‘In levying taxes and in shearing sheep it is well to stop when you get down to the skin.’

Austin O'Malley

4.1. Taxes in Theory

Strong tax system is fundamental to the development of a nation’s economy. Taxation is, however, about significantly more than revenue mobilization. The manners in which taxes are administered and collected, and the uses to which they are put, define the symbiotic relationship between the state and its citizen; strengthening the former, while making it necessarily more accountable to the latter.

More than 200 years ago, Benjamin Franklin admonished that “in this world nothing is certain but death and taxes.” As much as anyone might like to totally do away with the latter, it does appear as if Franklin is correct. In general, societies and jurisdictions tax themselves for two reasons, to alter behaviour or to raise funds to pay for services that the private marketplace would not or cannot otherwise provide. Thus, a jurisdiction may raise a liquor tax to increase the price of alcohol and discourage drinking. Alternatively, a jurisdiction may levy a tax to fund fire protection services if its residents will not or cannot privately fund efforts to prevent and extinguish fires. Questions of whether a jurisdiction should discourage a given activity, or whether a jurisdiction should provide a certain service, are likely to be answered within a political arena. Of course, the impact will always be reflected on employers’ bottom lines and residents’ wallets. If taxes are levied in an overly
burdensome way, those taxes designed to raise revenue will certainly end up altering behaviour; they will encourage residents and employers to flee.\textsuperscript{85}

4.1.1. Taxation Theory as Background

Government has a variety of tools at its disposal that can be used to generate policy responses. Those tools can be grouped into command and control approaches, including various laws, and rules designed to regulate the conduct of individuals, and fiscal approaches including decisions regarding how to tax and spend, which then generate market responses. Because questions about how to levy taxes will generate sweeping market responses and affect everyone who lives and does business in the society, decisions about what to tax and how to tax are crucial to the society’s future

While, in general, taxes are levied to generate revenues or change behavior, there are many different ways to levy those taxes. Questions of how to tax will become as important as or more important than questions of how much to tax when judging a given tax structure.

Even if the ultimate decisions surrounding taxation are political ones, sound theory can inform those political decisions. According to classical economic theory, the canons of taxation suggest that taxes should be:

- Fair: equals should pay equally according to benefits received,
- Certain: the time, manner, and amount of payment should be clear to payers,
- Convenient: the means and timing of payment must be convenient to payers, and
- Efficient: the cost of collection must be low relative to the yield.

All things being equal, two individuals who purchase the same item or earn the same salary should pay the same amount in taxes associated with those purchases or salaries. Those individuals should pay their taxes at a fixed time and with a fixed procedure so that they can make decisions based on how

\textsuperscript{85} Pramod K. Rai, “The challenges of Tax Collection in Developing Economic (with special Reference to India)”, Georgia Law, 3(2004)
and when the tax is levied without surprises or ambiguity. The process for paying taxes should not be problematic for the taxpayer or overly costly for the taxing jurisdiction.

Taxes differ based on how they affect those taxed and can be categorized as regressive, proportional, or progressive. A regressive tax takes a larger percentage of the income of lower-income people than of higher-income people. A proportional tax is levied at a single flat percentage rate for all individuals regardless of how much or how little they earn. The progressive tax takes a higher percentage of income from high-income people than from low-income people. In other words, the more one earns the higher percentage one pays. In the India, the Income Tax is an example of a progressive tax because individuals who earn more money pay a higher percentage of their income than those who earn less money.\textsuperscript{86}

Additionally, taxes have a strategic element. All taxpayers do not have the same ability to avoid taxes by leaving a given jurisdiction. Depending on tax disparities in competitor locations, taxpayers may or may not be tempted to move. Therefore, decisions surrounding whom to tax can be influenced by how competitors tax as well as who must pay taxes. For example, there will be little strategic advantage to raising or lowering taxes if all competitor locations are raising or lowering their taxes at the same time. Conversely, there is a clear strategic disadvantage to raising taxes or maintaining high taxes when competitors have low taxes or are lowering their taxes. Considering the likelihood that taxpayers would move to a competitor location involves the amenity package offered by competing jurisdictions, but also involves those taxpayers’ ability to move. Firms with large capital investments in a given area, firms that capitalize on their particular location, and firms that depend on a local resource will be less likely to leave than firms with no capital investments or no particular attachment to a location or local resource. So, all things being equal, a jurisdiction might have greater success taxing those firms that are more attached to that jurisdiction than firms that have greater mobility. Similarly, it may make more sense to tax individuals in the

same manner because a tax that affects residents may drive individuals to move but a tax that affects visitors may not discourage tourists from visiting popular vacation spots. While such strategic elements are not necessarily fair or justified in a larger theoretical framework, they represent real factors that must be considered within a political environment.

4.1.2. Tax Theory Meets Tax Practice

It is possible to merge tax theory with tax practice to create a framework to evaluate the current mix of taxes and any future recommendations. Because taxation decisions will create winners and losers, theory can only provide ammunition for political debate. Elected officials are mindful of how tax policy affects their core constituencies. Interest groups lobby for changes that benefit their members. Immediate needs may crowd out considerations for long-term consequences. Party and personal politics further complicate efforts to create alternative policies.

4.2. Tax Structure in Ancient India

In India, the tradition of taxation has been in force in one form or another from ancient times. The word ‘kara’, which refers to taxes, finds mention in the Srimad Bhagvatam. When Chanakya aphorised in the Artha Shastra, “Kosha moolo danda”, he made the important point that the treasury and its inflows are the sources of a government’s might. Indeed, the Sanskrit word ‘danda’, which translates to the sceptre, is the manifest form of a government’s identity, consciousness and conscience.87

Manu, the ancient sage and law-giver, laid down that traders and artisans should pay one-fifth of their profits in silver and gold; while agriculturists, depending upon their circumstances, were to pay one-sixth, one-eighth or one-tenth of their produce.

In his book Public Finance in Ancient India, the learned author K. B. Sarkar commends the system of taxation in ancient India: “Most of the taxes of Ancient India were highly productive. The admixture of direct taxes with indirect taxes secured elasticity in the tax system, although more emphasis was laid on direct tax. The tax structure was a broad-based one and covered most people within its fold. The taxes were varied and the large variety of taxes reflected the life of a composite population.”

4.2.1. Tax Structure in Medieval India

In the medieval period, the Sultans of Delhi collected taxes under five main categories. The Mughal emperors granted land revenue rights to a mansabdar in exchange of promises of soldiers during wartime. The Treaty of Allahabad of 1765 gave the British and the French the right to collect taxes on behalf of the Emperor. Thus, the British system of collectors of land revenues was firmly established well before the disintegration of the Mughal Empire after 1857.

4.2.2. Tax Structure in British Period

Public administration in India during the latter half of the nineteenth century saw large shifts and overhauls in its structures and processes. In July 1860, James Wilson, the first Finance Member of the Governor-General-in-Council, quoted thus from the authority of Manu while introducing the act for levying income tax in the country, “As the leech, the calf and the bee take their food little by little, even so must the King draw from his realm, moderate annual taxes.” As we proceeded through this century, the financial obligations of the Raj increased, and the need to revamp the tax system was felt.

In India, the first systematic attempt at defining the roles of central and state governments was done as far back as 1918, when the Montague-Chelmsford reforms were implemented. However, it was the Government of India Act, 1935, which clearly demarcated the roles of the two levels of government, and
in many respects, the present constitutional assignment closely follows that demarcation.  

4.2.3. Evolution of Indian Tax System

The basic framework for the tax system in independent India was provided in the constitutional assignment of tax powers. The important feature of the tax assignment is the adoption of principle of separation in tax powers between the central and state governments. It assigned the major broad based and mobile tax bases to the centre and these included taxes on non-agricultural incomes and wealth, corporation income tax, customs duties, and excise duties on manufactured products. Over the years, the last item has evolved into a manufacturers’ VAT on goods. The major tax powers assigned to the states include taxes on agricultural incomes and wealth, sales taxes, excises on alcoholic products, taxes on motor vehicles, passengers and goods, stamp duties and registration fees on transfer of property, and taxes and duties on electricity. They also have powers to levy taxes on entertainment, taxes on professions, trade, callings and employment and these have been exercised by the states themselves in some states and in others they have been assigned to local bodies. Although the state list also includes tax on property and tax on the entry of goods into a local area for consumption, use or sale, these have been assigned to local bodies. The central government levied tax on selected services on the basis of the residuary entry in the Union list from 1994, but in 2003, power to tax services was specifically assigned to it.

Tax policy in India has evolved as an important component of fiscal policy which had to play a central role in the planned development strategy. In particular, tax policy was the principal instrument to transfer private savings for public consumption and investment. It was also employed to achieve a number of other objectives including encouraging savings and investment, bringing about reduction in inequalities of income and wealth, fostering

balanced regional development, encouraging small scale industries on the assumption that they are employment intensive and influencing the volume and direction of economic activities in the country.\textsuperscript{89}

The evolution of tax policy within the framework of public sector based, heavy industry dominated, import substituting industrialization strategy has had several implications. First, tax policy was directed to raise resources for large and increasing requirements of public consumption and investment irrespective of the efficiency implications it entailed. Second, the objective of achieving socialistic pattern of society on the one hand and the large oligopolistic rents generated by the system of licenses, quotas and restrictions on the other, necessitated steeply progressive tax structure in both direct and indirect taxes. Third, pursuit of multiplicity of objectives enormously complicated the tax system with adverse consequences on efficiency and horizontal equity. This also opened up large avenues for evasion and avoidance of taxes. The disregard for efficiency considerations was a part of import substituting industrialization strategy. Fourth, all of the above required not only differentiation in tax rates based on arbitrary criteria but also legitimized selectivity and discretion in tax policy and administration. This gained legitimacy from the plan priorities. Once selectivity and discretion were accepted as legitimate, it mattered little whether these were exercised as intended. This provided enough scope for the special interest groups to influence tax policy and administration. Fifth, the influence of special interest groups, changing priorities and lack of information system and scientific analysis led to \textit{ad hoc} and often, inconsistent calibration of policies. Finally, poor information system was both the cause of selective application of the tax system as well as its effect.

\textbf{4.2.3.1. Fiscal Decentralization: Theoretical Considerations}

Fiscal decentralization has two fundamental facets: (i) the assignment of functions and sources of revenue to finance them and (ii) the layers, numbers

and morphology of jurisdictions that constitute the governmental system. One could take the structure of government and jurisdictions as given and determine the equilibrium assignment of powers or, alternatively, establish an efficient jurisdictional organization or structure for the given set of functions.

4.3. Tax and Expenditure in India: Constitutional Assignments

The constitution, in its seventh schedule, assigns the powers and functions of the center and the states. The schedule specifies the exclusive powers of the center in the Union list; exclusive powers of the states in the State list; and those falling under the joint jurisdiction are placed in the Concurrent list. All the residuary powers are assigned to the center.

India’s tax system is based on the assignment of separate taxation rights to the Parliament in the Centre and to the legislatures in the states. These taxation powers are contained in List I the Union List and List II the State List of the Seventh Schedule to the Constitution of India, read with the relevant articles that provide the substantive power to levy and collect taxes. The evolution of the tax system over the last 60 years reflects the changes in India’s development strategy, tax legislation, the institutional structure of tax administration and the role of information technology.

The major direct taxes levied by the Centre are tax on personal and corporate income; excluding tax on agricultural income for which the authority to levy tax is with the states, and wealth tax. The indirect taxes levied and collected by the Centre are Central Excise Duty, customs duty and service tax. A fixed proportion of the taxes collected by the Centre devolve to the states, based on the recommendations of the Central Finance Commission, which is set up every five years to review this sharing mechanism. Presently, 32 per cent of the revenue collected from these taxes is transferred to the states through devolution under the advice of the 13th Finance Commission. The inter se
share of different states is also determined on the basis of their recommendations.  

4.3.1. Taxation Heads Assigned to the Union and the States

<table>
<thead>
<tr>
<th>Union Subjects</th>
<th>State List</th>
</tr>
</thead>
<tbody>
<tr>
<td>90 Taxes other than stamp duties on transactions in stock exchanges and future markets</td>
<td>53 Taxes on the consumption or sale of electricity</td>
</tr>
<tr>
<td>91 Rates of stamp duty in respect of bills of exchange cheques promissory notes, bills of lading, letters of credit, policies of insurance, transfer of shares, debentures, proxies and receipts.</td>
<td>54 Taxes on the sale or purchase of goods other than newspapers, subject to the provisions of entry 92A of List I.</td>
</tr>
<tr>
<td>92 Taxes on the sale or purchase of newspapers and on advertisements published therein.</td>
<td>55 Taxes on advertisements there than advertisements published in the newspaper and advertisements broadcast by radio or television.</td>
</tr>
<tr>
<td>92A Taxes on the sale or purchase of goods other than newspapers, where such sale or purchase takes place in the course of interstate trade or commerce.</td>
<td>56 Taxes on goods and passengers carried by road or on inland waterways.</td>
</tr>
<tr>
<td>92B Taxes on the consignment of goods (whether the consignment is to the person making it or to any other person), where such consignment takes place in the course of interstate trade or commerce.</td>
<td>57 Taxes on vehicles, whether mechanically propelled or not, suitable for use on roads including tramcars, subject to the provision of entry 35 of List III.</td>
</tr>
<tr>
<td>97 Any other matter not enumerated in List II or List III including any tax not mentioned in either or both the Lists.</td>
<td>58 Taxes on animals and boats</td>
</tr>
<tr>
<td></td>
<td>59 Tolls</td>
</tr>
<tr>
<td></td>
<td>60 Taxes on professions, trades, callings and employments</td>
</tr>
<tr>
<td></td>
<td>61 Capitation taxes</td>
</tr>
<tr>
<td></td>
<td>62 Taxes on luxuries, including taxes on entertainments, amusements, betting and gambling.</td>
</tr>
<tr>
<td></td>
<td>63 Rates of stamp duty in respect of documents other than those specified in the provision of List I with regard to rates of stamp duty.</td>
</tr>
</tbody>
</table>

Source: As listed in the Seventh Schedule of the Constitution of India.

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4.3.2. Recital of Constitutional Provisions

Part XI of the Indian constitution defines the power distribution between the federal government (the Centre) and the States in India. This part is divided between legislative, administrative and executive powers. The legislative section is divided into three lists: Union list, States list and Concurrent list. Unlike the federal governments of the United States, Switzerland or Australia, residual powers remain with the Centre, as with the Canadian federal government.

Federalism in India has a strong bias towards the Union Government. Some unique features of federalism in India are:

- There is no equality of state representation. Representation in the Parliament can vary widely from one state to another depending on a number of factors including demography and total land area.
- No double citizenship, i.e. no separate citizenship for country and state.
- The consent of a state is not required by the Parliament to alter its boundaries.
- No state, except Jammu and Kashmir, can draw its own Constitution.
- No state has the right to secede.

The functions of the central government can be classified as those required to maintain macroeconomic stability, international trade and relations and those having implications for more than one state, for reasons of economies of scale and cost efficient provision of public services. Issuing currency and coinage, dealing in foreign exchange, foreign loans, the operation of the central bank of the country (Reserve Bank of India or RBI), international trade, banking, insurance and operation of stock exchanges are some of the major functions assigned to the central government to maintain macroeconomic stability. Functions like the operation of railways, posts and telegraphs, national highways, shipping and navigation on inland waterways, air transport, atomic energy, space, regulation and development of oilfields and major minerals, interstate trade and commerce and regulation and development of interstate rivers are the major functions assigned to the center for reasons scale economies and spillovers in respect of services with benefits spanning more than one State.
The power of the center has been further augmented by placing a number of additional items in the Concurrent list and vesting it with overriding powers in regard to these subjects. The important items included in the concurrent list are: economic and social planning (which embraces virtually all items under economic and social services), commercial and industrial monopolies, trade unions, social security, employment and unemployment, welfare of labor, price control and trade and commerce in and production of certain basic goods such as foodstuffs, cotton and any other goods if the Parliament decides to bring it into this category.

The major subjects assigned to the states comprise public order, police, public health, agriculture, irrigation, land rights, fisheries and industries and minor minerals. As mentioned earlier, the states do have jurisdiction over concurrent items and can take initiatives with regard to these subjects. However, in the event of conflict between the center and the states, the former has overriding powers. Subjects like public health, agriculture and irrigation involve considerable governmental intervention and expenditures. Even in regard to the subjects in the concurrent list like education and transport, social security and social insurance, in a democratic polity, being proximate to the people, the states would be compelled to assume a significant role.  

The assignment of tax powers, however, is based on the principle of “separation”, and the tax handles are exclusively assigned either to the center or to the states. Most of the broad-based and productive tax handles have been assigned to the center perhaps, for reasons of stabilization and redistribution stated earlier. These include taxes on income and wealth from non-agricultural sources, corporation tax, taxes on production (excluding those on alcoholic liquors, opium, hemp and other narcotics) and customs duty. A number of tax handles are assigned to the states as well. These include taxes on agricultural income and wealth, taxes on the transfer of property (stamp duties and registration fees), taxes on motor vehicles, taxes on the transportation of goods and passengers, sales tax on goods, excises

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on alcoholic beverages, entertainment tax, taxes on professions, trades, callings and employment, property tax and taxes on the entry of goods into a local area for consumption, use or sale (octroi). However, from the viewpoint of revenue productivity, only the tax on the sale and purchase of goods is important. The center has also been assigned all residual powers which imply that the taxes not mentioned in any of the lists automatically fall into its domain.

4.4. Revenue Receipts of the Central and State Governments

<table>
<thead>
<tr>
<th>Items of Revenue</th>
<th>Revenue Share 2010-2011</th>
<th>Percent of Total</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Center</td>
<td>States</td>
</tr>
<tr>
<td>A. Tax Revenue (a+b)</td>
<td>45.5</td>
<td>54.5</td>
</tr>
<tr>
<td>a. Exclusive Central Taxes</td>
<td>100.0</td>
<td>-</td>
</tr>
<tr>
<td>1. Corporation Tax</td>
<td>100.0</td>
<td>-</td>
</tr>
<tr>
<td>2. Custom Duties</td>
<td>100.0</td>
<td>-</td>
</tr>
<tr>
<td>3. Other</td>
<td>100.0</td>
<td>-</td>
</tr>
<tr>
<td>b. Exclusive State Taxes</td>
<td>-</td>
<td>100.0</td>
</tr>
<tr>
<td>1. State Excise Duties</td>
<td>-</td>
<td>100.0</td>
</tr>
<tr>
<td>2. Sales Taxes</td>
<td>-</td>
<td>100.0</td>
</tr>
<tr>
<td>3. Taxes on Transport</td>
<td>-</td>
<td>100.0</td>
</tr>
<tr>
<td>4. Other</td>
<td>-</td>
<td>100.0</td>
</tr>
<tr>
<td>c. Shared Taxes</td>
<td>49.1</td>
<td>51.9</td>
</tr>
<tr>
<td>1. Personal Income Tax</td>
<td>22.2</td>
<td>77.8</td>
</tr>
<tr>
<td>2. Union Excise Duty</td>
<td>55.9</td>
<td>44.1</td>
</tr>
<tr>
<td>B. Non-tax Revenue</td>
<td>80.8</td>
<td>19.2</td>
</tr>
<tr>
<td>1. Net Contribution from Public Enterprises</td>
<td>119.2</td>
<td>-19.2</td>
</tr>
<tr>
<td>2. Administrative Receipts</td>
<td>18.8</td>
<td>81.2</td>
</tr>
<tr>
<td>2. Interest Receipts</td>
<td>161.2</td>
<td>-61.2</td>
</tr>
<tr>
<td>3. External Grants</td>
<td>100.0</td>
<td>-</td>
</tr>
<tr>
<td>C. Grants to States</td>
<td>-</td>
<td>100.0</td>
</tr>
<tr>
<td>D. Total Revenue Accrual</td>
<td>38.4</td>
<td>61.6</td>
</tr>
<tr>
<td>E. Total Revenue Collections</td>
<td>65.5</td>
<td>34.5</td>
</tr>
</tbody>
</table>

4.5. Share of State Governments in Total Expenditures

<table>
<thead>
<tr>
<th>Items of Revenue</th>
<th>Revenue Share 2010 - 2011</th>
<th>Per cent of Total</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Center</td>
<td>Capital</td>
</tr>
<tr>
<td>A. Tax Revenue (a+b)</td>
<td>37.2</td>
<td>-</td>
</tr>
<tr>
<td>B. Defense</td>
<td>0.0</td>
<td>0.0</td>
</tr>
<tr>
<td>C. Administrative Service</td>
<td>66.2</td>
<td>14.7</td>
</tr>
<tr>
<td>D. Social and Community services of which:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>i. Education</td>
<td>86.1</td>
<td>43.4</td>
</tr>
<tr>
<td>ii. Medical and Health</td>
<td>91.4</td>
<td>96.1</td>
</tr>
<tr>
<td>iii. Family Welfare</td>
<td>93.5</td>
<td>100.0</td>
</tr>
<tr>
<td>iv. Others</td>
<td>81.6</td>
<td>65.2</td>
</tr>
<tr>
<td>E. Economic Services, of which:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>i. Agriculture and Allied Services</td>
<td>45.8</td>
<td>72.4</td>
</tr>
<tr>
<td>ii. Industry and Minerals</td>
<td>50.7</td>
<td>47.4</td>
</tr>
<tr>
<td>iii. Power, Irrigation and Flood Control.</td>
<td>91.2</td>
<td>77.9</td>
</tr>
<tr>
<td>iv. Transport and Communication</td>
<td>67.6</td>
<td>52.7</td>
</tr>
<tr>
<td>v. Others</td>
<td>66.1</td>
<td>49.2</td>
</tr>
<tr>
<td>F. Others</td>
<td></td>
<td></td>
</tr>
<tr>
<td>i. Loans</td>
<td>85.9</td>
<td>-</td>
</tr>
<tr>
<td>ii. Advances</td>
<td>-</td>
<td>62.9</td>
</tr>
<tr>
<td>G. Total@</td>
<td>58.1</td>
<td>53.7</td>
</tr>
</tbody>
</table>


The Constitution recognizes that assignment of tax powers and expenditure functions would create imbalances between expenditure needs and abilities to raise revenue. The imbalances could be both vertical among different levels of government and horizontal among different units within a sub central level. Therefore, the constitution provides for the assignment of revenues (as contrasted to assignment of tax powers), sharing of the proceeds of certain centrally levied taxes with the states, and making grants to the states from the Consolidated Fund of India.

Assignment of tax revenues includes those taxes levied by the center, but with the proceeds assigned to the states. Articles 268 and 269 empower the center to levy taxes such as estate duty on non-agricultural property, terminal
taxes on passengers and goods carried by railway, sea or air; taxes on railway fares and freights, taxes on transactions in stock exchanges and futures markets, taxes on the sale and purchase of newspapers and on advertisements published therein and taxes on sale and purchase in the course of interstate trade. All of them except the last one are levied and collected by the center and the proceeds assigned to the states entirely. In the case of the last one, the states have been allowed to collect the tax subject to a ceiling rate specified by the center.

The Constitution also provides for the compulsory sharing of the net revenue from non-corporate income tax; Article 270, and optional sharing of the proceeds of Union excise duty; Article 272. The shares of the center and the states and their allocation among different states of both the taxes are to be determined by the Finance Commission appointed by the President of India every five years or earlier as needed. As this arrangement is alleged to have created serious disincentives to the central government in raising revenues from the two taxes, and based on the recommendation of the Tenth Finance Commission, the central government has proposed replacing of the sharing of the two taxes with sharing of revenues from all central taxes. However, constitution is yet to be amended for the purpose.

In addition to tax devolution, the Finance Commission is also required to recommend grants to the states in need of assistance under article 275. The quantum of shared taxes, their distribution among the states and the amount of grants to be given to the states is determined by an independent quasi judicial body, the Finance Commission, appointed by the President of India every five years.92

4.6. Major Issues in Fiscal Assignment in India

The analysis of constitutional assignment in India brings out the following issues:

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1. **Centripetal bias:** The Constitution exhibits a clear centripetal bias in the distribution of fiscal powers. In addition to the expenditure functions assigned, the center can also influence the expenditure decisions of the states. The assignment of most of the broad-based taxes and residuary tax powers to the center, its overriding powers in regard to the functions in the concurrent list and domination through economic planning and control over virtually the entire financial sector are only some instances of the center’s dominance in the economic sphere.

2. **Separation of tax powers:** The assignment of tax powers follows the principle of ‘separation’ in contrast to that of ‘concurrence’ followed in federations like the U.S.A. and Canada. This however, could not avoid de facto overlapping. The clear demarcation of tax powers in the legal sense has not prevented concurrency in economic sense. This has prevented the center from levying income tax on a comprehensive base, hindered the development of neutral and broad-based sales taxation and has given rise to overlapping consumption tax systems at central, state and local levels which is distorting and iniquitous.

3. **Internal trade barriers:** The Constitution allows levy of some taxes which can create severe impediments to interstate trade. The levy of tax on interstate sale of goods by the exporting state (subject to a ceiling rate of 4 per cent) besides creating resource distortions has caused perverse transfer of resources from the poorer consuming states to the more affluent producing states. Similarly, the states can levy a tax on the entry of goods into a local area for consumption, use or sale (octroi). This has created impediments to the free movement of goods and also erected a number of tariff zones coinciding with the localities in the country (Rao, 1993). The tax on interstate sale of goods has not only posed impediments to the movement of goods across the country, but also has been a serious source of inefficiency and inequity. Enabling the states to export the tax burden has led to widespread “free- riding, and as the ability to free-ride depends on the
level of development of the state, this has caused inequitable resource transfers.

4. **Incentives and tax sharing**: The assignment of tax powers has also been a source of disincentives to the central government. It is suggested that devolution of a very high proportion of income tax and excise duty is alleged to have robbed the central government of the incentive to collect revenues from these sources and concentrate on non sharable taxes like the customs duty, causing distortions in the tax structure. However, the recent initiative of giving the states a fixed share of the total tax revenue would remedy the situation to a large extent.93

**4.7. State Finances and Effectiveness of Policy Measures**

In the Indian federal set up, the States play an important role in accelerating and sustaining growth. The Indian Constitution assigns important responsibilities to States in many sectors such as agricultural development, infrastructure, poverty alleviation, water supply and irrigation, public order, public health and sanitation. Furthermore, they have concurrent jurisdiction in several areas like education, electricity, economic and social planning and family planning. In view of the larger responsibilities assigned to the States, their expenditure accounts for a substantial portion of the Government sector expenditure in India. The comparative position across countries reveals that in India the share of aggregate States’ expenditure in Government sector expenditure is higher than that in several other countries such as Australia, Denmark, Argentina, USA and Germany (World Bank, 2005). The composition of receipts and expenditure of the Government sector in India reveals that while the State Governments collect about one-third of the total Government sector receipts, they incur more than three-fourth of the total expenditure on social services and more than half of the total expenditure on economic services. The States’ ability to undertake and perform the

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developmental functions adequately and effectively is critically determined by their fiscal position.

A State specific assessment of fiscal position assumes importance in view of the wide disparities that exist among the Indian States and their increasing role in the development. The policy measures and prescriptions which are suggested for aggregate State finances may not be appropriate and effective for drawing out strategies for an individual State. It is worth noting as stated in the Economic Survey, (2004-05), Government of India, “Though the fiscal deterioration of States began much later than that of the Centre, the fiscal stress of some of the State Governments is more acute and an important constraint in their development.” The analysis of State finances in historical perspective since the mid 1980s reveals:

(i) steady deterioration in revenue receipts-GSDP ratio, (ii) stagnating social sector expenditure, (iii) inadequate investment for basic infrastructure sectors, (iv) pre-emption of high cost borrowed funds for financing current expenditure, (v) large and persistent resource gap, and (vi) accumulation of high debt stock and debt service payments.

Many States undertook various policy measures to strengthen their finances mainly in the late 1990s. Given the size of the problem, the effectiveness of such policy measures, however, remained largely inadequate. Most of the policy measures were ad hoc in nature and were guided by the exigency rather than being structured.94

4.8. Analytical Framework

In a federal system, the sub-national governments are assigned certain sources of revenues and expenditure responsibilities. In the Indian context, the State Governments have their own independent sources of revenue as well as transfers from the Central Government. Accordingly, the level of resource flow at State level in India is determined by both (i) endogenous factors (i.e., States’ own efforts in generating resources) and (ii) exogenous

factors (i.e., the resource transfers from the Central Government). The details of various sources of revenues and expenditure responsibilities of State Governments are set out below.

4.9. Sources of Revenues: States’ Own Revenues

(i) States’ own tax revenues: States’ own taxes can be grouped into three parts, viz., (i) taxes on commodities and services such as sales tax, State excise, taxes on vehicles and taxes on goods and passengers, (ii) taxes on property and capital transactions such as stamps and registrations and land revenue, and (iii) taxes on income such as profession, trade and agricultural income. Among the above, the principal sources of States’ tax revenue are sales tax, State excise and stamps and registration fees. Sales tax alone accounts for nearly two-thirds of the total States’ own tax revenue. Realizing the need for tax reforms, many States have switched over to a Value Added Tax (VAT) regime on the basis of the recommendations of the Empowered Committee of State Finance Ministers with effect from April 1, 2005. VAT may be defined as a tax on the value added at each stage of production and distribution of a commodity.

(ii) States’ own non-tax revenues: These include (i) interest receipts, (ii) dividend and profits, (iii) user charges on account of social and economic services, and (iv) general services which mainly include State lotteries. The major part of revenues comes from interest receipts, State lotteries and user charges on account of economic services.  

4.9.1. Current Transfers and Devolution from the Centre

The current transfers and devolution from the Centre include States’ share in the Central taxes and grants. The provision for these transfers to States aims at addressing the vertical imbalance or fiscal gap that stems from asymmetric devolution of functions and tax powers among different Government levels. Furthermore, such transfers aim to secure fiscal equalization among the

\[95\] Pramod K. Rai, “The challenges of Tax Collection in Developing Economic (with special Reference to India)”, Georgia Law, 3(2004)
States which is necessary and imperative in the interest of equity and efficiency.

4.9.2. Expenditure Responsibilities of States

State Governments incur considerable expenditure towards provision of various social and economic services in addition to expenditure requirements towards maintenance of various organs and general administration. The total expenditure comprises of revenue and capital components. Broadly the expenditure which does not result in creation of assets is treated as revenue expenditure. Capital expenditure mainly includes expenditure on acquisition of assets like land, building, machinery etc. and also loans and advances by States mainly to Public Sector Undertakings (PSUs). Under revenue expenditure, certain items of expenditure, viz. interest payments, pensions outgo, wages and salaries and expenses towards administrative services have downward rigidity.

4.10. Financing Pattern of Gross Fiscal Deficit (GFD)

The analysis of the State Government finances during previous two and half decades reveals that invariably almost all the States incur more expenditure than the revenues they mobilize. Consequently, the States undertake borrowings from a number of sources to finance their resource gap/GFD. The financing pattern of resource gap indicates that, historically, loans from the Centre have been the most important source of borrowings for the States. However, with the changes in accounting system in respect of small savings since April 1, 1999 and operationalisation of Debt Swap Scheme (during 2002-03 to 2004-05), the share of this source in financing GFD has declined significantly. The small saving receipts are emerging a major source to finance the resource gap – constituting over two third of GFD in the recent period (RBI, 2005). The other major sources of financing available to the
States include: (i) market borrowings, (ii) loans from banks and financial institutions (FIs) and (iii) public account borrowings.\textsuperscript{96}

4.11. Scheme of Presentation of States’ Fiscal Analysis

Taking into account the fiscal developments on fronts, \textit{viz.}, (i) endogenous factors (within States’ control) and (ii) exogenous factors (States’ dependence on Central transfers), the period under review has been divided into four phases.

(i) Revenue Account in Surplus Position: This phase covers the period 1980-81 to 1985-86. The buoyant growth in States taxes particularly sales tax led to the higher growth in revenues than the expenditure resulting in surplus in the Revenue Account.

(ii) Emergence of Fiscal Imbalances: This phase deals with the period 1986-87 to 1997-98. The growth in revenues remained sluggish on account of low/negligible user charges and dividends and profits coupled with stagnation in States’ share in Central taxes. The liberalization of trade and investment policies providing various incentives and concessions to attract private investment impacted the States’ finances.

(iii) Deepening and Persistent Fiscal Imbalances: This phase pertains to the period 1998-99 to 2003-04. The major reasons behind the worsening of fiscal imbalances were the significant increase in revenue expenditure due to Fifth Pay Commission award and growing interest payments on the past high cost borrowed funds. The growth in revenues remained sluggish due to stagnation in States’ tax-GSDP ratio and decline in States’ own non-taxes and Central transfers, particularly, grants to States.

(iv) Recent Fiscal Developments and Challenges Ahead: This phase takes into account the period since 2004-05 onwards. Implementation of VAT with effect from April 1, 2005, recommendations of Twelfth Finance Commission for the period 2005-10 and the States’ continued

emphasis on the on-going fiscal reforms with statutory backing such as fiscal responsibility legislations which got further boost on account of recommendations Twelfth Finance Commission’s are the major recent developments. The fiscal position of States would be largely influenced in the medium term by these developments. This phase also highlights the major challenges for the States in the medium term.

The details of major fiscal indicators to examine the fiscal situation of States include: (i) trends in revenue receipts, States’ own revenues and share in the Central taxes and grants, (ii) pattern and trends in major components of expenditure, (iii) available resources for financing resource gap, and (iv) movement in major deficits and debt stocks.97

4.12. Finances of Major States: Review and Assessment

A quick overview of the fiscal position of major States reveals that they were generating surpluses in their revenue account in the first phase. The fiscal position of States, however, had started to show signs of stress in the second phase and fiscal imbalances deepened and persisted during the third phase. The factors responsible for the widening fiscal imbalances include: (i) growing interest burden, (ii) increasing wages and salaries (iii) pension liabilities, (iv) losses incurred by State Public Sector Undertakings, (v) inadequate user charges/cost recoveries and (vi) deceleration in the Central transfers (RBI, 2004). In the recent years, interest payments alone constitutes over one-fourth of the revenue expenditure and absorbs between 30-50 per cent of revenue receipts in many States; West Bengal, Orissa, Punjab, Rajasthan, Gujarat, Uttar Pradesh. Notably, during 2002-03 to 2003-04, interest payments and pensions outgo taken together absorbed as high as around 70 per cent of revenue receipts in case of West Bengal and nearly 50 per cent of revenue receipts in Kerala.

The fiscal stress experienced by the States has seriously constrained their ability to discharge major responsibility of developing social and economic

infrastructure. The expenditure for developmental activities, which are directly related to growth, has suffered. On the other hand, expenditure on non-developmental purposes, largely committed in nature, has witnessed a steady rise. The problem was exacerbated by low productivity of capital expenditure. The proliferation of projects spread the resources thinly and inadequate financial allocations cause severe cost and time over runs.

The Planning Commission, while stressing the need for fiscal and other reforms at the State level, observed that “… a joint effort by the Centre and States is needed to fulfill the Tenth Plan objectives. Along with the Centre, States need to reform more and much faster, and raise substantially higher levels of their own resources to mobilize the financial resources essential for the much needed productive investments.98

4.12.1. Finance Commissions Impact on State Finances

The Finance Commissions’ recommendations for fiscal consolidation in the States will have far-reaching implications for the federal-state fiscal relationship. The States’ fiscal imbalances are likely to ease on account of higher tax devolution, enhanced grants as well as the debt relief schemes by the Finance Commission. The critical aspect of the recommendations of the Finance Commission is the linking of certain resource transfers to enhance the fiscal prudence on the part of the States, in general, and the enactment of financial controls by the States, in particular. The increase in transfers recommended through tax devolution and grants are expected to facilitate the States to undertake fiscal correction even while undertaking social and infrastructure expenditure required moving on an accelerated growth path.

4.13. A New Borrowing Regime for States

Following the Twelfth Finance Commission’s recommendations that the Centre should not act as an intermediary for future lending and allow the State

Governments to approach the market directly, a new borrowing regime for the States was put in place.

Accordingly, in the Union Budget 2005-06, there was no provision made for Central loans for State Plan Schemes. The Union Budget indicated an amount of Rs.29,003 crore which was to be raised by the States and Union Territories with Legislature directly from the market. Furthermore, as per the Twelfth Finance Commission’s recommendations, external assistance would be transferred to the States on the same terms and conditions as attached to such conditions by external funding agencies. The States would get the same maturity, moratorium and amortization schedule as the Centre gets from the external lender.

The past experience of some States reveals that the weaknesses in their finances invited adverse reaction from the financial markets as manifested in the widening spread on State Government securities and under-subscription to market loans. The under-subscription to the State market loans also brings to the fore various factors that impact State Governments liquidity. These factors include: (i) the fiscal health of the State Governments, (ii) the credibility of their prospective policy actions and, (iii) transparency of their budgets.

In view of the new borrowings regime, States would need to improve the market perception about their fiscal position by exhibiting adequate will and action for fiscal rectitude by actively considering the fiscal reforms measures. The better fiscal performing States would get the benefit relatively more than the fiscally weak States from the market.99

4.13.1. Challenges Ahead

In the process of fiscal correction in the medium term, the allocation of adequate resources towards productive sectors, which is essential to accelerate the growth and to increase the revenues particularly through non-taxes by increasing user charges, cost recovery, dividends and profits, etc., would be major challenges for the States.

The large repayment of market borrowings, from Rs. 6,274 crore in 2005-06 to increase two-fold by 2007-08, three-fold by 2010-11 and nearly six times by 2014-15, would have a bearing on the fiscal health of the States.

Furthermore, the impact of the Pay Commission on fiscal health, if followed by the State Governments, also needs to be taken into account.