SHANKAR IAS PARLIAMENT
Information is Empowering

# Tax Buoyancy and Tax Devolution

## What is the issue?

- Poor responsiveness of tax collection to economic growth poses new challenges for norms on sharing taxes with the states.
- In this regard, here is a look at tax buoyancy trend and its impact on tax devolution.

## What is tax buoyancy?

- Tax buoyancy is one of the key indicators to assess the efficiency of a government's tax system.
- Generally, as the economy achieves faster growth, the tax revenue of the government also goes up.
- Tax buoyancy explains this relationship between the changes in government's tax revenue growth and the changes in GDP.
- In other words, it measures the responsiveness of tax mobilisation to economic growth.

## What are the determining factors?

- Tax buoyancy depends largely on -
    i. the size of the tax base
    ii. the friendliness of the tax administration
    iii. the reasonableness and simplicity of the tax rates
- Look at just one year's tax buoyancy to arrive at any conclusion on the tax system's efficiency would be unfair.
- There are many other factors at play in either boosting or pulling down tax buoyancy.
- Also, there is a lag effect of taxation policies.
- This can be captured only by examining the trend over a longer period of time.
- Thus, tax buoyancy in a year may reflect the impact of an adverse set of developments during that year.
- However, usually, the longer-term trend of tax buoyancy during a period of about 5 years results from policy changes made a few years earlier.
- So, the lag effect of policy changes on tax buoyancy can hardly be ignored.

## How has the trend been?

- The highest tax buoyancy rate for the Union government during the last 28 years after economic reforms was achieved in 2002-03.
- Tax buoyancy that year had risen to 2 at that time.
- This meant that the Centre's gross tax revenues had grown at double the rate at which the Indian economy had grown in nominal terms.

- However, just a year before tax buoyancy hit the record high of 2, gross tax collections in 2001-02 actually declined.
- This was even as the economy had clocked a nominal growth rate of just over 8%.
- So, in the 5 years of 1999-2000 to 2003-04, there was poor tax buoyancy in 2 years and commendable tax buoyancy rates in the other 3 years.
- The period thus holds the record for both the highest and the lowest tax buoyancy rates in post-reforms India.
- During the 2004-05 to 2008-09 period, the first 4 years recorded tax buoyancy between 1.3 and 1.7, a creditable performance.
- In the fifth year (2008-09), there was a sharp fall in tax buoyancy to about 0.2.
- This was due to the impact of the global financial meltdown and the tax measures taken to alleviate its impact on the economy.
- Thus, tax buoyancy was fairly moderate between 1 and 1.3 in 4 of these 7 years between 1991-92 and 1997-98 and was poor in the remaining 3 years.
- But, the tax reforms undertaken during this period did help boost the tax buoyancy rate in the following decade.
- Similarly, the tax reforms during 1999-2004, particularly in the indirect taxes regime, helped tax buoyancy in the 2004-09 period.
- The period of 4 years between 2009-10 and 2011-12 saw tax buoyancy quite irregular.
- The 2014-19 period saw steady performance in tax buoyancy.
- In the first half of 2019-20, the Centre's gross tax revenue grew by just 1.5% over the same period of 2018-19.
- However, tax buoyancy fell further to about 0.15.
- This is on the assumption that the nominal economic growth in the first half is 10%.

## What does the slowdown indicate?

- Deterioration in tax buoyancy in the recent year is a cause of concern for the central exchequer.
- It can upset the government's plans for fiscal consolidation.
- It can also provide a misleading basis for the 15th Finance Commission's

calculations on sharing the Centre's tax revenues with the states.

- If the current low tax buoyancy is used to project the revenue growth for the next 5 years, revenue challenges for both the Centre and the states will only become more complicated.

### What lies ahead?

- The task before the 15th Finance Commission is how it can arrive at a more reliable base for calculating tax buoyancy in the coming years.
- If it makes the wrong assessment now, the tax collection assumptions can become flawed, adversely affecting the new tax devolution formula.
- So, getting a sense of the long-term and sustainable trend of tax buoyancy will be crucial for the tax sharing recommendations of the 15th Finance Commission.

**Source: Business Standard**