

## **Taxation of Agricultural Income: A Holistic View\***

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The issue of agricultural income tax has become the focus of endless controversy in recent year. It has been so thoroughly debated that few aspects remain unexplored. Unfortunately, however, the debate has lost objectivity and the vested interests are using all types of arguments against one another. Scholarly analyses too show sometimes remnants of ingrained subjectivity. The object of this paper is to look at the issue objectively and suggest a possible way out.

The question of taxation of agricultural income can be examined from the following points of view:

- (a) Historical perspective;
- (b) Equity;
- (c) Administrative considerations;
- (d) Constitutional provisions; and
- (e) Revenue potential.

### **HISTORICAL PERSPECTIVE**

Historically, two things of special interest should be noted about the imposition of income tax in undivided India. One, the year of its imposition, and two, its coverage. Compared to the imposition of income tax in Canada in 1917, and in Australia in 1915-16, in India it was imposed as early as in 1860 [Shirras (1924)]. Its coverage was very wide. It applied to income from all sources including agriculture even though the latter was already under heavy taxation through land revenue. It remained in force for five years. It was reimposed in 1869 and was once again applied to all income including agricultural income. The tax was repealed in 1873 and reimposed in 1886. This time, however, agricultural income was excluded and the exclusion has stayed ever since. In sum, except for the initial nine years, agricultural income has remained exempt from income tax for over a century.

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An important reason for the exemption in 1886 was that agriculture was already subject to a major tax in the form of land revenue which was considered a counterpart of income tax. Also, agriculture was subject to a cess on land which was levied in lieu of income tax in 1877-78.

Soon after the exemption, agitation for the reimposition of income tax on agricultural incomes started. It gained momentum as the incidence of taxation on non-agricultural sectors increased and that of land revenue on the agricultural sector declined over the years. Further, the abolition of cess on land in 1905-06 strengthened the case of those who wanted the reimposition of agricultural income tax. The exemption also created a powerful temptation for the income tax assesses to show a part of their non-agricultural income as agricultural income to evade income tax. In 1918, a proposal was made that agricultural incomes should be taken into account in determining the tax rate applicable to income from other sources [Government of India (1928)]. The proposal, however, was rejected by the Government.

In 1925, the Indian Taxation Inquiry Committee made a vigorous effort to bring agricultural income within the ambit of income tax. It observed that there was no historical or theoretical justification for the continued exemption from income tax of incomes derived from agriculture [Government of India (1928)]. The Committee also endorsed the earlier proposal that agricultural income should be clubbed with other income for rate purposes. Both the recommendations, however, remained unimplemented. Then came the Government of India Act, 1935. It took away from the central government the jurisdiction to impose income tax on agricultural income. It, however, empowered the provincial governments, if they so desired, to impose a tax on agricultural incomes in the provinces concerned [Government of India (1935)]. In 1936, the Income Tax Inquiry Committee repeated the recommendation that agricultural and other income should be clubbed for the determination of the rate applicable to non-agricultural income. The recommendation was not accepted.

In 1937, a Land Revenue Committee was set up by the Punjab Government to examine whether a practical scheme could be devised by which the principles of income tax assessment could be applied to the assessment of land revenue. Interestingly, the Committee received a memorandum from a certain Institute of Agrarian Reform in Lahore, which demanded on behalf of the peasants of Lahore, the abolition of land revenue and the taxation of agricultural incomes according to a graduated scale as in income tax [Narain (1939)]. The Committee did not agree to the replacement of land revenue by income tax but suggested the following

major reforms in the land revenue system:

- (a) The introduction of a sliding scale system; and
- (b) Using a modified form of graduation with multiples of land revenue on larger farmers.

These recommendations, the Committee thought, would give land revenue a semblance of income tax which is assessed annually and has got progressive rates [Government of the Punjab (1938)]. The reforms were not implemented.

The Committee did not agree to the abolition of land revenue and its replacement by agricultural income tax mainly because that would have entailed a huge loss of revenue. In 1938-39, it may be noted, land revenue yielded as much as Rs 25 crore for the country as a whole compared to income tax which yielded only Rs 15 crore.

In 1938, in pursuance of the provisions in the Government of India Act 1935, Bihar was the first province to levy agricultural income tax. It was followed by Assam and Bengal in 1944. None of the provinces now constituting Pakistan introduced provincial income tax. Only the former East Pakistan had a provincial agricultural income tax. West Pakistan's agricultural income tax, levied in NWFP in 1948, in the Punjab in 1951 and in Sindh 1965, is a misnomer as it is only a multiple of land revenue.

Since 1947, almost every tax committee or taxation commission, both in Pakistan and in India, has recommended the imposition of central income tax on agricultural incomes, but the constitutional ban inherited from the Government of India Act, 1935, has stood in the way of its implementation. However, the twin recommendation that agricultural and non-agricultural incomes should be clubbed together for rate purposes had no constitutional barrier and was implemented in India in 1973-74 and in Pakistan in 1989-90.

While much agitation was going on for the imposition of Central Income Tax on agricultural incomes, land revenue which was once a major source of Government revenue imperceptibly passed into oblivion. Land revenue which contributed as much as 45 percent of the total central and provincial tax revenues of India in 1860 declined so sharply that in 1948-49, it formed only 9 percent of the aggregate tax revenues of Pakistan. Today, it forms a meagre 0.3 percent of the total tax revenues. Even if we add the *ushr* collections, the ratio rises only to 0.5 percent. It is tragic to note while so much fuss was being made over the years for the imposition of an agricultural income tax, a major source of government finance in the form of land revenue was allowed to die off almost unnoticed.

## EQUITY CONSIDERATIONS

Justice in taxation demands that equals should be taxed equally; also that unequals should be treated unequally. The former implies horizontal and the latter vertical equity. Both are based on the ability-to-pay principle. Equity is usually considered in the context of individual tax-payers. In the debate on agricultural taxation, however, it is the "intersectoral equity" approach which has received most attention. It implies that an equal proportion of income should be taken from each sector of the economy by way of taxation.

The concept of intersectoral equity can be faulted principally on two grounds. First, each sector hides within itself vast inequalities. In the agricultural sector, for instance, the top 10 percent of the landowners possess 54 percent of the total area. In other sectors, also the inequalities are equally marked. With so much intersectoral inequality, it seems to be totally fallacious to talk about "intersectoral equity".

Secondly, the estimation of aggregate sectoral tax burdens is based on so many arbitrary assumptions that widely divergent estimates have emerged in recent years. For instance, Kazi (1984) estimated that only 27 percent of the total indirect taxes were paid by consumers in the agricultural sector. Qureshi (1986), on the other hand, estimated that as much as 42 percent of the total indirect taxes was paid by the agricultural sector. Needless to say, such widely divergent estimates of sectoral tax burdens can be of little use for policy purposes.

In view of these conceptual and statistical problems, the intersectoral equity concept only leads to fruitless controversy and should be avoided. It may be more realistic to make estimates of the aggregate tax burden on individual tax-payers in comparable income brackets by the case-study method. Sectoral estimates of tax burden conceal more than what they reveal and can be highly misleading about the tax situation of the individual tax-payers in the sector. Further, the economic policies of the Government affect the entire economy while income tax is levied on particular individuals. Appropriately, any economic policy, e.g. the price policy, which militates against a particular sector deserves to be rectified in its own right and need not be mixed up with the income tax policy. Also, it is one thing to make an academic estimate of the burden of indirect taxes on a sector and quite another to argue on that basis against the imposition of income tax. A person who buys a Pajero and consequently has to pay a heavy amount of indirect taxes cannot use it as an argument against the payment of income tax.

An alternate concept of equity that appeals to common sense and is much

simpler to understand is that if a person having a sum of money to invest could secure an annual net return of, say Rs 80,000 from investing in business, Rs 60,000 from urban property or Rs 50,000 from investing in modern agriculture, there seems to be little justification why he should have to pay income tax on income from the first two investments and not on that from the third. The argument that the return from agricultural investment is already lower than that from the other investments due to government's discriminatory policies, does not justify its exemption from income tax because returns on investment vary from industry to industry. Also policies may change from one year to another causing consequent changes in returns. Lower income could invite lower amount of tax and vice versa. If net income is below the exemption limit, there will be no tax at all. On the equity ground, therefore, there is no justification for the exemption of the agricultural income from income tax.

### ADMINISTRATIVE CONSTRAINTS

Much has been said about the administrative difficulties in taxing agricultural income. Historical evidence in this regard is instructive. Firstly, if as far back as in 1860, the agricultural income could be taxed through income tax, there is no reason why it could not be done today. Secondly, the administration of income tax was with the provincial governments till 1922 when it was taken over by the central government. There is hardly any reason why provincial governments cannot administer a provincial agricultural income tax. Thirdly, administrative load depends upon the size of the exemption limit. Historically, the exemption limit of Rs 200 fixed in 1860 had to be raised to Rs 1000 in 1872 for administrative convenience. If 25 acres of irrigated and 50 acres of unirrigated land holdings were exempted from income tax, as provided in the 1977 Act, the potential number of assesseees would have been only 10 percent of the total land holders. Large commercial farmers who presumably maintain accounts and those who are purely cash rent receivers could be taxed easily as the determination of their net income should present no problems. In the case of owner-operators, who do not keep accounts, the determination of net income does present problems which have been tackled in various ways in other countries, e.g. by expressing net income as a function of the cash rent or by taking a fraction of the gross returns as net income.

### CONSTITUTIONAL PROVISIONS

As mentioned earlier, under the constitution, as in the Government of

India Act 1935, the federal government cannot impose income tax on agricultural income as it is neither included in the federal list nor in the concurrent list. In January 1977, however, the federal government did impose central income tax on agricultural income through Finance (Supplementary) Ordinance 1977. Before, however, the Act could be implemented, Martial Law was promulgated in July, 1977, and the law regarding agricultural income tax was first suspended and later its implementation cancelled. It is only the provincial governments which can impose an agricultural income tax, if they so desire.

### REVENUE POTENTIAL

It goes without saying that the government desperately needs additional revenues not only to finance development but also to meet its current expenditure. Presently, only 72 percent of the current expenditure of the central government can be financed by its current revenues. The remaining 28 percent of the current expenditure and the entire development expenditure have to be financed by internal and external borrowing. A major objective before the government in wanting to tax agricultural income must be resource mobilization rather than ensuring inter-sectoral equity. The fundamental consideration, therefore, is whether agricultural income tax has a sizeable revenue potential or not.

There are not very many estimates of the potential yields of agricultural income tax. Many people think unrealistically that there is a vast scope for raising additional revenue by taxing agricultural incomes. Some authors have estimated a yield of over Rs 4 billion [Faiz (1987)]. It is, however, too high an estimate. It does not require any sophisticated calculation to show that the revenue potential of agricultural income tax is very limited. The logic behind it is quite simple. The total yield of central income tax on the non-agricultural sector is only Rs 14-15 billion. The agricultural sector accounts for only 23 percent of the total GDP. That would imply that, at most, agricultural income tax could yield Rs 4-5 billion. However, that appears to be too high an estimate when we realize that nearly 52 percent of the total income tax revenue comes from domestic public companies, 7 percent from foreign companies, 32 percent from domestic private companies and only 9 percent from individuals and partnerships [Government of Pakistan (1986)]. In 1983-84, the total number of company assessees was 11,375. Nearly 40 percent of the income tax collection came from only 175 companies. In the light of these revealing facts, the revenue potential of the agricultural sector, which is marked by the lack of such corporate bodies would be very limited indeed. Even if we take into account the possible ending of tax

evasion presently occurring by non-agricultural incomes being shown as agricultural incomes, and the moving up of some assesseees in high tax brackets with the clubbing of the agricultural and non-agricultural incomes, the revenue yield cannot be very high. If I were to venture an estimate, I would not put it at more than Rs 1-2 billion, which is nothing but the proverbial peanuts especially when we see it in the perspective of Rs 2 billion coming from export duty on raw cotton alone in 1987-88.

### ALTERNATIVES

In view of the poor revenue potential of agricultural income tax, it is necessary to look for an alternative which can yield higher revenue. In my view, the obvious choice is the rehabilitation and reform of land revenue which is an old and familiar tax, a 'heritage of immemorial antiquity'. It has a vast revenue potential. In our enthusiasm for imposing an elusive agricultural income tax, we have lost, in the bargain, one of the most productive sources of government revenue.

To rehabilitate land revenue as a major agricultural tax, the following measures suggested by the I. U. Khan Committee need to be undertaken [Government of Pakistan (1966)]:

- (a) The period of settlement should be reduced to 15 years; and
- (b) The legal restriction whereby the land revenue demand cannot be increased by more than 25 percent of that imposed at the last settlement should be removed.

To reform the land revenue assessment system the following measures suggested by the 1937 Land Revenue Committee need to be adopted [Government of the Punjab (1938)]:

- (a) A sliding-scale system should be introduced according to which assessment of land revenue could be varied up or down according to changes in prices; and
- (b) A graduated surcharge upon the amount of land revenue due from the larger owners should be continued and made an effective instrument of resource mobilization.

### SUMMARY

Historical analysis shows that agricultural income like all other income was subject to income tax for nine years, i.e. from 1860 to 1865 and from 1869

to 1873. It was then exempted from income tax and has remained exempt ever since. While much agitation has been and is still going on for the imposition of central income tax on agricultural incomes, it is tragic to note that land revenue which was once a major agricultural tax has been allowed to fall into oblivion.

It goes without saying that from the equity point of view, agricultural income like all other income should be taxed. However, a major government objective in wanting to tax agricultural incomes must be resource mobilization rather than merely ensuring inter-sectoral equity. The fundamental consideration, therefore, is whether agricultural income tax has a significant revenue potential or not. In my estimation, the potential is very limited. The only alternative to mobilize a substantial amount of revenue from the agricultural sector is to rehabilitate and reform the system of land revenue. Experimenting with any new tax in agriculture is ill-advised. For the rehabilitation and reform of land revenue, recommendations have been made in the paper.

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