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Abstract

The estimate of tax revenue foregone by the government crashed in 2015-16 after steadily rising over the previous decade. This was, however, on account of substantive methodological revisions rendering the estimates incomparable across years. Reconstructing the series accounting for these revisions reveals that the crash entirely disappears. In absolute nominal terms, the tax revenues foregone have remained stable and the share of revenues foregone on direct taxes (in the total) has increased. With significant changes to the overall tax architecture (e.g., the move from VAT to GST), it is unclear how useful the current method of calculating the tax revenue foregone series remains for an assessment of tax expenditures or latent fiscal space.

Keywords: Tax revenue foregone, tax exemptions

JEL classification: E62, H20

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A. Introduction

Starting in the mid-2000s until 2015-16, the tax revenue foregone statement (TRFS) became one of the most eagerly awaited figures when the Budget was announced. As the name suggests, the TRFS estimates the tax revenues foregone by the state on account of exemptions provided on various grounds. Despite various methodological shortcomings (see Rao 2013 for more details), the TRFS provided consolidated information on tax expenditures by the state hitherto unavailable.

Almost all countries provide tax emptions to promote certain socially desirable behaviours. The Indian government has deployed tax policy for an expansive range of objectives including industrialization of backward areas, promotion of small-scale industries, encouraging research and development, and development of Special Economic Zones. These come at a cost – to tax administration, tax revenues and with unquantifiable evidence of its impact on the desired behaviour (Bagchi, 1974). Importantly, they result in unintended distortions in resource allocations and lack transparency like other forms of expenditures like direct subsidies (Gupta 1984; Rao, 2010). The limited research on the efficacy of tax exemptions in the Indian context suggests ambiguous results coupled with considerable costs (Tulasidhar and Rao 1986; Rao 2009; Mani 2010).

Good tax policy which minimizes the costs of taxation is broadly characterised by a broad-base, lowest possible tax rate given revenue needs, and limited taxes on production (Bird and Zolt 2008). Additionally, a simple and transparent tax system reduces the compliance costs. In contrast to these widely accepted best practices, tax exemptions narrow the base, increase compliance costs, and create avenues for tax evasion. Consequently, economists have tended to be sceptical of tax exemptions and generally recommended against their inclusion in the tax code.[1]

Even before the Government of India started publishing the TRFS, review of the Indian tax laws suggested that tax expenditures were large (Bagchi 1974; Gupta 1984). However, any exercise of quantifying the magnitude was severely constrained by the lack of systematic management and reporting of data. Since 2006-7, the government has published the TRFS along with the budget documents. To estimate the tax revenue foregone, the government uses the difference between the "standard" (or declared) rate of taxation and the "effective" rate (resulting from exemptions) (Rao 2013).

Figure 1 plots the series for the entire period, along with the breakup for direct and indirect tax revenue foregone. Between the financial years 2014-15 and 2015-16, the absolute TRF dropped from Rs. 5.54 lakh crores to Rs. 2.87 lakh crores (in nominal terms). As a percentage of gross revenue receipts of the government, the tax revenue foregone was halved – from 50% of gross revenue receipts to just 24% in 2015-16. The drastic reduction was not entirely on account of a reduction in exemptions, but also due to a change in methodology in calculating the TRFS.[2] The effect of the lack of a comparable series across the years, has 'demonetized' the use of the TRFS in public debates.

[1] In the context of the United States, see Auerbach and Slemrod (1997) for a review of the Tax Reform Act 1986 which eliminated various special provision for specific sectors of the economy along with broadening the tax base and reducing marginal tax rates.

[2] Starting 2015-16, the budget documents renamed it "Statement of Revenue Impact of Tax Incentive under the Central Tax System".

This short note attempts to reconstruct a comparable (across years) series of TRFS. This is important given that on the one hand, fiscal space is said to have shrunk in the economy, and on the other, there appears to be a need for a fiscal stimulus to boost demand in a flagging economy.

B. Adjusting for changes introduced since 2015-16

The following major changes in methodology have occurred since 2015-16. Figures 1a and 1b report how the tax revenue foregone changes (upwards) for each for the adjusted components. [3]

1. **Unconditional and conditional exemptions**: 'Unconditional' exemptions on customs and excise and exemptions on customs due to trade agreements duties began to be excluded. The adjustment on account of trade agreements is justified, as the Indian government does not have discretion over some of these. As the budget documents report these exemptions (see e.g., Table 1.19, p. 45 in the TRFS 2018-19), we add them to make the series comparable with previous years.
2. **Excise related adjustments**: Excise was subsumed under Goods and Service Tax (GST) from 2017-18 onwards, so it has not been reported in the recent TRFS. For the sake of comparability, for 2017-18 and 2018-19, as an approximation, we can either (i) take the value of 2016-17 for both years or (ii) make simple projections using previous years data. We take the lower of the two for computing the lower bound (i.e., repeating the value of 2016-17) and projected values in the estimate of the upper bound.
3. **Incentives and exemptions for exports**: Revenue foregone on export-linked incentive schemes on account of duty scrips etc. were excluded from the estimate of foregone revenues prior to 2015-16. In order to resolve this inconsistency with the earlier series, we exclude them for 2017-18 and 2018-19 also.

These three adjustments have been labelled A, B and C respectively in Figures 1a and 1b and have been discussed below.

C. Basic Trends in India

Figures 1a and 1b provide a time series of what has been happening to the tax revenue foregone, in nominal terms (Figure 1a) and expressed as a percentage of Gross Tax Revenues (Figure 1b). Both figures plot the unadjusted series (i.e., as reported in the TRFS) as well as the adjusted series (making an allowance for the adjustments outlined in the section above). As is evident in Figure 1a, the crash in the series in 2014-15 when the methodology was changed, disappears entirely when the adjustments are made. In the past six years, the tax revenues foregone have been stable between Rs 5-6 lakh crores. There has been a steady decline in tax revenues foregone as a percentage of gross tax revenues (GTR) since 2011-12 (when it was 60% of GTR) down to 28% of GTR in 2019-20 (the latest year for which data are available).

As far as the components of the tax revenue foregone are concerned, the largest share throughout the period has been on account of exemptions in customs and excise duties (around 60%). With the new methodology, the relative share of indirect tax revenues foregone seem to shrink (to 30%), but after adjustments, their share remains high (more than half, as before). The revised methodology under the NDA government (Figure 2a) appears to shrink the largest pre-revision component (indirect

[3] Wherever necessary, we estimate an upper and lower bound. The upper bound is reported in the annexure, and the lower bound is used in the discussion.

taxes). The adjusted (nominal) series shows that these remained the largest components of the total tax revenues foregone, and while there has been a reduction in both, the decline is nowhere as large as depicted in government estimates.

After adjustments, revenues foregone on direct taxes (corporate and individual) remain a smaller component than on indirect revenues. Panels A and B of Figure 2 clearly show that the share of exemptions in personal taxes has been rising steadily since 2013-14. In the past two financial years, as per adjusted estimates, its share has been one-fifth of all tax revenues foregone. Their share in total tax revenue foregone has increased from 10.5% and 6.4% in 2013-14 to 17.9% and 20.7% respectively in 2019-20. [4]

D. Other changes over time

Rao (2013) flagged that correction on account of Minimum Alternate Tax (MAT) were not accounted for prior to 2010-11. This had the effect of inflating the revenue foregone on corporate tax. We used Prowess to estimate MAT prior to 2010-11 as the estimates from there match budget estimates presented in Meel and Sharma (2017). The companies that are included in the Prowess database are few but account for around 70% of corporate tax collections of the government. Therefore, as an approximation, we use the MAT credits accumulated and MAT credits utilized variable to get the MAT for these years. We use the average over these years to estimate how much the tax revenues foregone need to be reduced to correct for earlier years.

Another minor adjustment (improvement) is possible. For the years 2006-07 and 2008-09, the government underestimates revenue foregone on corporates by 10% due to incomplete data. Underestimations of a similar magnitude are made for firms/AOIs/BOPs for the years 2006-07 to 2010-11. Usually, in such cases of incomplete data, the government has corrected by making appropriate extrapolations, however, they do not do so for these cases. We make appropriate extrapolations for these though the impact of such correction is small. These two adjustments (i.e., on account of MAT and incomplete data) are presented in Figure 3.

E. Concluding remarks

Other unresolved issues, highlighted by Rao (2013), with respect to the TRFS include: one, the TRFS excludes dividends received by individuals from Indian companies and exemptions provided for long-term capital gains and two**,** activities exempt from taxation (e.g., agricultural incomes and some services). Both these would have the effect of increasing the tax revenues foregone. We have not provided adjustments for these factors either.

Further, customs duties are prescribed primarily as basic custom duties (BCD), countervailing duties (CVD), or Special Additional Duty (SAD). Starting 2017-18, CVD and SAD have been subsumed under GST and exemptions on CVD and SAD have been withdrawn. Since the exemptions itself have been withdrawn, adjustments on this account are not required. Since the introduction of GST, should we be thinking about revenue foregone on account of GST? If so, how? How should we be thinking about

[4] On unconditional and conditional exemptions: The upper bound, available in the Appendix, shows a higher rate of growth than the lower bound.

revenue foregone on 'excise' since technically that tax category does not exist in the tax structure anymore (see point 2 in Section B above).

From 2014-15, the total income filed by charitable entities is reported, but not used in the estimates of the TRFS. The total income reported by charitable institutions in FY 2013-14 was Rs. 2.0 lakh crores (36% of the TRFS for that FY, and more than that foregone on excise).[5]

Rao (2013) had already highlighted the lack of comparability of these estimates across years on account of revisions in methodology. With so many changes in *both*, the overall taxation architecture and in the way that tax revenue foregone are estimated, it is not clear how meaningful the current method of estimating tax revenue foregone remains to comment on tax expenditures and latent fiscal space in the Indian economy.

[5] This relates to incomes by charitable institutions. Donations by individuals/firms to charities is accounted for in the corporate/ individual revenue foregone. It is not clear whether entire amount reported by the government as incomes filed count to revenue foregone. Presumably, the entire income should not be counted but only that which would be taxed under the tax system had they not been charitable institutions.

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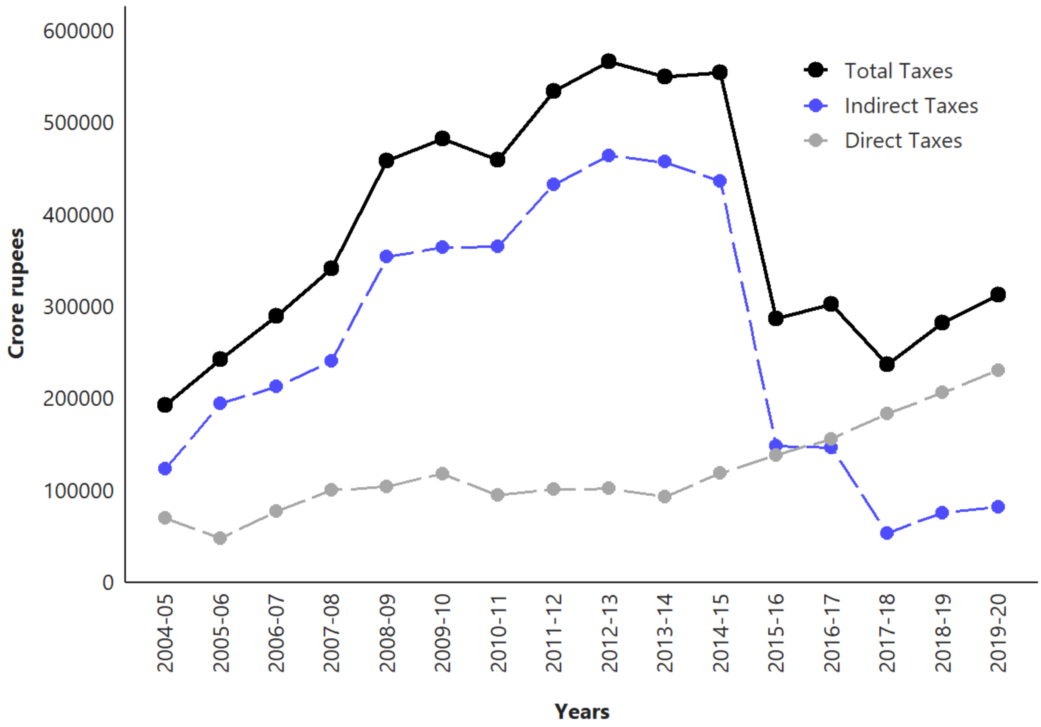
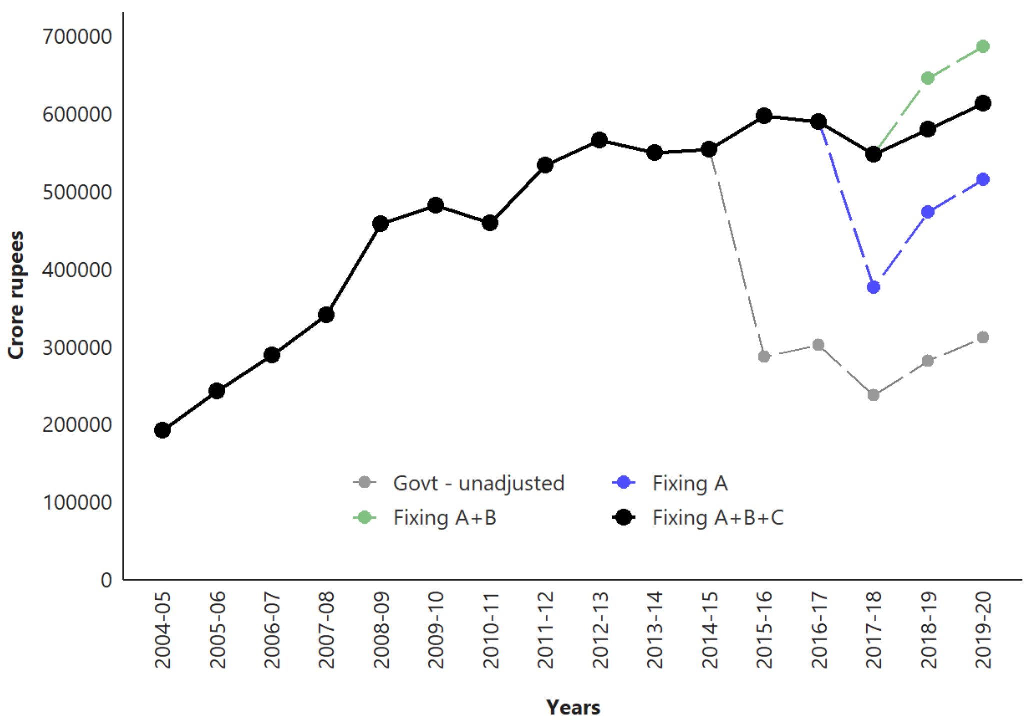
Figure 1: Total Revenue Foregone (Nominal, Rs. Crores) – Government estimates



Source: Tax Revenue Foregone Statement, various years

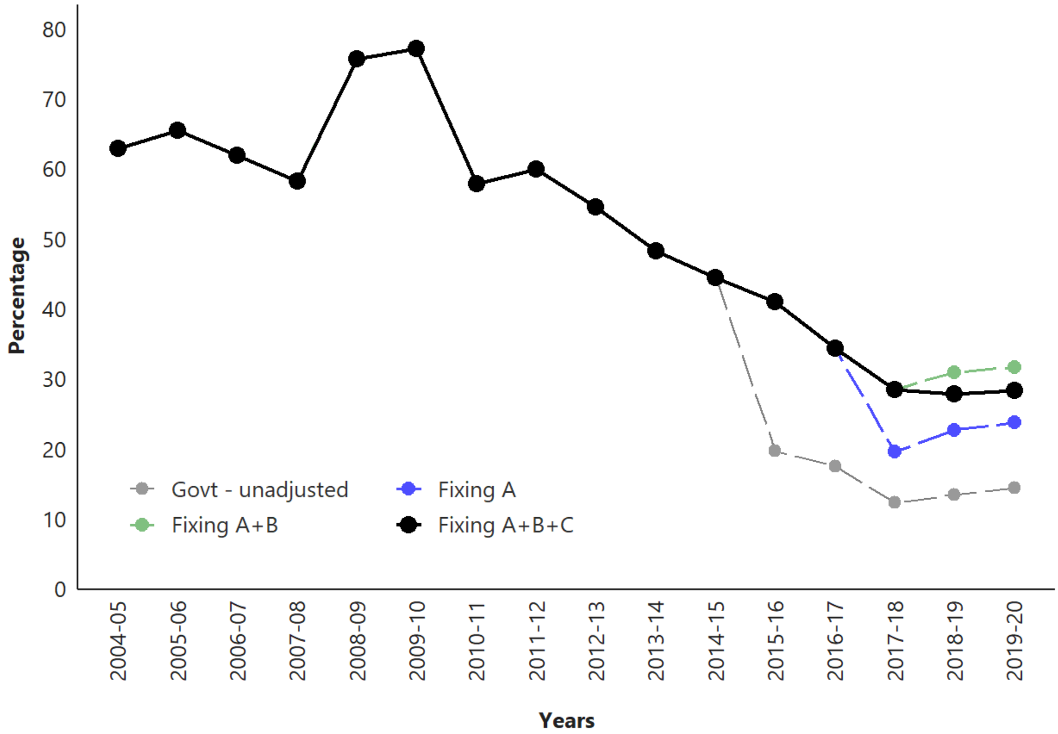
Figure 1A: Total Revenue Foregone (Nominal, Rs. Crores) – Magnitude of various adjustments



Source: Tax Revenue Foregone Statement, various years

Note: A: Unconditional customs & excise and FTAs; B: Excise under GST; C: Duty scrips

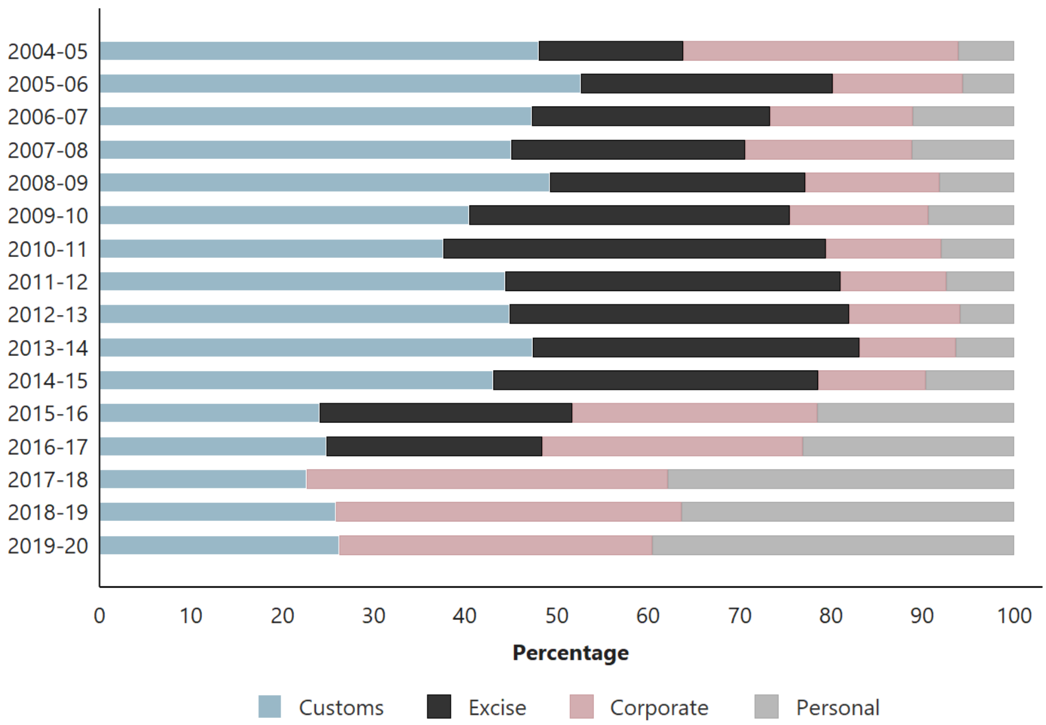
1B: Total Revenue Foregone as a Percentage of Gross Tax Revenue



Source: Tax Revenue Foregone Statement, various years

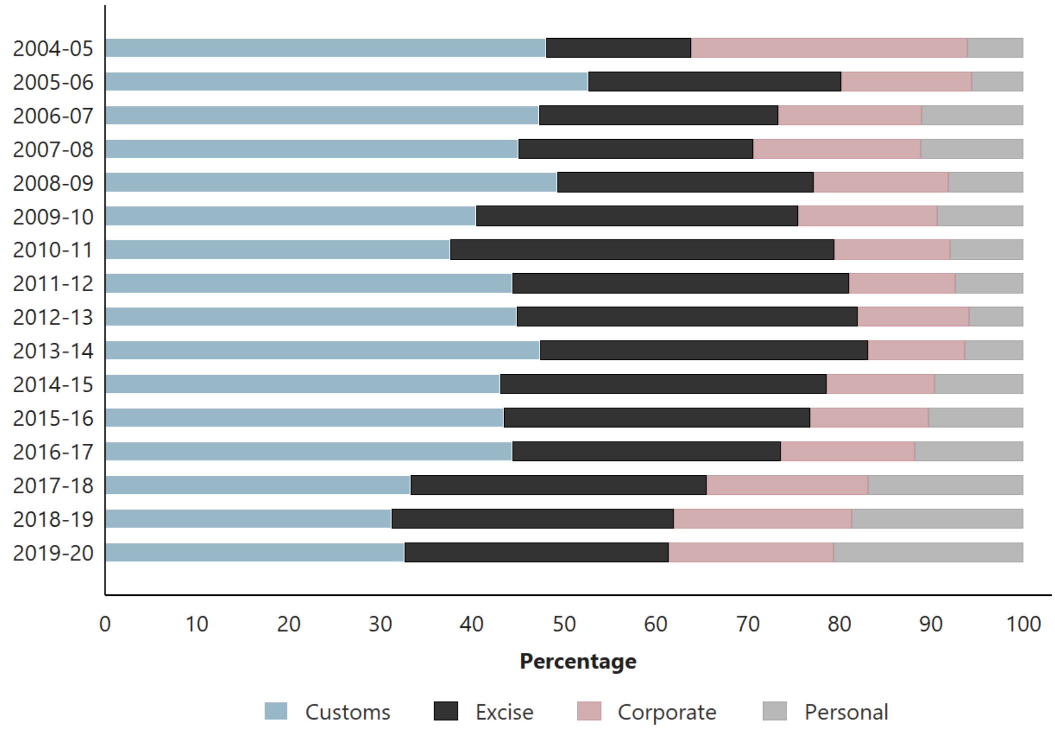
Note: A: Unconditional customs & excise and FTAs; B: Excise under GST; C: Duty scrips

Figure 2A: Shares of components of Total Revenue Foregone – Government Estimates



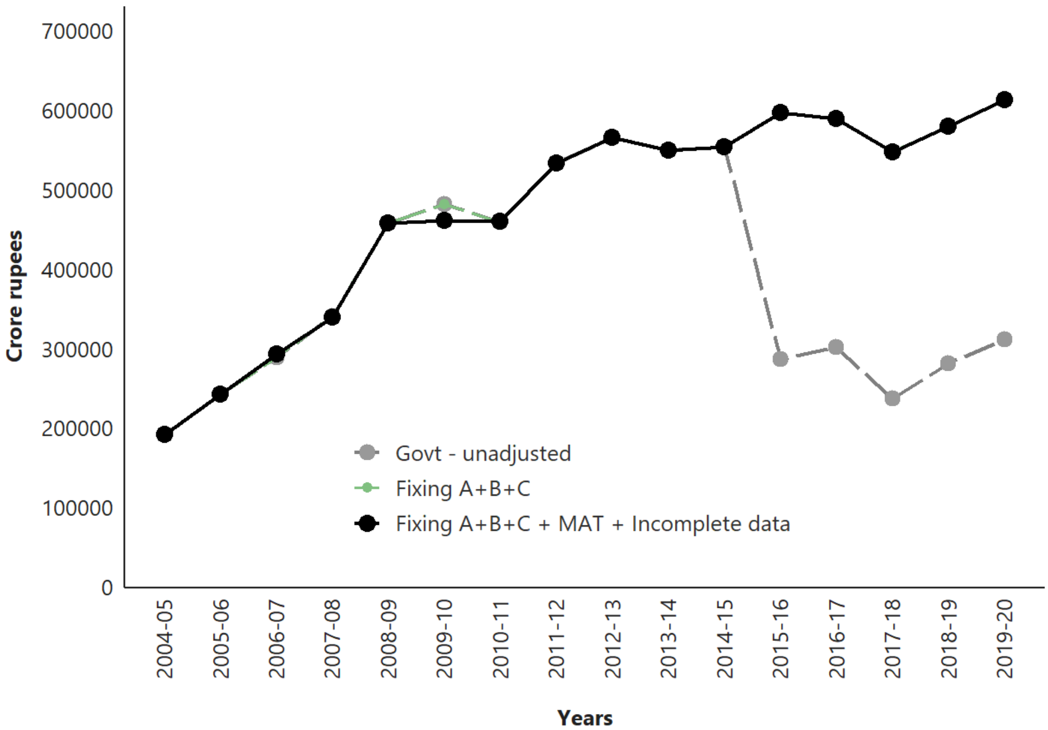
Source: Tax Revenue Foregone Statement, various years

Figure 2B: Shares of components of Total Revenue Foregone – Adjusted Estimates



Source: Tax Revenue Foregone Statement, various years

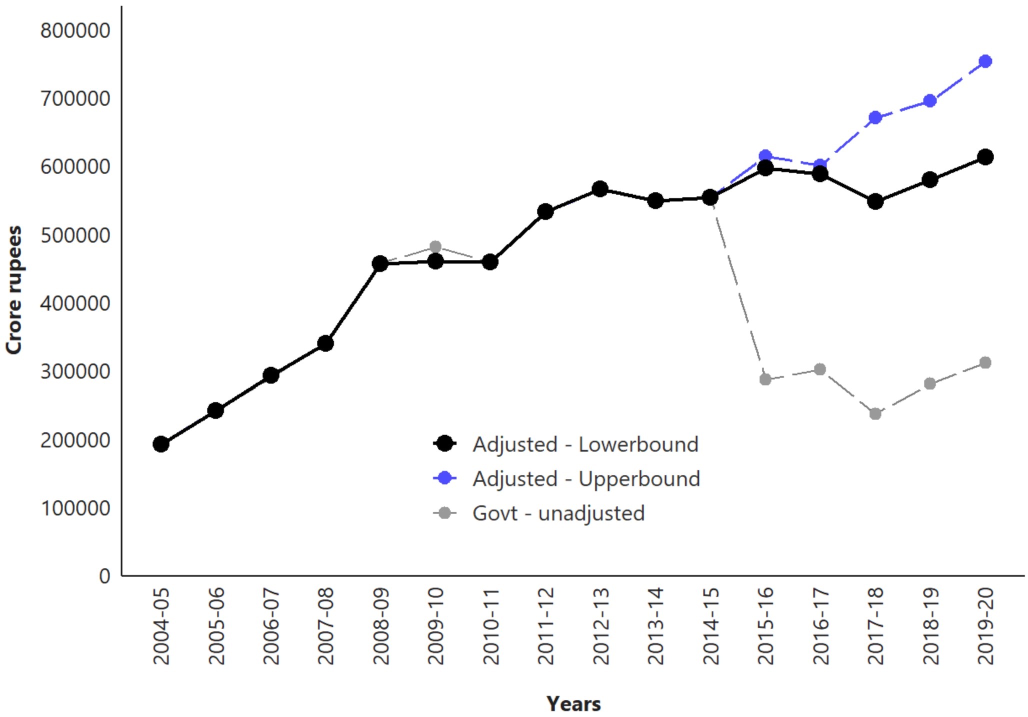
Figure 3: Total Revenue Foregone correcting for MAT & Incomplete data



Source: Tax Revenue Foregone Statement, various years

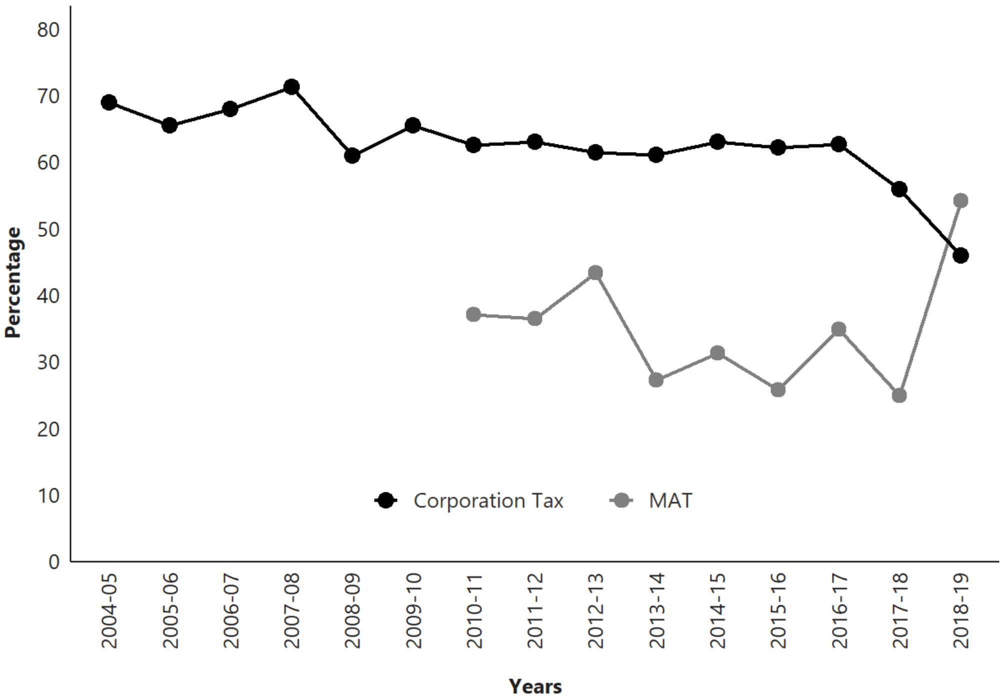
Note: A: Unconditional customs & excise and FTAs; B: Excise under GST; C: Duty scrips

Appendix Figure 1. Total Revenue Foregone – Govt vs Adjusted (including Upper bound)



Source: Authors' estimates based on Tax Revenue Foregone Statement, various years

Appendix Figure 2. Share of total budget taxes captured in Prowess database



Source: Budget Documents and CMIE Prowess Database

Note: This graph depicts the total corporation tax and additional tax due to MAT as recorded in the Prowess database as a percentage of the respective totals as reported in the budget documents.