III. TAX/GDP TRENDS IN THE 1990S AND FUTURE PROSPECTS

1. Introduction

Chapter II has indicated the target levels of gross tax revenue, both for Centre and states separately for the terminal year of the Tenth Five Year Plan, 2006-07. While doing so, it has also indicated target levels for 2000-01 and 2001-02, the first two years of the award period of Eleventh Finance Commission (EFC) and each year of the Tenth Plan, 2002-07. Target levels have been indicated in relation to GDP[1] as well, with the latter slated to grow nominally at 15 percent per annum over 1999-2000 (New Series). <u>The objective of this chapter is to examine these targeted tax/GDP levels in relation to historical trends as in evidence during 1989-2000.</u>

Thus, the analysis covers the period from 1989-90 to 2000-07. The period 1989-90 to 1999-2000 relates to historical trends. For the Centre, tax figures for 1999-2000 relate to revised estimates. For the states, tax figures for 1998-99 and 1999-2000 relate to revised and budget estimates respectively. The year 1999-2000, which has been taken as the base year by EFC reports two different sets of tax figures, one relating to historical trend and the other as normatively assessed. However, normative assessment with regard to central taxes is the same as reported under historical trends. For 2000-01 and 2001-02, projections by EFC have been adjusted in light of the assumed nominal growth of GDP at 15 percent, which is higher than 13 percent assumed by EFC. For the Tenth Plan period, by using a simple tax/GDP model, as discussed in the previous chapter, a set of projections has been derived.

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1 GDP at market prices is used. Figures for **GDP at market prices** relate to the new series which, for the period 1993-94 to 1999-2000, are taken from the report of the EFC and thereafter grown at 15 percent per annum for the years that follow. For the period 1989-90 to1992-93, GDP figures (New Series) are obtained by multiplying the old series with a factor of 1.0577. The factor is obtained by averaging out the excess of GDP (New Series) over the old series for the years 1993-94, 1994-95 to 1996-97. Incidentally, a similar exercise is also performed by EFC for deriving GDP figures (Old Series) for 1997-98 to 1999-2000.

The design of this chapter is as follows. **Section 2** examines tax/GDP ratios for the system as a whole as well as for Centre and States separately. **Section 3** examines tax/GDP ratios for the Centre separated into Customs, Union Excise, Corporation Tax and Personal Income Tax. **Section 4** examines tax/GDP ratios for the states as a whole separated into Sales Tax, State Excises, Stamps & Registration Duties, Tax on Motor Vehicles, Tax on Goods & Passengers, Electricity Duty, Professional Tax, Land Revenue and Entertainment Tax. **Section 5** offers concluding observations.

2. Gross Tax Collections of Centre and States

Total gross tax collections for the system as a whole in relation to GDP has come down by 1.89 percentage points from 16.07 percent in 1989-90 to 14.18 percent in 1999-2000. For the Centre, the reduction has been of the order of 1.89 percentage points from 10.69 percent to 8.80 percent and for the states, maintained at the level of 5.38 percent. While for the Centre, the decline has been steady, interspersed with few years of trend reversal, for the states the fluctuation has been within a narrow band of 0.30 percentage points. The declining ratio for the Centre has reduced its share in total tax collections from 66.5 percent in 1989-90 to 62.0 percent in 1999-2000. This is further borne out by differences in tax buoyancy, which (roughly calculated by dividing the average annual growth in tax revenues by the average annual growth in GDP) for the Centre stands at 0.85 and for the states at 1.00. Tax buoyancy for the system as a whole stands at 0.90 during the period 1989-90 to 1999-2000 (see Graph III.1 and Appendix table Tables III.1 and III.2).

As against this, the tax/GDP ratio is required to reach 17.78 percent in 2006-07, which is higher by 1.71 percentage points to what was attained in 1989-90 and by 3.69 percentage points to what is prescribed in the base year (1999-2000). As against the base year, for the Centre the required increase to meet the target level is 2.08 percentage points and for the states, 1.61 percentage points. In terms of buoyancy, it implies that during 2000-07, the Centre must achieve an average annual buoyancy of 1.24, States, 1.30 and the system as a whole, 1.26. While the increase in buoyancy for the entire system measures 0.36, for the Centre and States it stands at 0.39 and 0.30 respectively. However, this is still not good enough to increase the share of central taxes in total taxes which, between the base and terminal year, reduces by 1.30 percentage points.

Thus, it follows that though in terms of relative efforts, the EFC assigns a higher responsibility to the Centre than to the states, the share of states in the gross collection of taxes in the terminal year increases with respect to the base year, thereby sustaining a secular decline in the share of central taxes as witnessed from historical trends. This is because notwithstanding a greater effort assigned to the Centre with respect to the base year 1999-2000, the final effort as projected in 2006-07 for the Centre exceeds the 1989-90 levels by a smaller amount as compared to the states.[2] If gross central tax revenues are to be restored to their 1989-90 share, the prescribed growth of central tax revenues by 2006-07 needs to be still higher. However, instead of doing that, Advisory Group has sought to focus more on state revenues, reflecting greater potential for generating higher tax revenue at the level of states.

The declining share of central tax revenues in total revenues together with an increasing share of states' share of central taxes has also implied that the Centre has been unable to strike a revenue account balance. In the projection made, Advisory Group has required a revenue effort by the Centre to arrive at a full revenue balance for the system as a whole, by 2006-07. In fact the revenue account for the entire system shows a surplus of 0.50 of GDP in the terminal year.

3. Gross Tax Collections of Centre

In terms of tax/GDP ratios, the fastest growing central tax has been the Corporation Tax, which increased by 0.57 percentage points from 0.98 percent in 1989-90 to 1.55 percent in 1999-2000. Next to follow was Personal Income Tax that increased by 0.34 percentage points from 1.04 percent to 1.38 percent during the same period. These growths were by and large steady. Customs and Union Excise recorded declining trends. In relation to GDP, Customs collections reduced by 1.26 percentage points from 3.73 percent in 1989-90 to 2.47 percent in 1999-2000 and Union Excises by 1.48 percentage points from 4.64 percent to 3.16 percent over the same period. Though a relatively better performance of Corporation and Income Tax increased their combined weights in total central taxes from 18.9 percent in 1989-90 to 33.3 percent in 1999-2000, the combined weights of Customs and Union Excise still remained higher despite reducing from 78.3

2 This reflects the fact that the Centre's tax/GDP ratio fell between 1989-90 and 1999-2000.

percent in 1989-90 to 64.0 percent in 1999-2000. Thus the combined reduction in Customs and Excises outweighed the enhancement in the Corporation and Personal Income Tax ratios to GDP. As a result, the overall central tax to GDP declined by 1.89 percentage points over the given period (see Graph III.2 and Appendix Tables III.3 and III.4).

The improvement in the performance of Corporation and Personal Income Tax is perhaps explained by an increase in the number of assessees and better compliance due to structural changes including reduction in the average and marginal tax rates. In fact a one-time Voluntary Disclosure Scheme (VDIS) in 1997-98, whose proceeds are included under the category ‘Others’ showed a significant jump thereby indicating a large potential for direct taxation. The below par performance of Union Excises is explained by lowering of rates and significant extension of the tax credit system under the MODVAT Scheme. The decline in the share of Customs could be explained in terms of a steep decline in the highest rate and substantial reduction in the average effective rates. Indeed, a major reason for reduced revenue collection in both cases is that rate reductions were not accompanied by removal of concessions and exemptions. Since further reduction of custom tariffs and comprehensive extension of the tax credit system under the MODVAT- governed Union Excises are on the anvil, it would not be prudent to assign significant efforts to indirect taxation for the purpose of projecting the terminal year benchmarks.

As compared to base year estimates, Customs have been assigned to decline by 0.03 percentage points of GDP from 2.47 percent to 2.44 percent, the latter being significantly lower than 3.73 percent achieved in 1989-90. However, Union Excises have been assigned a marginal growth of 0.34 percentage points from 3.16 percent in the base year to 3.51 percent in the terminal year, the latter again being significantly lower than 4.64 percent achieved in 1989-90. Corporation Tax on the other hand has been assigned a significant jump of 0.80 percentage points from 1.55 percent in the base year to 2.35 percent in the terminal year, which is 50 percent more than the growth during the period 1989-2000. Personal Income Tax has also been treated similarly, being assigned a growth of 0.50 percentage points from 1.38 percent in the base year to 1.88 percent in the terminal year of the Tenth Plan.

Thus, an assignment of larger effort to direct taxes to almost one and one half times of 1989-2000 performance during the period 2000-07 and freezing the effort of indirect taxes to base year levels, increases the combined weight of Corporation and Personal Income Tax in total central taxes from 33.3 percent in the base year to 38.9 percent in the terminal year. The combined weight of Customs and Union Excises reduces from 64.0 percent in the base year to 54.8 percent in the terminal year. However, the weight of 'Others' increases by two and a half times from 2.7 percent to 6.4 percent. In relation to GDP, the growth of 'Others' in fact trebles. The growth is entirely due to taxation of services, which reflects the proposed structural shift in tax policies that is expected to successfully bring in the yet neglected, highest and fastest growing share in GDP, into the tax net.

4. Gross Tax Collections of States

The performance of individual taxes under states' taxes has by and large been stable with negligible fluctuations on either side of the tax/GDP trend line. Sales Tax and State Excises, two major constituents of states' taxes only marginally increased their weight in total states' taxes from 72.8 percent in 1989-90 to 74.00 percent in 1999-2000. Expectedly their ratios with respect to GDP also did not undergo significant changes, which for Sales Tax increased marginally from 3.12 percent in 1989-90 to 3.18 percent in 1999-2000. Excises followed a trend line of 0.80 percent, except for the period 1994-95 to 1996-97, where a declining trend could be explained by a policy of prohibition in a few states. However, performance of Land Revenue as a percentage to GDP, significantly deteriorated from 0.14 percent in 1989-90 to 0.08 percent in 1999-2000. This may be due to a major compositional shift in GDP from agriculture to services. The stagnancy of Professional Tax at 0.07 percent builds up a case for an extensive coverage of service taxation at the state level. (see Diagram III.1 and Appendix tables III.5 and III.6

Given Advisory Group's base and terminal year benchmarks for state taxes consistent with the macro economic assumptions, pro-rata changes are effected on individual items of state taxes aggregated across all states and as obtained in 1999-2000 (historical trends). This builds up projections for the base year as well as the period of projection. As a result, inter-se weights of individual taxes as obtained in 1999-2000 (historical trends) get duplicated in the base year as well as each of the years of the period of projection.

Thus, Sales Tax and State Excises that constitute 74 percent of total State taxes in 1999-2000 continue to be so in future as well. In relation to GDP, Sales Tax is projected to increase from 3.12 percent in the base year to 4.07 percent in the terminal year. State Excises are projected to increase from 0.78 percent to 1.02 percent. Stamps and Registration from 0.47 percent to 0.61 percent. In combination, this is not infeasible in reflection of anticipated VAT reforms of states. The combined weights of the three taxes at 82.6 percent in 2006-07 have terminal year projections higher than what was achieved in 1989-90. This is consistent with the combined state tax effort projected at 6.90 percent in the terminal year exceeding 5.38 percent obtained in 1989-90 by 1.52 percentage points.

Terminal year benchmarks for Sales Tax and State Excises in excess of what was achieved in 1989-90 may appear to be inconsistent with the understanding that the entire indirect tax structure, both for the Centre and states, is scheduled to graduate to VAT under which input tax credit would be comprehensively given. Thus, some reduction in tax collection could be expected unless final rates were appropriately adjusted upwards. However, this seemingly anomalous situation could be mitigated by extending the VAT beyond first point taxation. Currently Sales Tax in all states is primarily first point. Since value added at subsequent points is not taxed, it constitutes a good potential for augmenting the Sales Tax base which, if tapped successfully, could help achieve the benchmarks derived from the Group's projections.

5. Concluding Observations

For the system a whole, the share of Union Excises and Customs in gross total tax collection has reduced from 30 percent and 23 percent respectively in 1989-90 to 20 percent and 14 percent respectively in 2006-07, a combined loss of 19 percent. On the flip side, the share of Corporation Tax, Personal Income Tax, Sales Tax and State Excises in gross total tax collection has increased from 6 percent, 6 percent, 19 percent points. and 5 percent respectively in 1989-90 to 13 percent, 11 percent, 22 percent and 6 percent respectively, a combined gain of 16 percent points. The balance 3 percent points gain has come from expansion of service taxes, which is reflected under ‘Others’. ‘Others’ would increase due to a larger contemplated coverage of services in the tax net. Thus, the loss of indirect taxes at the Centre is countered by the gain of direct taxes at the Centre, major taxes of states and service taxation. This shift in the tax composition has been in evidence in recent years and is expected to continue further to the terminal year projections for 2006-07. In line with this compositional change, the following policy stances emerge:

- A concerted effort is required to tap the hitherto untapped potential under Corporation and Personal Income Tax as well as to target services as a tax base. Increasing the number of assessees, simplifying tax structure, reducing the tax burden to encourage compliance, and improving the efficiency of tax administration comprise thrust areas.

- A composite reduction of customs tariffs to internationally comparable levels for increased competition and global integration may be accommodated as projected growth in customs revenue in relation to GDP has been allowed to decline marginally with respect to the base year. A comprehensive central VAT may also be put in place in lieu of Union Excise Duties by eliminating any remaining cascading of input tax. A moderate growth of Union Excise revenue as projected with respect to the base year should allow for this structural change.

- State Governments hitherto slow in terms of raising tax revenue in relation to GDP must focus on two primary sources of revenue, Sales Tax and State Excises. In this light, the intended adoption of a State VAT will provide an impetus to revenue collection, as value additions after the first point sales tax, thus far outside the tax base, would be fully tapped. Given a positive and significant growth assigned to Sales Tax and State Excises, adoption of a State VAT at the level of states must be taken up on priority basis and at the earliest.