SUMMARY AND CONCLUSIONS

Fiscal federalism deals with financial arrangements and their working in a federal polity. It refers to the division of revenue and expenditure functions among Central, State and local layers of governments. An evaluation of federal governance raises the issue that 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. Federalism, it is believed, helps to achieve efficiency in the allocation of natural resources by assigning governmental functions to different levels of government according to their comparative advantage in performing them. It is also considered to be an optimal institutional arrangement for the provision of public services. Also, the more decentralized the government is, greater is the chance that people’s expectations are fulfilled and the government’s portrayal as a Welfare State is achieved.

India is a quasi-federal set up where both Centre and States (including local bodies) are allocated tax and expenditure powers so as to meet the growing needs and diversified preferences of people. However, while allocating the powers between the Centre and the States, Indian Constitution has assigned most of the buoyant sources of tax revenue to the Central government and expenditure functions to the States. This has resulted in a mismatch between the revenue sources and expenditure functions and is called fiscal imbalances. These imbalances may be vertical (i.e imbalances between the Centre and the States, where the degree of dependence of States on the Central government is high and concentration of economic power is more with the Central government). India’s federal fiscal arrangements are also characterized by horizontal imbalance (i.e inter-jurisdictional imbalance or inter-State differences in budgetary receipts and expenditure’s arising out of differential per capita fiscal capacities).

Sources of Tax Financing

As far as the revenue sources of a government in a developing economy are concerned, taxation is considered to be the most important source. Taxes may be
Indirect (on outputs) or Direct (on factors) depending on the incidence of the tax. An analysis of the relative significance of both direct and indirect taxes in the total tax revenue of Centre and States reveals that the share of indirect (commodity) taxes (72%) in the total tax revenue of Central and State government is substantially larger than that of direct taxes (28%) in the year 2004-05.

India’s indirect tax system is unique, in that, the Constitution specifies the tax powers of different levels of government under three lists; the Union List, the State List and the Concurrent list. The Union list empowers the Central government to levy excise duties (now called CenVAT), customs, and income tax other than agricultural income. The State list authorizes the State government to impose Sales tax (now it is State VAT), State excise duty, electricity duty, entertainment tax etc. The transactions taking place between the two States i.e. the inter-state transactions are taxed by the Centre under the Central Sales Tax (CST). However, the CST is assigned to the States and the exporting State (i.e. the State from where the goods are sent to the other State) collects the tax on the basis of origin and retains it. The fact is that out of the Central taxes, excise duty (44.6%) was the most important revenue-generating source for the Central government. While out of the different State taxes, Sales tax (36.1%) occupies the prominent position in the year 2003-04.

In case of Commodity taxes, the framers of the Constitution had conceived excise duties as a tax levied by the Central government on a few commodities on the manufactures. Initially, it remained as a tax on a few manufactured goods and the revenue was also not very significant. States imposed a low rate of sales tax primarily at the retail level. Therefore, in the initial stages of introduction of these taxes, there was no major overlapping of taxing powers.

Overtime, to raise more revenue, to fulfill the targets of planning process, both the Central and State governments exploited these taxes. Consequently, on the part of the Centre, excise duties were levied on all the manufactured items causing high incidence of tax. Simultaneously, new taxes in the form of additional excises, cesses on specified commodities and additional duties of excise on textiles were levied. Similarly, on the part of the States, the concept of levy of sales tax on final sales had been ignored and States had shifted to a system of first-point tax. So, the tax was levied mainly at the level of manufacture and if not available, at the level of wholesale.
Thus, the two systems of taxation, excise duties and sales tax had been levied primarily on the same base. In terms of revenue, the two important commodity taxes levied by the Central and the State governments accounted for almost half the combined revenue of both the governments. This had caused extensive double taxation of the base at the manufacturing level by the two tiers of the government. Further, the same had caused considerable cascading and pyramiding effects. The result had been vertical integration of firms and lack of transparency of the tax burden. The structure of Commodity taxes was unintegrated and had given rise to several problems.

Theory of Federalism and Taxation

The conservative economists have shown a keen interest in having a uniform structure of indirect taxation to overcome these problems and even the government’s policy reflect this view. A uniform tax policy is generally based on equity and efficiency considerations but there exists a trade-off between these two important objectives. However, the partial equilibrium analysis demonstrates the non-desirability of uniform rates. When the tax is imposed, the price gets distorted and causes efficiency loss. Then to increase efficiency in the tax system, the equity consideration is affected in the process. Various models are considered in this regard. The Ramsey tax model with an efficiency objective in view, has examined whether the uniform tax is preferable or not. In case of lumpsum tax, welfare rises. But on the issue of commodity wise variation no solution could be derived. The answers may however, be obtained by relaxing and varying different assumptions.

But the equity objective does not imply uniform taxation when the elasticity of demand differs between the goods in question. So only if the price elasticity were the same that uniform tax rates would be horizontally equitable.

Apart from uniformity in the tax system, another aspect that is taken into consideration in a tax system in a federal country is harmonization of broad taxes (like union excises, sales tax, service tax etc.).

It is also necessary to take into account the different theoretical principles that guide the federal fiscal arrangements in federalist countries. As discussed earlier, federalism is formulated to fulfill the goal of social welfare maximization when the public services are made efficiently. This requires that the basic functions of budget
policy i.e allocation, distribution and stabilization are provided to various levels of
governments but with economic efficiency.

Different models are explained to show how the government maximizes the
welfare of the consumers, while undertaking allocation function. According to
Breton’s Perfect Mapping Model, there exists an association between incentives of
government and the existence of competition among governments. The competition
among governments creates incentives for their decision makers and it lowers prices
and higher welfare for consumers.

Olson’s approach analyses the necessary condition for the allocative efficiency
in the provision of collective goods by considering stabilization and income
redistribution functions as most appropriate to Central governments.

According to Olson, both the ‘centralizing’ and ‘decentralizing’ ideologies are
wrong and leads to inefficiencies. If there are several levels of government, these
large numbers of governments can reduce the disparities between the boundaries of
jurisdictions and the boundaries of collective goods. Thus, there is a need for both
centralized and decentralized government in the same framework.

Wallace Oates has presented a model where each level of government,
possessing complete knowledge of the tastes and preferences of its consumers and
seeking to maximize their welfare, would provide the Pareto-efficient level of output.
This is given by the equation:

\[
\text{MRS}^A_{X,Y} = \text{MRS}^B_{X,Y} = \text{MRT}_{X,Y} + \lambda_2 \text{F} \quad (4)
\]

Where

A and B are two natural sub-groupings within the total population with
identical preferences.

X and Y are two private goods that are consumed by all members of the
society.

\( \lambda_2 \) = The Lagrangian multiplier associated with society’s production
possibilities, \( F ( ) = 0 \).

\( \lambda_3 \) = The lagrangian multiplier associated with the new constraint, \( y^A = y^B \).

Finally, Tiebout’s model talks about the choice process of individual’s
jurisdictions where the residents will determine an equilibrium provision of local
public goods in accord with the tastes of residents, thereby sorting the population into optimum communities.

In India, the federal fiscal arrangements are explained in the Constitution from where both Central and State governments derive their powers and functions. However, discrepancy has emerged in the powers and functions of both these levels of government since financial powers are concentrated in the Central government and responsibility with the States. These discrepancies are known as Fiscal Imbalances and there are two types of imbalances. One is the imbalances at different levels of the government or inter-governmental imbalances known as Vertical imbalances. Other is the Horizontal imbalances which exists at the different units of the same level of government. Common tax base of two levels of government is another problem faced by the federal system. To mitigate these discrepancies inter-governmental or fiscal transfers are done through Finance Commission, Planning Commission and central transfers to States.

Another problem faced by the federal system is of Overlapping of tax and expenditure functions among different governmental units. These overlapping can again be Vertical – between different levels of government and Horizontal – among different units within each level. In India, the States collect about 30% of aggregate total revenues of the Centre and the States taken together and incur about 55% of total expenditures. Thus, the revenues raised by the State governments form quite a significant proportion of total revenues and therefore, the method of raising these revenues and their consequences would have important allocative and equity implications. States’ finance 43% of their expenditure from their own tax revenue sources and depends upon central transfers for the remaining 57%. The share of States’ own revenue in their current expenditures (or fiscal independence) has declined from 45.1% in 1970-71 to 41.1% in 2003-04.

Adoption of Value Added Tax (VAT) as prevalent in most West European countries is considered to be a most important solution to the problems of Indian commodity tax system. In fact, almost all-successful tax reforms are associated with the introduction of VAT and by now 140 countries had comprehensive VAT. In federal economies, to initiate tax reforms, the prevailing tax system should be made simple, transparent, board based and States should be given more fiscal powers.
The existing taxes on commodities and services can be converted into VAT when certain conditions are fulfilled. This requires that commodity taxes are extended up to the retail level, broad based taxes are included, no taxes should be paid on inputs, capital goods and inter-State sale of goods and revenue generated by Centre and States should at least remain the same as before the tax reforms. This requires levy of concurrent VAT by both Centre and States. It has a number of advantages also. Besides making the tax system efficient, this will safeguard the fiscal autonomy of the States, and when inter-State transactions are zero-rated, will get rid of tax exportation as well.

However, such a system required a coordinated effort on the part of Centre and States. Through negotiations they can form a uniform tax base for both the levels of government, but a State could levy different tax rates for providing a higher level of public services. But this needs an amendment in the Constitution allowing the Centre to levy tax at stages subsequent to manufacturing and to allow the States to levy the tax on consumption of services in addition to those on goods allowed presently.

The international experience regarding levy of VAT by sub-national levels of government is not quite heartening. In Brazil, sub-national VAT is levied but has not proved to be successful in eliminating inter-State tax exportation. However, the system of VAT followed by the European union, where inter country transactions are zero-rated, present a good example of successful levy of VAT at sub-Central levels.

As we have already seen that excise duties and sales tax are the most important commodity taxes of Centre and State governments respectively. So an effort has been made to harmonise both these taxes.

**Union Excise Duty (CenVAT)**

At the Central level, at the time of Independence, India inherited a system of commodity taxation wherein union excise duties were levied on about a dozen articles yielding a small proportion of total tax revenue to the Centre. Following Independence, the rates were raised, the base was enlarged and more and more items were brought into its net. In 1970-71, the share of excise duties in total tax revenue was 56%. But its share reduced to 27% in 1995-96. Excises were also levied on
finished goods, raw materials, intermediate goods and capital goods. However, their share again reached to 48.5% in 2003-04.

This proves that excise duties occupy a dominant position in the revenue growth of the Central government. The calculated buoyancy and growth rate estimates of excises reveals the same scenario. The buoyancy and growth rate are moving simultaneously i.e if one is increasing, the other is also increasing and vice-versa. But when comparing the trend during the pre-MODVAT period with post-MODVAT period, buoyancy rate has declined from 1.07 to 0.94, i.e, from an income-buoyant source it has turned into a non-buoyant source.

But the growth rate has increased from 12.8% to 13.46%. It implies that the growth rate in GDP has been much faster than the growth rate of excises explaining fall in its income buoyancy. Except in the decadal period 1990-2000 and overall period 1970-2004, when both buoyancy and growth rates are lower, in other decadal periods buoyancy and growth rates are rising.

The weak revenue performance of central excises was due to certain problems affecting the excise system. These inefficiencies had resulted from structural and administrative system followed by the tax authorities. These problems were: -

i) **The Extended System**

The system was not integrated but an ‘extended’ one, wherein the taxes were levied at the different stages of production. The final product, the inputs, intermediates and raw materials, the packaging material etc were all subject to excise duties. The duties had been raised on most occasions, but reduced only rarely. There was no single levy as the “excise duty”; but there was the basic excise duty, the special excise duty, the auxiliary duties of excise, the additional excise duties on specified textiles, the additional duties of excise and customs in the case of the whole range of P.O.L products, the various cesses and, of course, the additional duties of excise in lieu of sales tax. These different levies made it inconvenient and time consuming for the assesses to calculate the exact amount under each head and the total duty payable. Also, most of the listed products bear at least two of these levies and some, like the textiles, the P.O.L levies and products, 3 or 4 different levies and cesses.
ii) **Taxation at the Manufacturer level**

Although the Constitution had distinctly defined excisable goods as goods manufactured or produced in India and sales tax as tax on sale or purchase of goods. But the two taxes had come to overlap as the sales tax were levied on manufacture and importers to avoid problems in administering taxes levied it at the retail level.

iii) **Definitional Irregularities and Problem of Valuation**

Excise taxation implied taxation at the manufacturer level, but the term “manufacturing” is quite difficult to define as goods might had undergone a change of form due to a variety of processing activities performed after their initial production or manufacturing.

In taxation at the manufacturer level, determination of manufacturing value also was equally troublesome. Manufacturers often sold their products through their own distributors or wholesalers and sometimes directly to the customers. In determining the value at the manufacturer level adjustments had to be made for trade margins at different trade levels. Then came the question whether costs of after-sale service, advertisement and selling, organization expenses come under manufacturing cost. The Supreme Court ruled in a leading case that the post manufacturing expenses to be added to the assessable value; only the durable and returnable containers were exempted and the value of all other packing was added (Union of India Vs Bombay Tyre International). Even after such rulings, determination of excisable value had continued to present acute problems.

iv) **Multiplicity of Rates**

Prior to tax reforms initiated in 1991, excise taxation in India was an interesting example of the multiple of rates, which were subject to frequent revisions. Various considerations contributed to the complexity of excise rates.

Broadly speaking, necessities of life were either exempt or paid a low rate of duty, semi-luxuries were moderately taxed, and luxuries and tobacco products stood out distinctly as high-rated tariff items ranging from 100 to 110 per cent, capital goods were however, subject to a relatively low rate of duty.

v) **Taxation of Inputs and Capital Goods**

Input excises (raw materials, components and other intermediates) enhanced costs and profits and therefore increased the prices of goods much more than the
amount of excise collected. Moreover, if excises were imposed on inputs as well as the finished goods for which these inputs were used, a gap emerges between the nominal rate of tax and the cumulative rate of tax. This phenomenon made the excise system complicated and hindered the proper evaluation, particularly on equity criterion.

Still further, excises on inputs may promote vertical integration in an industry, a trend that is harmful to the growth of small-scale sector. Lastly, input excises impose inequitable burden on different economic classes by not discriminating between essential and non-essential uses of a product.

vi) Exemptions and Concessions

As in other countries, exemptions and concessions were an integral part of the Indian excise system. Excise preferences and reliefs were given to promote a wide range of socio-economic objectives. If wisely used, such tax preferences could become an effective tool of economic change on desired lines.

However, excise exemptions narrowed the tax base and therefore reduced governmental revenue. They interfered with the designing of the excise system and led to complexities in the excise law, which in turn caused tax evasion and litigation. They also obscure the evaluation of excise system, particularly from equity angle. Excise concession to a particular industry resulted in similar demands by other industries, causing unsettling effects on producers, consumers, and the administration.

Some of the goods exempted from the excise duties were technical, educational and research institute, goods of welfare of defence personnel, goods donated to the National Defence Fund or to the Ministry of Defence etc.

vii) Controlled use of Modvat System

To tackle the cascading effects of input taxation of excises, a modified system of value added tax (VAT) or MODVAT was introduced in 1986-87. At that time, a full fledged Value Added Tax (VAT) could not be adopted as the Indian excise system was quite complicated with large number of excise rates and any major change would affect the system drastically. Under the Modvat scheme, credit of the excise duty and additional duty of customs (countervailing duty) was paid on inputs when used in the manufacture of the final products. However, there was restrictive use of Modvat facility since the scope of the provisions of law was not readily accepted.
Purchases, which from the economic angle clearly pertain to the manufacture of the commodities, were often denied Modvat credit on technical grounds.

vii) Exclusion of Services

The excise taxes were levied on goods only, excluding the services from its base. Services form an integral part of manufacturing and the distinction between goods and services had minimized.

In response to these inefficiencies, the government, time and again initiated various reform measures. However, a detailed study of these reform measures is done in the Chapter VI. The result of these reform measures was implicit, in the shift from union excise duties to a Central VAT (CenVAT) in the Budget 2000-01.

Now, the prevailing structure includes (i) CenVAT (present name of excises), (ii) special excise duty, (iii) additional excise duty in lieu of sales tax, (iv) additional duty of excise on textiles and textile articles, and (v) cesses on specified commodities.

(i) CenVAT: CenVAT is levied on all goods manufactured or produced in the country. With effect from March 1, 1986 Modvat was introduced under the union excise duty as a system of giving credit for excise duty on inputs. Initially, it was introduced for a selected number of commodities. The coverage was limited to 37 chapters out of a total of 91. Overtime, Modvat was extended and finally replaced by CenVAT in the Budget 2000-01. CenVAT has in general a single rate of 16% with some variations for select commodities. This coverage of CenVAT has been extended to all commodities except high speed diesel, motor spirit and matches.

(ii) Special excise duty: There are three rates of special excise duty of 8%, 16% and 24% on specified products. Most of the items under special excise duty are final products but some of the items also fall in the category of intermediate goods.

(iii) Additional excise duty in lieu of sales tax: It is levied only on tobacco, textiles and sugar. As followed earlier, this is a tax rental arrangement between the Centre and the States with the difference that Eleventh Finance Commission has recommended its inclusion under the shareable taxes.

(iv) Additional excise duty on textiles and textile articles and cess on specified commodities are primarily meant to raise resources for the development of
concerned industries. The revenue department administers it but some other departments also contribute in this endeavour.

The structure and procedures under CenVAT as given above indicates that the new system results in transparency of the tax burden under union excise duty. In addition, it reduces cascading effect of input taxation as well as pyramiding effect of the tax. Also, it generates a mechanism to check evasion of tax through self-policing.

In addition, the reforms implemented under excises have simplified its structure especially through CenVAT. While previously there were large numbers of rates, over the years it has been brought down considerably and the general rate of CenVAT is 16%. Apart from rationalization of rate structure, exemption notifications have also been curtailed and the specific rates are converted into *ad valorem* rates. Further, the rate structure of CenVAT is linked to the Harmonized System of Nomenclature (HSN) present in a number of countries for providing help in international trade.

**Weaknesses of the System under CenVAT**

The existing structure of CenVAT and the procedures for its administration are characterization by the following weaknesses:

(i) The existing procedures for physical controls are outmoded. In the context of the liberalized economy the physical control system should be replaced by self-assessment procedure.

(ii) The provision of registration of wholesalers has created number of loopholes since there was no distinction between a manufacturer, first stage, second stage dealer and so on. This facility should be restricted to only the first-stage dealers.

(iii) The coverage of CenVAT has not been extended to all the commodities. Misuse of CenVAT tax crediting provisions and widespread evasion also.

**Excise duty Reform Measures**

The CenVAT structure however, requires immediate reform measures to be initiated by the Central government. These measures are:

(i) The administrative reform of excises is the most important aspect of the reform policy.
(ii) There is a strong case for carefully reviewing the large number of products, which enjoy complete exemption. Apart from loss of revenue, such exemptions affect the CenVAT chain, which provides the core value of VAT-type taxes. Many products need to restored to the CenVAT rate of 16%.

(iii) Also, the role of special excise should be limited to few luxury consumer products such as cars, refrigerators etc. The rates of such duties should be in the range 5 to 15%. Apart from raising much needed additional revenue, such taxes would counter the regressive nature of a uniform CenVAT.

(iv) The service tax should be integrated with the CenVAT/excise structure.

Sales Taxes (State VAT)

Sales tax, on the other hand occupies an important position in the revenue structure of the States. Modern sales tax system has its origin with imposition of general sales tax in the State of Tamil Nadu at a modest rate on multi-point basis. Since then all other States also started levying this tax.

Sales tax is normally an \textit{ad-valorem} levy imposed and collected from the seller with reference to the transactions or sale at the single point stage or at the multi-point stage. The sales tax system till switching over to VAT, was partly origin-based and partly destination-based. The share of States’ tax revenue in their total revenue has increased substantially; it was 51% in 1970-71, 57% in 1990-91 and it increased to 69% in 2003-04. It’s importance as a buoyant revenue source for the States has increased by leaps and bounds.

The buoyancy and growth rate estimated for the States in the period between 1970-2004 and the decadal periods from 1970’s show some interesting results. The buoyancy and growth rate were quite high (more than 1) in all decades except 1999-2000 when sales tax was a non-buoyant source.

Another feature that is noticeable in the estimates of buoyancy and growth rate is that except the two periods 1990-2000 and 2000-04, in all other periods buoyancy and growth rate are moving/changing in the same direction. In these two periods when the buoyancy rate was increasing from 1.02 to 1.52, the growth rate in fact reduced from 15.3% to 14.6%. This shows that during these two periods growth in sales tax revenue was comparatively more with regard to GDP growth. Moreover, it can also
be concluded that out of the two commodity taxes; excises and sales tax, sales tax were a more buoyant source of revenue.

Predominantly, first point sales tax was imposed by many of the States, rendering the tax base narrow. Multiplicity of rates and surcharges, turnover taxes and entry taxes loaded on to them made the systems complex and opaque. Moreover, the levy of central sales taxes (CST) created severe impediments to internal trade and market segmentation, inequitable resource transfers with richer States collecting significant amount of taxes from the consumers in poorer States.

However, in India, the initial moves to implement VAT at the State level came in 1993 with the then finance minister Dr. Manmohan Singh, in his budget speech stated the need to reform the outdated States sales taxes by replacing them with the VAT. The States became interested with the idea only when a presentation was made by the National Institute of Public Finance and Policy, New Delhi in May 1994 before a conference of chief ministers for consideration. Small groups of chief ministers and finally an empowered committee of finance ministers were formed to examine the alternatives and select an acceptable design of VAT and to workout a schedule for its implementation. After a number of round of deliberations a deadline was set for the transition. But a final decision could not be reached. Then the date was set April 1, 2003. But hindrances occurred again at the last moment as traders and several States protested angrily. The date was shifted forward to June 1, 2003. Sixteen States seem to be ready and in one State Haryana, VAT has been actually introduced. But the union finance minister Jaswant Singh declared that VAT couldn’t be implemented unless all States were prepared for it. Thus, another golden chance of reforming the commodity tax system was lost. Finally, all except one State (Uttar Pradesh, who is also now ready to adopt VAT with the change in the Government recently) have adopted the system in the year 2005.

The experience of implementation of VAT has been very encouraging so far. During 2005-06, the tax revenue of the VAT implementing States showed an increase of around 13.8% over tax revenue of 2004-05. During April-June, 2006, the tax revenue of VAT implementing States has shown an increase of about 27.1% over the corresponding period of last year, which is quite remarkable and indicates that the VAT system has started stabilising and yielding the desired results.
Another area of concern was the phasing of CST in a planned manner and to compensate the States for the loss of revenue as a result of phasing out. Chidambaram announced the gradual phasing out of CST from April 1, 2007 with a compensation package for the States.

Another important aspect of the commodity tax system is the services tax which requires due consideration. Beginning with just three services taxed in the year 1994, the ambit of service tax has widened substantially, in terms of coverage of services and revenue generated by them. The service tax collections have shown a steady rise since its inception in 1994. The tax collections have grown manifolds since 1994-95 i.e Rs.410 crores in to Rs.14196 crores in 2004-05.

A comprehensive Goods and Services tax (GST), however, requires the CenVAT/ services tax to be integrated with the State VAT’s introduced in 19 States and 2 UTs on April, 2005 in place of earlier sales taxes.

It has been observed that commodity taxes in India have undergone a massive overhaul over the period. The foundation of these reform measures was laid down with the publication of Report of Taxation Enquiry Committee, 1953-54. At various intervals, policy interventions have changed its course. Major among them is the Report of Indirect Taxation Enquiry Committee, 1978 paving the way to introduce VAT in Indian model of MODVAT on commodities at manufacturing level (UED) in 1986. Subsequently, changes were made to rationalize the excise structure and finally, MODVAT was converted into CenVAT in 2000-01. The other report is Domestic Trade Taxes which was instrumental in introducing VAT at State level by replacing sales taxes.

However, both these forms of taxes at Central and State need a lot of changes, i.e. a comprehensive VAT is required. Also, service taxes are assuming greater fiscal importance, which is in the hands of Union government. It also bears the issue of revenue sharing. The ultimate solution therefore, seems to be a comprehensive National Goods and Services tax (GST) merging CenVAT, State VAT and service tax to a single tax rate.