CHAPTER – I
FISCAL FEDERALISM AND TAX REGIME IN INDIA: AN OVERVIEW

Prologue

Present era polity belongs largely to federalism - political and fiscal. The last
decade of the twentieth century had witnessed the most unexpected developments in
the sphere of federalism. There are trends, which were characterized by movements
towards both formation of new federations and disintegration of two federations. The
European countries, which fought two world wars in order to retain their political
identity, moved towards a unified monetary and political system. They were
encouraged by impressive economic benefits of the Economic Union, which was
formed after the Second World War (Thimmaiah, 1999). What was more astonishing
was that inspite of their diverse languages, their ethnic heterogeneity had not
interfered in the formation of a United Europe.

On the other side of the European Continent, USSR and Yugoslavia have
disintegrated as federations. These two federal nations were held together by very
powerful Central governments. But over centralization led to absence of regional
participation that created dissatisfaction apart from stagnation of the pace of
development resulting in deterioration of the standard of living of the common
people. Lack of autonomy for the regions led to the collapse of the two federal
systems when the central authorities became weak. This event had also got a lesson
for Indian Union in that the States had been demanding adequate degree of political
and financial autonomy (establishment of States of Jharkhand, Chattisgarh,
Uttaranchal etc.) for a long time. If the demand for fair degree of autonomy is not
conceded by the Central government, the mutual trust between the Central and the
State governments will be lost and the whole edifice of the federal structure may
shake when the power of the Central government became weak.

Indian Experience

A federation means a union of several States brought about by the instrument
of a treaty or agreement. The very first article of the Indian Constitution defines India
as a Union of States. Though the word federation has been deliberately avoided in the
Indian Constitution, the fiscal structure created under it is essentially federal in nature.
The federal form of government implies that the Constitution has provided for two tiers of government, i.e., the Union and the State governments (including Local bodies) and there is a division of legislative, administrative and financial powers and functions between them.

Federal system of government is a mixed blessing. It has the advantage of economic integration which promotes industrial and defense capabilities of a nation. Simultaneously, decentralized decision making units meet the politico-economic aspirations of the people at the sub-national level.

Although a federal system provides for divided governmental functions and powers, imbalances also often arise between functional responsibilities and financial resources at different layers of the government. This is so because revenue-raising capacities and revenue needs of various federating units are different.

Financial imbalances at the vertical level (Centre vs. States as well as States vs. Local) and at the horizontal level (among the States and Local bodies) are sought to be removed or reduced through Constitutional arrangements. In this regard, President of India (under article 280) appoints Union Finance Commission every quinquennium or earlier if necessary and under article 283 (i) and (y) the Constitution provides for appointment of State Finance Commission at each State level.

The Union Finance Commission recommends to the President, the principles of distribution between the Union and the States of the proceeds of taxes and the allocation among the States of the shares of such proceeds.

Now the question that is raised is why these imbalances arise in a federal system of government? To get an answer to the question we have to look into the fiscal structure of the economy. Since Independence, India has followed the path of planned economic development. The government spends on developmental activities to improve income distribution, to direct the allocation of resources in the desired lines, to generate and accelerate economy and also to promote employment opportunities. Government’s expenditure is financed by revenue from various sources such as taxes, borrowing from the people and banks, profits of public undertakings, deficit financing (i.e. creation of new money) and foreign aid. Of all these, taxation is the most important source of revenue for the government.
In most democratic countries like India, taxation powers of Central, State and local governments are mentioned in the Constitution itself through precise entries in the three lists in the Seventh Schedule of the Constitution i.e. the Centre list, State list and Concurrent list. The Centre list consists of defence, national industries and mines, foreign affairs, banking and currency, inter-State commerce, national highways, railways, airways, telecommunications and waterways. The State list covers health, education, agriculture, irrigation, roads, and law and justice. Labour relations, education and criminal law fall under concurrent list. Accordingly, the Indian Constitution made revenue and expenditure assignments to governments at different levels to carry on the constitutionally entrusted functions.

However, the problem of double taxation had emerged where the States complain on Centre’s increased encroachment on the sphere exclusively allotted to them under the Constitution.

In this scenario when the taxation powers of the government at different levels were mutually exclusive or overlapping and the fiscal decision of different levels of government was not coordinated, it had resulted in various kinds of inefficiencies in the tax system. These were i) cascading ii) vertical integration of the firms that militate against the objective of promoting ancillary industries iii) non-transparency iv) evasion and avoidance of tax, and v) inequity. Various Economists have suggested harmonization of the tax system as a solution to these inefficiencies.

An Overview of Finances of Centre and States

As we all know that the role of a government has undergone a radical change. It is a Welfare State that is committed to accelerate economic development (Agarwala, 1985). It has to provide public services and for the purpose it must have adequate resources. It further needs resources for financing development programme. The primary means of financing all such programme by the government is taxation.

A tax is a compulsory payment levied on the persons or companies to meet the expenditure incurred on conferring common benefits upon the people of a country. The Tax policy formulated after Independence aimed at accelerating growth with social justice and was based on a socialistic pattern of society, basically drawn from the socialist model. Within the framework of mixed economy, the tax policy was assigned the following objectives: -
1) To bring about optimum and efficient resource allocation within the economic system.

2) To help accelerate the rate of savings and investment.

3) To reduce income inequalities.

4) To check price rise and inflationary tendencies.

5) To promote employment opportunities.

With the above objectives in view, the tax policy had a central role in the planning process, especially in providing social justice through equitable distribution. It was directed to raise resources from well to do. The First Five-year plan (FYP, 1953) for e.g., pronounced “the state must itself raise, to the extent possible through taxation... in consonance with accepted social criteria”. It is true that many productive sources of revenue have been tapped, but “the systems of taxation generally have not been built on sound principles suited to the requirements of rapid economic growth.”

According to Chelliah (1969) a tax system is needed to bring in revenues to the government but tax revenues can be raised in many different ways. The theory of taxation deals mainly with a question of what would be the best and proper way of raising taxes for the government. In other words, the main criteria of a good tax system are: - (a) The tax system should be fair or equitable, (b) It should cause the least possible harmful effects to the economy and to the extent possible promote its growth, (c) It should be simple both for administration and compliance and (d) Last but not the least it should be income elastic. The characteristic of income elasticity is important because a system is required which will automatically produce more revenues when the economy grows so that it would not be necessary for the government to keep raising tax rates or introducing new taxes from time to time to get more revenues.

There are different types of taxes and to distinguish among these taxes is to consider their point of impact in the circular flow of income and expenditure in the economy (Musgrave & Musgrave 1989). Taxes may be imposed on household income, consumer expenditures, business receipts, profits, wage receipts, retained
earnings, dividends etc. Broadly taxes may be classified as Indirect (on outputs) and Direct (on factors) taxes.

Alternatively they can be distinguished based on whether or not the burden of a tax can be shifted wholly or partly to others. In the case of direct taxes, the liability is determined with direct reference to the taxpayer, while in the case of indirect taxes such ability is assessed indirectly. If a tax is such that its burden cannot be shifted to others and the person who pays it to the government has also to bear it, it is called a Direct tax. Examples of direct taxes are income tax, corporation tax, gift tax, inheritance tax, expenditure tax, wealth tax, capital gains tax and so on are examples of direct taxes.

On the other hand, indirect taxes are those whose burden can be shifted to others so that those who pay these taxes to the government do not bear the whole burden but pass it on wholly or partly to others. For instance, excise duty on the production of sugar is an indirect tax because the manufacturers of sugar include the excise duty in the price and pass it on to buyers. Ultimately, it is the consumers on whom the incidence of excise duty on sugar falls, as they will pay higher price for sugar than before the imposition of the tax. Thus, though excise duties are on the production of commodities but they can be shifted to the consumers. Likewise, sales tax on commodities can also be passed on to the buyers or consumers in the form of higher prices charged for the commodities. Therefore, excise duties and sales taxes on commodities are example of indirect taxes. A more simple classification of direct and indirect taxes is that of all taxes on commodities and services and on income. Taxes such as sales tax, excise duties, customs duties, taxes on entertainment, rail and bus passenger fares and so on are called Indirect taxes. They are also known as Commodity taxes.

Although there is no legal definition of direct and indirect taxes in India. Taxes under the charge of Central Board of Direct Taxes (CBDT) are direct taxes while those administered by the Central Board of Excise and Customs (CBEC) are indirect taxes.

Table 1.1 shows that in 1970-71, direct taxes accounted for a sizeable 21.2% of total tax collections: Rs. 10.09 billion out of Rs.47.52 billion. However, the proportionate share dropped to less than half at 14.4 % in 1985-86, and stood at 14% in 1990-91. The declining trend of direct taxes led to a rising share of indirect taxes.
The ratio between direct and indirect taxes worsened with every passing decade, recording 21.2% to 78.8% in 1970-71, 16.5% to 83.5% in 1980-81 and 14% to 86% in 1990-91. Of late, the decline in the relative share of direct taxes has not only been arrested but also reversed. For the year 1995-96, the share of direct taxes stood at 20%, 23.5% in 2000-01, 24.5% in 2002-03 and 28.1% in 2004-05. The combination of low tax rate and broader base supported the rising share of direct taxes in total tax revenue as part of the accepted recommendations of the Tax Reforms Committee constituted by the government of India in August 1991 (TRC). On the other hand, indirect taxes show a decline trend from 80% in 1995-96 to 76.5% in 2000-01, 75.5% in 2002-03 and 72.65% in the period 2004-05 (Table 1.1). For details see Annexure A.1.2 and A.1.3.

<table>
<thead>
<tr>
<th>Year</th>
<th>Total tax collection(A+B)</th>
<th>Direct taxes(A)</th>
<th>Indirect taxes(B)</th>
<th>Share of direct taxes in total (%)</th>
<th>Share of indirect taxes in total (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1970-71</td>
<td>47.52</td>
<td>10.09</td>
<td>37.43</td>
<td>21.23</td>
<td>78.77</td>
</tr>
<tr>
<td>1975-76</td>
<td>111.82</td>
<td>24.93</td>
<td>86.89</td>
<td>22.29</td>
<td>77.71</td>
</tr>
<tr>
<td>1980-81</td>
<td>198.44</td>
<td>32.68</td>
<td>165.76</td>
<td>16.46</td>
<td>83.54</td>
</tr>
<tr>
<td>1985-86</td>
<td>432.67</td>
<td>62.52</td>
<td>370.15</td>
<td>14.44</td>
<td>85.56</td>
</tr>
<tr>
<td>1990-91</td>
<td>877.22</td>
<td>122.6</td>
<td>754.62</td>
<td>13.97</td>
<td>86.03</td>
</tr>
<tr>
<td>1995-96</td>
<td>1752.59</td>
<td>357.77</td>
<td>1394.82</td>
<td>20.41</td>
<td>79.59</td>
</tr>
<tr>
<td>2000-01</td>
<td>3053.2</td>
<td>717.62</td>
<td>2335.56</td>
<td>23.5</td>
<td>76.4</td>
</tr>
<tr>
<td>2001-02</td>
<td>3145.35</td>
<td>731.09</td>
<td>2414.24</td>
<td>23.24</td>
<td>76.75</td>
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<tr>
<td>2002-03</td>
<td>3562.77</td>
<td>873.65</td>
<td>2689.12</td>
<td>24.52</td>
<td>75.48</td>
</tr>
<tr>
<td>2003-04</td>
<td>4140.85</td>
<td>1095.43</td>
<td>3045.38</td>
<td>26.45</td>
<td>73.55</td>
</tr>
<tr>
<td>2004-05(R.E)</td>
<td>4940.16</td>
<td>1390.17</td>
<td>3550</td>
<td>28.14</td>
<td>71.86</td>
</tr>
</tbody>
</table>

Source: Government of India, Ministry of Finance, Indian Economic Statistics (Various Issues)

The declining share of direct taxes was not consistent with the norms of tax theory. It is well known that as an economy experiences modernization, diversification, and expansion of corporate sector, the scope for direct taxes widens.

In India, the share of service sector in national income has increased over the years and lately it has become the largest sector of the economy. Though the base for direct taxation has also grown with the enlargement of the service sector but the proportionate share of direct taxes had fallen.

The limited role of direct taxes in developing countries can be explained in terms of their peculiar circumstances, which include large agricultural sector of...
subsistence nature, small-scale industrial activities, lack of monetisation and accounting practices, and low levels of income. Even a modest exemption limit of personal income tax keeps the vast majority of income earners outside the income tax net. In addition to these underlying reasons, a host of specific factors also contributed to the reduced role of direct taxes. These included: (a) scaling down rates of direct taxes, (b) plethora of exemptions/ concessions, (c) abolition of estate duty, (d) declining share of the Centre in income tax revenue, and (e) large-scale tax evasion.

In India, taxes are levied by all the three levels of government, namely, Central, State and Local. Some of the taxes levied by different levels of government fall on a common tax base. The major taxes levied by the Centre are corporate income tax, personal income tax (non-corporate income tax), CenVAT (earlier called union excise duties) and customs duties. The other Central taxes include wealth tax, gift tax, expenditure tax, service tax, and interest tax. The major taxes levied by the States are State VAT (earlier called sales tax), State excise duties and stamp and registration fees. The other State taxes include entertainment tax, motor vehicles tax, goods and passenger tax and profession tax (which falls on trade or on those who provide professional services such as legal practitioners and contractors). Property tax and octroi (a tax on entry of goods into a local area) whenever levied have been the major taxes of local governments.

**Constitutional Provisions**

India’s Constitution is the supreme organic law of the land. The Constitution which became operative on January 26, 1950, describes in detail the subject matter of laws that may be enacted by the Union and the Legislatures of the States and it is elaborated in lists I, II, and III of the Seventh Schedule of the Constitution. Under Article 246 read with the Seventh Schedule of the Constitution, these powers have been defined through precise entries. Thus, in the Constitution, Entries 82 to 92 B of List I (Union list) in the Seventh Schedule refer to the taxation powers of the Union government (Annexure A.1.4). Entries 45 to 63 of List II (State list) in the same Schedule specify the taxation powers of the State governments (Annexure A.1.5). List III (Concurrent list) does not contain any head of taxation, which means the Union, and the States have no concurrent powers of taxation (Annexure A.1.6). The absence of joint occupancy of tax fields is meant to avoid duplication in tax administration, and minimize tax rivalry between the Centre and the States, and among the States
themselves. The residual powers of taxation, as in general legislation, belong to the Union vide entry 97 of List I in the Seventh Schedule. For example, gift tax imposed by the Union derives its authority from these residual powers.

The Constitution, however, does not provide for any taxation powers to Local governments as they derive them from respective States. However, the implication of Article 276 was that the taxes on professions, trades, callings or employment are for the benefit of a State or of a municipality, district board, local board or any other local authority. The States on their own may assign any of the taxes in the State list to the local bodies and they are called assigned taxes. The taxes generally assigned to local governments are property taxes, octroi and other taxes on vehicles.

However, the property of the Centre is exempt from State taxation under Article 285 (1). Likewise, the property and incomes of the States are exempt from Union taxes [Article 289 (1)]. In respect of the Union Territories, the Parliament has the power to impose any tax included in the State list.

The Constitution made elaborate and complex arrangements relating to the distribution, between the Union and the States, of taxes, the power of borrowing, and provision for grants-in-aid by the Union to the States. The underlying philosophy of these arrangements was to place at the disposal of the two tiers of government adequate financial resources to enable them to discharge their respective responsibilities under the Constitution.

Although there was no strain on Centre-State relations in the fields exclusive in the Central sphere, the strains were felt exclusively in the areas covered by the List II and III. As we had already seen that taxes are broadly classified as either on commodities and services or on income. Here this study emphasizes on commodity taxes only.

**Fiscal Significance of Commodity Taxes**

The tax revenue of Centre and States taken together as a proportion to Gross Domestic Product (GDP) shows an increase from 10.4% in 1970-71 to 13.8% in 1980-81 and further to 15.4% in 1990-91. It, however, declined to 14.5% in 2000-01 and after remaining stable for the next two years it has shown a slight recovery and it was 15% in 2003-04 (Table 1.2).
<table>
<thead>
<tr>
<th>Year</th>
<th>Total tax revenue (All India) (A+C)</th>
<th>Central taxes (gross) (A)</th>
<th>State's share in central taxes (B) (%)</th>
<th>Central taxes (net) A – B</th>
<th>State's own taxes(C)</th>
<th>State's tax revenue (B+C)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Direct</td>
<td>Indirect</td>
<td>Total</td>
<td>Direct</td>
<td>Indirect</td>
<td>Total</td>
</tr>
<tr>
<td>1970-71</td>
<td>2.21</td>
<td>8.19</td>
<td>10.4</td>
<td>1.9</td>
<td>5.12</td>
<td>7.02</td>
</tr>
<tr>
<td>1975-76</td>
<td>2.99</td>
<td>10.43</td>
<td>13.43</td>
<td>2.65</td>
<td>6.49</td>
<td>9.14</td>
</tr>
<tr>
<td>1980-81</td>
<td>2.27</td>
<td>11.53</td>
<td>13.8</td>
<td>2.08</td>
<td>7.08</td>
<td>9.17</td>
</tr>
<tr>
<td>1985-86</td>
<td>2.25</td>
<td>13.32</td>
<td>15.56</td>
<td>2.02</td>
<td>8.29</td>
<td>10.31</td>
</tr>
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<td>1990-91</td>
<td>2.16</td>
<td>13.27</td>
<td>15.43</td>
<td>1.94</td>
<td>8.19</td>
<td>10.12</td>
</tr>
<tr>
<td>1995-96</td>
<td>3.01</td>
<td>11.74</td>
<td>14.75</td>
<td>2.83</td>
<td>6.54</td>
<td>9.36</td>
</tr>
<tr>
<td>2000-01</td>
<td>3.4</td>
<td>11.08</td>
<td>14.49</td>
<td>3.24</td>
<td>5.71</td>
<td>8.95</td>
</tr>
<tr>
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<td>3.2</td>
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<td>13.79</td>
<td>3.03</td>
<td>5.17</td>
<td>8.2</td>
</tr>
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<td>2002-03</td>
<td>3.57</td>
<td>10.98</td>
<td>14.54</td>
<td>3.4</td>
<td>5.41</td>
<td>8.81</td>
</tr>
<tr>
<td>2003-04</td>
<td>3.97</td>
<td>11.03</td>
<td>15</td>
<td>3.81</td>
<td>5.41</td>
<td>9.21</td>
</tr>
<tr>
<td>2004-05(R.E)</td>
<td>4.45</td>
<td>11.37</td>
<td>15.83</td>
<td>4.3</td>
<td>5.5</td>
<td>9.8</td>
</tr>
</tbody>
</table>

Source: Same as in Table 1.1
The total tax revenue so generated by the two tiers of government, was unequally distributed; 67% was raised through the taxes assigned to the Centre (gross) and 33% through the taxes allotted to the States (own taxes) in the year 1970-71 as shown in Table 1.3 and Table 1.4 respectively. For details refer to Annexure A. 1.3. However, a change has been witnessed in the pattern of the revenue generated by the Centre and States. There has been a decline in the share of the Centre’s revenue and it reached to around 59.5% in 2001-02 but it again increased and was 61% in 2003-04. On the other hand, the share of State’s revenue show a rising trend from 33% to 41% in 2001-02 but reduced to 39% in 2003-04.

Table 1.3: Significance of Central taxes (%)

<table>
<thead>
<tr>
<th>Year</th>
<th>Share of gross central taxes in total tax revenue</th>
<th>Share in gross central taxes</th>
<th>Share of net central taxes in total tax revenue</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>Share in gross central taxes</td>
<td>Direct taxes</td>
</tr>
<tr>
<td>1970-71</td>
<td>67.5</td>
<td>27.1</td>
<td>72.9</td>
</tr>
<tr>
<td>1975-76</td>
<td>68.0</td>
<td>28.9</td>
<td>71.1</td>
</tr>
<tr>
<td>1980-81</td>
<td>69.9</td>
<td>22.74</td>
<td>77.26</td>
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<tr>
<td>1985-86</td>
<td>66.26</td>
<td>19.6</td>
<td>80.4</td>
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<td>1990-91</td>
<td>65.6</td>
<td>19.15</td>
<td>80.85</td>
</tr>
<tr>
<td>1995-96</td>
<td>63.46</td>
<td>30.17</td>
<td>69.83</td>
</tr>
<tr>
<td>2000-01</td>
<td>61.77</td>
<td>36.21</td>
<td>63.79</td>
</tr>
<tr>
<td>2001-02</td>
<td>59.47</td>
<td>36.99</td>
<td>63.01</td>
</tr>
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<td>2002-03</td>
<td>60.6</td>
<td>38.61</td>
<td>61.39</td>
</tr>
<tr>
<td>2003-04</td>
<td>61.42</td>
<td>41.32</td>
<td>58.68</td>
</tr>
<tr>
<td>2004-05(R.E)</td>
<td>61.95</td>
<td>43.85</td>
<td>56.15</td>
</tr>
</tbody>
</table>

Source: Same as in table 1.1

Table 1.4 Significance of State Taxes (%)

<table>
<thead>
<tr>
<th>Year</th>
<th>Share of State taxes in total tax revenue</th>
<th>Share in State taxes</th>
<th>Direct taxes</th>
<th>Indirect taxes</th>
</tr>
</thead>
<tbody>
<tr>
<td>1970-71</td>
<td>32.53</td>
<td>9.05</td>
<td>90.95</td>
<td></td>
</tr>
<tr>
<td>1975-76</td>
<td>31.95</td>
<td>8.06</td>
<td>91.94</td>
<td></td>
</tr>
<tr>
<td>1980-81</td>
<td>33.58</td>
<td>4.06</td>
<td>95.94</td>
<td></td>
</tr>
<tr>
<td>1985-86</td>
<td>33.73</td>
<td>4.32</td>
<td>95.68</td>
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</tr>
<tr>
<td>1990-91</td>
<td>34.36</td>
<td>4.08</td>
<td>95.92</td>
<td></td>
</tr>
<tr>
<td>1995-96</td>
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<td>2000-01</td>
<td>38.22</td>
<td>2.96</td>
<td>97.04</td>
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<tr>
<td>2001-02</td>
<td>40.52</td>
<td>3.06</td>
<td>96.04</td>
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<tr>
<td>2002-03</td>
<td>39.39</td>
<td>2.85</td>
<td>97.05</td>
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<tr>
<td>2003-04</td>
<td>39.07</td>
<td>2.79</td>
<td>97.21</td>
<td></td>
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</tbody>
</table>

Source: Same as in table 1.1
Commodity taxes are the main sources of income for both Centre and States. They constitute around 80% of tax revenue for Centre (Table 1.5) and 91% of tax revenue for States (Table 1.6) in 1970-71. The two tables show that commodity taxes in case of States have shown a rising trend only and its share has reached to 99% in the year 2003-04. But, in case of Centre there have been fluctuations and the share of commodity taxes reduced to just 63.3% in 2001-02 but the very next year the share was 83.5%. The trend of share of the different taxes in the total tax revenue (Table 1.5) indicates that in 1990-91 i.e. just prior to the beginning of the reforms the revenue from customs duty as per cent the total revenue of the Centre accounted for 48%, union excise duty 33% and personal and corporation income taxes taken together accounted for 15.3%. Sales tax as per cent to the States’ own tax revenue accounted for 63%, State excise 18% and vehicle taxes (motor vehicles tax, passenger and goods taxes taken together) accounted for 9.9% (Table 1.6). There has been a slight change in the trend after the reforms and in 1995-96 the share of income tax at the Centre has increased to 5.3% and of the corporation tax to 20.1%, increasing the total of the two taxes to 25.4%. In case of States, sales tax increased to 66.3%, state excise declined to 15.9% and vehicle taxes accounted for 9.8%.

The share of commodity taxes in case of Centre has considerably declined. The contribution of the State taxes however, remains unchanged. So, it was necessary to analyse the main reasons why the share of commodity taxes, specifically, union excise duty and sales taxes, has declined over the period and what measures could be taken to reform the system. While there was no essential difference between the excise tax and sales tax, from the angle of incidence on the consumer, it has to be recognized that the two taxes are neither identical nor interchangeable and that there are some basic deficiencies between the two different levies.¹

In the first place, an excise is a levy at the production point whereas a sales tax is levied on a commodity at one or more points of sale or purchase between the stages of production and final consumption. Any particular commodity completes its production process only at one stage and theoretically incidence of an excise duty should be only at one point. Since, however, the component parts of the commodity are subject to excise duty, an excise duty on the final product involves a multiple duty on the components unless the duty is based on the value added by the manufacturer. In the case of sales, the same commodity might pass through various stages of sales,
leading to sales tax at more than one point, depending upon the system of the sales
tax levy. Unlike excise duty levied at the production point, sales tax includes not
merely the cost at the production point, but also subsequent costs after the production
/ stage i.e. freight, insurance and also profits and the excise duty itself.

The Centre levies excise duties uniformly throughout the country and does not
differentiate between one region and the other, while the sales tax structure and the
rates of sales taxes differ from State to State. Again, while most of the excise duties
are specific, sales taxes are ad-valorem duties and during the period of high inflation,
the sales tax yield automatically increases, other things remaining the same.
However, in some countries sales tax is considered to be same as excise duties and
question has been raised whether the ad-valorem excise duties are not really sales
taxes (Gurumurthi, 1999). Despite all these similarities, both taxes have
“distinguishing features” and both have “a positive place in a comprehensive system
of taxation and are expressly mentioned in our constitution”(GOI, 1965).

During the last 30 years Union excise duties and State sales taxes have
expanded substantially showing phenomenal growth and buoyancy. Among the tax
receipts of the Union, the excise duties occupy the most dominant position and
account for 56% in 1970-71 of the total tax receipts of the Centre as compared to
33.3% during 1990-91. However, it again increased to 49.3% in 2003-04. Taking all
the States together the yield from State sales taxes in 1970-71 was 51% of the
aggregate State taxes. During 1990-91 the sales tax revenue was 57% and in 2003-04
it was 69.2% of the total yield from the State taxes. In the coming chapters we’ll talk
in detail about theses two taxes.

Now briefly an analysis of the revenue significance of the Central taxes and
the State taxes in the total tax revenue of the government would be done.

**Trends in Central Taxes**

Central taxes accounted for about two-thirds of total tax collections in India in
the decades of 70’s and 80’s. The relative significance of various taxes in Central
revenues has undergone major changes since Independence. In 1970-71, the share of
Central taxes was 67.4%, in 1980-81 it increased to 69.9%. But, 90’s onwards, there
was a decline in the share from 65.6% in 1990-91 to 59.47% in 2001-02. But it again
increased to 63.08% in 2004-05 (Table 1.3).
As in the case of combined (Centre and States) tax revenues, tax structure at the Central level has also evolved around indirect taxes during the post-Independence period. The share of direct taxes in Central tax revenues declined almost consistently over the years 1970-90 with the result that indirect taxes came to occupy a dominant place in Central finances (Table 1.3). The share of direct taxes in gross Central taxes reduced considerably from 27.1% in 1970-71 to 22.74% in 1980-81, further to 19.6% in 1985-86 and 19.2% in 1990-91. On the other hand, share of indirect taxes increased from 72.9% in 1970-71 to 77.3% in 1980-81, 80.4% in 1985-86 and 80.85% in 1990-91.

The TRC was asked, \textit{inter alia}, to examine and make recommendations on “ways of improving the elasticity of tax revenues both direct and indirect as a proportion of total tax revenues and of GDP.” Pursuant to its recommendations, rates of both corporate and personal income tax were substantially reduced. Following better compliance, the declines in the relative share of direct taxes have been reversed. Direct taxes as a percentage of Centre’s total tax collections rose from 19.2% in 1990-91 (pre-reform period) to 30.2% in 1995-96, 36.2% in 2000-01, 38.6% in 2002-03 and 43.9% in 2004-05 (Table 1.3).

The relative significance of various taxes in Central revenues has also undergone major changes since 1970’s (Table 1.5). Some of the important direct taxes of the Central government include Income tax, corporation tax, wealth tax and gift tax, while indirect taxes include Excise levies, custom duties and service tax.

\textbf{Income Tax}

In 1970-71, income tax accounted for almost 4.65\% of Central tax collections. It further increase to 7.98\% in 1975-76. However, the relative contribution declined over the years and was 2.9\% in 1990-91. For the year 1995-96, it is estimated at 5.26\%. Thereafter, it increased substantially and was 23.12\% in 2002-03 and 21.47\% in 2003-04. (Table 1.5) For details refer to Annexure A.1.7. In the case of Corporation tax, the relative contribution was 15.09\% in 1970-71 while in 1990-91 it was 12.39\%. In the intervening period, however, moderate changes are noticeable in the proportionate share of corporation tax. For the year 1995-96, its share in total Central tax collections is estimated at 20.12\%, 18.42\% in 2000-01 and 28.96\% in 2002-03 and 33.58\% in 2003-04.
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<td>93.87</td>
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<td>819.39</td>
<td>1366.58</td>
<td>1366.62</td>
<td>1594.25</td>
<td>1869.82</td>
<td>2258.04</td>
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<td>A. Direct taxes of \which</td>
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<td>14.62 (24.32)</td>
<td>19.83 (21.12)</td>
<td>37.55 (17.72)</td>
<td>69.09 (16.05)</td>
<td>222.91 (27.2)</td>
<td>496.51 (36.33)</td>
<td>477.07 (34.9)</td>
<td>830.9 (52.11)</td>
<td>1050.91 (56.2)</td>
<td>1341.97 (59.43)</td>
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<td>i) Corporation tax</td>
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<td>13.11 (13.96)</td>
<td>28.65 (13.52)</td>
<td>53.35 (12.39)</td>
<td>164.87 (20.12)</td>
<td>251.77 (18.42)</td>
<td>251.33 (18.39)</td>
<td>461.72 (28.96)</td>
<td>635.62 (33.99)</td>
<td>830 (36.75)</td>
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<td>ii) Income tax</td>
<td>1.14 (4.65)</td>
<td>4.8 (7.98)</td>
<td>5.04 (5.36)</td>
<td>6.63 (3.13)</td>
<td>12.56 (2.91)</td>
<td>43.18 (5.26)</td>
<td>237.66 (17.39)</td>
<td>221.06 (16.17)</td>
<td>368.65 (23.12)</td>
<td>413.87 (22.13)</td>
<td>509.3 (22.55)</td>
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<tr>
<td>ii) Wealth tax and \gift tax</td>
<td>0.17 (0.69)</td>
<td>0.59 (0.98)</td>
<td>0.73 (0.77)</td>
<td>1.65 (0.77)</td>
<td>2.34 (0.54)</td>
<td>0.85 (0.1)</td>
<td>0.09 (0.1)</td>
<td>1.05 (0.1)</td>
<td>1.54 (0.36)</td>
<td>1.36 (2.65)</td>
<td>2.65</td>
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<tr>
<td>B. Indirect taxes of \which</td>
<td>19.47 (79.44)</td>
<td>45.47 (75.68)</td>
<td>74.04 (78.88)</td>
<td>174.24 (82.28)</td>
<td>361.32 (83.95)</td>
<td>596.48 (72.8)</td>
<td>872.64 (63.85)</td>
<td>865.11 (63.3)</td>
<td>1331.75 (71.22)</td>
<td>1331.76 (66.1)</td>
<td>1492.57</td>
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<td>i) Customs</td>
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<td>14.19 (23.61)</td>
<td>34.09 (36.31)</td>
<td>95.25 (44.97)</td>
<td>206.44 (47.96)</td>
<td>357.57 (43.63)</td>
<td>341.63 (24.99)</td>
<td>283.4 (20.73)</td>
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<td>486.29 (26)</td>
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<td>ii) Union excises</td>
<td>13.68 (55.81)</td>
<td>29.88 (49.71)</td>
<td>37.22 (39.65)</td>
<td>73.3 (34.6)</td>
<td>141 (32.75)</td>
<td>221.76 (27.06)</td>
<td>497.57 (36.4)</td>
<td>544.7 (39.85)</td>
<td>823.1 (51.6)</td>
<td>907.74 (48.5)</td>
<td>1007.2 (44.6)</td>
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<tr>
<td>iii) Service tax</td>
<td>N.A</td>
<td>N.A</td>
<td>N.A</td>
<td>N.A</td>
<td>N.A</td>
<td>8.62 (1.05)</td>
<td>19.64 (1.43)</td>
<td>22.39 (1.63)</td>
<td>41.22 (2.58)</td>
<td>789.1 (4.2)</td>
<td>141.5 (6.2)</td>
</tr>
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Source: Same as in Table 1.1
Wealth Tax and Gift Tax

These are so called capital taxes of the Central Government without much revenue significance.

Union Excise Duties

In the post-Independence period, a major change in the Indian tax system pertains to the phenomenal rise in the relative revenue significance of Union excise duties. In 1970-71, excise revenue accounted for a modest 55.8% of total Central tax collections: Rs.13.68b out of Rs.24.51 b. It declined substantially to 27.06% in 1975-76. But it again started rising and it increased to 39.85% in 2001-02. In the 2002-03 budget, its share stands at 51.6%. The relative contribution of excise revenue has declined since the 1970’s owing mainly to proliferation of exemptions/concessions, evasion, and litigation.

Customs Duties

During pre-Independence days and even during the early post-Independence period, customs duties formed the mainstay of Central tax revenues. However, the relative share of customs duties started declining from early 1950’s till 1970’s in view of a protective trade policy and dwindling foreign exchange reserves. The share of customs revenue in Centre’s total tax collections increased from 21.37% in 1970-71 to 47.96% in 1990-91. This upward trend was attributable to a changed emphasis from physical to fiscal controls to regulate imports, a policy reiterated in the Long-Term Fiscal Policy of December 1985. But since then there has been wide fluctuations in the customs duties and it has reduced to 24.99% in 200-01, 20.73% in 2001-02. Then it however increased to 28.13% in 2002-03.

Service Tax

The service tax was levied in 1994 and since then its share has increased quite substantially. It was 1.05% in 1995-96 and increased to 4.4% in 2003-04; Rs 8.62b out of Rs 819.39b and Rs 83b out of total Central tax collections of Rs 1875.38b

Trends in State Taxes

From a modest amount of Rs. 15.3 billion in 1970-71, revenue from States’ taxes has grown consistently over the years and was estimated at Rs. 66.2b in 1980-81, 303.8b in 1990-91, 1180 b in 2000-01 and 1599.2 b in 2003-04 budgets of the
State governments. As in the case of Central taxes, the proportionate share of direct taxes at the State level has dropped significantly from 21.9% in 1970-71 to 12.3% in 1980-81. In 2001-02 it declined to 86% but again increased to 87% in the next year. On the other hand, the share of indirect taxes has increased sharply from 78.1% to 87.7% over the same period (Table 1.6) (For details see Annexure A.1.8).

**Land Revenue**

There is no direct tax, which can claim a prominent place in the tax systems of the States. Land revenue that formed the bulwark (backbone) of State’s tax revenue during the pre-Independence period and even in the early post-Independence years has declined in importance over the years (Table 1.6). In some States, land revenue has been abolished. Its share has increased from Rs 1.1b in 1970-71 to 1.5b in 1980-81, further to 6.1b in 1990-91, 14.2b in 2000-01 and 22b in 2003-04.

**Agricultural Income Tax**

Agricultural income tax, which could have been an important source of revenue for the States, has remained negligible till date. If we analyse the data, the share of agricultural income tax, which was 0.11b in 1970-71, only increased to 0.46b in 1980-81. In the coming years, though it has reached the figure of 1.98b in 1990-91 but it again declined and was 0.42b in 2003-04.

**Sales Tax**

An outstanding development in the sphere of State finances since Independence has been the abrupt growth in the relative revenue significance of sales tax. Sales tax also known as trade tax, has grown considerably in depth and coverage, and forms the mainstay of State’s tax revenue. It is levied not only on consumer goods but also on raw materials and capital goods. In 1970-71, the relative share of sales tax was 53.5%; Rs. 7.1b out of a total collection of Rs. 12b from States’ taxes. This share increased considerably and was 64% in 1980-81 (Rs 38.9 b out of Rs 58.8 b), 68.9% in 2002-03 but declined to only 36.1% in 2003-04.

**State Excises on Liquor**

Under Entry 51 of List II in the Seventh Schedule of the Constitution, the States are empowered to levy, “duties of excise on....(a) alcoholic liquors for human consumption; (b) opium, Indian hemp and other narcotic drugs and narcotics; but not
including medicinal and toilet preparations containing alcohol or any substance included in sub-paragraph (b) of this entry”.

After sales tax, State excise duties (on liquors and other narcotics) are the most important source of States’ own tax revenues. Though second in importance, their relative significance has fluctuated considerably over the years from 14.5% in 1970-71 to 13.6% in 1980-81 and increasing to 18.03% in 1990-91. It however started declining and now its share just stand at 7.3% in 2003-04. This has happened because of the policy of prohibition adopted in some States from time to time. However, it is noteworthy that while in Western counties the main objective of duties on intoxicants is revenue collection, in India the overriding consideration in imposing these duties is to discourage consumption of intoxicants as a matter of public policy.

Taxes on Motor Vehicles and Passenger and Goods Tax

Under entry 57 of List II in the Seventh Schedule, State Governments enjoy the power to levy taxes on vehicles suitable for use on roads. Although motor vehicles taxes basically meant for regulating and controlling motor traffic, in recent years, it has been used as a fiscal measure and has assumed fiscal importance. These are levied for registration, permits, driving licenses etc. and are based on the type of vehicle (truck, bus, car, scooter etc). The yield from the tax increased from Rs 1.73 b in 1970-71 to Rs 6.87 b in 1980-81, 26.28 b in 1990-91, and 87.41 b in 2000-01 and 143.28 b in 2003-04. Its share in states’ own tax revenue has increased from 13.05% in 1970-71 to 8.29% in 2000-01 and 5.3% in 2003-04. Passenger and goods tax has, of late, gained in prominence. However, in many of the States these two taxes have been merged, so both the taxes are taken together and secondly, both the taxes fall on the same base. (Table 1.6)

Entertainment Tax

Under entry 62 of List II in the Seventh Schedule of the Constitution, States are empowered to levy taxes on entertainment. Such taxes are levied on the price charged for admission to any place of entertainment such as a circus, cinema, theatre, exhibition, variety show, etc. With the expansion of cinema, the bulk of revenue from this tax is provided by the cinema shows. Though the tax is collected from the exhibitors, the ultimate burden is borne by the cinegoers. The trend of revenue from entertainment tax at all – States shows that the yield remained almost constant at the rate of 4% except changes in two years (1985-86 & 2003-04) when the rate actually went below 2%. 17
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<td>32.7</td>
<td>60.74</td>
<td>132.8</td>
<td>265.91</td>
<td>535.25</td>
<td>1054.41</td>
<td>1179.87</td>
<td>1248.91</td>
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<td>A. Direct taxes of which</td>
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<td></td>
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<tr>
<td>i) Agricultural income tax</td>
<td>1.24</td>
<td>2.59</td>
<td>1.92</td>
<td>4.8</td>
<td>8.05</td>
<td>14.8</td>
<td>15.22</td>
<td>23.29</td>
<td>17.97</td>
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<td>(9.35)</td>
<td>(7.92)</td>
<td>(3.16)</td>
<td>(3.61)</td>
<td>(3.03)</td>
<td>(2.77)</td>
<td>(1.44)</td>
<td>(1.97)</td>
<td>(1.44)</td>
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<td>j) Land revenue</td>
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<td>1.27</td>
<td>1.98</td>
<td>1.54</td>
<td>1.07</td>
<td>1.29</td>
<td>0.47</td>
<td>0.42</td>
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<td>(0.83)</td>
<td>(0.88)</td>
<td>(0.76)</td>
<td>(0.96)</td>
<td>(0.74)</td>
<td>(0.29)</td>
<td>(0.1)</td>
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<td>B. Indirect taxes of which</td>
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<td>58.82</td>
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<td>257.86</td>
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<td>(96.38)</td>
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<td>(5.06)</td>
<td>(3.39)</td>
<td>(3.75)</td>
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<td>(1.55)</td>
<td>(0.82)</td>
<td>(1.37)</td>
<td>(0.66)</td>
<td>(0.64)</td>
<td>(0.28)</td>
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Source: Same as in Table 1.1
Electricity Duty

Along with the electricity rates, consumers are charged a duty whose revenue is shown under ‘taxes’ in the Budget. The yield from the tax depends upon the amount of consumption of electricity. Indirectly, the yield of the tax depends on industrial development; also the consumption of electricity can be taken as an indicator (index of development). Also, availability of electricity supply affects the yield of the tax. The trend of revenue from the tax at all States level, as given in Table 1.6, shows that the yield from the tax was Rs. 0.67 b in 1970-71, rising to Rs. 6.33 b in 1985-86 and with a decline to 4.4 b in 1995-96 it again began rising and was 14.47 b in 2000-01. Then there was a decline to 7.56 b in 2003-04. The share of the tax in States’ own tax revenue decreased from 5.06% in 1970-71 to a meagre 0.28% in 2003-04.

Local Finance

The Constitution does not reserve any taxes for the local bodies. Since local government is a State subject (entry 5 of List II), State Governments may assign any of the taxes in the State List, wholly or partially, to urban local bodies. Taxes usually assigned to local bodies are property taxes, octroi and taxes on professions. Property tax (house tax) is an important source of revenue for local bodies.

Assigning taxes enables State Governments to exercise a degree of supervision and control over the affairs of city corporations, municipalities, district boards, and other local bodies. These local bodies provide certain public services like basic health and education, construction and maintenance of local roads, sanitation, street lighting, and parks. Local governments also receive grants-in-aid from State Governments and earn non-tax revenue from enterprises operated by them.

Octroi

Octroi was a tax on the entry of goods into a local area from other areas for the purpose of consumption or sale. It was mentioned in entry 52 of List II (State List) in the Seventh Schedule. Industry and trade circles have criticized the continuation of octroi and termed it as a retarding factor in the growth of business and commerce in the country. By obstructing the free movement of vehicles carrying goods, the levy of octroi causes delays and thus hampers industrial progress. Although, octroi is abolished now in major States but still it’s an important source of revenue for local bodies in certain States.
Basic Problems of the Commodity Taxes

Commodity taxation is an important part of fiscal armoury of India. It however, lacks transparency as to who pays the tax (Aggarwal, 1997). Introduction of tax reforms in India had to take into account its possible effects on the financial relations of Centre and the States. In the Indian federation, when the fiscal system could not coordinate the fiscal decisions of different levels of government, it caused various inefficiencies in the system. It includes cascading, vertical integration of the firms, inequalities, evasion and avoidance of tax. Some of the reasons of these inefficiencies in the system of commodity taxation were: -

a) Point of Levy/ Tax Base

Indian Constitution had clearly defined the tax bases of excise duties and sales taxes (Entry 84 and 54); excises to be levied at the manufacturer or producer level and sales tax at the time of sale and purchase of goods. In practice, however, the levy of sales tax had also switched over mostly to the first point of sale i.e on manufacturers and importers of goods due to problems in administering taxes at the retail level. This had led to overlapping between the tax bases of excise duties and sales tax and caused cascading. Also, it increased the cost of holding of inventories, higher interest payments, changes in relative factor prices and inefficient production techniques.

b) High and multiple rates

Another important problem of the commodity taxes was multiplicity and large number of rates. There used to be some 350 specific excise duty rates and 40 ad valorem rates the highest of which was 105% (Purohit & GOI, 1993). The rates were kept high to raise the same amount of revenue since tax base is narrow. Since the level of sales taxes at the first point cannot be increased any further the States imposed new taxes like turnover tax, additional sales tax, surcharges, and so on, making the system totally non-transparent. This distorted rate structure led to wrong classification of goods causing unfair assessments, the diversion of trade as well as shifting of manufacturing activities from one State to another, providing incentives for evasion and avoidance and generated pressures for exemptions and concessions (Naresh 1994).
(c) A plethora of incentives and exemptions

Almost all the States provided large number of incentives to the industrial sector to promote industrialization. Also, concessions were given to certain goods, producers under political pressure and to encourage local business activity. These exemptions caused erosion of tax base and raised the rates of non-exempted goods.

(d) Exclusion of the service sector

In India, services were excluded from the tax base of both excises and sales tax. It narrowed the tax base and caused tax evasion.

(e) Input Taxation

The evolution of the tax structure in India has led to the taxation, not just of final goods but also of inputs also used in the production process. This has led to cascading and rising commodity prices. Although both Centre and States do provide some tax relief on inputs (the Centre through Modified Value Added Tax, MODVAT, the States by providing concessions and exemptions) but it has limited scope.

(f) Barriers to Domestic trade

The enforcement of these taxes resulted in hindrance to the free-flow of domestic trade. Trade across State borders was often subject to both Central Sales Tax (CST) as well as local sales tax, which created bias against inter-State trade as locally produced goods bear only local sales tax. This prevented India from being a common market and exploits its advantages. It, however, promoted smuggling of goods setting of trade centers across the high taxing States.

(g) Faulty Administration

The Indian tax administrative system exhibited features such as complex procedures, out-dated methods, confusing notifications and evasion. At times, field officials do not receive timely government notifications related to changes in tax rates and exemptions and dealers suffer a lot as a result. Surprisingly, there used to be approximately 700 exemption notifications in relation to the union excises alone. Also, there was a 7-year backlog of excise tax cases before the courts (Jain 1993). In cash of sales tax, the situation was even more serious.

To overcome these problems, economists suggested different solutions. However, adoption of Value Added Tax (VAT) as prevalent in most West European
countries was considered to be a most important solution to the problems of Indian Commodity tax system.

However, in India, the initial moves to implement VAT at the State level came in 1993. After a number of round of deliberations, finally, in 2004 VAT was implemented in almost all the States.

In case of union excise duties, the reform process was started in 1986, with the introduction of MODVAT. Then in the Budget 2000-01, CenVAT finally replaced excise duties.

The ideal scenario is of a Single VAT i.e Goods and Services Tax (GST) merging Central and State VAT.

Objectives of the Study

With the background of the foregone analysis the present study purports to:

a) analyse the changes in the Indian tax structure with relation to indirect(commodity taxes) during the period (1970-2005).

b) analyse the concept of fiscal federalism and the problems of commodity taxation in a federal system particularly in India.

c) examine in detail the problems and possible reforms of the two main commodity taxes: Union excise duties and Sales taxes.

Hypothesis

The present study proposes the following hypothesis:

“Tax Reforms would improve income buoyancy and thereby productivity of these taxes and in fiscal federalism contribution of shared taxes would increase in relation to own revenue overtime”.

Research Methodology

In this study, an attempt has been made to examine the relative changes in the two major commodity taxes i.e. union excises and sales tax and for this purpose standard statistical techniques would be employed.
Estimation of Income Buoyancy

Methodology

Tax elasticity measures the responsiveness of a tax system to change in GDP and is defined as the percentage change of tax revenue exclusive of discretionary changes (legal changes in tax structure and tax base etc) resulting from a one percent change in GDP. Tax buoyancy is the percentage change in tax revenue (discretionary changes included) caused by a one per cent change in GDP. A value less than one suggests a low tax elasticity and ineffective discretionary changes, whereas a value greater than one implies that discretionary changes are improving the responsiveness of the tax system (Skeate, Copin, Boamah).

Measurement of tax buoyancy does not pose any problem. However, computation of tax elasticity confronts intricate methodological difficulties. The elasticity of tax revenue is more stringently defined as the underlying revenue response, holding constant all parameters of tax policy. In developing countries, where tax policy parameters are changed every year and sometimes in the course of the year, the elasticity of tax revenue is virtually impossible to estimate with an appreciable degree of accuracy (Rajaraman, Goyal & Khundrakpam, 2006). To measure elasticity coefficient, it is necessary to eliminate from the actual tax revenues the effects of discretionary changes. This problem is dealt with by alternative methods including – (a) use of dummy variables (b) constant rate base method, and (c) proportional adjustment method (Rao, 1979). In such a fiscal context, buoyancy coefficient may provide the alternative to estimate the revenue generating properties of the tax system. In this particular study also, we have calculated only the buoyancy coefficients for the two taxes.

Estimation

Estimation of elasticity and buoyancy is obtained by fitting a linear regression of tax revenue on national income/appropriate bases. The response coefficient from time series data is estimated by using the following revenue exponential function.

\[ Y = ax^b \]

Or \[ \log y = \log a + b \log x \]

Where ‘y’ is tax yield, ‘x’ national income, ‘a’ is a constant and ‘b’ the elasticity
In a least square fit of this logarithmically linear equation on time series data, the regression coefficient ‘b’ signifies percent change in (y) that accompanies percent change in (x). For responsiveness of tax-to-base and base-to-income, the respective expression would be the following:

\[ \log y = \log a + b \log B \text{ and } \log B = \log a + b \log X \]

Where B is the base of the tax.

If coefficient b turns out to be more than 1, the responsiveness of the tax system will be considered relatively high and if it is less than 1, the same will be termed as relatively low.

This method assumes that the buoyancy or elasticity is constant over the range of income considered, i.e., the proportionate response of the tax to an income change of 1 percent is the same irrespective of the level of income. It also assumes the existence of a significant correlation between y and x. An indication of this is provided by the statistic R² which measures the goodness of fit of the functional relationship being measured. In the absence of a significant correlation between the two variables, the least square estimate of ‘b’ will convey little meaning. There is no attempt to add other independent variables to the estimation equation.

**Sources of Data**

The proposed study is based on the data collected from secondary sources. These secondary sources include different government publications like Reserve Bank of India Bulletin, Indian Public Finance Statistics, National Income Accounts Statistics etc. Various journals like American Economic Review, Economic and Political Weekly, Economic Journal, Indian Economic Journal, Journal of Public Economics, Quarterly Journal of Economics, Public Finance Review etc. are referred to. Also references are downloaded from various web sites. Further, the reports of various committees formed by the Central government to reform the commodity taxes are also taken into consideration.

**Limitations of the Study**

1) In this study, only two indirect/commodity taxes are taken into account i.e. excise duties and sales tax.
2) Though Optimality concept is relevant and important but only it's theoretical concepts are discussed here. We could not compute the optimal tax structure for the two taxes under study for various reasons. However, it could have wide applications also.

3) The accurate implications of the imposition of VAT could not be presented due to lack of data availability.

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1 The words 'Centre', 'Union', and 'Federal' are used interchangeably in this study.

2 According to a study conducted by Raja Chelliah and others for a group of 47 developing countries for the average of the period 1969-71, the average share of indirect taxes was 64% of the total tax revenue. As for developed economies, the share of indirect taxes ranged between 45%-50% of the total tax revenues. It is noteworthy that in India the proportion of indirect taxes stood at 78.8% in 1970-71, much higher than the international average of the developing world.

3 Tax collections (or receipts) of the Central Government are different from its tax revenues because parts of the proceeds from income tax, and union excise duties are transferred to state government under various tax sharing arrangements of the Constitution.

4 Prohibition refers to legal ban on production and sale of liquor in the notified area. Obviously, the state excise would have no yield from this tax when prohibition is imposed.

5 Until 1957-58, only Assam, Bihar, Punjab, Tamil Nadu, and West Bengal levied it. But since then all the other States have introduced this tax.