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A DIRECT OUTCOME OF DEMO IS A SHARP INCREASE IN FY18 IN TAX BUOYANCY. GIVEN THIS "UNEXPECTED" RESULT, WILL THE KNEE-JERK CRITICS OF DEMO PLEASE STAND DOWN?

Tax fruits of demonetisation

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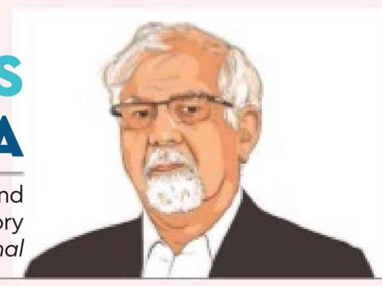


ONE STRONG ARGUMENT against the policy of demonetisation is that it has failed to achieve its goal of catching black money—and it has brought about a perceptible decline in GDP growth. In FY16, GDP growth averaged 8%; in FY17, GDP growth was 7.1%, and FY18, the CSO expectation is for an average of 6.5%. A 1.5% lower growth rate is very close to the Congress's claim that GDP growth would decline by 2 percentage points because of demonetisation. I don't know if the negative growth effects of demonetisation were expected to persist for 17 months (demonetisation was announced on November 8 2016, and fiscal year FY18 ends March 2018), but the correlation of the decline with demonetisation is pronounced.

Of course, there are other factors that could have led to the decline in the GDP growth rate. The "usual suspects" for growth decline include macroeconomic imbalance, lack of adequate infrastructure, growing NPAs of banks, and an appreciating exchange rate. All of these problems (except an appreciating exchange rate) were present in FY16. The nominal exchange rate did depreciate by 7% in FY16 when the growth rate accelerated from 7.5% to 8%; however, in FY13, the exchange rate depreciated by 14% (rupee/$ went from 54.4 to 60.4) and GDP growth rate declined from 6.6% to 5.5%. Further, note that the average exchange rate in fiscal year FY18 is just 2% higher than that which prevailed in the high growth year FY16.

There will be another occasion to discuss how much, and in what manner, the exchange rate affects GDP growth. For the moment, I just want to observe that no economist associated with the UPA government is mentioning, let alone pointing to, the major contributory cause to the lower growth rate in FY18—the large increase in real repo rates to 3%, the highest observed in India since 2003, and the third-highest among major countries in FY18 (behind Brazil and Russia).

I want to go back to demonetisation; some economists (and their followers on Twitter) are unabashedly claiming that no "good" economist has supported the policy of demonetisation. Of course, this is an embarrassingly self-serving ideological view, but we will let that pass, for the moment. There are at least three realised short term "costs" to the policy of demonetisation; costs of implementation (standing in queues, etc); all the money being returned into the system (no black money being caught red-handed), and most importantly, a decline in the GDP growth rate (but that could also be due to exchange rate, infrastructure, NPAs, or real interest rates).

So, what did India gain from demonetisation? Demonetisation was announces on November 8 2016. In an article written 11 days later (*goo.gl/C5Dbxc*), I wrote that a necessary condition for considering demonetisation a success would be a significant increase in direct tax compliance, i.e., the tax revenue collected from individuals and firms should increase significantly.

In other articles over the last two years, I have discussed how circa FY14, personal tax compliance in India was a low 25%, i.e., the government was able to collect only 25% of the money that was due (based on the tax schedule and income distribution). As comparison, in the US (IRS data), the government is able to collect 82% of taxes due from households.

In other words, if tax compliance were to increase, there would be considerable scope for revenue enhancement for a given unit of income (nominal GDP) growth.

One measure of an increase in tax compliance is an increase in tax buoyancy. Buoyancy is conventionally defined as the ratio of percentage change in tax collection to percentage change in GDP, where the latter is a proxy for percentage change in personal pre-tax income.

Direct tax compliance has averaged around unity for most of the years 2002-2014 (see chart). Note that in four of the early years (2002, 2003, 2006 and 2007) buoyancy was above 2, reflecting the increasing spread of taxation (more people being brought under the tax net) and increasing spread of TDS (tax deducted at source), as well as a rather robust growth in corporate profits.

Between FY10 and FY15, direct tax buoyancy averaged 0.93, i.e., for each 10% increase in GDP, direct tax collections rose by 9.3%. From 2014, a time-period during which the Modi government was very public about its "attack" on corruption and its efforts to increase tax compliance, until late 2016, tax buoyancy did not change much.

In 2015, direct tax buoyancy was the same as in 2014, a low 0.81. In demonetisation year FY17, direct tax buoyancy increased to 1.22. And based on data for three-quarters of the fiscal year FY18, tax buoyancy has jumped to 1.90—the highest excluding the four exceptional years noted above (2002, 2003, 2006 and 2007).

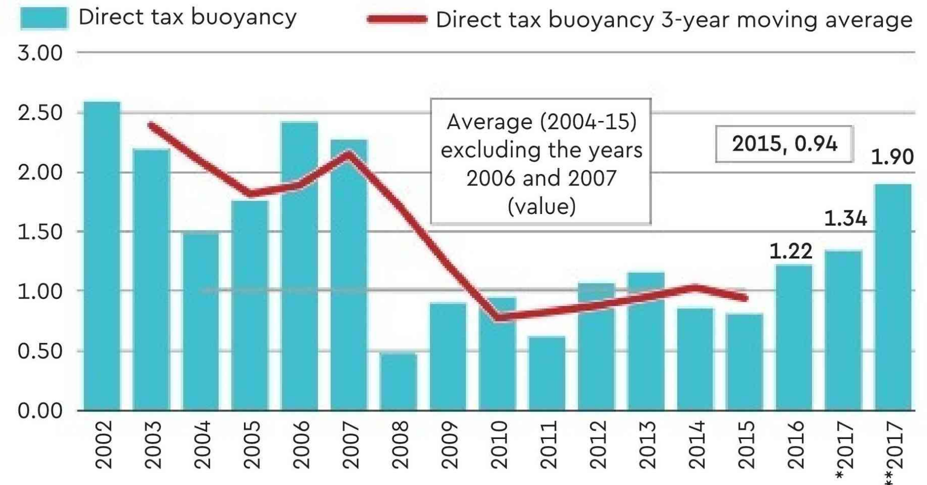
At the time of presentation of the Budget FY18 (February 1, 2017), demonetisation was less than three months old, and its effects were highly uncertain. Yet, the Modi government pencilled in a large 15.7% increase in direct tax revenues along with the expectation of an 11.75% increase in nominal GDP, i.e., an expected tax buoyancy of 1.34, a significant increase over the recent decadal average of unity.

However, nominal income only increased by 9.5% (partly, or mostly, due to a very hard-line monetary policy). With the expected tax buoyancy of 1.34, direct tax revenues would have increased by 12.7%, resulting in a direct tax revenue deficiency of ₹26,000 crore in FY18.

Now, with net direct tax revenues growing at an 18.2% rate (April through December), rather than the budgeted 15.7% rate, there should be close to ₹20,000 surplus in direct tax collections. Net-net, the economy will have gained ₹46,000 crore.

There is little reason to believe that the extra buoyancy is temporary; rather, this is likely to be a permanent change in India's fiscal landscape. The full implementation of GST should also enhance the buoyancy of both direct, and indirect, tax collections. If tax collection buoyancy is also reflected in GST collections, then the budget deficit for FY18 is likely to be close to the budgeted target of 3.2%. And if that happens, will demonetisation critics say that perhaps it was good that no "good" economist endorsed demonetisation?

Direct tax revenue buoyancy



Note: X axis is fiscal year e.g. 2016 is April 2016-March 2017 *Budgeted, **Expected