How “Buoyant” are Central Government Taxes?*

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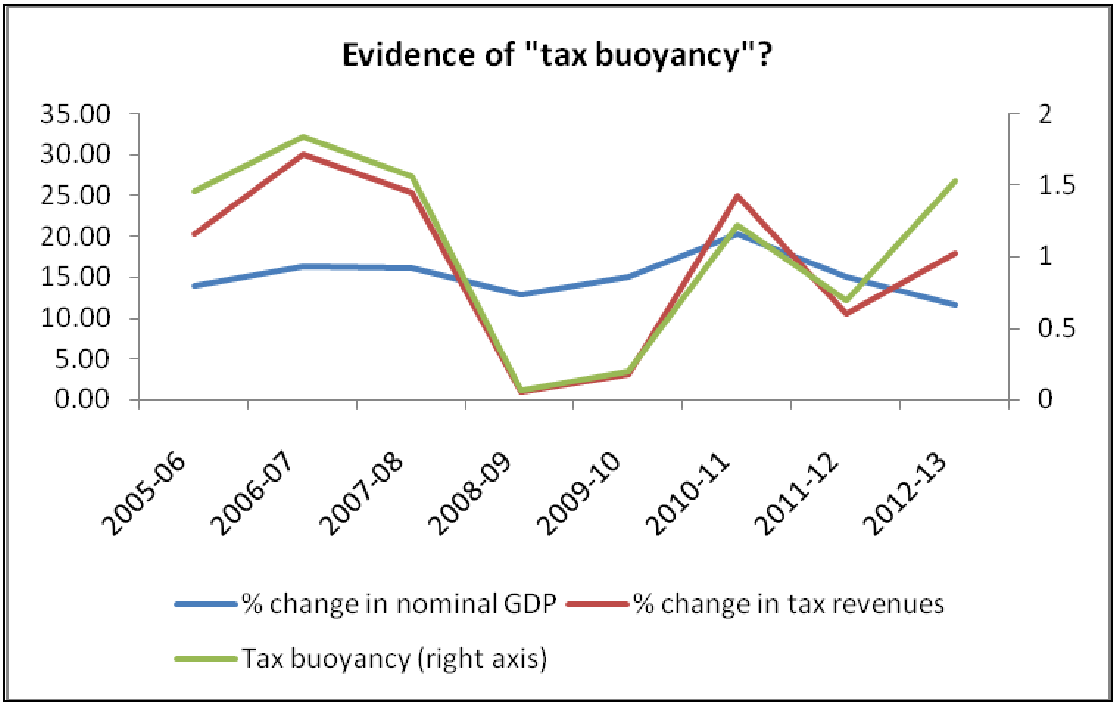
One of the features of several Union Budgets over the past decade and more has been the tendency to window dress the projected accounts through very optimistic expectations of tax revenues. The previous Finance Minister Mr P. Chidambaram may even be reckoned as a pioneer in this regard in the Indian context, with a Budget he presented as part of the United Front government back in 1996. But since then it seems to have become a standard device of many Finance Ministers, allowing them to anticipate lower fiscal deficits than would otherwise seem to be warranted by their expenditure and revenue raising patterns. The latest Budget presented by Mr Arun Jaitley is no exception, using extremely optimistic estimates of tax revenues to generate a relatively low Budget estimate of the coming fiscal deficit.

This is typically done by assuming high rates of “tax buoyancy” – in other words, assuming that GDP growth will generate higher tax revenues independent of (or even because of) lower rates of taxation. Taxes are said to be buoyant if the tax revenues increase more than proportionately in response to a rise in national income or output.

Sometimes this perception is then linked to the Laffer Curve– the idea that tax revenues will increase in response to lower rates because of higher compliance. Although this hoary old idea has been generally rejected by now in most countries as it has not conformed to actual experience, it is still periodically revived in India. And this idea is also implicit in the current Budget, where reductions in tax rates are nevertheless associated with anticipated increases in tax revenues.

It is worth examining the evidence on “tax buoyancy” in India. Chart 1 provides estimates of changes in GDP and changes in tax revenues in the period after 2004-05, as well as an estimate of “tax buoyancy” defined as the ratio between the two. The evidence clearly does not suggest any systematic relationship. It is interesting that “buoyancy” as defined here seems to be entirely driven by the changes in tax revenues rather than by changes in GDP – and we know that these changes in tax revenues in turn have been largely determined by changes in tax policies and tax administration. So assuming that “buoyancy” will work to generate higher tax revenues in the current year does not seem to be justified by the experience of the past decade in India.

Chart 1: Tax revenues do not seem to respond systematically to changes in nominal incomes



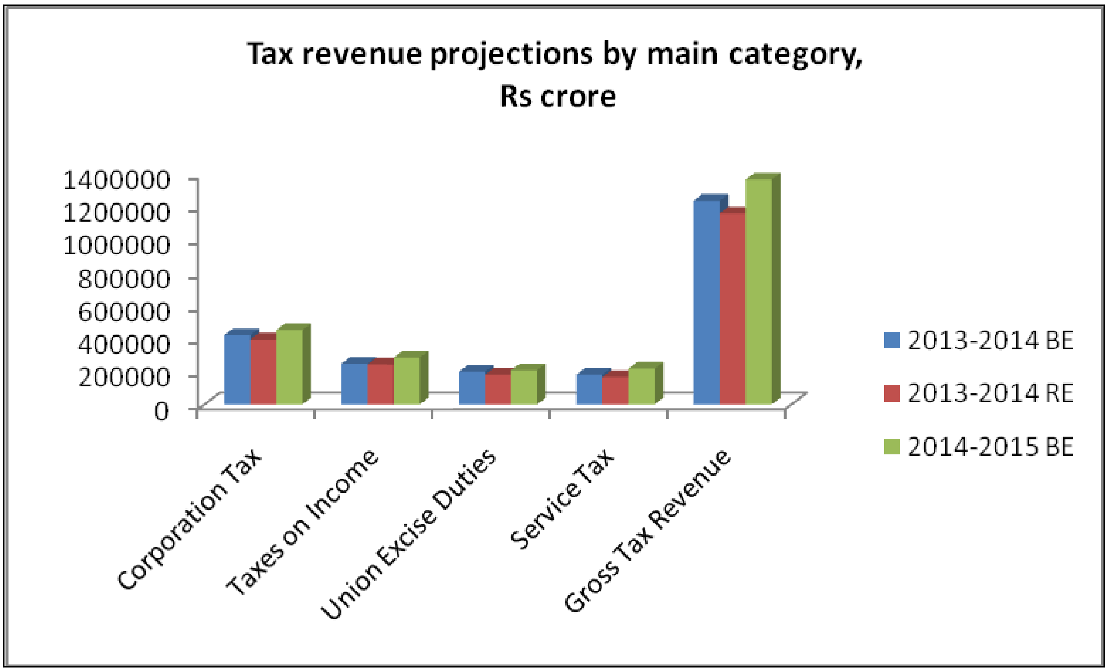
As it happens, the Budget does contain a number of tax sops, provided both to corporate who were so important in funding the rise to power of this government, as well as to a relatively small section of the middle class that the ruling party probably sees as an important constituency. So there has been an increase in minimum income that would be subject to taxation and enhanced exemptions of income diverted to savings and investment. Similarly there are concessions to companies on dividend taxation as well as more tax incentives for various types of corporate investment as well as foreign portfolio investment.

The individual benefits from these various measures may be small, but the aggregate fiscal cost is not insignificant. The Finance Minister himself estimates the revenue loss arising from these and other direct tax concessions at Rs 22,200 crore. His effort to partly recoup that loss by tinkering with indirect taxes yields only Rs 7,525 crore, implying a net revenue loss of Rs 14,776 crore.

Despite these tax concessions, the Finance Minister expects to increase gross tax revenues by more than Rs. 220,000 crore in 2014-15 as compared with around Rs. 122,700 crore in 2013-14. But nominal GDP is anticipated to increase by only 13.4 per cent. If, despite the various tax concessions that amount to considerable fiscal loss tax revenues are still expected to keep approximate pace with the projected nominal GDP, this is really assuming very high tax buoyancy indeed, at a rate that is not warranted by the previous Indian experience in any way.

As it happens, Mr Jaitley may not believe his own revenue projections, any more than Mr Chidambaram believed his over optimistic projections in the previous year. Chart 2 shows that tax revenues fell short of the Budget estimates last year in all the major categories of taxation as well as in the total. If Mr Chidambaram was still able to keep the overall fiscal deficit down to his Budget estimate, that is only because he slashed spending, in almost all major areas that affected the welfare of the people and the development of the country.

Chart 2: Tax revenues fall well short of Budget projections



Indeed, in some cases the expenditure cuts were so cynical that they even involved not paying the dues of the Central government, for example of wage payments under the MNREGA. More than Rs 1100 crore is the amount of unpaid wages that were not paid last year to desperately poor daily wage labourers who had put in their manual labour under this programme – probably only because the Government could keep the spending under this head down to the Budget provision, even though this is supposed to be a demand-driven programme that responds to workers' need for work.

A similar strategy may well be in the current Finance Minister's mind, which points to another unfortunate element of continuity in the economic strategy of the central government.

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