CHAPTER II

THEORETICAL PERSPECTIVE

2.1 Methodology

In the context of the questions raised in the previous chapters regarding the states' revenue performance in view of their economic performance and economic growth there is a need to develop a scientific model to find answers to the raised question.

This study makes an attempt to examine the growth, composition and determinants of revenue receipt of Indian states over the last seventeen years covering both the periods of pre reform and post reform. It also proposes to build up theoretical & econometric models and test them with the empirical data. Alternative models are tested by using the econometric technique of panel data analysis. Few other simple statistical tools are also used to substantiate the hypothesis. The study is based on the secondary data. To achieve the objectives of the study, the quantitative data of the 16 major Indian states' Revenue Receipts and growth indicators are collected over the period of 1985-86 to 2003-04. The states covered under this study are; Andhra Pradesh, Assam, Bihar, Gujarat, Haryana, Himachal Pradesh, Kerala, Karnataka, Maharashtra, Madhya Pradesh, Orissa, Punjab, Rajasthan, Tamil Nadu, Uttar Pradesh and West Bengal; these states cover the 93 % of the Indian population. New states Chhattisgarh, Jharkhand and Uttaranchal are not being taken separately due to unavailability of data of these states individually for the years before their formation.
2.1.1 Data Sources

The quantitative and qualitative data have been collected from the publication of both government and non-government organisations (research institutes). States’ revenue data are collected from Reserve Bank of India Bulletin from 1985 to 2002. The RBI publication has covered these data presented in the budget of respective states. New states that are formed presented their data of revenue in their respective budgets. Data for Uttarakhand and Chhattisgarh are available since 2000-2001 only while that of Jharkhand is available after March 2001. However for obtaining a long time series of the erstwhile states and making them comparable since 1985-86, these data are clubbed with their parent states. The amount of Revenue receipts are given in rupees crores.

Data on states’ income – Gross State Domestic Product at factor cost and GSDP at factor cost from various agriculture, industry and tertiary sectors - are taken from EPW research foundation publication namely – ‘Domestic Product of States of India 1960 – 61 to 2000 – 01’. This helped to obtain the data which are comparable and consistent over the time and space. GSDP at factor cost both at current prices and constant (1993-94) prices are presented. However, the data for the period of 1985-86 to 1992-93 are converted at 1993-94 prices for making the series comparable.

Data of total population and urban population are collected from the India Census for 1981, 1991 and 2001. Compound growth method was applied to find the population data for the intermediate years.
2.1.2 Chapter Scheme

The proposed thesis is divided in six chapters. First chapter discusses the need and objectives of the study and provide extensive review of literature. Second chapter deals with theoretical issues. It provides the methodology, chapter scheme and theoretical classification of states’ Revenue Receipts in India. A theoretical explanation of each revenue sources is given in this chapter.

Third chapter discusses the growth pattern of the various revenue sources an individual state. Different growth models have been analysed. Comparative study of 16 states in terms of their growth rate of Tax Revenue, Own Tax Revenue, Non-Tax Revenue & Own non-Tax Revenue is calculated and also buoyancy coefficients of Tax Revenue Receipts and Own Tax Revenue are estimated for the period of 1985 to 2002.

The composition of the Revenue Receipts may also change due to structural changes in the state economy and hence the study of revenue composition becomes inevitable. Fourth chapter examines the share of each source of revenue in the total basket of the state revenue. Different revenue sources will have diverse share in the revenue collected by the state and thus will have different implications. Thus variation in the composition of the state revenue over a period of time and space are also examined.

One observes significant difference in the economic growth and development not only across the states but also for a particular state across the time period. In this context it becomes important to examine whether the variations in growth and development of the states over the period of
time determine the revenue receipts specifically own tax and Own Non-Tax Revenue. An econometric model is proposed to be tested based on panel data to capture both the time variations and spatial variations in economic growth and revenue receipts of Indian states.

The last chapter summarises the outcome of the thesis and tries to derive the policy implications.

Various statistical techniques are used depending on the requirements. A detailed explanation on methodology and model building is done in respective chapters.

2.2 Classification of States’ Revenue

Historically, the monarchs focused mainly on raising the financial resources for their kingdoms. The emperors were interested in accumulating more and more wealth and revenue from the land ownership and trade. These resources were utilized to rule the nation. However, gradually the role of the state changed from that of the ruler to the facilitator. The government started focusing more on the growth and development of the nation. With these changes in the role of the states, the forms of revenue, its objectives and its utilization or allocation also changed. In today’s world, more and more fiscal resources are needed to execute government functions. Government needs to spend on economic and social activities which include, providing education & health facilities, developing infrastructure facilities, maintaining law and order and so on. The financial sources that are required to perform these activities may be collected from various sources. These sources can take the form of taxes, user charges or borrowing. Tax and Non-Tax Revenue sources are grouped
as revenue receipts. They do not attract any interest burden, whereas capital receipts are consisting of borrowed funds and the amount repaid by other government. Obviously therefore, the growth in the former is always intended and appreciated by the state, while that in the latter is justified only if accompanied by concomitant growth in assets (Archana Dholakia, 2000). However Tax and Non-Tax Revenue do create an excess burden or high compliance cost on the consumers and producers. Taxes and user charges are withdrawn from private sector without leaving the government with a liability to the payee. Borrowing involves a withdrawal made in return for the government’s promise to repay at a future date and to pay interest in the interim (Musgrave & Musgrave, 1989, 212). The present study focuses on the Revenue Receipts that include Tax and Non-Tax Revenue.

In case of the federal structure of an economy, each layer of the government has different fiscal responsibilities and powers. The traditional theory of fiscal federalism lays out a general normative framework for the assignment of functions to different levels of government and the appropriated fiscal instruments for carrying out these functions (Wallace E. Oates, 2005, 395). India is a classical federation with a constitutional division of functions between the union and state governments. Both centre and states have the clear demarcation for their expenditure and revenue powers. States in India have the authority to levy certain taxes and generate their Own Tax Revenue. In addition to that, states can also collect the revenue from non-tax sources. States also derive their additional sources of revenue from central transfer in the form of share in central taxes and grants to meet their rising expenditure responsibilities. States collect about 65 % of their revenue themselves; the remaining 35% is transferred to them by the central government (State fiscal reforms in India,
Revenue receipts generated by the states can be classified as Tax Revenue and Non-Tax Revenue. Tax Revenue can be broken down into Own Tax Revenue and Share in Central Taxes while Non Tax Revenue can be broken down into Own Non-Tax Revenue and Grants from the Centre.

Tax Revenue v/s Non-Tax Revenue

Government revenue can broadly be classified into Tax and Non-Tax Revenue. Tax Revenue is generated by imposing the taxes – both direct and indirect. It incurs cost to the consumers and producers in the form of
fiscal and economic welfare loss generally termed as excess burden. The distinction between Tax and Non-Tax Revenue is not watertight. There are some borderline uses which pertain to certain fees and charges levied in connection with a specific services or activities. Non-Tax Revenue is collected in the form of prices and fees. It aims at recovering the cost of social and economic services provided by the government. Non-Tax Revenue does not have the disincentive potential which generally goes with high rate of taxes. They do not present various administrative problems which confront the developing country. It is believed that the Non-Tax Revenue can not be avoided or evaded because a prior discharge of monetary obligation is necessary to enable the consumers of the various services provided by the government to acquire a command over these services. However, in India due to the inefficiency in recovering prices from public the evasion of Non-Tax Revenue also takes place. (Dholakia and Sarma, 2000) Most of the non-tax source of revenue contain an element of quid pro quo, a price and so is difficult to be avoided (Tripathi, 1985). Still for instance the recovery of water charges around 1993-94 was hardly 30 % in Gujarat.

➢ **Own revenue v/s central transfers**

Own Tax and Own Non-Tax Revenue mainly depend upon the states’ own efforts. While share in the central tax and union grants mainly are distributed under the direction of Finance Commissions to achieve the objectives of equity and efficiency. Thus, if one aims to analyse the performance and the potential of the states in augmenting their financial sources, the study of Own Tax and Own Non-Tax becomes significant.
Hence, states’ Revenue Receipts in India can be classified in the following groups.

2.2.1 States’ Own Tax Revenue

In India states are given the financial power to levy and collect certain taxes. These taxes include Agricultural Tax, Sales tax or Value Added Tax (VAT), Profession Tax, Property Tax, Motor Vehicles Taxes, Taxes and Duties on Electricity and Entertainment Tax. A brief note on each of this revenue resource is given below.

Agricultural Tax:
The major taxes on agriculture are land revenue and agricultural income tax. Land revenue in most of the states have negligible contribution to the exchequer and serving no purpose except maintaining the land records. In case of tax on agricultural income, it is levied on two alternative bases (i) the income-based system where the agricultural income is assessed after making certain allowances and (ii) the holding-based system under which the tax depends on the extent of land held by the owner. There are a few states like Gujarat that have not imposed the agriculture tax and levy land revenue on only large farmers.

Profession Tax (excluding agriculture):
This tax falls under the category of direct taxes levied by the state which includes taxes on profession, trades, callings and employment. The tax is levied on the i) salary and wage earners, ii) professionals and other self-employed iii) corporate bodies, firms and establishments. However, most state either do not tap this source or use it only to a limited extent.
Sales Tax:
The constitution empowers the states to levy taxes on sale or purchase of goods other than newspapers. States are entitled to levy a sales tax on transaction within a state. The structure of sales tax, prior to fiscal reforms undertaken in late nineties was characterised by multiplicity of tax rate & tax exemptions, large amount of incentives and cascading of taxes. However, almost all states have now introduced VAT.

Stamp Duty and Registration Fees:
This tax includes stamp duty, registration fees and urban immovable property tax. Stamp duties are of two main classes: Judiciary and non-judiciary. The former related to giving legal status to a document while the latter to a transaction regarding property, business and trade (ADB report, 1998). The stamp duty rates were excessively high in most of the states until the fiscal reforms were implemented by the state governments.

State Excise Duties:
The power of states to levy excise duties is limited to alcoholic liquors for human consumption, and opium, Indian hemp and other narcotic drugs excluding those used for medicinal purpose or for toilet preparation. The revenue accrue to the states takes the form of licence duties from the vendors as well as the tax, which can be specific or ad-valorem. Excise duties in the states have a special position in the armory of taxes since they are applied on consumption that is considered to be injurious to the health of the consumer. However, among all the states Gujarat is the only state which has been implementing prohibition policy since the beginning and hence it does not generate revenue from this source.
**Motor Vehicle Tax:**

Motor vehicle tax takes many forms. It includes taxes on vehicles, road transport, taxes on goods and passengers. In most states a compounded system of motor vehicle tax exists, where a one time levy is paid for the life of the vehicle. This may be useful, particularly if the tax payers are to be saved from the hassle of interacting with the tax department every year. (Srivastva D.K., 2005)

**Electricity Duty:**

The electricity duty is charged to consumers along with the electricity tariffs or rates. The rates are meant for electricity boards or the providers of electricity, while the electricity duty is meant for the state coffers. Nevertheless states in India generate very insignificant amount of their Tax Revenue from this source. The state government administers the electricity prices and also supports the SEB by giving high level of subsidies which however is observed to remain unpaid in most of the states. Due to this situation SEB after collecting the electricity duty do not pass these to the state government.

**Entertainment Tax:**

The entertainment tax is levied on admission to places of amusement or entertainment including cinema, circus, theatrical performances, exhibitions etc. The tax rates on cinemas vary depending on the size of the population of the village, town or city, ticket price, gross collection per show per week. In case of cable operators, it is on the basis of number of connections provided.
2.2.2 Share of Tax Received from the Centre

The revenue generated by the states is not enough to meet all their expenditure responsibilities. Union government does share the Income Tax and excise duty with the states. As per the constitution under the guidance of the finance commission it is the obligation to the centre to share these taxes with the states. However the decision of how these taxes will be shared depends upon the finance commission approach of devolution. This also includes the share in the central sales tax which is levied on the transactions outside states.

2.2.3 States’ Own Non-Tax Revenue

Non Tax Revenues consist of a heterogeneous mix of sources encompassing interest receipts on loans given by the governments, dividends on equity investment, and user fees and tariffs for social and community services, economic services, provided by the governments, profit from public sector and so on.

Interest Receipts and Dividend:
Interest receipts accrue to states against institutional and non-institutional loans given by the state governments. Institutional lending is mainly to state level public sector undertakings, which include state electricity boards, state road Transport Corporation and other commercial and promotional enterprises. Non-institutional loans are extended mostly to government employees.
Dividends and Profit:

This revenue arises from the State governments’ investments in the shares of co-operative institutions, statutory corporations, government companies and other joint stock companies.

Receipts from General Services:

These comprise receipts from Public services commission, Police, Jails, Stationary and Printing, Public works, Other administrative services, Contribution and recoveries towards pension and other retirement benefits and other miscellaneous general services.

Receipts from Social Services:

The major items falling in this category are education, sports, arts and culture, medical and public health, family welfare, water supply and sanitation, housing, urban development, information and publicity, labour and employment, social security and welfare and other social services. These sources basically collect revenue in the form of fees, user charges for availing the above services by the citizens of the states, recoveries of government programmes and so on.

Receipts from Economic Services:

The major sources of revenue under this class are crop husbandry, animal husbandry, dairy development, fisheries, forestry & wild life, mining & metallurgical industries, co-operation, other agriculture & rural programmes, major & medium irrigation, minor irrigation, village & small scale industries, power, petroleum, ports & light house, road transport & tourism and others. This form of revenue is mainly the income originated by the state government by running the business and providing the economic services to the people.
2.2.4 Grants from the centre:

As per the approach adopted by the finance commission and planning commission, centre is required (under the article 275) to give grants to the states. As the system of grants has evolved in India, grants flow from the centre to the states in three ways. The first consists of grants-in-aid given under the recommendations of the finance commission. The second category consists of plan grants covering central assistance for state plans as decided by the Planning Commission, as well as the plan grants given by the central ministries for implementation of plan schemes. The third type of grants, which is much smaller in magnitude, essentially consists of discretionary grants given by the central ministries to states on the non-plan side.

Planning commission decides the grant for the implementation of government schemes and welfare or developmental programmes. While finance commission directs the distribution of grants for non-plan activities, relief expenses of the states in the time of natural calamities and others.

In the context of federal structure in India, the states generate revenue receipts from four different forms. However, states’ own efforts to augment revenue influence only their own tax and non-Tax Revenue. The revenue obtained from share of central taxes and grants-in-aid are treated as exogenous. In this regard the own revenue sources have higher significance.

Each of the above sources of revenue has a particular role to be performed in the entire basket of states’ revenue and they would have experienced a
particular trend of growth over the period of time in different states. This provides the base for the study of growth pattern of various revenue sources and their share in the states’ revenue. Next chapter deals with estimating the rate of growth of components of the states’ revenue receipts.