

## On Measurement of Tax Effort of Indian State Governments

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Tax effort of state governments has been a neglected issue in the studies on Indian public finance. Although the need for measuring tax effort of state government was realised by the First Finance Commission (1952), it was only the Fifth Finance Commission (1969) which attempted to measure and use 'tax effort' as one of the criteria for devolving the statutory transfers from the Centre to the States. It used, however, per capita tax-income ratio as the measure of tax effort which is an extremely crude measure. Reddy (1975) attempted to measure the states' tax effort by the "taxable capacity ratio approach." But many of the explanatory variables included in his 'tax effort model' have strong multicollinearity between them which undermines the reliability of his results. Recently, Chelliah and Sinha (1982) have made a comprehensive study (hereafter referred to as C-S study) of the tax effort of 15 state governments, at the request of the IBRD. In this study, they have followed the Representative Tax System Approach. It is the findings of this study that are most likely to form the basis of the public opinion, within the country and abroad, on the issue of tax effort by the Indian state governments. Besides, if a Finance Commission decides to use 'tax effort' as one of the criteria for the statutory devolution of central resources among the states, the C-S estimates of tax effort may play an influential role. The C-S estimates, however, suffer from certain methodological drawbacks which raise doubts about the appropriateness of the Representative Tax System approach and, consequently, about the validity of the results.

The purpose of this paper is to offer a critique of the C-S study and present an alternative measure of states' tax effort. It will also be shown that a different methodology can substantially alter the ranking of states in their tax performance.

### II

#### THE C-S STUDY

Before we analyse the major drawback of the C-S study, a brief review of methodology of this study is in order.