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 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.

In a federal set up, governmental activities and powers are distributed among various layers of government such as Central, State and local governments. 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 problem of varying fiscal strength across different layers of government (Centre and State) and horizontal i.e among different jurisdictions at each level of government.

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 or Direct depending on the incidence of the tax.

Chapterwise introduction to the study is as follows:

In Chapter I an effort has been made to analyse the relative significance of both direct and indirect taxes in the total tax revenue of Centre and States. It is concluded that the share of indirect (commodity) taxes in the total tax revenue of Central and State government is substantially larger than that of direct taxes.

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, Income tax other than agricultural income. The State list provides the authority to State government to impose Sales tax (now it is State VAT), State excise duty, electricity duty, entertainment tax etc. Out of
the central taxes, excises were the most important revenue-generating source for the Central government. While out of the different State taxes, Sales tax occupies the prominent position.

Apart from the problem of mismatch of tax and expenditure powers of Centre and State government, the two important commodity taxes i.e excises and sales tax levied by both levels has caused distortions and inefficiencies in the tax system. Some of these basic problems confronting the Indian commodity tax system are discussed in this chapter. These include cascading, vertical integration of the firms, inequalities, tax evasion etc.

Chapter II then provided an overall perspective on commodity tax structure and reform with reference to India. The Chapter gave the conceptual framework, which has guided this study. It discusses certain issues, which are related to both federalism and independent to Centre and State. These issues relate to lack of coordination in the fiscal decisions of both levels of government i.e Centre and State that resulted in conflicts in the form of fiscal imbalances and overlapping of tax bases. The ultimate solution lies in harmonizing the two main taxes of Union (i.e excises) and State government (i.e sales tax) in the form of a National Goods and Services Tax (GST). The process has already begun and a lot has been done in this direction by transforming central excises into CenVAT (2001) and sales tax at different rates as prevalent in States has been transformed and adopted by almost all States as a single State VAT. The Union Finance Minister Shri P. Chidambaram has also announced in his Budget speech (2006), his intent to introduce GST from 2010.

In Chapter III, an attempt has been made to analyse the theoretical aspects of fiscal federalism and indirect taxation in a federal country. This studies an ideal tax system, which requires uniformity in its structure based on equity and efficiency considerations. 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.).

The next section undertakes the study of theoretical principles guiding the federal fiscal arrangements in federalist countries. A number of comprehensive definitions of fiscal federalism are given, which also exhibits the benefits/merits of adopting federal principles in a fiscal system. Moreover, the economic theories of fiscal federalism are also explained in the light of three main functions of a government in a federal system i.e stabilization, redistribution and allocation. Different models are also discussed to explain how the government maximizes welfare of the consumers, when undertaking allocation function. These models include:-

a) Breton’s perfect mapping model  
b) Olson’s fiscal equivalence model.  
c) Oates’ decentralization theorem.  
d) Tiebout’s hypothesis.

As discussed earlier, 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 generally, 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 the 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, broad 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.

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.

Then in the next two Chapters a comprehensive study is done of the two most important revenue generating taxes for Union and State governments; Union excises/Cenvat and Sales tax/State VAT. In Chapter IV, a detailed analysis of the Excise taxes: its genesis, development, significance, trends and reforms is attempted.

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, thereby, resulting in more revenues also. Excises were levied not only on finished goods, but also on raw materials, intermediate goods and capital goods. As a result of these factors, excise duties have come to occupy a dominant position in the revenue growth of the Central government.
But there has been a decline in the revenue growth in the decade of 80’s and 90’s. The situation however, again changed and there is an increase in the excise revenue growth. 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 cannot be adequately explained by the reduction in rates. Some of the major problems affecting the growth of excise revenue are also discussed. 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.

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.
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.

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.

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.

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. 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.

vii) **Exclusion of Services**

The excise taxes were levied on goods only, excluding the services from its base. Services however, 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.

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. However, the existing structure of CenVAT and the procedures for its administration are also characterized by some weaknesses.

The CenVAT structure thus 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. Also, the service tax should be integrated with the CenVAT/excise structure.

In Chapter V, an overview is done of the system of State sales tax: its significance, trends, issues and reform measures. 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 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. 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.
Various studies were done, since the Study Team on Domestic Trade Taxes submitted its report and the steps envisaged by these committees were to transform the prevailing sales tax system in the States into a destination based consumption type, retail stage value added tax (VAT). The Empowered Committee of State Finance Ministers was formulated and in 1999 decided to implement VAT in place of sales tax. Though deliberations were carried on by the empowered committee but a consensus couldn’t be reached with the States and it’s only in the year 2005 that almost all the States agreed to introduce State VAT.

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.

In this Chapter, another important aspect of the commodity tax system is considered i.e services tax. 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. 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.

Chapter VI broadly outlines the various reform measures initiated by different study teams and committees set up by the government to overcome problems confronted by the commodity taxes (specifically, excise duties and sales tax) in the Indian economy. 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 the course of commodity taxes in India. 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 the number went on increasing and MODVAT was converted into CENVAT. The second Report is Domestic Trade Taxes which was instrumental in introducing VAT at State level by replacing sales taxes. Both these forms of taxes at Central and State need a lot, i.e. a comprehensive VAT is required. Secondly, 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 seems to be Goods and Services tax (GST) only.

Then, in the final Chapter VII, an overall review of the thesis is presented in a summarized form.