CHAPTER - II
REVIEW OF LITERATURE

Introduction

In the previous Chapter, an overview of the taxation system practiced by the Central and State governments was attempted. In this Chapter, an attempt would be made to review some of the previous studies with their major findings. Since issues are related to both federalism and independent to Centre and State, the review tries to cover both.

On Need for Fiscal Federalism

According to Prasad (2003), in recent years the emergence of a number of political and economic changes has given rise to new awakening of interest to re-examine the Indian Fiscal Federalism. On the economic front, a greater role assigned to the market in resource allocation and on the political front, the transition from a period of one party rule at the Centre and State levels to that of coalition government and locally dominated regional parties has given rise to confrontational politics between the Centre and the States.

On Historical Underpinnings

If we take into account the historical background of federalism in India Nayak, (1999), has given a vivid description of the system of federal finance in India, which has a long history behind it, dating back at least to 1870. With the take-over by the British Crown from the East India Company in 1858 a highly centralized system came into being. The provincial governments were entirely dependent on annual allotments by the Central government for the maintenance of their administration.

It is only after 1870 that the process of centralization was reversed, when the first step towards financial devolution was taken under the pressure of three successive budget deficits. However, the Government of India Acts of 1919 (based on the Montague-Chelmsford Report of 1918) and 1935 loosened the powers of the Government of India over the provinces and were the major step towards federation when the Centre and the provinces were allotted certain broad heads of revenue; the
The former has customs, income tax, posts, salt and railways, whereas the latter had jurisdiction over land tax, excise, irrigation and stamps.

The Government of India Act (1935) carried the principle of federalism further. It was further decided that the proceeds of certain central taxes such as income tax and export duties could be divided between the Centre and the provinces, with the rules of division to be left with the Centre. This scheme continued in Independent India, but now it is through the recommendation of the Finance Commission.

As a prelude to the introduction of the 1935 Act, Sir Otto Niemeyer was appointed to make recommendations on the assignment of revenues and sharing of taxes. He kept two main objectives in view in making his recommendations. The first was to maintain the financial stability of the Centre. The second was to evolve a scheme of assistance, which would not only meet the immediate needs of the provinces, but also their future needs. Population was chosen the criterion for distribution of income tax.

**On the Constitution and Supremacy of the Centre**

From its very inception, the Constitution is loaded in favour of the Centre. The concept of strong Centre has been incorporated in the anatomy of the Constitution through a variety of devices, among which the following are noteworthy: supremacy of Union Legislative power, Union control over State legislation and also in case of emergency (both external aggression and financial), restrictions on States’ taxation powers.

Apart from the restrictions, the major and elastic sources of tax revenue belong to the Centre while relatively inelastic sources of revenue come under the purview of State governments. The rationale behind this Constitutional division of taxation powers between the Centre and the States is economic and administrative convenience. Taxes with inter-State base and those in the case of which all-India uniformity in rates is desirable to facilitate industry and trade are vested in the Central Government. While taxes which are location specific and relate to subjects of local consumption are with the States.

The revenue instruments of Centre are excises, customs, income tax etc. and the sources of revenue for State governments are sales taxes, state excises, taxes on
land, agricultural income tax etc. As we have already seen in detail in the Chapter I that the Commodity taxes are the main sources of income for both Centre (56% of tax revenue) and States (97%) in the year 2003-04. Customs and excises respectively constitute 26% and 49% of tax revenue of the Centre while sales taxes and State excises constitute 60% and 13% in 2003-04. There is a mismatch between constitutionally assigned revenue collecting powers and expenditure responsibilities of different levels of government in India. While the Centre is favourably entrusted with more revenue raising powers than required to meet its expenditure needs, States and local self governments are left with revenue raising powers much short of their expenditure needs.

On sharing of certain Central Taxes

There are certain provisions in the Constitution, which indicates some kind of flexibility in India’s Constitution in terms of distribution of financial resources between different layers of the government. These provisions relate to the revenues from certain taxes and duties leviable by the Union but are totally assigned to or shared with the States to supplement their revenues in accordance with their needs.

On mechanism of Transfers

Recognizing the fact that the financial resources of the States may prove inadequate for undertaking welfare, maintenance and development activities the framers of the Constitution did make elaborate, albeit complex, arrangements relating to transfer of funds from the Centre to the States. These central transfers are effected through three main channels:

1) Statutory transfers through the Finance Commission.
2) Plan transfers through the Planning Commission.
3) Discretionary transfers for Centrally Sponsored Schemes; relief from natural calamities, and relief and rehabilitation of displaced persons.

Bagchi & Sen (1989), who have taken a stock of the current situation of economic administration in India, also emphasizes the same fact that it is centralized, partly due to Constitutional provisions and partly due to extra-constitutional developments. They have suggested a framework of different possibilities for further decentralisation.
According to them, the key to decentralization in India lies in decentralizing the planning process itself. Transfers of funds to States from Planning Commission is as important as transfer of federal funds to the States by the Finance Commission. Also, totally decentralized planning, with mutually independent plans, may not be suitable or practicable for India due to large disparities between States and also within the States.

In this framework, the process of decentralization is used as an aid to the planning process. It requires bodies at sub national levels to provide inputs for the formulation of plans and once plan is formulated, implementation work should also be shared by them.

**On Issues in Federal governance**

After going through the literature, which analyses the structure and the characteristic features of fiscal federalism, the next step is to make a study of the emerging fiscal and economic issues in the federal governance.

*Bagchi (2003)*, has done an evaluation of India’s fiscal federalism for the past fifty years and a major question that is raised is whether the system of federal governance also yielded the economic benefits associated with federalism. The question, however, assumes relevance, as it is the economic virtues of federalism that have come to the fore in recent years, drawing even independent nations to join in economic combines while not surrendering their independence, the European Union being a prime example. In this paper, an attempt has been made to appraise the economic effects of the operation of India’s fiscal federalism in the last fifty years from a broader angle i.e. how it has impacted on the efficiency of the public sector in performing its fiscal tasks and the performance of the Indian economy.

According to *Prasad (2003)*, the centralization process in the country has resulted in the structure where the Central government has a comparative advantage in raising revenues and sub-central governments in spending. Taxable capacities and unit cost of providing public services do vary across different jurisdictions due to historical and political factors. This has resulted in vertical and horizontal imbalances. The analysis of Indian fiscal federalism shows that the Constitutional assignments as well as the execution of federal fiscal arrangements have severely impacted on horizontal and vertical fiscal imbalances. The imbalances have not only been high but
have also been increasing over-time. The growing imbalances have had adverse effects and the mechanism to resolve these imbalances has not worked satisfactorily, thus creating a serious problem in inter-government relationships. The Centre needs to provide a leadership role in fiscal consolidation, particularly in an era of intensively competitive politics and coalition governments.

To overcome the horizontal and fiscal imbalances, a system of fiscal transfers is followed between the Centre and States. According to Nambiar (2003), an analysis of the total resource transfers from Centre to States reveal that the share of tax and grants are lowering in the recent years, but the share of loans was on the rise. It implies that the States are getting more and more indebted. This is considered to be yet another issue in the fiscal relation of the Centre and States.

Another comparative study has been made regarding transfer of resources by different category of States as very poor, poor, middle, rich and very rich. Tax devolution more or less followed a progressive pattern that the per capita receipt was highest in the case of very poor States and reduces with the increase in the income level of the States. But grant devolution, on the other hand followed a different pattern. The highest per capita grant was received by the low-income States, which was 30% higher than the per capita receipt of very poor States on an average. Similarly, the high-income states received an average per capita grant more or less of the same size of the very poor States. Loans also followed more or less a similar pattern. Thus, what is required is that grants should also follow a progressive pattern in its devolution.

Although the system of Centre-State transfers in India with the formation of the Finance Commission as its main principle, has often been praised but it has come under criticism on various points.

Firstly, none of the Finance Commissions have made an objective assessment of the overall resource position of the Centre and total resources available to meet the demand (Mukhopadhayay D. 2003).

Secondly, the gap-filing approach of the Finance Commission has disincentive effects on tax effort in the sense that the Centre relies on non-shareable resources (like the administered price mechanism). This not only distorts the pattern of resource
mobilization at the Union level but also leads to extravagant expenditure at the State level.

The most serious deficiency of the transfer system is the unreasonable incentives it creates for efficiency and fiscal discipline among the States. The Eleventh Finance Commission came for particularly sharp criticism due to total neglect of efficiency in fiscal management and focus only on equity. (Bagchi & Chakraborty 2004).

According to Rao & Singh (2005), India’s transfer system “…. on the whole has an equalizing effect, it is not designed to offset shortfall in fiscal capacity and cost disabilities fully.”

Chakraborty (2003) has prepared a ‘fiscal effects’ model using data for 15 major States for the year 1990-91 to 1999-2000. He finds that aggregate fiscal transfers are a positive (and not negative) function of per capita income, suggesting that the mechanism of Centre-State transfers in operation in India has been very regressive.

Another point of criticism, voiced particularly by the States has been that the transfers have not been adequate to bridge the vertical gap. Even though larger proportions of central revenues have been devolved to the States, but the transfer system has not been able to reduce the vertical and horizontal imbalances. In fact, fiscal transfers have led to fiscal stress all around. Thus, it is said that fiscal transfer system is in urgent need of reform. (Rao, 1997)

Rao (2002) suggested that the last decade has seen a steady deterioration in State finances. To a large extent this deterioration has been caused by reduction in central transfers. The pay revision of State Government employees, further worsened the fiscal imbalances in the States. There has been a steady deterioration in State’s own tax revenues, significant drain on State’s resources due to losses from public enterprises and increase in subsidies and transfers.

Another important factor, which has affected the State’s finances, has been the lending by multilateral lending institutions (World Bank and ADB) to States. Although the Centre guarantees repayments of these loans, the States are required to initiate fiscal reforms to improve their repayment capacity. However, while the loans have resulted in States’ indebtedness, fiscal reforms undertaken by them have failed
to find solution to the States’ problems. The deterioration in the fiscal position of States has resulted in making fiscal operations unsustainable, contributed to macroeconomic instability and constrained the provision of social and physical infrastructure.

The situation of fiscal imbalances was more severe in special category States than in non-special category States. There was, however wide variations in the deterioration in the fiscal situation in different non-special category States.

*Rangarajan & Srivastava (2004)*, have compared Indian fiscal federal system with that of Canadian federal system and drawn some lessons from it. According to them, while comparing the Canadian system of inter-governmental transfers with the system of fiscal transfers in India, the following features may be highlighted:

a) The Canadian system of fiscal transfers has two important features: equalization grants, which are constitutionally guaranteed, and the Canadian Health and Social Service Transfers (CHST). Together these transfers are able to eliminate to a considerable extent both vertical and horizontal imbalances.

b) Vertical imbalance is corrected in most federations through tax assignment, revenue sharing and grants. India follows all the three routes, while in Canada, the emphasis is on tax assignment and grants. In Canada almost all tax bases are common to both levels of governments, but not in India. CHST is a special purpose grant in Canada to correct vertical imbalance.

c) Incomes as well as population are concentrated in just a few provinces in Canada, namely Ontario, British Columbia, Alberta and Quebec. This facilitates a transfer system aimed at equalization. On the contrary, redistribution in India is more difficult because the share of population in States which have a high per capita income is smaller than the population in the States with low per capita incomes, which require transfers.

d) Even after the determination of the actual transfers in any given year, calculations remain open in Canada for 4 years where amounts are adjusted in view of the revised data. In India however, this facility is not available, particularly for the Finance Commission transfers, although amounts of tax devolution automatically adjust with reference to the actual realizations of
Central taxes. In fact, most grants are fixed in nominal terms well in advance of the years for which those grants are to be given.

c) In the Canadian system there is no autonomous body like the Finance Commission. Most of the decisions are arrived at through consultations and discussions. However, in India, apart from the Constitutionally mandated body like Finance Commission, there are other institutions also dealing with different aspects of Federal-State relations, like the Planning Commission and various Central Ministries and departments. So, the Indian system of transfers is fragmented, with several bodies being responsible for the transfers.

On Reform Measures

According to Coady (1997), economic theory can contribute to the analysis of fiscal policy and help policy makers and tax analysts determine the appropriate design of fiscal systems. Optimal tax theory has identified important features which one should attempt to incorporate into fiscal systems. The problem of tax reform is presented in terms of raising sufficient government revenue as efficiently and equitably as possible while also taking account of the administrative capability of the government. Domestic resource mobilization is one of the ways of financing expenditures; alternatives are foreign borrowing and printing money. However, these alternatives result in severe internal and external disequilibria and are not sustainable in long run. Therefore, an efficient and equitable domestic resource mobilization mechanism appears to provide the only viable long-run method of financing government expenditures. This case is further reinforced by the present high levels of interest rates and difficulties in securing foreign borrowing.

Bagchi & Sen (1989), have highlighted the problem of devolution of tax revenue from the States to local bodies, as it is not mentioned in the Constitution and it is left entirely to the States to decide how much to devolve. According to them this requires immediate attention. It is in this regard, two solutions are suggested by them. The first is to make a constitutional provision for local finance commission on the lines of the existing Finance Commission. Secondly, large infrastructure expenditure should be undertaken by either Centre or States or both of them and local bodies should be relieved of this responsibility. Rest of the Paper lays greater emphasis on providing more powers to local bodies both urban and rural.
To reduce vertical imbalances, Mukhopadhyay D. (2003), suggested reforms in both tax and expenditure policies at the state level. There should be a limit to decentralization of tax revenue as more decentralization may affect equity and efficiency adversely.

Further, overlapping in the functions of the Planning Commission and the Finance Commission are to be avoided. Rao, suggested the “constructive federalism” and particularly “cooperative federalism” - a greater degree of consultation and partnership in our “layer cake” perspective of government functions.

However, the concept of cooperative federalism requires a combination of the criteria of autonomy fiscal discipline and inter-state equity so that a mutual trust and confidence between the Centre and the States and also amongst States themselves are fostered. Precautions have to be taken before preparing a room for cooperative federalism since the relationship between various levels of government is competitive indeed.

According to Rao, the need of the hour is to formulate an effective fiscal reforms programme. In this direction most non-special category States have decided to publish their contingent liabilities. Some States like U.P, A.P, Karnataka etc. have brought out White Papers to increase public awareness of their problems. They have also tried to appoint Tax Reforms Committee and Administrative Reforms Committee, initiating legislation on fiscal responsibility.

Bagchi (1999) and Srivastav (1999) have formulated a minimum programme to raise the non-tax revenue. Few suggestions are:

a) Formula based central assistance as under the modified Gadgil formula should be given up and annual Plans should be discontinued. Instead, Planning Commission should help the States in drawing up their own plans, particularly weak States.

b) Tax powers of the States should be enlarged for e.g by transferring the power to tax services to the States.

c) All revenue transfers should be done only through Finance Commission, leaving the Centre to make discretionary transfers only in abnormal situations.
d) Conditionalities can be attached also to loans. There should be a hard budget constraint on the states and a commitment on the part of the Centre to a ‘no bail out’ policy. (*Bagchi 1999*)

e) *Srivastava* suggested an integrated normative approach towards all general-purpose transfers (tax devolution and general grants) should be adopted.

f) The secretariat of the Finance Commission should evolve a proper framework of projections of expenditure requirements and revenue capacities.

g) Reduction of low priority non-merit subsidies and making the subsidy regime transparent, less input-based and better targeted.

*Gurumurthi (2003)* has taken into consideration the changes in the vertical and horizontal system of tax sharing to reduce both vertical and horizontal imbalances. Earlier only selective Central taxes, namely income tax and union excise duties were shareable with States. The other two major taxes, namely corporate income tax and customs duty were not shareable at all. However, with the constitutional amendment of August 2000, all Central taxes have become shareable with states and 29% of the pool of Central taxes (on net basis) are to be shared with the States; this percentage is subject to review by the Finance Commission (FC) every five years. Twelfth FC, for the first time has reviewed this percentage. It was felt that this system could help to increase the rate of tax devolution to the States (as a percentage of gross tax revenue of the Centre) which was stabilized for a long time. It could also help to make the Central tax structure more equitable and simple and in bringing about some stability to the fiscal policies of the Central government, if the percentage is fixed for a minimum period of suppose 20 years.

Finance Commissions in the past have recommended different formulae to redistribute the shareable tax revenue among the States by choosing different economic indicators. The formulae for redistribution of income tax and union excise duties have also been different. The Eleventh FC followed the same pattern but also introduced a new element called ‘fiscal discipline’, and changes in the weights for certain vital economic indicators. The weightage assigned to distance factor has increased from 62.5% as against 60% in the Tenth FC but a change in population from 20%(TFC) to 10% and tax effort from 10%(TFC) to 5% were drastic and unnecessary.
On Other Federal Issues

According to Murty (1995), in the Indian federation, since the fiscal system does not coordinate the fiscal decisions of different levels of government it has resulted in various inefficiencies some of which are given as follows:

a) A conflict has developed between the fiscal objectives of Centre and State governments.

b) A problem of overlapping of tax bases of central excise duties and sales taxes has emerged which caused cascading problem. Any unilateral decision by Central and State governments about commodity taxes may effect the revenue of both the governments.

c) Widespread taxation of inputs by both Centre and States without giving credit to taxes levied by Centre while fixing taxes by the States and vice versa resulted in cascading problem and rising commodity prices.

d) Autonomy of State governments to fix tax rates has resulted in fiscal competition and the States provided incentives to reduce their relative tax rates so that each one of them can attract business and investment at the cost of the others.

e) Both Central and State taxes were affected by the complexity of rates and bases which had caused difficulties in administration and resulted in large scale of tax evasion.

f) Incomprehensive tax base for the taxation of domestic goods and services had resulted in more reliance on trade taxes as an important source of revenue to central government.

   The Domestic trade taxes Report (1994), has highlighted these problems and has considered the system of domestic trade taxes operating at that time as archaic, irrational and complex.

g) Another serious shortcoming of the Indian tax system as mentioned by Jain & Jain (1983), has been that differential tax treatment accorded to the agricultural and non-agricultural sectors which has violated the principle of horizontal equity. Under the Indian Constitution, only the State governments
are empowered to tax agricultural income and excluded from the ambit of central income tax, continues to this day.

According to Chelliah (1994), tax reform has been an integral part of the structural adjustment programme that has been undertaken by several developing countries. Two major developments have contributed to the motive and impetus for tax reform. The first, is the realisation by policy makers and tax administrators that the economic effects of taxation had to be given due consideration otherwise resource allocation gets distorted and economic growth adversely affected. The second is the awareness, on the part of economists and tax designers that the administrative implications had to be kept in view since a theoretically perfect tax structure would be of no avail if it cannot be administered effectively. As we shall see later on, these aspects are definitely incorporated in the reform measures suggested by various tax committees.

According to Chelliah, the three criteria on which a sound and practicable tax system should base are equity, economic efficiency and administrative ease. This requires a simple and transparent tax system.

The system of commodity taxes must be such that its burden will fall on the consumption of different individuals and the distribution of the burden can be predetermined as well as measured. At the same time, the commodity tax system should not adversely affect productive activities. The VAT fulfills this description. A fully retail sales tax will be equivalent to a VAT but suffers from the disadvantage that it concentrates the entire burden of the tax at one stage, whereas under the VAT the government collects the tax in instalments at various stages of production. VAT is a multi-point tax system under which rebate is given to tax paid on inputs at earlier stages.

If the VAT with full setoff for taxes on inputs (including capital goods) is levied at a single rate it will act as a proportional tax on consumption. Such a tax is to be supplemented by selective excises on consumption at somewhat higher rates. With such a structure of indirect taxes superimposed by a broad based income tax, would constitute a fair, simple and progressive system of taxation with no adverse effects on production.
The VAT will be levied on a fairly comprehensive base covering most goods and services. It will fall on imports as well as on domestically produced goods so that they are put on par. VAT will have only one or two rates; that would make it easy to administer and besides tax would be generally neutral. Non-neutrality where needed in the social interest will be introduced through special excises outside the VAT system. Thus the VAT will have the merit of being a comprehensive consumption tax which would treat equally those with equal consumption.

Bagchi (1995), has made the observation that the programme of tax reform initiated by the Union Finance Minister since 1991 recognizes the need for moving over to a system of VAT to remedy the ills of the present system and move the tax structure towards promoting competition and efficient allocation of resources in the economy consistent with equity and revenue need of the government. The task is formidable in a federal country, for the constraints of e federal polity cannot be wished away. Nevertheless, every attempt has to be made to strike a balance between autonomy of the States on the one hand and efficiency, equity and simplicity on the other. Tax coordination is the avenue to achieve such a balance.

Murty (1995) has also suggested that the ultimate aim of commodity tax reforms in India should be a comprehensive VAT covering value added by all business enterprises from the manufacturing to the retailing activities. The tax should have consumption base and follow the tax credit method to compute the net tax liability of a business firm. The tax liability of international and inter-state flows has to be calculated using the destination principle.

The two main commodity taxes of the Central and State governments are union excises and sales tax. Due (1985) and Sury (1988) had explained in detail the importance, relative significance, structure and problems associated with both these taxes.

According to Sury, excise duties comprise the single largest source of tax revenue for the Central government. In 2003-04, they accounted for 49% of the Centre’s total tax collections. In 1947, excise taxation in India was highly selective in terms of commodity coverage and after 1954 there was increase in commodity coverage, culminating in the introduction of a generalized system of excise taxation in 1975.
By virtue of the taxation powers set forth in Entry No.84 of List I of the Seventh Schedule to the Constitution, the Central government is authorized to impose excise duties on goods manufactured or produced in India, except alcoholic liquors and narcotics which are imposed by the State governments. However, the Central Excises and Salt Act, 1944 is the primary Law under which duties are levied on different goods.

Rates of excise duty approved by the Indian Parliament are termed as statutory or tariff rates. However, the government enjoys the power to exempt, by notification, any excisable goods from the whole or any part of duty leviable on such goods. In exercise of this power, the executive periodically determines and announces the effective rates of duty. As far as the nature of tariff is concerned, in the early days of the excise system, the emphasis was on specific duties due to administrative reasons. However, the emphasis shifted to ad valorem rates during inflationary periods (particularly in the 1970’s). In the 1980’s, however, the trend toward ad valorem rate not only has halted but has also reversed as a result of the unprecedented spurt in litigation concerning disputes over classification and valuation of goods for purposes of excise levies. To combat tax avoidance and evasion, the basis of duty has been changed from ad valorem to specific on a number of commodities.

As far as the problems related to the excise taxation are concerned, one of the major problem is of multitude of rates which are subject to frequent revisions. The rate of taxes varied from 10% to 400%.

The other problem is related to the taxation of inputs which then resulted in cost and profit escalations and also promoted vertical integration in industries to the disadvantage of the small scale sector. The introduction of Modified value added tax (MODVAT) in the Long Term Fiscal Policy Statement as on 1ST March 1986 grants excise relief to inputs. The MODVAT scheme provided for immediate and complete reimbursement of the excise duty paid on components and raw materials which are used in the manufacture of finished goods. The MODVAT is designed to operate as a cost-saving device by allowing the manufacture immediate credit for duty paid on the inputs and the consequent reduction of the interest costs. It is claimed that MODVAT will check excise evasion because credit of input duty cannot be claimed unless actual production is declared to excise authorities. The introduction of MODVAT scheme is a positive measure in the reform of indirect taxation in India.
Acharya (2005), in his article has sketched the story of India’s tax reform from the mid 1970’s to the present and finds that enormous progress has been made in the last 30 years in the field of excise duties based on economic efficiency, equity, built in revenue elasticity and transparency.

According to Virmani (2001), the tax reform in the 1990’s was also widespread. In 1991, the Narsimha Rao\Manmohn Singh Congress government made comprehensive tax reforms one of its main reform planks. The Tax Reform Committee (TRC) chaired by the country’s leading public finance authority, Raja Chelliah, was swiftly established and it quickly gave an Interim Report (December 1991); followed by a two-part Final Report (August 1992 and January1993). Taken together, these 3 volumes of the Chelliah Committees Report (GOI 1991-93) constitute the finest treatment of tax policy and reform issues in India in the past 30 years. The details of this report will be discussed in Chapter VI.

However, not all the TRC recommendations were implemented fully or exactly as originally envisaged. During Congress government regime (1991-96) MODVAT was extended to capital goods and petroleum products, the bulk of excise taxation was shifted from specific to ad-valorem rates, the number of excise rates was substantially reduced and number of special exemption notices were cut by half. The budget was also innovative in introducing taxation of an initial set of services.

The government changed in 1996 and United Front government (Chidambram as Finance Minister) continued the reduction of excise duty rates.

NDA government came to power in 1998 and finance minister Yashwant Sinha presented the budget. He made very major progress in the budget 1999-2000 by moving the excise tax structure towards a single rate manufacture’s VAT when 11 excise rates ranging from 5 to 40% were clubbed into just three rates (8, 16 and 24%). In addition, two non-Modvatable additional excise rates (6 and 16%) were levied on a handful of luxury consumer goods like cars, air conditioners. In the following budget for 2000-01, Sinha conflated the three excise rates into a single Central VAT (CenVAT) rate of 16% with special additional excise rates (at 8, 16 and 24%) for a few commodities mainly consumer luxuries. Also the number and scope of exemptions and preferential rates had been reduced to certain extent. However, in the area of tax administration, the TRC’S recommendations had been observed largely in the breach.
Tax policy changes continued in the new millennium. But to some extent they seem to have lost the vision and coherence of the TRC. It may be due to the advent of new views advocated in some fresh government reviews and reports on tax policy. The first of these, the Shome report of the Advisory Group on Tax Policy and Tax Administration for the Tenth Plan (GOI, 2001a), was broadly in the TRC tradition and provided the very useful service of highlighting the agenda for the future. Shortly thereafter came the Kelkar reports of Task Forces on Direct and Indirect Taxes (GOI 2002a, 2002b). While they contained much good advice, especially on revamping of tax administration, they were criticized on certain points also. In particular, the recommendation to move to a dual rate structure in excise and customs was criticized by Mukhopadhya 2002 and Acharya 2003.

Continuing our discussion about the trends in excise taxation, the 2003-04 budget of Jaswant Singh focused on a triple rate (8, 16 and 24%) excise structure and failed to draw the crucial distinction between an unique CenVAT rate and (additional) special excises. This was not in conformity with the TRC model and also the international practices which had been ushered in by the Yashwant Sinha budgets for 1999-2000 and 2000-01. That model (and budgets) clearly laid importance on a single CenVAT of 16% (for all goods which are in production chain with other goods) supported by additional special excises on a small number of luxury consumer goods and items such as tobacco. Earlier budgets had retained intermediate rates of 4, 8 and 12 % as temporary rates for few commodities that were to be gradually raised to the full CenVAT rate of 16%. In contrast, the 2003-04 budget viewed the 8% rate as a permanent feature and went on to reduce the rates on some items form 16 to 8%.

Even the recent budgets by Chidambram failed to project the important distinction between a near universal 16% CenVAT rate and additional selective excises on consumer luxuries. Without such a structure of the excises there is grater chance of getting a regressive indirect tax structure. Recent budgets have granted excise exemptions to various products like computers, toys, tractors, hand tools and mosaic tiles affecting the VAT chain.

Yet another problem faced by the excise system is the variety of exemptions and concessions granted through government announcements to manufacturers using labour intensive technology, cottage and village industries, handicrafts and leather. According to Virmani complication in the excise taxes can be minimized only by
switching over to a single, ‘general VAT rate’ and reorienting the administration towards cross checking.

According to Due (1985) and Sury (1988), sales tax is the most controversial and intricate aspect of the Indian tax system. Under the Constitution, the right to levy sales tax is allocated to the State government. Each State is, therefore, empowered to collect tax on the sale of goods within its territory according to its own rules. Different State governments impose sales tax on a wide range of commodities at different rates with different procedures and rules for its collection. The Central government also enters the picture in so far as it prescribes the ceiling for sales tax on goods in inter-State commerce. In the case of 3 important commodities, i.e. textiles, sugar and tobacco, additional duties of excise are imposed in lieu of sales tax, the proceeds of which are distributed among the States.

Sales tax, in its modern form, was first imposed by the Province of Bombay in 1938. Since then it has grown considerably in depth and coverage, and forms the backbone of State’s tax revenues. The relative significance of sales tax in the tax structure of the States is 60.4% in the year 2003-04.

Sales tax may be a single-point, double-point and/or multi-point levy. Single point is the main type of sales tax imposed on most commodities in all States. Single point may either be levied at the first stage of sale, i.e. at the manufacturer’s level or at the final stage of sale, i.e. at registered retailer’s level. Multi-point sales tax, a kind of general turnover tax, is imposed on some commodities in a few States, i.e. Kerala, Karnataka, Andhra Pradesh and Tamil Nadu. A few commodities are subject to double-point sales tax in Maharashtra and Gujarat.

The rate structure of sales tax is highly complicated in view of different lists of exemptions, a large number of nominal rate categories in different States and a diversity of concessions and administrative procedures in the States. These variations have caused disparities in the effective rate of sales tax on similar commodities in different States.

Discussion generally arises about the appropriate stage of sales tax adopted by the States. As already noted, single-stage levy at the manufacturing level is the predominant form of sales tax in most States. If sales tax is levied at the manufacturing level, no functional difference between sales tax and the excise duty
exists except in nomenclature. However, sales tax at the retail stage is the most satisfactory method because it avoids the cascading or pyramiding effects of taxation. Given revenue can be realized by applying a lower tax rate because of the enlargement of the tax base at the retail stage. Again, the desired change in the ratio of tax to consumer expenditure can be achieved more effectively in case of retail stage sales tax. Furthermore, sales tax at the retail stage can be evidenced separately from the price of the goods and thus made known to the final consumer, increasing tax consciousness among the taxpayers. Lastly, expected changes in the rates of retail sales tax do not lead to changes in the inventory position of the firms.

However, retail-stage sales tax has its own problems, the main one being the large number of taxpayers operating as small shopkeepers in scattered retail outlets. Therefore, from an administrative viewpoint, sales tax at the wholesale stage or manufacturing level is preferable because the number of taxpayers is small and readily identifiable. But the problem of cascading reemerges as we move away from the retail stage.

The rates of sales tax are prescribed by the Central government based on certain classifications. Thus, goods are either “declared goods” (goods of special importance) or “non-declared goods”, a person may be a registered or a non-registered dealer. However, the tax is collected and appropriated by the State governments.

The maximum prescribed rate of sales tax on “declared goods” in a State is 4% of the sale price and is not leviable at more than one stage. In the case of inter-State sales of such goods to registered dealers, the rate of tax is same but for non-registered dealers it is 8%. If “non-declared” goods are sold to a registered dealer in the course of inter-State trade, the ceiling rate is 4% or the rate applicable to internal sales of the concerned goods, whichever is lower. However, on inter-State sales of “non-declared” goods to non-registered, the rate of CST is 10% or the rate applicable to the sale of such goods inside the exporting State whichever is higher.

As far as the taxation of services are concerned, successive finance ministers have expanded the domain of the tax providers and input tax rebate principles were gradually introduced. Manmohan Singh had introduced service taxation at 5% on three services in 1994 and raised less than 0.5% of Central government revenues through this instrument in that year. Ten years later, in 2004-05, service taxation had
been extended to over 70 services and the revenue yield accounted for nearly 5% of gross central revenues.

Following the recommendations of the ‘Govinda Rao’ Expert Group on Taxation of Services (GOI 2001), credit for taxes paid on inputs to all services for service inputs. At the same time he raised the rate of service tax from 5 to 8%. In the next budget, Chidambaram extended the credit of service tax and excise duty across all goods and services and also the service tax rate to 10% to move towards the path of full integration between CenVAT and services taxation.

In the words of Due, possible general reform of the State sales taxes is much more difficult than reform of the Central excises.

With regard to the prevailing cascading type sales tax Gurumurthi (1999), suggested it to be substituted with VAT. Rao has said that transition to VAT is necessary not only to impart efficiency to the tax system but also to enhance revenue productivity.

However, a number of conceptual and operational issues have to be sorted out before shifting to VAT. These include treatment of declared goods, AED items, inter-state sales and purchases. Besides, VAT that is a destination based comprehensive tax on goods and services, it is necessary to enable the States to levy taxes on services. This requires the Constitution to be amended to provide concurrent power of taxing services to States.

Also, a series of sales tax reforms are required. They include setting of floor rates so that inter-state competition could lead to convergence of the actual rates to floor rates. This could result in simplification and harmonization of the sales tax system. Simplification of the tax system, strengthening the administrative and enforcement machinery, introduction of self-assessment scheme, creating a robust information system and computerization of tax administration are important steps that would improve voluntary compliance of the tax.

According to Purohit (1999), over the years, commodity taxes have been used extensively in such a way that there is considerable overlapping of tax on the same base. This has caused cascading and pyramiding effects, promoted vertical integration of firms and has not fulfilled the criterion of neutrality. It is, therefore, suggested that the system of commodity taxes be reformed to adopt a system of VAT.
The empirical estimates presented in the paper suggest that the State VAT would not only give more revenues to the developed States but would also benefit others due to the fact that the tax would now be distributed on the basis of consumption and on destination principle.

In addition, the existing Countervailing Duties (CVD'S), and the tax on services should be made shareable. The proposed pollution taxes could also form part of the shareable pool. This group of taxes should help achieve horizontal equity.

Finally, the efforts must be made to restructure State finances through introduction of VAT to replace sales tax, levy of State excise on the Maximum Retail Price (MRP) base, rationalizing stamp duty and registration fee and introducing profession tax and environmental taxes.

*Rao & Sarma (1997)* have indicated that the need for co-ordinated development of commodity taxes in the Indian federal polity has shifted the focus to reforms in the State's sales tax systems. The reason is that attempts to reform sales taxes, however, have not been always in the right direction, and, in addition have met with resistance from traders. The paper, has set out a strategy and stages of reform towards evolving the VAT which is less distortionary and more acceptable to traders.

They have suggested various stages of reform. The first stage of reform is to rationalize the existing tax rates on the lines suggested by the State Finance Minister's Committee and extends the tax beyond the first point by setting off the tax paid at the previous stage. The second stage of reform involves the extension of the sales tax on services and it requires constitutional amendment. It would be ideal to give concurrent powers to the States to levy tax on services. In the third stage, all forms of tax reliefs and incentives should be eliminated. The fourth stage involves further rate rationalisation into one or at the most two rates to ensure revenue neutrality.

However, they recognized that a full-fledged VAT can't be achieved unless inter-State sales tax is brought down and eventually all such sales are either zero-rated or set-off.

In April 2005, after much of deliberations by the State's Finance Ministers Committee and pressure of the government, the remaining States agree to switch over to VAT replacing the existing retail sales tax system. But *Bagchi (2006)* suggested that
even after two decades of reforms, a full fledged VAT which was considered necessary for the economy to function efficiently and smoothly is not adopted.

Neither CenVAT, the current name for excise duties levied by the union government based on the VAT principle nor the VAT’s that have come into operation in the majority of the States since April 2005 bear all the attributes associated with a good VAT. So the announcement by Union Finance Minister Chidambaram in Budget 2006, speech to introduce a national Goods and Services Tax (GST) from 2010 has been enthusiastically welcomed by many, especially corporate businesses.

Kelkar (2006), Rao (2006) and Srivastava (2007) have raised doubts and issues about the form of GST that the Finance minister is contemplating. According to Srivastava (2007), in the last decade much has already been achieved on the road to reforming the commodity tax system. He, however suggested that four critical steps remain a) The CST, currently being levied at 4% needs to be abolished, b) There is a need to determine a suitable GST rate, which should be much lower than the sum of core rate of CenVAT at 16% and State VAT of 12.5%, which relate to the taxation of goods, c) States need to be enabled to tax services and the service tax rate should be same as that for goods, d) The Centre should be enabled to tax value added in the case of goods upto the retail stage.

It is contemplated that these changes would lead to a comprehensive and unified system of taxation of goods and services, which exactly is what GST is, as prevalent in many countries.

Summary & Conclusion

In reviewing the relevant literature on fiscal federalism and commodity taxes (Union excises and State sales tax), certain issues may be highlighted. The fiscal system in the country is unable to coordinate the fiscal decisions of both levels of government i.e Central and State governments. It had resulted in conflicts between the two levels of government. Also, problem of fiscal imbalances and overlapping of tax bases has emerged. The solution as envisaged by economists lies in harmonizing the two main taxes of Union and State government (i.e excises and sales) in the ultimate form of GST. The Union Finance Minister Shri. P. Chidambaram in his Budget (2006) speech has announced of his intent to introduce GST from 2010. Though a lot has been done in this direction but still much more needs to be done.