few and their ranges fairly large to minimise distortions arising out of bracket creep.**

- **The maximum marginal rate of tax should be moderate, so that the distortions in the economic behaviour of taxpayers and incentive to evade tax payment are minimised.**

This Task Force endorses these principles.

4.15 Personal income tax rates in India were at their peak in 1973-74 — with the exemption limit at Rs.5,000, the minimum marginal rates of tax at 10 per cent, and the maximum marginal rate of tax rising to 85 per cent spread over eleven tax slabs. Additionally, there was also a surcharge of 10 per cent where the total income was below Rs.15,000, and a rate of 15 per cent in other cases. Therefore the "effective" maximum marginal statutory

rate was 97.75 per cent. The progressivity of the tax system was very high.[20] The large number of tax slabs, also distorted the progressivity of the tax system due to bracket creep. The design of the tax rate schedule was neither economically efficient nor equitable, nor amenable to voluntary compliance.

4.16 Since those days, there has been a steady increase in the exemption limit, decrease in the maximum marginal rate of tax, and reduction in the number of tax slabs. As a result, the design of the tax rate schedule has been made relatively more efficient. Since the number of tax slabs has been reduced substantially, the distortion in the equity of the schedule arising due to bracket creep has also been considerably minimised. However, there has been a steady decline in the progressivity due to the sharp reduction in the maximum marginal rate of tax and failure to adjust the tax slabs to inflation.

4.17 The exemption limit of Rs.5,000 in 1973-74 is equivalent to Rs.50,000 at current prices in 2001-2002. However, the exemption limit was increased to Rs.50,000 in 1998-99 itself i.e. 3 years in advance. Therefore, the increase in the exemption limit has outpaced inflation. Further, a survey of the effective exemption levels across countries indicate that the exemption level in India is relatively high — thereby keeping out a relatively larger number of people outside the tax net. If the share of direct taxes to GDP has to be increased to internationally prevalent levels, it is equally necessary that the tax system is as broad based as in other countries.

4.18 At present, there are three tax slabs. Most countries have three to five slabs. As mentioned, greater the number of tax slabs, larger is the distortion due to bracket creep. The fairest (in terms of horizontal equity in the broadest sense), the simplest and the most easily administrable form of income tax is a moderately progressive flat, or single marginal rate, income tax levied on a comprehensive base[21]. With a flat rate income tax, most of the defects in, and the problems caused by, an income tax with a progressive rate schedule virtually disappears[22]. With a moderate single rate, almost all the deductions and tax-preferences could be eliminated making the task of administration easy. All those with

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[20] The Advisory Group on Tax Policy and Tax Administration for the Tenth Plan has measured the variation of tax liability for different levels of taxable income and estimated the coefficient of variation in 1973-74 was then at a high of 1.06. Since then the progressivity of the tax rate schedule has declined substantially to 0.64.

[21] Government of India,(December 1991), Interim Report of the Tax Reforms Committee.

[22] Ibid.

taxable incomes can opt for tax deduction at source to the maximum extent possible — thus making tax deduction at source can become an important way of collecting tax.

4.19 Full integration of personal and corporate income taxes can be achieved by applying the same single rate to both incomes and exempting dividends in the hands of the shareholders. With a single rate, the inequality in the treatment between steady and fluctuating incomes as well as between incomes that are concentrated during a short period in life and those that are spread over a long period will be greatly reduced. All capital gains can be taxed as ordinary income, with long-term gains being suitably indexed for inflation. With a single rate, "bunching" does not cause any serious problem. There will be need only for the indexation of the exemption level; there will be no bracket creep. Inflation will still create problems, but the interaction of inflation and income taxation will produce much less iniquitous effects than under a progressive schedule.

4.20 However, a single rate cannot be pitched at a high level. Therefore, the rate of progression that can be achieved will inevitably be moderate. By many, this is considered to be the single most significant demerit of the system. In the Indian context, since a single rate would have to be around 30 per cent, the exemption level would also have to be fairly high. That, in turn, would leave out some people who could reasonably be brought within the income tax net with a lower tax rate.

4.21 **The Task Force, therefore, decided to reject the imposition of a single individual income tax rate, and instead opt for a reformed system of personal income tax with more than one rate. The Task Force believes that the alternative lies in a multiple rate schedule, but with very little spread.**

4.22 An opinion was expressed in some quarters that the entry tax rate in personal income tax should be relatively low so that it does not frighten potential taxpayers from being in the tax net. However, with a low entry rate, the number of rates inevitably multiplies, and the tax administration ends up at square one — all the problems associated with a progressive rate schedule.

4.23 The Task Force's aim is precisely to minimise these problems. Our perception is that potential taxpayers at the lower end of the scale are frightened not by the entry rate of

tax (since the average tax continues to be very low) but more by the compliance and enforcement procedures. The Task Force, therefore, believes that it is not necessary to lower the entry rate of tax. **Further, in view of the distortionary impact of multiple slabs, the Task Force recommends a two rate schedule for personal income tax.23 But before outlining the slabs and their rates, it is necessary to explain the empirical reasons for arriving at such a conclusion.**

4.24 In 1973-74, the tax rates of 10 per cent and 20 per cent were applicable for incomes up to Rs.10,000 and Rs.20,000 respectively. The corresponding inflation adjusted income levels are Rs.1,00,000 and Rs.2,00,000 in 2001-2002. Thus, the existing corresponding income levels of Rs.60,000 and Rs.1,50,000 are substantially lower than the inflation-indexed levels — thereby resulting in an increase in the real tax liability. Historically, while the top marginal rates of tax have been reduced, the tax liability at the middle has indeed increased. This has, not surprisingly though, has given rise to the problem of "the missing middle". **If the full effect of lower tax rates has to be realised, it is not only necessary to have an optimal enforcement strategy but also ensure that the benefits of a tax cut apply to all class of taxpayers — rather than be restricted to a handful of taxpayers at the top end. This is possibly achieved by broad basing the tax slabs and we recommend accordingly.**

4.25 **In view of the above, we had recommended in the Consultation Paper for public debate that the personal income tax rate schedule should be revised along the lines indicated in Table 4.1.**

Table 4.1 : Proposed Personal Income Tax Structure.

Income level	**Tax rates**
Below Rs. 1,00,000	Nil
Rs. 1,00,000-4,00,000	20 percent of the Income in excess of Rs. 1,00,000/-
Above Rs. 4,00,000	Rs.60,000/- plus 30 percent of the Income in excess of Rs. 4,00,000\-

[23] This is consistent with the recommendations in the Interim Report of The Tax Reforms Committee (Chairman : Professor Raja J. Chelliah)

4.26 **Further, the revenue gain from levy of surcharge is generally illusory since such a levy has the effect of increasing the marginal rate of tax, which adversely affect compliance. Therefore, we had also recommended that the present surcharge of 5 per cent on taxpayers with incomes above Rs. 60,000/- must be eliminated.**

4.27 Reacting to the rate schedule proposed in **Table 4.1**, some section of the public (including tax administrators) have expressed apprehension at the possibility of a large number of taxpayers dropping out of the tax net consequent to the sharp increase in the exemption limit. It was felt that if indeed this happened, the programme for widening the tax base would suffer a serious set back. However, given the package of administrative and policy reforms and empirical evidence, the apprehension is misplaced.

4.28 A substantial part of the proposed increase in the exemption limit will be neutralized by our recommendations in the subsequent sections for the withdrawal/elimination of standard deduction, saving incentives u/s 80-L, and conversion of income based deduction into rebates. Therefore, the effective increase in the exemption limit is substantially less.

4.29 The recent sharp increase in the number of taxpayers is attributed to the one by six scheme, which provides for filing of returns by any person who owns the specified assets or has incurred specified expenditure. This scheme has had a direct effect on increase in the number of non-taxpayer filers. However, it appears that this scheme has also had a deterrent effect[24]; taxpayers who would not have otherwise filed their tax returns and disclose their income, have been induced to file their return for fear of identification through the one by six scheme. Since there is no recommendation by us to abolish this scheme, we believe that it would not be possible for existing filers to escape their filing liability.

4.30 We recognise that there could be filers who are not covered by the one by six scheme but have taxable income in the range of Rs. 50,000/- to Rs. 1,00,000/-. Consequent to the increase in the exemption limit, such filers would drop out of the tax net. This is possible only in a static condition. With annual increase in taxpayers income, such filers would be pushed back into the tax net. Empirical evidence suggests that increase in exemption limits have never resulted in the fall in the number of taxpayers **(Table 4.2)**.

[24] However, this needs to be proved empirically.

Table 4.2 : Trend of Exemption Limit for Personal Income Tax and the Growth of Taxpayers Base

Financial year	Number of taxpayers (as on 1st April of the year)	Exemption limit (at current prices)	Financial year	Number of taxpayers (as on 1st April of the year)	Exemption limit (at current prices)
1965-66	2126398	3000	**1984-85**	4932094	15000
1966-67	N A	3500	**1985-86**	4937657	18000
1967-68	2696407	3500	**1986-87**	5502142	18000
1968-69	2708464	3500	**1987-88**	6261465	18000
1969-70	N A	3500	**1988-89**	7883247	18000
1970-71	3230000	5000	**1989-90**	8583690	18000
1971-72	3012570	5000	**1990-91**	8934442	22000
1972-73	3208516	5000	**1991-92**	9391172	22000
1973-74	3388259	5000	**1992-93**	9671289	28000
1974-75	3460843	6000	**1993-94**	10450677	30000
1975-76	3637434	6000	**1994-95**	11668075	35000
1976-77	3796258	8000	**1995-96**	13208781	40000
1977-78	3778724	10000	**1996-97**	14094644	40000
1978-79	3955244	10000	**1997-98**	15979205	40000
1979-80	3969965	10000	**1998-99**	17578326	50000
1980-81	4175615	12000	**1999-2000**	21744508	50000
1981-82	4594425	15000	**2000-01**	25052380	50000
1982-83	4660865	15000	**2001-02**	28681380	50000
1983-84	4797260	15000	**2002-03**	34407380	50000

Sources : 1. Annual Reports of the Ministry of Finance (different years) 2. Comptroller and Auditor General of India, reports for various years. 3. Performace Statistics of the Income Tax Department (different years). 4. CAP statement of Income Tax Department(different years)

Note : The number of taxpayers as on 1st April, 2002 indicated is based on the above sources. The CBDT has informed that the number of taxpayers as on 1st April, 2002 is 300.02 lakhs. This needs to be reconciled. However, this difference does not in any way effect the point that the Task Force intends to make

4.31 Our recommendation relating to broad basing of the tax slabs will reduce the marginal rate of tax for most taxpayers. This in turn, at existing enforcement levels, will induce a large number of taxpayers (particularly businessman / professionals) to disclose higher incomes. Increase in voluntary compliance will therefore contain the potential damage to the tax base.

4.32 The creation of the Tax Information Network (TIN), would enable the department to continue to keep a watch on non-taxpayers at the margin and also identify non-filers. This will, in-fact, provide an impetus to the ongoing programme for widening of tax base. Further, we are also guided by the consideration that an average family[25] need not necessarily be subjected to a progressivity tax in the form of income tax and its compliance burden. Their contribution to the national exchequer through consumption tax should be adequate.

4.33 A large number of individuals file their returns to claim refund because their income has been subjected to TDS even though their aggregate income is below the exemption limit. Since income will continue to be subject to TDS, such returns will continue to be filed. **In the light of the above, the Task Force is of the view that the current initiatives to widen the tax base would not be jeopardised in anyway.**

4.34 A section of the public (including some in the government) expressed a view that a two rate structure is not progressive enough. It was also argued that as in most other countries, we should continue to have a three rate structure with a lower entry point of tax.

4.35 The Task Force has estimated the progressivity of the tax schedule as measured by the coefficient of variation of tax liability at assumed levels of taxable income (Table – 4.3 and Chart – 1). The progressivity of the tax schedule has registered a steady decline since 1973-74 from a high of 1.18 to 0.7 in 2002-03[26]. The progressivity will increase from 0.7 to 1.04 consequent to the reduction in the number of slabs. The intuitive logic for this increase in progressivity is simple. Under the existing three slab rate schedule, the maximum marginal rate of 30 per cent is applicable to incomes above Rs. 1,50,000/-. Therefore, most

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[25] Given the per-capita income of Rs. 18,000/- in 2001-02, the average family income in most cases would be Rs. 1 lakh in 2003-04.

[26] It increased to 1.26 in 1974-75 before beginning to decline steadily.

taxpayers are subjected to tax at the same higher rate. Under the rate schedule proposed by us, most taxpayers would be taxable at the lower rate of 20 per cent and about 2 per cent of the taxpayers at the upper end only will be liable to tax at 30 per cent.

4.36 Most countries across the world have three to five rates, not because of the virtues, if any, of a multiple rates structure. Infact, multiple rate structures enhance problems of bracket creep and income smoothening. These countries have such a structure because of a low exemption limit with virtually no other exemptions / incentives. As a result, it is necessary to have low rates at the entry point to maintain the average rates at reasonable levels. If you have a low entry point of tax, then it becomes necessary to have multiple rates to reach a specified maximum rate. In India, the general exemption limit is at a moderate level coupled with large number of tax exemptions. Reform of such a system is possible only by substituting specific incentives by a generalized deduction in the form of an increase in exemption limit[27]. If the general exemption limit has to be raised, the rate of tax at the entry point cannot be relatively low since it will result in significant revenue loss without any design improvement.

4.37 **In view of the above, we do not consider necessary to alter the personal income tax rate schedule contained in Table-4.1 and accordingly endorse the same.**

Personal Income Tax Base

4.38 A negative effect of the early high marginal tax rates was that the income tax became replete with exemptions, allowances, deductions and incentives. Various exemptions and deductions still continue — in spite of significant reduction in personal income tax rates. As a result, the personal income tax law remains riddled with complexity, which inhibits voluntary compliance. Further, these benefit only a class of privileged taxpayers[28] and to the extent base is eroded, the large mass of general taxpayers have to bear the entire burden of a target revenue mobilisation effort. The consequential effect is the increase in marginal rates of tax — which in turn distorts economic efficiency and incentivises tax

[27] The tax reform proposals are generally designed to be arithmetically revenue neutral and therefore withdrawal of incentives must necessarily be compensated by increase in the general exemption limit and/ or reduction/rationalisation in tax rates.

[28] This is further restricted due to information asymmetry.

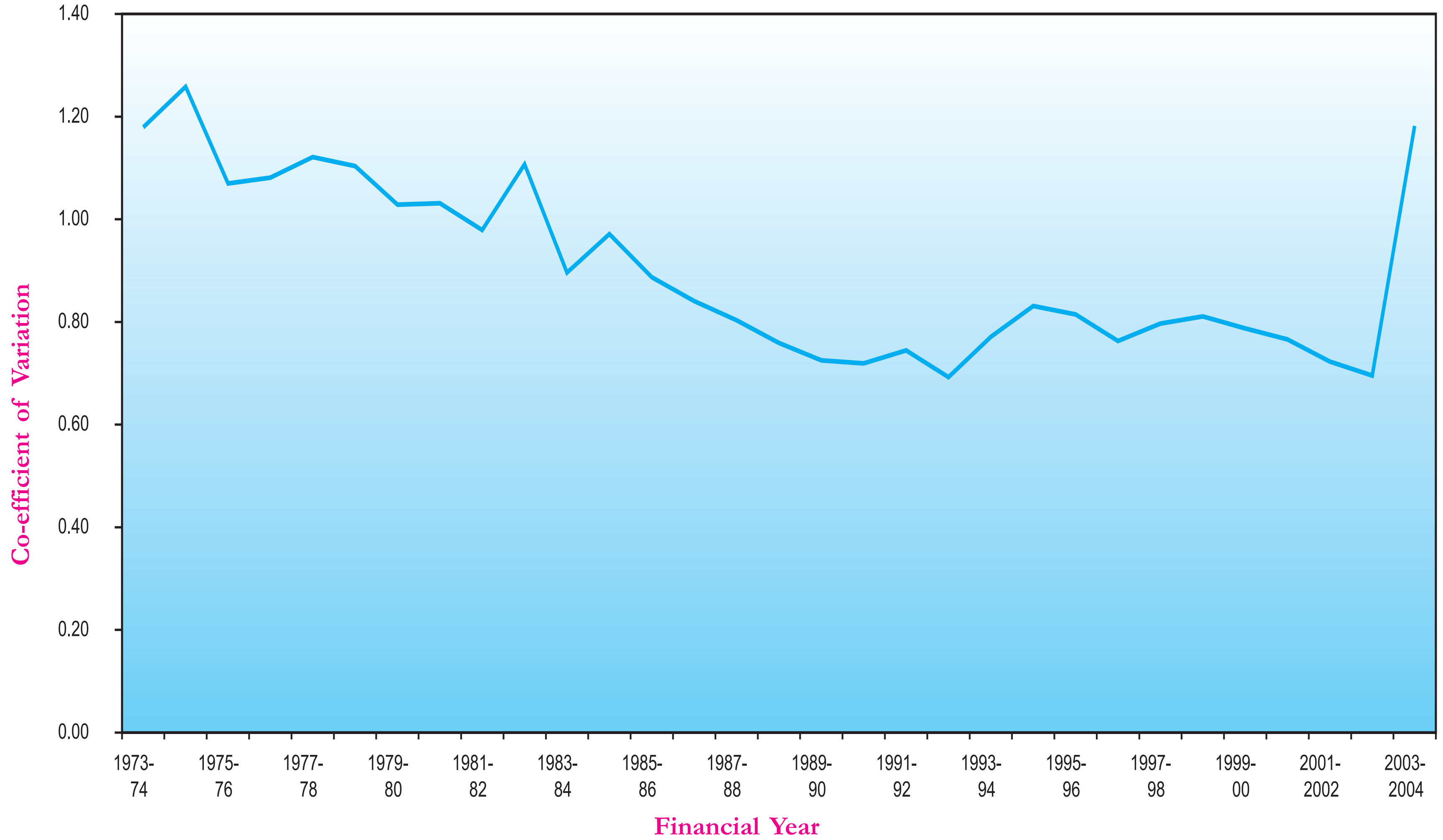
Table – 4.3

PROGRESSIVITY OF THE PERSONAL INCOME TAX SCHEDULE

Fin. Year		Average tax Liability for Assumed Level of taxable Income at 2003-2004 prices												Coefficient of Variation
	Income Levels	50000	60000	75000	100000	120000	150000	175000	200000	300000	500000	1000000	2000000	
1973-74		0.00	1.47	3.37	5.28	7.26	9.55	12.10	13.89	22.08	37.91	58.51	75.26	**1.18**
1974-75		0.00	1.96	4.21	6.95	8.54	10.95	12.83	15.35	26.07	0.00	57.08	67.04	**1.26**
1975-76		0.00	0.00	2.15	6.29	8.36	10.99	20.95	22.46	34.28	61.78	70.33	73.66	**1.07**
1976-77		0.00	0.00	1.90	5.55	7.37	9.76	11.59	13.58	21.79	32.55	47.02	56.51	**1.08**
1977-78		0.00	0.00	0.00	6.54	6.19	9.09	11.66	13.96	23.38	35.00	50.16	59.58	**1.12**
1978-79		0.00	0.00	0.00	6.89	6.66	9.47	12.22	14.63	24.12	35.73	50.78	59.89	**1.10**
1979-80		0.00	0.00	4.63	7.97	8.02	11.34	14.03	16.78	26.83	39.09	54.37	63.18	**1.03**
1980-81		0.00	0.00	5.54	4.38	6.95	10.83	13.82	16.94	25.96	38.03	51.34	58.67	**1.03**
1981-82		0.00	0.00	0.00	5.45	10.05	14.96	18.47	21.66	29.90	41.16	53.27	59.63	**0.98**
1982-83		0.00	0.00	0.00	7.49	11.74	16.62	20.36	23.31	31.76	0.00	54.56	60.28	**1.11**
1983-84		0.00	0.00	1.85	8.79	13.10	18.72	22.48	25.29	34.54	46.09	56.79	62.15	**0.90**
1984-85		0.00	0.00	3.06	8.69	12.49	17.51	9.59	14.02	32.40	42.68	52.28	57.08	**0.97**
1985-86		0.00	0.00	0.78	6.83	10.65	14.52	16.73	18.39	25.53	33.24	41.62	45.81	**0.89**
1986-87		0.00	0.00	2.46	8.40	12.00	15.60	17.66	19.81	26.54	34.41	42.21	46.10	**0.84**
1987-88		0.00	0.00	4.43	10.29	13.57	16.86	19.89	22.65	29.10	37.56	45.03	48.77	**0.80**
1988-89		0.00	1.18	5.94	11.74	14.78	17.82	21.51	24.07	30.05	38.66	45.58	49.04	**0.76**
1989-90		0.00	2.66	7.16	12.87	15.72	20.14	23.43	25.91	31.74	40.65	47.32	50.66	**0.73**
1990-91		0.68	3.90	8.18	13.63	16.36	20.14	22.98	25.11	34.86	43.32	49.66	52.83	**0.72**
1991-92		0.00	2.69	6.71	12.53	15.61	20.49	23.27	28.41	36.26	44.16	50.08	53.04	**0.74**
1992-93		1.18	4.32	8.90	14.17	17.90	22.32	24.85	26.74	38.12	45.27	50.63	53.32	**0.69**
1993-94		0.00	1.33	5.07	8.80	12.33	15.87	17.89	21.73	29.42	35.57	40.19	42.49	**0.77**
1994-95		0.00	0.00	2.62	6.97	9.83	13.86	16.17	17.90	29.45	33.67	36.83	38.42	**0.83**
1995-96		0.00	0.00	2.21	6.66	10.54	14.43	16.66	18.32	25.54	31.33	35.66	37.83	**0.81**
1996-97		0.00	0.00	3.72	8.63	12.19	15.75	17.79	20.16	26.77	32.06	36.03	38.02	**0.76**
1997-98		0.00	0.46	2.37	5.70	8.08	10.46	11.83	12.85	18.08	22.85	26.42	28.21	**0.80**
1998-99		0.00	0.00	1.45	5.90	8.25	10.60	11.94	13.34	18.89	23.33	26.67	28.33	**0.81**
1999-00		0.00	0.00	2.20	7.15	9.63	12.10	13.51	15.45	21.30	25.98	29.49	31.25	**0.79**
2000-2001		0.00	0.30	3.21	7.91	10.26	12.61	14.61	17.09	22.89	27.54	31.02	32.76	**0.77**
2001-2002		0.00	0.77	3.83	7.97	10.04	12.11	13.81	15.91	20.81	24.72	27.66	29.13	**0.72**
2002-2003		0.00	1.22	4.77	8.83	10.86	12.89	15.06	17.12	21.91	25.75	28.62	30.06	**0.70**
2003-2004		0.00	0.00	0.00	0.00	3.33	6.67	8.57	10.00	13.33	18.00	24.00	27.00	**1.04**

Chart - 1

Trend of Progressivity of Tax Schedule



evasion. The very objective of reduction in tax rates is, therefore, only partially achieved. **If compliance is to be fostered and nurtured and economic incentive sustained, it is necessary to review the various exemptions, deductions and rebates.**

Exemption Based on Residential Status

4.39 Under the Income Tax Law in India, the tax base of a taxpayer is effected by the residential status enjoyed by him. A taxpayer could have one of the following three residential status:-

- **Resident :** A taxpayer is treated as a resident if he is:
  - (a) Resident in India for 182 days or more during the financial year;
  - (b) In India for a period of 60 days or more during the financial year and resident in India for at least 365 days in aggregate during the preceding four financial years.
- **Resident but Not Ordinarily Resident :** A taxpayer is treated as resident but nor ordinarily resident if he is:
  - (a) Resident in India for less then 9 years out of the preceding 10 financial years ; or
  - (b) Resident in India for a period or periods amounting in all to less then 730 days during the preceding 7 financial years.
- **Non Resident :** A taxpayer is treated as non resident if he is neither a resident or resident but not ordinarily resident.

4.40 Residents are subject to tax on their world-wide income. Persons who are resident but not ordinarily resident are taxed only on Indian-sourced income[29], Non-residents are taxed only on Indian-sourced income and on income received, accruing or arising in India[30].

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[29] This includes income deemed to accrue or arise in India, income received in India or income received outside India arising from either a business controlled, or a profession established, in India.

[30] Nonresidents may also be taxed on income deemed to accrue or arise in India through a business connection, through or from any asset or source of income in India, or through the transfer of a capital asset situated in India (including a share in a company incorporated in India).

4.41 Persons who are resident but not ordinarily resident, enjoy exemption in respect of their foreign sourced income, even though in qualitative terms they are no different from residents. To the extent that most double taxation avoidance agreements provide for taxation of interest income in the country of residence, persons who are residents but not ordinarily residents enjoy exemption from foreign tax by claiming to be residents in India for the purpose of a treaty. Thanks to this peculiar category, therefore, a large number of such taxpayers end up paying no tax on their foreign sourced income, either in India or in any other part of the world. Further, most countries across the world provide for only two status: Residents and Non-residents.

4.42 **Accordingly, the Task Force recommends that residents but not ordinarily residents must be subjected to tax on their global / world-wide income at par with residents. To do so, this unusual category of resident but not ordinarily resident taxpayers must be deleted.**

4.43 **This will not only enhance the income tax base, but also remove an antiquated anomaly and simplify the law.**

Standard Deduction for Employees

4.44 Under the Income Tax Act, a taxpayer is allowed a deduction of a certain percentage of his salary income subject to a maximum amount as standard deduction in the computation of his salary income chargeable to income tax. At present standard deduction is allowed from the gross salary of the taxpayer, according to the following schedule:-

1. For gross salary below Rs.1.5 Lakh the amount is restricted to 1/3rd of the gross salary or Rs.30,000, whichever is less.

2. For gross salary between Rs.1.5 Lakh and Rs.3 Lakh, the amount is restricted to Rs.25,000.

3. For gross salary between Rs.3 Lakh and Rs.5 Lakh, the amount is restricted to Rs.20,000.

4. For gross salary above Rs.5 Lakh, no standard deduction is allowed.

In addition to the above, salaried employees are also eligible for a deduction up-to a maximum of Rs.9,600 towards conveyance allowance received from their employer.

4.45 The standard deduction allowed against salaried income is ostensibly to compensate, on an estimated basis, for the expenditure incidental to the employment of the taxpayer. The existing high level is often justified on the ground that unlike in the case of a self-employed taxpayer, a salaried employee does not have opportunities to evade taxes[31]. As a result, the effective tax burden on salaried employee is greater then those deriving income from self-employment/business and that the bulk of the personal income tax revenues flow from salaried employees. Therefore, the standard deduction should be seen as compensating for loss of such 'privilege' and mitigating the effective tax burden.

4.46 It is indeed true that a self-employed taxpayer has greater opportunities to evade taxes by lumping there personal expense with other expenses which are tax deductible. However, such lumping is often investigated and in most cases disallowed. Further, it is not uncommon amongst salaried employees both in the private and public sector to evade taxes (like self-employed taxpayers) on their illegitimate incomes through rent seeking and voucher payments.

4.47 Similarly, the perception that the effective tax burden on salaried employee is greater than those deriving income from self-employment/business is also not borne by the tax treatment of perquisites received by a salaried employee. The tax treatment of various forms of income in the hands of a salaried employee and a self-employed is summarised in **Table 4.4**. A large number of perquisites which are available to salaried employees is either concessionally treated or fully exempt, thereby substantially reducing the effective tax burden on a salaried employee. In the case of a self-employed all such benefits have to be paid for out of the post tax income. Hence, the justification of standard deduction on the count that the effective tax burden on salaried taxpayers is relatively higher then self-employed taxpayers is extremely weak.

4.48 The argument that the bulk of the income tax revenues are contributed by the salaried taxpayers is driven by perception rather than facts. On estimate, salaried taxpayers

[31] Self-employed taxpayers have the opportunity of lumping their personal expenses with other business expenses which are tax deductible.

Table 4.4 : Treatment of benefits/expenditures across salaried and self-employed taxpayers.

Nature of benefit/ expenditure	Treatment in the hands of the salaried employee	Treatment in the hands of the self-employed	Remarks
Expenditure on travelling from home to work place.	Almost, all salaried employees in the organised sector are granted a conveyance allowance, which is **exempt** from tax, subject to a ceiling of Rs. 9,600/-.	No deduction available.	
Expenditure incidental to the employment of the taxpayer.	A standard deduction restricted to 1/3rd of the gross salary or Rs. 30,000/- whichever is less for taxpayers with gross salary below Rs. 1.5 lakh. However, the standard deduction is restricted to Rs. 25,000/- and Rs. 20,000/- for taxpayer with gross salary between Rs. 1.5 lakh to 3 lakh and between Rs. 3 lakh to 5 lakh respectively. No standard deduction is available to a taxpayer whose gross salary exceeds Rs. 5 lakh.	No such deduction is allowed.	Lumping of any such personnel expenses with business expenses is disallowable.
Valuation of residential accommodation provided by the employer	Concessional tax treatment.	No such perquisite is available.	A self-employed can avail of the benefits of a residential accommodation can only be availed from post tax income.
Value of furnished accommodation.	Concessional tax treatment.	No such perquisite is available.	A self-employed can avail of the benefits of a residential accommodation can only be availed from post tax income.
Perquisite value of motor car used for personnel purposes.	Concessional tax treatment.	Fully taxed.	

Contd… Table IV.4

Nature of benefit/ expenditure	Treatment in the hands of the salaried employee	Treatment in the hands of the self-employed	Remarks
Provision of medical facilities (proviso to Sec. 17(2).	➢ Fully exempt, if the medical treatment is in specified hospitals ➢ Medical reimbursement other than above is exempt up-to Rs. 15,000/-	Fully taxed	
Interest free/concessional loans for medical treatment of specified diseases	Fully exempt	Fully taxed	
Expenses on employee's telephone including mobile phone	Fully exempt	Fully taxed	
House rent allowance	Concessional tax treatment	Fully taxed	
Leave travel allowance	Fully exempt	Fully taxed	

contribute only about 35 per cent of the personal tax revenues; the balance 65 per cent is contributed by the self-employed.

4.49 The levels of standard deduction have increased substantially over the years both in terms of the percentage and the overall ceiling — almost out of sync with the actual employment related expenses. The level of Rs.500 in 1974-75 allowable as standard deduction would now be equivalent to approximately Rs.5,000 in current terms. Once conveyance expenditure is separately exempted from taxation, it is difficult to visualise any other employment related expenditure other than personal in nature. This is particularly so when most employers provide for books and periodicals in the work place[32].

4.50 Unfortunately over the years, the increase in the standard deduction is an outcome of periodic demand for increase in the exemption limit by the salaried employees. Further the provision of a standard deduction to salaried taxpayers over and above the basic exemption limit is iniquitous in as much as it discriminates against self-employment. The Advisory Group on Tax Policy and Tax Administration for the Tenth Plan strongly recommended downward adjustment of this benefit.

4.51 Since then, the Task Force has also collected information across countries on the allowability of employment related expenses **(Table 4.5)**. In most countries, no deduction is allowed for employee related expenses. Where such expenses are allowed, these are either based on actuals supported by documentation or on a presumptive basis with a cap at a very low level both in percentage and absolute terms (except Thailand). Therefore, the scale of the deduction for employee related expenses in the form of standard deduction is not in line with the best international practice.

4.52 The loss in revenue on account of standard deduction is substantial — more so because conveyance allowance is exempt from tax. Also, standard deduction of this relative scale are not in line with the best international practice and our recommendation on enhancing the general exemption limit.

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[32] In fact in the government, the expenditure by senior officers on newspapers is reimbursed. In the case of the corporate sector, the expenditure on newspapers and periodicals is an allowable business deduction without being treated as a perquisite in the hands of the employee.

Table 4.5 : Tax treatment of Employee related expenses@

Country	Whether any deduction is allowed for employee related expenses@?	Remarks
Bangladesh	No	
Singapore	No	
Italy	No	
New Zealand	No	
Sri Lanka	No	
Malaysia	Yes	Actuals supported by documentation.
Indonesia	Yes	5 per cent up-to a limit of Rp 1296 a year.
Philippines	No	
Germany	Yes	A lump-sum amount of Euro 1044 is deductible.
Netherlands	No	
Argentina	No	
Peru	No	
United Kingdom	Yes	Actuals
Japan	Yes	Standard deduction
Australia	No	
France	Yes	10 per cent of the salary subject to a limit of Euro 12229.
Thailand	Yes	40 per cent subject to a limit of Baht 60000.
United States	No	
Canada	No	
India	Yes	Standard deduction of 33.3 per cent subject to a limit of Rs. 30000.

@ Employee related expenses are those, which are equivalent to the expenses, represented by the standard deduction u/s 16(1) of the Income Tax Act 1961 of India. Such expenses are wholly and exclusively incurred by the employee in the performance of the duty of employment, otherwise than those, which are reimbursed by the employer.

4.53 **The Task Force, therefore, recommends that standard deduction under Section 16(1) of the Income Tax Act should be eliminated. However, the exemption of conveyance allowance subject to a ceiling of Rs. 9,600/- should be continued. This should serve as a reasonable deduction for employment related expenses. The additional liability of a taxpayer on this account will be more than met by the reduction in rates of personal income tax proposed by the Task Force.**

Treatment of Imputed Income from Owner Occupied House Property

4.54 Up to assessment year 1986-87, a notional annual value subject to a maximum of 10 per cent of the adjusted total income was imputed to the benefit flowing from the self-occupation of the house property. Accordingly full allowance by way of deduction was made for ground rent, repair and maintenance, interest on borrowed capital and similar other items of expenditure.

4.55 However, from assessment year 1987-88, the notional annual value imputed to the benefit flowing from self-occupation of the house property was deemed to be nil. Accordingly, it was provided that no deduction for the various items of expenditure would be allowed except a small amount of Rs.5,000 towards interest on borrowed capital. While non-deductibility of the various items of expenditure is consistent with the matching principle that expenditure relating to a particular item/source of income should be allowed only if the income is liable to tax in the economic/accounting sense, the allowability of interest expenditure up-to Rs.5,000/- is a deviation from this principle. The problem has been further compounded by increasing the ceiling from Rs.5,000 to 1,00,000 in assessment year 2001-02, and further to Rs.1,50,000 for assessment year 2002-03 and subsequent years. The increase far exceeds the inflation during this period.

4.56 This incentive is in the nature of tax subsidy. Such a tax subsidy is both iniquitous and inefficient. To the extent income from owner occupied dwelling is not imputed for tax purposes, it encourages owners to keep the dwelling premises vacant rather than rent. Similarly, the incentive is inequitous between non-taxpayer owners and taxpayer owners – a housing subsidy for owners with higher income. Even amongst taxpayer owners, it confers relatively higher tax relief to those with higher income since they are subjected to a higher marginal rate of tax.

4.57 **Table- 4.6** below indicates that during 2001-02, an amount of Rs. 14,811 crores was disbursed by all the housing finance companies to 4,41,143 loanees[33]. Of this, there were 3,76,556 new loanees who availed of loans below Rs. 5 lakhs constituting 85 per cent of the new loanees. The share of this category of loanees in the total amount disbursed is only 59 per cent. The average size of the loan to these 85 per cent of the loanees is Rs. 2,32,661/-. The annual interest burden on such average loans would be around Rs. 25,000/-[34]. A large number of the new loanees in this category are likely to be non-taxpayers and therefore do not enjoy any kind of subsidy. Equally large number would be those who would be taxpayer owners, of which a significant proportion would have rented out their houses while a small proportion would be under owner occupation. Hence, a very small proportion of this category of loanees benefit from the tax treatment of mortgage interest on owner occupied dwelling.

4.58 Similarly, there were 48,145 and 16,442 new loanees during 2001-02 who availed of loans between Rs. 5 lakhs to Rs. 10 lakhs and above Rs. 10 lakhs, respectively. They constitute 11 per cent and 4 per cent of the new loanees, respectively. There share in the total amount disbursed is 23 per cent and 18 per cent respectively. The annual interest burden on the average loan in the two categories is estimated to be Rs. 75,000/- and Rs. 1,60,000/- respectively. Given the size of the EMI payment for loanees in these two categories, it would be reasonable to assume that the average income of such loanees would be above Rs. 3 lakhs per year. Loanees in these categories will benefit substantially from our proposal to reduce tax rates and broaden the tax slabs. Additional relief by continuing with the tax subsidy for owner occupied dwelling for taxpayers with such high levels of income only helps to undermine vertical equity.

4.59 A conventional case for continuing housing incentive is based on the argument that it will adversely affect housing activities which has a multiplier affect on many other industries. It is also argued that the housing sector has been the engine of growth in the last two years driven mostly by the tax incentive for mortgage interest for owner occupied dwelling.

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[33] National Housing Bank has also informed that an equal amount with similar loan profiles can be estimated to have been disbursed as housing loans by the various commercial banks.

[34] This would be so for a repayment period of 10 to 15 years.

Table 4.6 : Number of Loanees and Amount Dispersed by Housing Finance Companies during 2001-02.

Size of the Housing Loan	No. of Loanees (Rs. in crs.)	Amount Disbursed loan	Percentage		Average size of the
			Loanees	Amount	
Up-to Rs. 5 lakhs	376556	8761	85%	59%	232661
Rs. 5 lakhs to Rs. 10 lakhs	48145	3442	11%	23%	714923
Above Rs. 10 lakhs	16442	2608	4%	18%	1586182
Total	**441143**	**14811**	**100%**	**100%**	**335741**

Source : National Housing Bank.

4.60 During the last two years the financial markets have witnessed instability due to scams etc. resulting in the erosion of investor confidence. This has compelled people to look for alternative forms of investment in the real sector like housing. Simultaneously during this period, the cost of housing has plummeted to its lowest; hence an attractive opportunity for people disillusioned with the performance in the financial market to invest in a house. While the opportunity is available, one of the factors affecting the decision to invest in a house would obviously be the effective cost of borrowing. Since this is, in turn, determined by the tax treatment of the nominal cost of borrowing, the tax incentive induces investment in housing. The prevailing nominal cost of borrowing was 12.5 per cent on housing loans for a period of 11 to 15 years[35]. The effective cost of borrowing for a taxpayer with a 20 and 30 per cent marginal rate of tax was 10 per cent and 8.75 per cent, respectively. The nominal cost of borrowing for similar loans have since reduced to 10.25 per cent. *Prima facie*, all the developments enumerated above are expected to have a positive effect on investment in housing. As yet, there is no study, which has disagreegated the impact of the various factors on the housing sector. It is therefore fallacious to argue that the withdrawal of the limited tax incentive will have any serious impact on housing. In any case, with the expected reduction in the interest rate for housing loans in the immediate future, the increased burden on account of withdrawal of the incentive would be substantially neutralised, if not eliminated.

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[35] This was so when the incentive was increased to Rs. 1,50,000 in the Union Budget 2001,

4.61 Further, incentives for savings in financial instruments are proposed to be eliminated across the board. The relative attractiveness of investment in housing will therefore continue. Since most taxpayers with capacity to pay annual interest of Rs. 1,50,000 will benefit substantially[36] from reduction in tax rates due to broad basing of the tax slabs, they will have relatively larger amount of equity fund to invest in a house. The weighted average effective cost of borrowing will in most cases remain unchanged. It will also enable the taxpayer to accelerate the repayment thereby benefiting from reduced interest outgo[37]. Such investors in house will also benefit from our proposal to abolish wealth tax.

4.62 The proposal to reduce corporate tax rates in the subsequent sections of this report will substantially benefit the housing finance companies since they would be unaffected by the simultaneous withdrawal of a large number of tax preferences[38]. These companies should be expected to shift this benefit forward to the borrowers by way of reduced interest.

4.63 Our recommendations on capital gains restricting the exemption for rollover of capital gains, to investments in housing and the bonds of the National Highway Authority should divert more than Rs.1,000 crores to housing. This in itself should spur housing and other allied activities.

4.64 Further the deduction for mortgage interest for owner occupied dwelling is also inconsistent with international practice. In most countries, the mortgage interest in respect of loans for acquiring owner occupied dwelling is not deductible, as **Table 4.7** shows.

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[36] We estimate tax savings of more than Rs. 35,000.

[37] The interest on home loans with shorter maturity period are relatively less than those with longer maturity period.

[38] There post tax profit can be expected to increase by as much as 10 per cent.

Table 4.7 : Tax Treatment of Mortgage Interest for Owner Occupied Dwelling

Country	Is the Imputed Income from Owner Occupied dwelling subjected to personal income tax?	Is Mortgage Interest Deductible for Tax Purposes?
Bangladesh	No	No
Singapore	Yes	Yes
Italy	Yes	Yes, A credit up to 19% of the interest paid, up to a maximum credit Italian 392.51 is granted to the loan drawn up before the year 1993.
New Zealand	No	No
Sri Lanka	No	Yes, No limit
Malaysia	No	No
Indonesia	No	No
Philippines	Not Available	No
Germany	No	No
Netherlands	Yes	Yes
Argentina	No	Yes, limited to ARS 20000
Peru	No	No
United Kingdom	No	No
Japan	No	Yes, subject to limit of Yen 5,00,000/-.
Australia	No	No
France	Not Available	No
Thailand	No	Yes, limited to Baht 50000
United States	No	Yes, subject to limits
Canada	Not Available	No
Sweden	Not Available	Yes
India	No	Yes, up to a maximum of Rs.1,50,000/-

4.65 It was argued before the Task Force that many of the smaller taxpayers, particularly in the working class, if left to them to fend for their old age, would end up requiring state support due to their individual myopia and destitution. Thus what is optimal at individual level may be socially sub-optimal. The aggregate of individual savings for old age income security, old age medical security and housing may not be adequate to generate socially optimal levels of such social security assets[39]. Therefore, such individuals should either be coerced or given adequate incentives to overcome their myopia. The Task Force recognises the potency of this argument even though there may not be any empirical evidence in support of the existence of individual myopia to the detriment of social needs.

4.66 In view of the aforesaid considerations, **the Task Force recommends continued support to loanees of home loans. Since the existing scheme of tax treatment of mortgage interest for owner occupied dwelling is targeted to taxpayers alone, the problem of individual myopia may not be fully resolved. Infact, individual myopia is most likely to exist only amongst the lower category of taxpayers and non-taxpayers. Therefore, the first best policy option would be to incentivise borrowings for housing by providing 2 per cent interest subsidy on all loans below Rs. 5 lakhs. This subsidy should be granted by the Government through the National Housing Bank. This will indeed target such loanees who suffer from individual myopia. The second best policy measure for this purpose would be to continue with the tax treatment of mortgage interest for owner occupied houses. However, given the average size of the home loan (around Rs. 3.5 lakhs), we recommend that the ceiling on the amount of mortgage interest deductible for taxable income purposes should be reduced from the existing level of Rs. 1,50,000/- to Rs. 50,000/- only.**

Tax Treatment of Agricultural Income

4.67 The continued exemption of agricultural income from the scope of income tax continues to be a sore point with all taxpayers. For the sake of brevity, this Task Force

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[39] Our decision to retain section 80CCC of the Income Tax Act which provides for tax relief for contributions to a pension scheme is primarily intended to provide old age income security. Similarly, our decisions to retain 80D of the Income Tax Act which provides tax reliefs for contribution to a medical insurance policy (mediclaim) and modify section 80DD to provide tax relief for medical expenses incurred by senior citizens, are intended to provide old age health security.

does not consider it necessary to repeat/reproduce the various arguments advanced by experts. Briefly, the arguments in support of an income tax on agriculture are the following:

1. It distorts both horizontal and vertical equity ;

2. It encourages laundering of non-agricultural income as agricultural income i.e. it has become a conduit for tax evasion.

Both the arguments are empirically verifiable. A close look at the tax returns of a large number of taxpayers in Mumbai by the Task Force revealed the following:

- A number of taxpayers had claimed large amount of income from agricultural operations. Since such income enjoyed exemption from the central income tax and there was no such tax effectively in place in the States, such taxpayers enjoyed favourable treatment vis-a-vis those earning equivalent level of income from non-agricultural activities. To this extent horizontal equity was distorted. Similarly, the favourable treatment of agricultural income also adversely affected vertical equity.

- *Prima facie* the claims for income from agricultural operations appeared to be doubtful to most officers since the agricultural operations are claimed to have been carried out in areas which are known to be infertile. Large-scale investigations against such claims are under progress. The department is expecting that most of these claims are likely to be withdrawn by the taxpayers.

4.68 Based on the sample in Mumbai, the revenue loss from laundering of non-agricultural income as agricultural income is estimated to be Rs.1,000 crores. Given the distortionary impact of continued exemption of agricultural income and the tax assignment under the Constitution, **the Task Force recommends the following:-**

(a) A tax rental arrangement should be designed whereby States should pass a resolution under Article 252 of the Constitution authorising the Central Government to impose income tax on agricultural income. The taxes collected by the Centre would however be assigned to the States.

(b) Tax from agricultural income for the purposes of allocation between States will be the difference between the tax on total income (including agricultural income) and the tax on total income net of agricultural income.

(c) Where a taxpayer derives agricultural income from different States, the revenues attributable to a State will be in the ratio of the income derived from a particular State to the total agricultural income.

(d) A separate tax return form should be prescribed for taxpayers deriving income from agriculture.

These recommendations will help mobilise additional resources for the States without the attendant problem of administering the agricultural income tax. Further, given our recommendations on increasing the exemption limit to Rs.1,00,000 per individual, most agricultural farmers would continue to remain out of the tax net. The proposed rental arrangement with the States could be packaged with the rental arrangement for taxation of services.

Rationalising income tax exemptions on savings instruments

4.69 Tax exemptions for savings instruments have earlier been extensively analysed by various committees and expert groups in the course of their deliberations relating to other fiscal and financial issues. The most comprehensive of these reports have been those of the Committees chaired by Dr. Raja J Chelliah, Dr. Parthasarathi Shome[40] and Dr. Y.V. Reddy[41] . Given their sensible and comprehensive treatment of tax exemptions relating to savings, this Committee is of the view that the best way to proceed is a judicious adoption of the best recommendations culled from these Reports, with only some slight modifications designed to enhance consistency and ease of implementation, rather than an elaborate "re-invention of the wheel", as it were.

4.70 Consumption expenditure rather than income serves as the most efficient form of tax base under an ideal tax system. Inspite of this, no country in the world has been able to successfully implement expenditure tax due to serious administrative problems. Almost all countries have relied upon income as a tax base. However, a tax on income is inherently

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[40] Advisory Group on Tax Policy and Tax Administration for the Tenth Plan, Planning Commission, May 2001.

[41] Expert Committee to Review the System of Administered Interest Rates and Other Related Issues, September 2001.

biased against savings. There are two alternative ways of devising an income tax which neutralises this bias and therefore effectively uses consumption as a tax base :-

(a) **Exempt Exempt Taxed (EET) Method :** Under this method, the contributions to a saving plan / scheme are deductible from the gross income, the income (accumulations) of the plan / scheme is exempt from tax and the withdrawal of the contribution along with benefits in the form of interest, dividend etc. is subjected to tax.

(b) **Taxed Exempt Exempt (TEE) Method :** Under this method, the contribution to a saving plan /scheme are out of post tax income (i.e. contributions are taxable), the income accumulation is exempt from tax and the withdrawal of the contribution along with benefits in the form of interest, dividend etc. is exempt from tax.

4.71 In order to neutralise the bias against savings, most countries design their income tax structure, so as to provide for exemption / concessional tax treatment of the various savings instruments by following one of the two methods[42]. Some experts are also of the view that the distortion arising out of the inherent bias against savings could be tolerated by adopting a simple income tax structure with reasonable rates and a comprehensive base.

4.72 The theory of tax incidence on financial instruments indicates no reasons for differential treatment for those of long-term maturity from those of short and medium-term maturity, taking the view that the term structure of interest rates would ensure efficient allocation of savings. In particular, the demands of fiscal neutrality that imposition of tax should not distort the choice between (a) different forms of saving, and (b) between consumption and saving are ensured under a non-discriminating tax treatment of savings irrespective of the maturity period. No strong empirical evidence exists, moreover, to support a hypothesis that tax incentives facilitate increased financial savings (by the private sector) at a macro level[43]. There is, therefore, a strong justification for taking an integrated view of fiscal concessions for financial instruments of all maturities.

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[42] The psychological impact of EET, however, providing tax benefits at the contribution stage, would be greater in promoting financial accumulation (Reddy Committee, 2001). *It may be noted that approximately two thirds of OECD countries follow the EET system, with some variations, for taxation of savings.*

[43] Report of the Expert Group to Review Existing Fiscal Incentives for Savings (Chairman: P. Shome), May 1997.

Box 4.1 : Tax Treatment of Savings in Select Countries

In the USA, a section 401(k) plan is a type of deferred compensation plan in which an employee can elect to have his employer contribute a portion of his wages to the plan on a pre–tax basis. These deferred wages are not included in the taxable wages but they are subject to social security, Medicare, and federal unemployment taxes. The amount that an employee may elect to defer to a 401(k) plan is limited. During 2001, an employee cannot elect to defer more than $10,500 for all 401(k) plans in which the employee participates. But if the employee participates in a SIMPLE 401(k) plan, the limit for 2001 is $6,500. Both of these limits are indexed for inflation. Generally, all deferred compensation plans in which the employee participates must be considered to determine if the $10,500 limit is exceeded. All contributions to retirement plans (including deferred compensation plans) are subject to additional limits.

Housing, pensions and Individual Savings Accounts (ISAs) now cover the saving activity of the bulk of the population in the UK. Over the last two decades the UK has moved from an incoherent tax regime for savings to a seemingly more satisfactory one[44] . The four main schemes designed to encourage savings, keeping in mind an ageing population, had been the Business Expansion Scheme (BES), Private Personal Pensions (PPP), Personal Equity Plans (PEP) and Tax Exempt Special Savings Accounts (TESSA)[45]. Personal Equity Plans were announced in the 1986 Budget, implemented in 1987 but substantially reformed in later years. TESSA was announced in the budget of March 1990 and became available from January 1991. PEPs were a vehicle for investment in equities, with tax-free income. Contributions to PEPs were not tax deductible, but any income or capital gains accrued within a PEP are tax free, and there is no tax on withdrawals. TESSAs gave the same tax treatment as a PEP for funds in designated schemes with annual contribution limits; saving were out of taxed income but interest earned is tax free and there is no tax on withdrawals. This

[44] Individual Savings Accounts (ISAs) have superseded PEP and TESSA (see text) since April 2001. ISAs are similar to the older schemes in most important respects and are designed to integrate the tax treatments for savings of disparate schemes. Existing subscribers to PEPs and TESSAs can continue with the schemes or migrate to ISAs.

[45] The Institute for Fiscal Studies, UK, Briefing Note No. 9, "A Survey of the UK Tax System", November 2001.

led to a situation of disparate tax treatment of different instruments used for similar purposes as well as for short- and long-term savings instruments. For example, for housing, equities and cash saving, saving was out of taxed income and there was no tax on returns and no tax on withdrawals, while, for pensions, saving is out of untaxed income, their fund income is untaxed but withdrawals are taxed. These two regimes produced the same effective tax rate of zero on the real return to saving. The one obvious exception is the existence of the tax-free lump sum in pensions, which makes the effective tax rate on the return to pensions saving negative.

In a bid to encourage personal saving, reforms introduced in November 2001 in Chile[46] allow new tax incentives to both salaried workers and the self-employed to encourage voluntary contributions to private pension funds. These will allow voluntary contributions to be deducted from an individual's taxable income. In order to qualify as deductible, they must, however, be invested in certain assets, such as mutual and other investment funds and life insurance, duly authorized by the appropriate regulatory authority. In addition, the new regulations allow individuals to withdraw part or all of their voluntary pension savings before reaching retirement age. However, in order to guard against excessive use of this prerogative, an exit tax will be levied on withdrawals, which will be treated as taxable income. Before the reform, only the AFPs (pension fund administrators) were allowed to offer tax-deductible savings schemes.

The Supplemental Retirement Scheme (SRS)[47] in Singapore, effective April 2001, is designed to encourage working employees to save for retirement, over and above their contributions to the Central Provident Fund (CPF). Contributions to the SRS by residents (up to an overall limit of S$15,000) are tax deductible the following year. The savings corpus, including interest, are to be taxed only upon withdrawal. Claims for deductions from taxable income are made automatically by the SRS operator to an individual's taxable income the following year. A penalty of 5 percent is imposed on premature withdrawal before retirement. The taxable base of the SRS corpus for an individual is 50 percent of his corpus, at a tax rate based on the individual's graduated tax rate of 0-26 percent.

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[46] "Capital Markets in Chile", Investment Review, Foreign Investment Committee, Chile, February 2002.
[47] Internal Revenue Authority of Singapore, SRS Brochure, 2001.

4.73 The Indian tax system (emanating from the Income Tax Act, 1961) provides broadly the following types of tax incentives for financial savings:

(a) Deduction under section 80CCC for contribution to pension funds of Life Insurance Corporation of India or any other insurer, subject to a ceiling of Rs. 10,000/-. The pension/annuity under the scheme is, however, taxable.

(b) Deductions, provided in Section 80L allow for exemption of income up to Rs.12,000/- from income tax on specified financial instruments (including bank deposits, NSC, post office deposits, Government securities, etc. with an additional and exclusive sub-ceiling of Rs.3,000 for interest income arising from Government securities).

(c) Exemption under Section 10(10D) in respect any sum received under a life insurance policy, including the sum allocated by way of bonus on such policy [other than any sum received under sub-section (3) of section 80DDA] [or under a Keyman insurance policy]

(d) Unlimited exemption under Section 10(11) and Section 10(12) in respect of any payment from a provident fund set up by the Central Government or set up under the Provident Fund Act 1925 or a recognised provident fund.

(e) Unlimited exemption under Section 10(13) in respect of any payment from a Superannuation Fund.

(f) Unlimited exemption under Section 10(15)(i) in respect of income by way of interest, premium on redemption or other payment on notified securities, bonds, annuity certificates, savings certificates, other certificates and deposits issued by the Central Government.

(g) Unlimited exemption under Section 10(15)(iib) in respect of interest on notified Capital Investment Bonds. However, no bonds can be notified after first day of June 2002.

(h) Unlimited exemption under Section 10(15)(iic) in respect of interest on Relief Bonds.

(i) Unlimited exemption under Section 10(15)(iid) in respect of interest on notified Bonds. However, no bonds can be notified after first day of June 2002.

(j) Unlimited exemption under Section 10(15)(iv)(h) in respect of interest on notified public sector bonds.

(k) Unlimited exemption under Section 10(15)(iv)(i) in respect of interest on deposits out of moneys received by an employee on retirement.

(l) Tax rebate, provided in Section 88, in respect of investment in specified assets (such as NSC, NSS, EPF and PPF, tax saving units of mutual funds, premium paid on life insurance, repayment of housing loans, and infrastructure bonds of IDBI and ICICI). In the financial year 2002-03, the rebates are provided at the following rates:

    (i) The rebate shall not be available in case of persons having gross total income (before deduction under Chapter –VIA) more than Rs.5 lakhs.

    (ii) For persons having gross total income (before deduction under Chapter – VIA) above Rs.1,50,000 but not more than Rs.5 lakhs, the rate of rebate shall be 15%

    (iii) The rebate 20% shall continue for taxpayers having gross total income, (before deduction under Chapter – VIA) not exceeding Rs.1,50,000.

    (iv) The rebate shall be higher @ 30% for salaried taxpayers having gross salary income not exceeding Rs.1 lakh (before allowing deduction under Section 16) and where gross salary income is not less than 90% of the gross total income from all other sources.

4.74 The limit of qualifying investment is Rs.1 lakh with exclusive limit of Rs.30,000 for subscription to equity shares or debentures of infrastructure companies, public financial institution and mutual funds.

4.75 The tax treatment of various financial instruments under the tax statue is summarised in **Table 4.8.**

Table 4.8 : Tax Treatment Of Financial Savings

Sl. No.	Nature of Instrument	Treatment of Contribution	Treatment of Accumulation	Treatment of Withdrawal	Method
1	Gratuity	Exempt[a]	Exempt	Exempt[2]	EEE
2	Pension/Deferred Annuity Plans	Exempt[b]	Exempt	Exempt[3]	EEE
3	Life Insurance Policy	Exempt[b]	Taxable	Exempt[2]	ETE
4	Provident Fund	Exempt[b]	Exempt	Exempt[2]	EEE
5	Superannuation Fund	Exempt[c]	Exempt	Exempt[2]	EEE
6	Notified Securities, Bonds, Annuity Certificates, Saving Certificates, and Other Certificates	Exempt[b]	Exempt	Exempt[2]	EEE
7	9% Relief Bonds	Taxable	Exempt	Exempt[2]	TEE
8	Public Sector Bonds/Debentures	Taxable	Exempt	Exempt[2]	TEE
9	Deposit Schemes for Retiring Employees	Exempt[d]	Exempt	Exempt[2]	EEE
10	Certain Pension Funds of LIC (Section 80 CCC)	Exempt[e]	Exempt	Taxable	EET
11	Medical Insurance (Section 80 D)	Exempt[e]	Taxable	Exempt[2]	ETE
12	Any Security of the Central Govt. or State Govt.	Exempt[b]	Exempt	Exempt[4]	EEE
13	National Saving Certificates (6th , 7th & 8th Issue)	Exempt[b]	Exempt	Exempt[4]	EEE
14	Debentures of any Institution, Authority, Public Sector Company or Co-operative Society Notified by the Govt.	Taxable	Exempt	Exempt[4]	TEE
15	National Deposit Scheme	Taxable	Exempt	Exempt[4]	TEE
16	Any Other Deposit Scheme Framed by the Central Govt. and Notified	Taxable	Exempt	Exempt[4]	TEE

Sl. No.	Nature of Instrument	Treatment of Contribution	Treatment of Accumulation	Treatment of Withdrawal	Method
17	Post Office (Monthly Income Account)	Taxable	Exempt	Exempt[4]	TEE
18	Units of Mutual Fund	Exempt[b]	Exempt	Exempt[4]	EEE
19	Units of UTI	Exempt[b]	Exempt	Exempt[4]	EEE
20	Deposits in Bank or Banking Co-operative Societies	Taxable	Exempt	Exempt[4]	TEE
21	Deposits in any other Bank	Taxable	Exempt	Exempt[4]	TEE
22	Deposits with Industrial Financial Corporations	Taxable	Exempt	Exempt[4]	TEE
23	Deposits with Local Development Authorities	Taxable	Exempt	Exempt[4]	TEE
24	Deposits by a member of a Co-operative Societies	Taxable	Exempt	Exempt[4]	TEE
25	Deposits with Housing Finance Companies	Exempt[b]	Exempt	Exempt[4]	EEE
26	Deposit Scheme of NHB	Exempt[b]	Exempt	Exempt[4]	EEE
27	ULIP	Exempt[b]	Exempt	Exempt[4]	EEE
28	10y Rs. or 15 yrs Account Post Office Savings Bank (Cumulative Time Deposits) Rules 1959	Exempt[b]	Exempt	Exempt[5]	EEE
29	Purchase of House Property	Exempt[b]	—	Exempt[6]	E-E

Note :

a : Employees are not required to contribute and the employers contribution to the Fund are deductible.
b : Eligible for tax rebate under Section 88.
c : Contribution by the employee is eligible for tax rebate under Section 88. Contribution by the employer to the superannuation Fund is deductible.
d : Contributions are from retirement benefits which are exempt from tax.
e : Contributions are deductible under Section 80D.
2 : Withdrawal of both the contribution and benefits are exempt.
3 : Commutation of pension is exempt but the monthly pension is taxable.
4 : Withdrawal of contribution is exempt. The withdrawals of benefit is partially exempt under Section 80L.
5 : Withdrawal of contribution is exempt but the withdrawal of benefit is taxable.
6 : Cost of the property is exempt. Capital gain is treated concessionally. Imputed Rent is exempt. Rent received is taxable.

4.76 Under the existing income tax provisions, therefore, financial savings of households is generally exempted from taxation at all the three stages of savings, *viz.*, contribution, accumulation and withdrawals[48]. This liberalized treatment has impacted economic efficiency, equity and revenue efforts.

4.77 Saving instruments with similar maturity but different tax concessions result in different effective yields, which involve a distortion of signals for investment decisions. While investment (or saving) under Section 88 is rewarded, disinvestment (dis-saving) is not brought under charge. The incentives encourage not necessarily just savings but also diversion of funds, from one form of investment to another and that too for mere locking up these funds (i.e., surrendering the purchasing power to the government) only for a specified period of time. The netting principle is not applicable and dis-savings remain untaxed. Therefore, there is a bias in favour of investment in short-term instruments, thereby creating serious distortions in the allocation of savings. The tax rebate, for repayment of instalments of housing loans made by taxpayers to specified institutions encourages debt as against "equity" financing.

4.78 In any scheme of incentives for savings, it is desirable that the investments to be encouraged have broadly similar rates of return. Any variation in these rates should only be due to differences in the holding period, underlying risk or some other overriding consideration of priority for a particular sector.

4.79 Deduction of net investment and allowing deduction of income from such investment are broadly equivalent in that each is sufficient to achieve treatment of savings as under a proportional expenditure tax. Yet, assets such as National Savings Certificates and provident funds enjoy both deductibility in investment (under Section 88) and of interest earning (under Section 80L and 10(11) or 10(12) respectively). This leads to inordinately high effective rates of return on these assets (see **Table 4.9**). In turn, these serve as a benchmark for rates of return (discount rate) and therefore lead to high cost of borrowing across all sectors in the economy and to dampening of investment.

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[48] except instruments listed at serials number 7, 8, 10, 14 to 17 & 20 to 24 of Table – 3.

4.80 The special limits of Section 80L deductions applicable to government securities create legally induced distortions in the allocation of savings as between these and other assets covered by Section 80L, irrespective of the intrinsic rates of return. While the major consideration behind the current incentive schemes seems to have been to encourage investment in financial assets so as to direct savings to the public sector, there are arbitrary variations in rates of return even among such assets. The rates of return bear no systematic relation to the length of the holding period of assets. In effect, by de-linking rates of return from holding periods, the public sector crowds out the private sector through offers of quick and perceptibly safer returns.

4.81 Exemptions from income tax for income from capital (as under Section 80L or Section 10) is equivalent to the expenditure tax principle but a progressive expenditure tax cannot be introduced through this route. Further, if exemption for capital income is given without limit under a progressive income tax, it amounts to having a progressive income tax only on work income. Hence, the introduction of public sector bonds and other instruments and exemption on these from income tax without any limit, as is the case under Section 10, leads to unjustified distortion.

4.82 A differential treatment of income from dividend/interest and capital gains introduces opportunities for distorted arbitrage arising between different maturities and different coupons and also leads to window dressing opportunities for tax purposes. Ideally, total return should form the basis for taxation. Moreover, certain savings instruments are more liquid than others. The resulting mis-alignment of the term structure of small saving instruments with market rates makes benchmarking more complex.

4.83 The existing tax treatment of saving schemes have also adversely effected the equity of the tax system. One consequence of the present scheme is that where the concessions take the form of deduction from income as in the case of Section 10, Section 80L and the provisions relating to rollover of capital gains tax, these favour upper bracket taxpayers disproportionately. The post-incentive rates of return vary substantially across taxpayers with different marginal tax rates. In general, the post incentive rate of return increases with the marginal tax rate of the saver. These provisions are therefore, regressive.

4.84 To the extent exemption is allowed for roll over of capital gains, the scheme is biased in favour of taxpayers with income on capital gains. Therefore, the scheme distorts horizontal equity. Further, since the large taxpayers generally have a larger proportion of their incomes from capital gains, the rollover provisions are biased in favour of the rich thereby distorting the vertical equity of the tax structure.

4.85 Inequity also arises from asymmetric information about the various tax concessions for savings. To the extent information is available with a taxpayer, he is able to avail of the tax concession. This problem is particularly aggravated in the absence of adequate taxpayer education and assistance program by the tax administration.

4.86 **Table 4.9** provides an illustration of the "excess returns" to selected small savings instruments that underlie these costs. It shows that a major portion of the excess returns arise due to Section 88. For instance, the excess return to NSC VIII, solely on account of the benefit under Sections 80L and 88, is 0.97 - 2.92 per cent and 6.06 per cent, respectively, over the tax adjusted nominal administered rate. In order to accommodate the total effective yield of NSC VIII adjusted for all three benefits (i.e., 10, 80L and 88) together, the issuer of a taxable bond had to incur a cost of 16.2 to 17.1 per cent, depending upon the income tax bracket of the investor. Similarly, the excess returns from PPF turn out to be very high due to its eligibility in Section 10. This will be in addition to return attributable to Section 88. Consequently, a taxable bond without any tax exemption would have had to incur a cost of 25.8 per cent to accommodate the return accruable from PPF (with all permissible withdrawals) to investors falling in the tax bracket of 30 per cent in 2000-01.

4.87 The existing tax system on financial instruments is quite complex, distorting the information efficiency of capital and debt markets and providing arbitrage opportunities resulting in misallocation of financial resources. The provision of various tax exemptions for savings instruments not only increases the costs of compliance but also serves to distort economic incentives and actually hinder economic growth in the long run.

4.88 An ideal income tax design entails full exemption for savings either on a TEE or EET method. However, this may not fully meet the ends of vertical equity and revenue loss would also be considerable. In order to overcome these problems, the incentives are generally capped. As a result, the income tax system is not fully neutral to savings. Hence,

Table 4.9 : Total effective returns adjusted for all tax concessions

	Excess Return Arising u/s 10/80L			Excess Return Arising u/s 88			Total Tax Benefit Adjusted Effective Return to Investor			Cost to Issuer of Taxable Bonds to Accommodate Total Effective Return		
Tax Brackets	10%	20%	30%	10%	20%	30%	10%	20%	30%	10%	20%	30%
NSC VIII												
Sep, 1993	1.18	2.37	3.55	6.55	6.55	6.55	18.38	18.38	18.38	18.84	19.36	19.97
Jan, 2000	1.13	2.26	3.39	6.43	6.43	6.43	17.73	17.73	17.73	18.17	18.66	19.24
Mar, 2001	0.97	3.39	2.92	6.06	6.06	6.06	15.78	15.78	15.78	16.16	16.59	17.09
PPF												
Sep, 1993	1.18	2.37	3.55	2.48	2.48	2.48	14.74	14.74	14.74	13.45	14.64	15.82
Jan, 2000	1.08	2.17	3.25	2.49	2.49	2.49	13.78	13.78	13.78	12.38	13.46	14.55
Mar, 2001	0.94	1.87	2.80	2.51	2.51	2.51	16.89	16.89	16.89	10.77	11.71	12.64
PPF with All Permissible Withdrawals												
Sep, 1993	2.17	4.24	6.22	6.45	6.45	6.45	19.02	19.02	19.02	21.80	24.88	28.35
Jan, 2000	2.16	4.22	6.22	6.49	6.49	6.49	18.16	18.16	18.16	20.90	23.93	27.32
Mar, 2001	2.15	4.21		6.54	6.54		16.89	16.89	16.89	19.57	22.51	25.78

Source: Annexure 1, Report of Expert Committee to Review the System of Administered Interest Rates and Other Related Issues, 2001.

so long as income remains the tax base, the bias against savings is inevitable. Further, the empirical evidence on the success of tax incentives for promoting savings is also extremely weak. Therefore, a comprehensive income tax packaged with a sufficiently high level of exemption limit and a two tier broad based rate schedule is preferred to income tax riddled with exemptions (including those relating to savings) with multiple rates on grounds of efficiency equity administrative simplicity and relatively low compliance burden. The bias against savings, if any is also minimised. The Task Force also recognizes the transitional administrative problems associated with the shift from the existing EEE method to EET method. Therefore, given the current imperatives of revenue and demographic profile of taxpayers, the preferred option is the TEE method.

4.89 A case for retention of the savings incentives is built around the argument that elimination of the saving incentives will adversely affect individual's savings behaviour and therefore national savings and social security. This is based on the consideration that the decision to save is affected, amongst other factors, by the return on savings (net of tax). Given the pre-tax return on savings, the post-tax return depends on the marginal rate of tax on personal income. In effect, the decision to save is also determined by the marginal rate of personal income tax. An exemption/deduction for savings has the effect of increasing the post tax return on savings. While, *a priori*, this may be true, the impact depends on the relative strengths of the income and the substitution effects, which in turn depends upon the individual's preferences for present consumption over future consumption. Empirical evidence indicates that given the pre-tax rate of return, taxation or exemptions from taxation have no significant effects on savings[49]. Considering the population as a whole, the income and substitution effects more or less cancel each other out. In fact, in recent years, the Kisan Vikas Patra mobilizes the maximum net savings in comparison to other instruments even though it does not enjoy any tax benefit. Therefore, the tax exemptions for savings do not in anyway enhance national savings. The impact on individual's savings behaviour and national savings is, at best, uncertain.

4.90 Further, consider the case of a person who is a "target saver". His only goal is to have a given amount of consumption in the future – no more and no less. For such "target saver", saving and the after-tax interest rate move in opposite directions. If the exemptions

[49] Report of the Advisory Group on Tax Policy and Tax Administration for the Tenth Plan.

for savings are eliminated, then the only way for him to reach his target is to increase savings, and vice versa.

4.91 It has been repeatedly pointed out that providing tax incentive to the "gross" savings in small saving instruments will encourage consumption and not savings. Because the exemptions are not designed to penalise dissavings, people can roll over their savings, avail tax credit and with higher disposable income (due to tax credit) increase consumption. Therefore, the elimination of the incentives could potentially have a positive impact on national savings.

4.92 The elimination of saving incentives will in turn lead to the elimination of forced savings and forced pre-emption of savings for certain sectors. It will now enable savings to flow into the most productive channel in a competitive manner. The current provisions relating to tax rebates for savings essentially act as SLR on individuals. There is no justification for pre-empting individual savings. A taxpayer can be freed to make his savings and investment decisions. The options for him are much wider with capital market reforms both in the debt and equity segments and the entry of many new intermediaries such as mutual funds and private sector banks.

4.93 Apart from the costs to the economy through the adverse impacts on efficiencies and equity outlined above, tax concessions involve various economic costs to the government — in terms of interest payment and forgone revenue. below. Given the relatively short recycling period of the savings instruments, the marginal contribution to national savings of the elaborate tax exemption system is negligible, and the transaction costs it entails are considerable. Such costs are estimated to be around 40 per cent. Details of costs

4.94 Tax incentives for savings, particularly for government guaranteed instruments, have the effect of increasing the floor interest rates across the economy. As a result, investment is adversely affected which in turn slows down the economic growth and employment creation[50]. Further, such incentives result in revenue loss thereby increasing the borrowings by government to meet its current expenditure. This further raises interest rates thereby crowding out private investment. Consequently, there is a slow down of

[50] Infact a slowdown in the employment creation results in greater unemployment and therefore a tax at 100 per cent. Clearly the effect is regressive.

incurred by the Government in mobilizing small savings in FY 1999-2000 are tabulated in **Table 4.10.**

Table 4.10 : Cost of Small Saving Schemes incurred by Government (as at end-March 2000)

		Absolute cost (Rs.Crores)	% to gross collection of the year	% to outstanding balance at the beginning year
A.	Interest Payment	20,198	32.5%	11.5%
B.	Cost of Management	1,767	2.8%	1.0%
	i. Remuneration to Department of Post	1,055	1.7%	0.6%
	ii. Payment to Bank and Agent	691	1.1%	0.4%
	iii. Promotion (NSO) and other Cost	21	1.0%	0.0%
C.	Foregone Income Tax Revenue	5358	8.6%	3.0%
	TOTAL COST	**27,323**	**46.8%**	**16.5%**

Source : Ministry of Finance, Government of India (Taken from Annexure 1 of the Report of Expert Committee to Review the System of Administered Interest Rates and Other Related Issues).

Note Foregone income tax revenue is calculated in the table above by deducting 20 per cent of gross mobilisation during the year for the schemes eligible for tax deduction under Section 88, e.g., NSS 1992, NSS (VIII Issue) and PPF. Another 20 per cent of interest income is added to cost for schemes that enjoy tax free interest income under Section 10 or 80L. The 20 per cent tax rate on interest income is considered based on the assumption that all investors uniformly fall in this income tax bracket and they actually reap the tax benefit on interest income. The estimates of income tax revenue foregone are at best under-reported since the actual revenue loss on account of these incentives is estimated to be around Rs.12,000 crores based on typical tax payer profile.

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investment in the economy and therefore economic growth. What appears to be micro rational is, in fact, macro irrational.

4.95 The important variable for growth is social saving, defined as the sum of government and private saving. If the government were to save a proportion of tax receipt by eliminating the savings incentives, social saving could indeed increase even if private saving decreased.

4.96 Further, the tax exemptions are generally restricted to the small savings. A significant proportion of these small savings is indeed by individuals whose income is below the exemption limit and are therefore non-taxpayers. Such incentives do not benefit

this category of savers. The amount of small savings attributable to taxpayers is indeed a very small proportion of the total savings in the economy. Even if, one were to assume that their saving behaviour will be adversely affected by the elimination of the saving incentives, the impact would be far too negligible[51].

4.97 Another argument extended in support of tax incentives for savings relates to the apprehension about its adverse impact on social security. It is also argued that in the absence of a social security system in the country, the government must incentivise long-term savings by individuals. The Task Force recognises that smaller taxpayers may not save enough for old-age security because of individual myopia, thereby imposing a social burden. Such individuals must necessarily be encouraged to overcome their myopia by providing incentive for contribution to saving plans[52].

4.98 The wide range of tax incentives for savings is inefficient and inequitous. The apprehension about the adverse effect of the elimination of these incentives on national savings is also misplaced. Therefore, **the Task Force recommends the elimination of the tax incentives for savings under Section 88, Section 80L, Section 10(15)(i), Section 10(15)(iib), Section 10(15)(iic), Section 10(15)(iid), Section 10(15)(iv)(h) and Section 10(15)(iv)(i) of the Income Tax Act. These benefits must be withdrawn with immediate effect and not through a sunset clause.**

4.99 Further, with a view to overcoming the problem thrown up by individual myopia, **we also recommend the continuation of the deduction under section 80CCC for contribution to the pension fund of LIC or any other insurance company. The ceiling on the deduction should, however, be increased from the existing levels of Rs. 10,000/- to Rs. 20,000/-. This income-based deduction u/s 80CCC be converted to a tax rebate at the minimum marginal rate of 20 per cent53. Consequently, the ceiling**

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[51] It will be fiscally prudent for the government to swap the high cost borrowing from taxpayers by the relatively low cost government securities.

[52] Such individuals tend to apply whole of their current income for consumption and prefer to depend on the society for their future consumption.

[53] In the case of a taxpayer whose marginal rate of tax is 20 per cent, and income based deduction of Rs. 100, confers a tax relief of Rs. 20 (Rs. 100*0.2). Similarly, a taxpayer whose marginal rate of tax is 30 per cent enjoys a tax benefit of Rs. 30 (that is, Rs. 100 * 0.3). Therefore, a taxpayer in the higher income bracket enjoys a relatively higher tax benefit and hence iniquitous. However, under the proposed scheme of tax rebate, all taxpayers irrespective of their personal marginal rate of tax, will enjoy a tax relief of Rs. 20 (Rs. 100*0.2).

on tax rebate for contribution to the pension fund should be Rs. 4,000/-. The new ceiling has been proposed keeping in view the needs of the smaller taxpayers with income below Rs. 2 lakhs. The scope of section 80CCC may also be extended to a larger number of pension/annuity schemes within the overall ceiling of Rs. 20,000/-. Since savings in these pension funds will be taxable at the withdrawal stage, the tax benefit for such savings will be consistent with the EET method of tax treatment.

4.100 However, any sum received under a life insurance policy (including bonus) will continue to enjoy tax exemption under section 10(10D) of the Income Tax Act. Similarly, any withdrawal (including interest) from the provident fund will continue to enjoy tax exemption under sections 10(11) and 10(12) of the Income Tax Act. As a result, the tax treatment of savings in these schemes will confirm to the TEE method as against the existing EEE method. To this extent, the change will be economically efficient. Our recommendations for not modifying the tax treatment of other saving plans u/s 88 or u/s 80L or u/s 10(15) either along the EET method or TEE method is primarily based on the consideration that the rates of return are considerably higher, or the maturity period is not long enough to discourage "round tripping".

Treatment of Educational Expenses

4.101 The income tax law provides for deduction of Rs.40,000 in respect of repayment of loan taken by any taxpayer for higher education (Section 80E).

4.102 In view of the International practice **(Table 4.11)** and the fact that education is one of the basic amenities of life, generating positive externalities, **the Task Force considers it necessary to provide continued support under the tax law. However, on grounds of equity, we also recommend that the income based deduction under Section 80E should be converted to a tax rebate at the minimum marginal rate of personal income tax. The maximum amount of tax rebate should be restricted to Rs.4,000.**

Treatment of Medical Expenses

4.103 The income tax law provides for deduction of Rs.15,000 in respect of payment of medical insurance premium (Section 80D) and Rs.40,000 for medical treatment (Section

80DDB). **Since health is one of the basic amenities in life, the Task Force considers it necessary to provide continued support under the tax law.**

4.104 However, the provisions of Section 80DDB relating to deduction for actual expenses incurred on medical treatment are liable to be considerably misused, in the absence of a strong verification system. Even if, the tax administration were to successfully put in place a strong verification system, it would impose considerable administrative and compliance burden. A survey across countries on the tax treatment of medical expenses **(Table 4.11)** indicate that while most countries do not provide any form of deduction, some exempt subject to a ceiling while some others exempt the perquisite value of medical expenses. Therefore, **on balance of consideration, the Task Force recommends the immediate withdrawal of the tax benefit under Section 80DDB. However, consistent with international practice and in view of the special health circumstances of senior citizens54 , deduction for medical expenses may continue to be allowed in the form of a tax rebate at the rate of 20 per cent of the medical expenses, subject to a maximum of Rs.4,000. Further, on grounds of equity, we also recommend that the income based deduction under Section 80D should be converted to a tax rebate at the minimum marginal rate of personal income tax (i.e. 20 per cent). The maximum about of tax rebate should be restricted to Rs. 3,000.**

Treatment of Senior Citizens

4.105 Section 88B of the Income Tax Act provides for a tax rebate of Rs. 15,000/- to a senior citizen. A taxpayer is considered as a senior citizen if he is of the age of 65 years or more on the last day of the previous year. In view of the recommendation for increase in the exemption limit to Rs. 1 lakh and deduction of medical expenses for senior citizens, the Consultation Paper submitted by the Task Force had proposed the deletion of the provisions of Section 88B of the Income Tax Act.

4.106 The Task Force received a large number of representations through e-mails and post pointing out the sharp increase in tax liability of senior citizens because of the cumulative impact of the withdrawal of tax incentives on interest income, reduction in

[54] Senior citizens should be defined as taxpayers who are more than 65 years. in age on the 1st day of the financial year.

Table 4.11 : Tax Treatment of Medical and Educational Expenses Across Countries.

Country	Whether Medical Expenses are deductible?	Whether Educational Expenses are deductible?
Canada	No	No
France	No	Yes, only school fees of children is deductible from tax
Germany	No	Yes, if education is necessary for current profession
Italy	Yes, tax credit at the rate of 19 per cent.	Yes, tax credit at the rate of 19 per cent.
Japan	Yes, expenditure in excess of Yen 100,000 up to a maximum of Yen 2 million	Yes, expense exceeding Yen 10,000 up to a maximum of 25 per cent of adjusted total income
Netherlands	Yes, maximum of Euro 718 or 11.2 per cent of income, which ever is lower	Yes, only expenses above Euro 500/- but below EUR 15,000/-
United Kingdom	No	No
United States	Yes, if medical expenses exceed 7.5 per cent of adjusted gross income	No, except for higher education
Thailand	No	No
New Zealand	No	No
Malaysia	Yes, maximum tax credit of RM 7,000/-	Yes, maximum of RM 5,000/- of income
Indonesia	No	No
Philippines	No	No
Argentina	No	No
Peru	No	No
Australia	No	No
Singapore	No	Yes, maximum of $ 2,500 if the course is related to employment or profession.

interest rates and the elimination of the tax rebate of Rs. 15,000/-. Even though part of the impact would be neutralised by the exemption of dividend income and long-term capital gains on equity, this would hold good only for a limited number of senior citizens. Most senior citizens are risk averse and therefore have a choice for debt instruments. Such senior citizens face the prospect of a double jeopardy: reduction in interest rates and withdrawal of incentives. Their problem is further compounded by their inability to recoup the loss of income through employment in view of their advancing age and physical condition. With a view to providing a human face to the tax reform proposals, **we recommend that the basic exemption limit for senior citizens should be Rs. 50,000/- more then the exemption limit for the general class of individual taxpayers. In other words, the exemption limit for senior citizens should be Rs. 1,50,000/- as against Rs. 1,00,000/- for the general category of individual taxpayers recommended by us in Table-4.1. The exemption limit for senior citizens should be revised as and when the exemption limit for the general category of individual taxpayers is revised. We also recommend that this benefit of higher exemption limit should also be extended to widows.**

Other Personal Deductions

4.107 The Income Tax Act provides for the following other personal deductions:

1. An income based deduction of Rs.40,000/- in respect of maintenance[55] including medical treatment of handicapped dependent (Section 80DD). This deduction is conditional to expenditure on maintenance being actually incurred.

2. An income based deduction of Rs.40,000 in case the taxpayer suffers from permanent physical disability (including blindness). (Section 80U)

3. A tax rebate of Rs.5,000 to women taxpayers below 65 years of age. (Section 88C)

4.108 **Given the personal circumstances of handicapped, the Task Force recommends the continuation of the personal deductions under Sections 80DD and Section 80U.**

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[55] Maintenance included payment to a scheme framed by the LIC and any other insurance agency for the maintenance of the handicapped.

However, on grounds of equity, we also recommend that the income-based deduction under these provisions should be converted to a tax rebate at the minimum marginal rate of personal income tax.

4.109 Further, in view of our recommendations for increase in the exemption limit to Rs.1,00,000/- and deduction of medical expenses for senior citizens, we recommend that the personal deductions in the form of tax rebate for senior citizens (Section 88B) and women (Section 88C) should be deleted.

Personal Tax Reforms : Implementation Strategy

4.110 The policy measures for the reform of personal income tax therefore comprises of the following elements:-

(a) Increase in the generalised exemption limit from Rs.50,000/- to Rs.1,00,000/- for all individual and HUF taxpayers. The exemption limit for senior citizens and widows would, however, be at an enhanced level of Rs. 1,50,000/-.

(b) The existing three slabs in the personal income tax rate schedule will be replaced by two slabs. Incomes between Rs.1,00,000/- and Rs.4,00,000 will be subjected to tax at the marginal rate of 20 per cent. All incomes above Rs.4,00,000/- will be subjected to tax at the marginal rate of 30 per cent.

(c) Dividends received from Indian companies will be fully exempt.

(d) Long term capital gains on listed equity will be fully exempt.

(e) The standard deduction for salaried taxpayers will be reduced to NIL. However, exemption for conveyance allowance subject to a ceiling of Rs. 9,600/- will continue.

(f) The income based deduction under Section 80D subject to a ceiling of Rs. 15,000/- in respect of payment of medical insurance premium will be converted to a tax rebate at the rate of 20 per cent subject to a maximum of Rs.3,000.

(g) The benefit of deduction under Section 80DDB will be withdrawn in so far as it relates to the general category of taxpayers. However, consistent with international practice and in view of the special circumstances of senior citizens,

deduction for medical expenses may continue to be allowed in the form of a tax rebate at the rate of 20 per cent of the medical expenses, subject to a maximum rebate of Rs.4,000.

(h) The income based deduction under Section 80E for repayment of educational expenses will continue to be allowed. However, on grounds of equity, the same should be allowed as a tax rebate at the rate of 20 per cent subject to maximum of Rs.4,000.

(i) The tax rebate schemes under Sections 88 for savings will be eliminated.

(j) The rebate under Section 88B for senior citizens will be eliminated in view of the enhanced exemption limit for them.

(k) The rebate under Section 88C for women taxpayers below the age of 65 years, will be eliminated.

(l) The income based deduction for handicapped under Section 80DD and 80U will however continue.

(m) The income based deduction under Section 80L for interest income and dividends will be eliminated.

(n) The exemption under Section 10 in respect of interest income from bonds, securities, debentures etc. will be eliminated.

(o) The deduction for mortgage interest in respect of loans for acquiring a owner occupied dwelling will be reduced to Rs. 50,000/-.

(p) The residential status of "Resident but Not Ordinarily Resident" will be eliminated.

4.111 The Task Force would like to place on record that the various recommendations relating to personal income tax in this report are interwoven and therefore indivisible. The recommendations must be seen as a package and piecemeal implementation must be avoided at all cost.