CHAPTER-I
INTRODUCTION

Incurrence of public expenditure is a necessity for any government to perform a variety of its functions for welfare of the society, for which public revenue is required to be generated. Public revenue holds the same status in the study of public finance, which production holds in the study of applied microeconomics.

Income of a government through all its sources is called public income or public revenue. It includes income from taxes, prices of goods and services supplied by public enterprises, revenue from the administrative activities (such as fees, fines, etc.), gifts and grants. Dalton (1971) has made a clear distinction between public revenue and public receipts; public receipts include all the incomes of the government which it may have during a given period of time. That is, public receipts equal public revenue plus income from all other sources, such as, public borrowings from individuals and banks (or Central Bank) and issue of paper currency.

As regards various sources of revenue, these include taxes, commercials revenues, administrative revenue, grants and gifts. Of these, tax is known to be a major source of revenue.

Taxes are compulsory payment to government without expectation of direct return or benefit to the tax payer (Taylor, 1948). Seligman (1920) defined tax as “a compulsory contribution from person to the government to defray the expenses incurred in the common interest of all, without reference to special benefits conferred.” Taussing (1971) puts it, “…the essence of a tax, as distinguished from other charges, by government, is the absence of a direct quid pro quo (or give and take) between the tax payer and the public authority.” According to De Marco (1958) “The tax is the price which each citizen pays to the state for covering his share of the cost of general public service which he will consume.” As per Dalton (1971), “the best system of taxation from the economic point of view is that which has the best, or the least-bad economic effects.”
Thus taxation is a necessary charge imposed upon the people for enabling the state to render its services to them all. Even if a person does not receive some of these services, he must contribute towards their expenses in the common interest. It thus becomes obvious that the elements of a tax are: a tax is a compulsory contribution, and that this contribution is for common benefit as between the services rendered by the government and the payment of a tax. A tax is not imposed upon an individual to realise the cost of benefit from him. A poor person may be benefited most by way of public expenditure, but he/she may be least affected by way of taxation. That is, a tax has no relation with the cost of service a government renders to an individual. Then, taxes are imposed by a government only; if the management or trust of a temple makes it compulsory for every family of a particular area to pay a specified sum every year, it can not be called a tax. The aim of taxation is the welfare of the community as a whole and not of a particular section of the community, on one hand, and removing disparities of income, on the other. Taxes are not exacted because they are compulsory, and the public expenditure is incurred for the common benefit, although the benefit may not be in proportion of the payment of a tax. Taxes may be assessed on income and capital, but they are actually paid out of income. Similarly, a tax may be imposed upon an individual or property or commodities but they are actually paid by individuals. Lastly, a tax is a legal collection (Tyagi, 1975).

Taxes have been classified in various ways on different criteria (such as the form, nature, aim and methods of taxation). Two of the commonly adopted classifications are:

A. (a) Progressive, (b) Proportional, (c) Regressive, and (d) Digressive taxes.

B. (a) Direct, and (b) Indirect taxes.

The term progressive, proportional, regressive and digressive refers to the relation between the tax rate and the tax base (income).

As per the second classification, taxes are mainly of two types: direct and indirect. A tax which is paid by the person on whom it is legally imposed and the burden of which cannot be shifted to any other person is called direct tax. As per Dalton (1939), “a direct tax is really paid by the person on whom it is legally imposed”. The
person from whom it is collected cannot shift its burden on somebody else. Thus the impact \textit{(i.e.,} initial burden or the first burden\textit{)} and the incidence \textit{(i.e., the ultimate burden)} of direct tax is on the same person. The tax payer is tax bearer. These taxes include: (a) Income Tax; (b) Estate Duties; (c) Wealth Tax; (d) Expenditure Tax; and (e) Gift Tax.

On the other hand, indirect tax is the one which is levied on one person, but paid partly or totally by another (Dalton, 1939). According to Mill (1909), “Indirect taxes are those which are demanded from person in the expectation and intention that he shall indemnify himself at the expense of another”. Indirect taxes include: (a) Excise Duties; (b) Export and Import Duties; (c) Sales Tax; (d) Passenger Tax, etc.

Indirect taxes are further classified as (a) Specific; and (b) \textit{ad valorem}. A Specific Tax is fixed per unit of the commodity or on the basis of physical quantity of the product. Specific tax is easier to apply and is, more or less, homogenous one. On the other hand, \textit{ad valorem} tax is imposed as a fixed percentage of the price of taxed product. As such, it is responsive to price changes of the products and has the characteristics of built-in flexibility. Moreover, if the commodity has many classifications and sub-classifications (as in case of textiles), \textit{ad valorem} tax is more suitable. However, in certain cases, specific tax and \textit{ad valorem} tax can both be combined for taxing a commodity on specific-\textit{cum-ad valorem} basis (Chelliah, 1994).

In India, both the Union Government as well as the state governments collect their tax revenue, mainly from two sources: (a) Taxes on Income; and (b) Taxes on Commodities.

The main source of revenue of Government of India is taxes on income, \textit{viz.}, a tax on personal income and another on corporation profits. The personal income tax, first levied in the year 1860, is imposed on the net income of individuals. It is a graduated tax and that rate of the tax increases with increase in income. This tax is based on the principle of ability to pay and conforms to the canon of equity. Another one is corporation tax which is a tax on the net profits of companies (Sundram, 1972).
According to the Indian Constitution, the Union government can impose taxes on commodities. There are two important commodity taxes for the Union Government: (a) Custom Duties; and (b) Union Excise Duties. Customs Duties are the ones which are levied on the goods exported and imported. Import duties act as a protectionist measure to defend domestic industries and also to earn foreign exchange from abroad. Similarly, export duties, in addition to earning income, are imposed so as to discourage the exports of raw materials and essential goods which are in scarce supply for domestic consumption (Sury, 1997).

At one time, custom duties were the largest source of revenue for the Central Government. But gradually (with the opening of the economy), their importance has declined because export duties were removed, almost completely, with the idea of pushing up exports. Central excise duties represent the single largest source of tax revenue in India. Excise duties are imposed on commodities manufactured and produced in India, except alcoholic drinks, opium, narcotics and narcotic drugs (Sury, 1997).

Since independence, the Indian tax system has undergone major changes from time-to-time. For instance, estate duty was abolished in 1985. Similarly, wealth tax has virtually been abolished by the Tax Reforms Committee, 1991. The committee recommended that in order to encourage the tax payers to invest in productive assets, such as shares, bonds, bank deposits, etc., these financial assets should be exempted from wealth tax. During 1991, gift tax was integrated with income tax and, thus, gift tax was abolished. It was argued that gift tax, as a separate entity has failed to serve a useful purpose; it may therefore be merged with income tax. By treating gifts as a source of income and thus levying income tax on the donee, a separate legislation for gift tax could be dispensed with. One reason for the abolition of these taxes was that the valuation of assets was difficult for tax officials. They were almost busy in detecting taxable assets, grappling with under-valuation of properties. Another likely reason for doing so could be that these taxes contributed insignificantly to the revenue generation (Sury, 1997). Thus, after abolition of these taxes, the country was left with taxes on income and taxes on commodities.
At the federal level, at the time of independence, India inherited a system of commodity taxes in which Union Excise Duties (UEDs) were levied on about a dozen articles, yielding a small proportion of total tax revenue to the centre. After independence, the rates were raised, the base was enlarged, and more and more items were brought under its net. Over a period of time, there has been a speedy extension of UEDs. It was not only levied on finished goods but also covered raw materials, intermediate goods and capital goods.

As of now, the Union Government levies basic UEDs on all goods manufactured or produced in the country. The prevailing structure includes (i) Central Value Added Tax (CENVAT, also called UEDs); (ii) Special Excise Duty (SED); (iii) Additional Excise Duty in lieu of Sales Tax [(AED (ST)]; (iv) Additional Duty of Excise on Textile and Textile Articles [AED (T and TA)]; and (v) Cesses on Specified Commodities (CSC).

With effect from March 1, 1986, Modified Value Added Tax (MODVAT) was introduced in place of the Union Excise Duty on inputs. Initially, it was introduced for a selected number of commodities. The coverage was limited to 37 Chapters (Group of Commodities) out of a totality of 71. Subsequently, MODVAT was extended and was finally replaced by Central Value Added Tax, known as CENVAT, in the Budget 2000-01. The coverage of CENVAT was extended to all commodities, except for high speed diesel (HSD), motor spirit (petrol) and matchsticks. In addition to general rate, there were three rates of Special Excise Duty (SED) of 8 percent, 16 percent and 24 percent on specified products. Most of the items under SED were final products but some of the items also fell in the category of intermediate goods.

In addition, the tax reforms in respect of UEDs during last fifteen years or so have been simplified in its structure, especially through CENVAT. Here it may be clarified that CENVAT is a tax which is levied on the manufacture or production of movable and marketable goods in the country. While previously, there were large number of rates; however, over the years, these have been brought down considerably. As of today, the standard rate of CENVAT is 12.36 percent. However, in many cases, the actual duty paid on inputs could be less than tariff rate through
exemption notifications. In addition, there are three rate categories (viz., 8, 16 and 24 percent) of special excises. These also are given credit for tax paid on inputs. Apart from rationalization of rate structure, exemption notifications have also been curtailed and the specific rates are converted into ad valorem rates.

The existing system of CENVAT (i.e. UED) and the procedure for its administration is characterized by the inherent weaknesses, like outmoded physical controls. Moreover, the coverage of CENVAT has not been extended to all the commodities. On the whole, the existing tax structure is complex and diverse, which has evolved over a period of time. The existing structure of sales tax in the Indian states is characterized by weaknesses, like lack of uniformity in tax rates, multiplicity of tax rates and cascading effect, etc. In view of these deficiencies, the central government has provided leadership and encouraged the state governments to reform their sales tax.

As is well-known, India is a federal state. Here, it may be clarified that federal state is a union of states in which authority is divided between the federal or national government and the state governments (Andley, 1972). The financial provisions of the Indian Constitution follow primarily the principle of rigid separation in the matter of distribution of taxing powers between the Union and the member states.

In the Indian Federal Structure, states, too, have to perform various duties, such as the maintenance of law and order, construction and maintenance of irrigation, power, road transport, etc., development of educational and health facilities, promotion of primary industries, etc. (Bhargava, 1978). States themselves also have power to levy and collect taxes and use the income from these taxes to perform some such functions. The legislative, executive and financial powers of states to raise revenue by way of taxation have been laid down in the state list, given in the Seventh Schedule of the Constitution of India.

The states have been getting revenue from taxes on income in three ways: (i) share of income tax imposed by the Centre, (ii) agricultural income tax, and (iii) profession tax. Agricultural income tax was first levied by the Bihar government way back in 1938, but later on certain other states followed. However, the revenue from this particular tax has always been fairly low since the exemption limit of the
tax has been kept at a very high level, so much so that the tax has been levied mainly on plantations and large estates. Sub-national governments have also imposed taxes on professions. This tax is, in fact, tax on income and, therefore, in order to prevent the tax competing with the central income tax, provision has been made in the Indian Constitution that the amount of tax under this head should not exceed Rs. 250 per annum for an assessee. This tax, too, has been imperceptible from the point of revenue generation.

At the state level, many taxes are levied on commodities and services. There include: sales tax, state excise, motor vehicle tax and passenger and goods tax, etc. Sales tax is the most important tax, yielding almost two-third of the state's own tax revenue. But the existing system of sales tax suffers from many weaknesses. In view of these deficiencies, State VAT has been introduced (through persuasion of the central government) in as many as 21 states with effect from April 1, 2005 (including Punjab).

The Government of India Act of 1935 assigned the power to levy taxes on sales and purchases of goods to the provinces. However, different state governments levied sales tax on a wide range of commodities at differential rates with diverse procedures and rules for its collection (Sury, 1997). In fact, the sales tax was imposed by the states mainly for revenue generation, as the abolition of Zamindari System led to a decline in the revenues of states and, therefore, alternative sources had to be found. State governments were also empowered to levy excise duties on alcoholic liquors, opium and other narcotics. The duty is levied by a state when the drugs concerned are produced in the state concerned or enter the state's jurisdiction from another state (Andley, 1972). The need for more revenue and the failure of prohibition policy has led to the abolition of prohibition, and the states have permitted the manufacture, sale and consumption of intoxicating drinks. Restrictions are, however, imposed on the place of sale, place of drinking and hours of sale, etc.

The state governments have three sources of income from property taxes: (i) revenue from land taxes, (ii) duty on transfer of property, and (iii) tax on urban immovable property. Among the taxes on property imposed by the states, the most important is the land revenue which is a tax on land. The basis and the rates of this tax vary from
state-to-state. Income from land revenue has not increased as much as the income from other sources. State governments also collect revenue from stamps and registration, and that an entertainment tax is also levied. But, in comparative terms, revenue collection from such sources is very meagre.

While the division of functions between the central and state governments are based on the principle of efficiency and autonomy; but, due to ramification and country-wise activities of big business, integration of economic life and importance of international trade, the more productive sources (such as taxes on income, customs and excise duties, etc.) are more efficiently administered by the central government (Najundappa and Jain, 1969). A major aspect of the awards of the Finance Commission relates to the recommendations determining the inter se allocation of the aggregate share of the states in central tax revenues. The overall formula for horizontal sharing has two basic components viz; (a) the criteria used, and (b) the weights assigned to these criteria. Various Finance Commissions have used a variety of criteria in their awards, such as, population, income distance, infrastructure distance, contribution/assessment, income adjusted total population, area, poverty, tax effort, fiscal self-reliance, post-devolution deficits, revenue equalisation, indices of economic and social backwardness, etc. As regards the weights assigned to different criteria, the same have ranged widely from 5 to 90 percent (Kumar, 2005).

The problem of fiscal disequilibrium arises because the relatively elastic sources of revenue come under the purview of the centre, whereas the social and developmental functions (the demand for which is of an ever-expanding nature) fall within the purview of the states (Johar and Parkash, 1983). It has created fiscal dilemma in the Indian Federal System. The states are thus faced with a widening gap between their ability to raise resources and their capacity to provide essential services (Parkash, 1994). As a result, states indebtedness to centre has been steadily increasing.

Indian fiscal system is based on federal principles of a state. Therefore, there is a definite division of powers between central government and state government. The nature and scope of governments’ function has changed manifold, over a period of time. Consequently, this has also changed the expenditure and tax pattern of
governments whether at the central or at the state level. As far as the fiscal system is concerned, Centre has become stronger over a period of time. However, the states have assumed larger responsibility in the areas of social infrastructure (including education, health & nutrition, water supply & sanitation, social security and welfare, etc.). With rising fiscal deficit, the situation in a number of states has become precarious. The situation has further worsened owing to the onset of important legislations limiting the state’s expenditure. Therefore, if no earnest efforts are made to look out for new avenues of revenue generation, the fiscal compression on expenditure could lead to turmoil and political instability. Under such a scenario, fiscal situation is apprehended to become unsustainable in the long run, given the increased risk of crises that is associated with high deficit and debt levels (Sharma, 2012).

Therefore, measure can be suggested by studying some dynamic aspects of fiscal deficit in respect of major Indian states. Investigation in respect of tax and non-tax revenue buoyancies would help us towards a deeper understanding the role of buoyancy of tax and non-tax revenue and would also provide foundation for suitable policy formulation at the states’ level. Rising Fiscal Deficit of states would push up Public Debt and Interest Payments, and vice versa. However, such an association requires empirical exploration at sub-national level in the Indian context which would help in answering the question “Are the Indian states fiscally sustainable or not”. Another interesting aspect could be an examination of convergence issues for fiscal deficit and other ratios of revenue of states to GSDP. Therefore, studying the presence and speed of convergence among the major Indian states in respect of variety of macro-economic aggregates on public finance could help us in knowing the inequalities among the Indian states on fiscal front. An in-depth analysis on some such aspects of fiscal parameters is expected to assume significance, particularly for the states like Punjab whose fiscal health has been rapidly deteriorating, due to a multiplicity of reasons (including poor governance).

Need of the Present Study

Since a large majority of developmental activities in the field of social sector, agriculture, irrigation, power, rural infrastructure, etc. fall under the purview of the
state governments, expenditure of the governments has been ever increasing to finance these activities. Besides, salaries, pensions, other incentives to the employees and interest money on state’s loans/ debts are multiplying. However, as it appears, requisite finance for undertaking developmental programmes has not been growing commensurately. In other words, functions of different states and expenditure of state governments have been increasing, thereby leading to widening of gap between expenditure and revenue. Since fiscal health of the Indian states, in general, and that of states like Punjab, in particular, has been far from being satisfactory; therefore, in this context, the present study aims at examining as to what are the likely forces which are primarily responsible for inducing deterioration in the fiscal health of Indian states. This also might assist us in suggesting suitable remedial measures to come out of the fiscal crisis. Although, the reviewed literature indicated towards the availability of a number of related studies, yet no exhaustive study seems to have been carried out in the context of the Indian states in the recent past. This called for the need to undertake the present elaborative study with the following specific objectives:

1. To perform a descriptive analysis of the recommendations of recent Finance Commissions of India;
2. To examine growth performance and structural transformations in tax and non-tax revenue generated among major Indian states;
3. To measure the extent of Fiscal Deficit; gauge the severity of instability therein and identify the major concomitants of the deficit at the sub-national level;
4. To estimate buoyancy of tax and non-tax revenue, and examine differentials, if any, among the states;
5. To examine the prevalence, or otherwise, of long-run sustainability among Fiscal Deficit, Public Debt and Interest Payments among the Indian states;
6. To examine inter-relationships, if any, between the pattern of development and fiscal health of the Indian states; and
7. To examine convergence, if any, among the Indian states in respect of different dimensions of their fiscal health vis-à-vis their income.
Hypotheses Tested:

The hypotheses tested in the study were framed as follows:

1. Different components of revenue have temporally grown at comparable rates among the different Indian states;  
2. Fiscal Deficit has undergone temporal changes among the major Indian states in a fairly consistent manner;  
3. Liberalization Policy Regime has significantly helped in improving both tax and non-tax buoyancy coefficients at the sub-national level;  
4. There is an absence of long-run sustainability between Fiscal Deficit, Public Debt and Interest Payments among the Indian states;  
5. Fiscal Deficit is closely associated with the pattern of development in both rural and urban regions at the sub-national level;  
6. There has been temporal convergence in different dimensions of revenue, expenditure and certain other related macroeconomic aggregates among the Indian states.

Chapter Scheme:

The study has been organized into a totality of eleven chapters. The first (i.e., present) chapter is devoted to introduction to the problem, highlighting orientation, objectives of the study, hypotheses to be tested, etc. The second chapter presents a brief review of the related studies of general nature, as the studies directly related with a given objective have been duly reviewed in the corresponding chapters. Chapter-III outlines the data base for the study. A descriptive analysis on the basis of recommendations of recent Finance Commissions of India (viz., 10th to 14th) has been performed in Chapter-IV. Growth performance and structural transformations in Tax and Non-tax Revenue among major Indian states has been dealt with in Chapter-V. Measurement of Fiscal Deficit among the Indian states and an identification of the chief concomitants of the deficit has been carried out in Chapter-VI. Measurement of tax and non-tax revenue buoyancies among the Indian states was the thematic objective of Chapter-VII. Long-run sustainability analysis among Fiscal Deficit, Public Debt and Interest Payments among the Indian states has been covered under Chapter-VIII. Next, an interrelationship between pattern of
development *vis-à-vis* fiscal health of the Indian states has been examined in Chapter-IX. Further, convergence analysis among the major Indian states with respect to different dimensions of their fiscal health *vis-à-vis* their income has been carried out in Chapter-X. And, finally, Chapter-XI presents summary, conclusions & policy implications derived from the study.