What demonetisation did to tax collections

The argument about whether demonetisation was good or bad for the economy refuses to die down even a year after the event. Former RBI Governor Raghuram Rajan took potshots at it in a recent speech.

While one can endlessly debate, with very little data, on whether the ban on high-value currency notes dealt a body blow to terrorism, corruption and counterfeiting, one area in which its impact can be quantified with data is tax compliance.

In the last sixteen months, there has been a lot of premature analysis on India's tax compliance metrics based on sporadic data points cited by the Finance Minister and tax officials. But with the deadline for FY17 return filings ending on March 31, official data on direct tax collections for FY17 and FY18 is available. This makes an objective analysis possible on what demonetisation did to India's tax base. The news is mostly good.

Better collections

India managed a second consecutive year of strong growth in its direct tax collections in FY18. Net collections (gross mop ups minus refunds) increased by 17.1% in the just concluded fiscal year, to Rs. 9.95 lakh crore.

This was after a 14.6% increase in the mop ups in FY17. It should be noted that income tax rates have largely stayed put in the last couple of years, with only minor increases in the surcharge and cess components.

Now, compared with the first two years of the NDA rule, the last two years' numbers are very healthy. In FY15 and FY16, India's direct tax kitty witnessed growth of just 8.9% and 6.9%.

But seen from a historical perspective, a 14% or even 17% annual increase in direct taxes isn't extraordinary for the Indian economy.

For instance, in fiscal year FY14 (under the UPA government), direct tax collections rose 14.3%. In FY11, they had expanded 18%. Clearly, these numbers were achieved without any tinkering with high-value currency notes.

So how would we know if direct tax collections have really revved up post-demonetisation?

Higher buoyancy

Well, a good way to gauge this is to evaluate direct tax buoyancy. Given that direct taxes both for individuals and businesses are levied as a percentage of their annual income, it is reasonable to expect taxes collected to march in step with GDP growth. This is what tax buoyancy measures, by dividing the growth in tax collections for each year by the nominal GDP growth. Higher the number, the better the compliance. Applying this measure to India shows that tax buoyancy has indeed picked up post-demonetisation. In the seven years from FY08 to FY14, direct tax buoyancy hovered between 0.5 and 1.1 times, averaging out at 1 for the period.

Put simply, every additional rupee of nominal GDP growth for India yielded an equivalent new rupee of direct taxes for the Centre. After hovering at 1.0 until then, in FY15 and FY16, direct tax buoyancy unaccountably slumped to 0.8 times and 0.6 times.

But since the note ban, buoyancy numbers have perked up quite a bit. Direct tax buoyancy doubled from 0.6 times in FY16 to 1.3 times in FY17 and accelerated further to 1.7 times in FY18.

(For these computations, we used the latest available nominal GDP estimates from the CSO, using the new series from FY12).

This is good news indeed, because India's nominal GDP growth has been below historical levels in the last two years, due to low inflation. If nominal growth revs up, and the new-found tax buoyancy holds up, the Centre's direct tax coffers could fill up even faster in the coming years.

More filers

Not all of the direct taxes flowing into the Centre's kitty come from citizens willingly paying up their tax. The direct tax collection numbers put out by the Central Board of Direct Taxes (CBDT) include mandatory deductions by way of the much-hated tax deducted at source (TDS).

It typically accounts for a third of the collections each year. A good way to measure voluntary tax compliance, and to strip out the impact of TDS, is to look at the number of Income Tax (IT) returns being filed by individuals and businesses each year.

In FY14, just before the NDA swept into power, 3.79 crore IT returns were filed by taxpaying entities (this includes individuals, small businesses and companies). Over the next two years to FY16, this number crept up to 4.36 crore. That's a 15% addition over two years.

But the latest CBDT data (provisional) tells us that the number of filings zoomed to 6.84 crore by the end of FY18. That's a 57% increase in the last two years (2.48 crore new filings).

As IT returns are typically filed for the previous financial year, the filings at the end of FY18 would fully capture the demonetisation impact. Yes, one can still debate if it was the act of demonetisation that sparked this sudden good behaviour.

The NDA government has made anti-evasion a top policy priority and has been systematically plugging loopholes in tax laws in its last few Budgets. In the post-note ban period, the CBDT has also been on an overdrive to show good collection numbers, unleashing a flurry of notices, warnings and raids on non-filers.

But without looking the gift horse on tax filings too closely in the mouth, one can still cheer this new found improvement in tax compliance. After all, getting non-filers to step into the parlour is the first step to expanding the income tax net. Once a citizen begins to file returns, a contribution to direct tax collections must inevitably follow. Better compliance would eventually provide headroom for the Centre to prune down income tax rates.

The outdated 3%

Income tax payers in India have always felt a sense of victimhood because they make up such a small sliver of the population, with dozens of memes and jokes dedicated to this 'unfortunate' 3%.

But recent numbers on India's tax base suggest that this figure is now quite outdated. In the latest Budget, the Finance Minister pegged India's current direct tax base at 8.27 crore taxpaying entities. The official definition of 'tax base' sweeps in all assessees who have filed their IT returns in the last three years, and adds in those who paid TDS.

Now, the Indian population featured 25 crore households as per the last Census. If one assumes agricultural households to make up about 40% of that number, (given that agricultural income is exempt from tax) potential tax-paying households (or entities) can be guesstimated at about 15 crore. A tax base of 8.27 crore makes up well over half of this number.

Tax base estimate

A ballpark estimate of the individual taxpayer base is equally reassuring. Of the estimated population of 132 crore, the working population is estimated at about 40% (52.8 crore). If half of the workforce is assumed to be engaged in agriculture, that's a potential tax base of 26 crore individuals. With individual income tax payers already topping 6 crore, it is clear that a fourth of those who owe income tax are already paying tax.

Detractors will point out that, though India's tax base has grown at a furious pace in the last couple of years, the CBDT has mostly netted small fish, as its tax collections haven't kept pace with the number of newbies joining the tax system. That is true. CBDT data does show that newbie return filers have mostly joined the bottom of the pyramid where tax rates are nominal or nil.

But hopefully, as India's income levels improve over the next few years and it transitions into a middle-income economy, these new return filers will graduate into the higher tax slabs and cough up their due share of taxes.

This should pave the way for the government to loosen up on its anti-evasion measures and prune its sky-high income tax rates.

On the flip side, only return filers at low tax rates have joined the bottom of the pyramid

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