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**Class : M.A. I (Economics)**  
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**Unit : II**

### ***Lesson No.***

- 2.1 : Principles of Multi-Unit Finance
- 2.2 : Fiscal Federalism in India: Assignment of Functions and sources of Revenue
- 2.3 : Finance Commissions in India
- 2.4 : Indian Tax System (Salient Features)
- 2.5 : Major Taxes in India
- 2.6 : Public Debt and Public Expenditure in India
- 2.7 : Fiscal Crisis and Fiscal Sector Reforms in India

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**LESSON NO. 2.1**

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**(A) PRINCIPLES OF FEDERAL FINANCE/ MULTI UNIT FINANCE**

- (I) Introduction
- (II) Objectives
- (III) Meaning of Federal Finance
- (IV) Division of Powers in Federal State
- (V) Principles of Financial Divisions
- (VI) The Theory of Federal Finance
- (VII) The Problems of Federal Finance

**(I) Introduction:**

In federal states, such as USA, Australia, Canada, India etc. there is a constitutional division of powers-executive, legislative and financial- between the Central Government and State Governments. (State Governments as compared to the Central Government with in the federal structure have limited autonomous powers). The powers of both the states and the centre are embodied in a written constitution, which cannot be easily amended. The powers are determined on the basis of certain principle like independence, adequacy, economy and self sufficiency etc.

**(II) Objectives**

The main objectives of this lesson is to acquaint students with the principles of federal finance. The other objectives are to make students: aware of the meaning of federal finance; understand the system of division of powers in federal state; principles and problems of financial division and understand the theory of federal finance

**(III) Meaning of Federal Finance/Multi-unit Finance:**

The federal set-up is a system of political organisations in which two or more states have a political unity but remain independent in internal affairs. There is a political unity which is distinct from the separate states composing it. There is a division of functions and resources between the centre and the states. There are at least two layers of government, the Central (Union) or the Federal Government on the one hand, the State Governments on the other. Within each State, there may also be the third layer of government i.e. local Governments. The two sets of authorities- The Central Government and the State Governments- are generally independent in the matter of their functions and jurisdiction.

**(IV) Division of Powers in Federal State:**

Though the details of the constitutional arrangements may vary in different federations, the broad basis of division of functions between the two authorities is that such functions which are of national importance or which can be more effectively performed for the country as a whole are assigned to the Central government, whereas those functions

which are more or less of local importance and/ or can be better performed on a local/ regional basis are allocated to the State Governments. Thus functions such as defence against foreign aggression, foreign affairs, currency and communications are generally the Central Subjects. On the other hand the maintenance of internal law and order, public health, education etc. are generally the state subjects. Indeed the division of functions cannot be always clear cut and sometimes they overlap. Moreover, even in the case of those subjects which are assigned to the States, some sort of control and co-ordination on the national level often becomes essential e.g., labour legislation, flood control measures, etc. The power of co-ordination rests either with the Central Government or with some other machinery specially constituted for this purpose.

**(V) Principles of Financial Divisions:**

Now, in a federal set-up just as functions are divided between the Central Government and the States, so also the financial or the fiscal resources are divided. This has to be done so that the different layers of Government are able to perform - these functions effectively. In practice, however, it has been found that, what ever be the basis for the division of resources, the needs and the resources of the Government do not balance. Hence, with a view to even out the resulting shortages and surpluses, adjustments are required. The main principles determining 'the financial policy of a federal set up are as under:

1. **Principle of Independence :** According to this principle, each layer of government central or state in a federation should have an independent financial authority. This simply means that each government should have separate sources of revenue, full powers to levy taxes, to incur expenditure and to borrow money so that it can perform its functions effectively.
2. **Principle of Adequacy :** The consideration of adequacy requires that the resources allocated to each government should be adequate enough for the functions which it has to perform. Indeed, the adequacy should refer not only to the present needs but also the future requirements. It has been found that generally the state governments are entrusted with functions such as agricultural and industrial development which need increasing expenditures. On the other hand, the central government has generally to perform functions which require more or less stable expenditures under normal conditions but very large expenditures in time of emergencies. Hence the allocation of fiscal resources between the two should be such as to (i) provide the central government with enough funds to meet its normal, routine requirements and also the emergencies such as wars, and provide the states with sufficient resources for normal expenditure and also for promoting economic development
3. **Principle of Uniformity :** The principle of uniformity warrants that each unit of the federation should contribute towards the common burden on an equal basis. This means that there should be equal treatment of

different units of the federation in the matter of payments that they have to make in respect of federal taxes.

No people in a particular state be made to bear a greater tax burden by the Central Government. For example tax-free income and various exemptions in income tax should be equally administered for the people of all states without any discrimination.

- 4. **Principle of Economy:** Allocation of resources between centre and states should be based on the principle of economy. It means that tax collecting system should be based on economy. The collection of tax revenue should be so designed that it should have least expense for the purpose and so that scope of evasion is minimised. The administrative delay should also be the least.
- 5. **Principle of Self-Sufficiency :** In a federal set up, the provision regarding the allocation of financial resources between union government and state governments should be based on the principles of self sufficiency or fiscal competence. The financial resources available with the two layers of the government should not only be sufficient for current needs but also be sufficient to meet future spending.
- 6. **Principle of Integration and Co-ordination :** The co-ordination is required in every sphere of the financial activities.

In addition to above stated principles, many more principles for the division of financial powers between central government and state governments are enumerated e.g. equity, flexibility, accountability and fiscal access.

<b>Self-Check Exercise-I</b>	
Q.1	Define the concept of multi-unit finance.
Ans:	..... ..... .....
Q.2	Discuss about principles of independence of financial division between centre and states.
Ans:	..... ..... .....

**(VI) The Theory of Federal Finance/ Multi-unit finance**

The theory of public finance that applies to a federal form of government is not fundamentally different from the general theory of public finance. The principles of taxation and the principles of public expenditure for a federal set up and unitary form of government are essentially the same. However, in view of the different nature and peculiar problems of the federal finance certain general values must be emphasised. These are as follows:

1. The federal government must have the authority to tax all the citizens and must have also the power to levy other direct taxes which can be closely related to the principle of ability to pay. In addition to this, it must have the authority to levy indirect taxes such as excise duties so that the scheme of taxation is not only progressive but also comprehensive.

2. The division of functions and fiscal resources between the federal and the state governments should be based on the principle of efficiency and economy. It has been found that ordinarily such scheme of division leaves too little resources with the states, because due to ramifications of big business, the integration of economic life and such other factors, the more productive sources such as income tax and excise duties are more efficiently administered by the federal government. On the other hand, the increasing acceptance of the concept and importance of a welfare state has necessitated more and more expenditure on social services which, in the interest of economy and efficiency, have to be organised on state or regional basis. In order to meet this disparity and also to ensure fiscal autonomy to the states, it becomes essential to have a scheme of 'shared taxes'. These taxes can be assigned to the federal government but the revenue collected from them can be divided between the federal government and the states in accordance with some mutually agreed scheme.

3. The constitution must provide a scheme of grants-in-aid so that the federal government can make up financial deficiencies of the relatively poorer states and thus abide by the principle of public expenditure for federation as a whole. These grants should be distributed in such a way that they ensure financial responsibility on the part of the state government. A system of grants in-aid would not only ensure budgetary equilibrium for the poorer states, by making their resources equal to their requirements, but would also ensure balanced regional development for the country as a whole.

The general rules of federal finance that have been discussed above show that in a federal set up transfer of resources from the federal government to the states are inevitable. To the extent of these transfers, the taxing and spending authorities are divorced, because the taxing authority is the federal government whereas the spending authorities are the state governments. A large number of economists criticise such a divorce of taxing and spending power. They hold that such a scheme would only promote extravagance on the part of the states. Actually, however, the view that the pleasure of spending tax revenues must always be linked with the pain of collecting them is not tenable. The provision of transfer of funds from the federal government to the state governments does not necessarily means that the states will be extravagant in their expenditures. In fact, any extravagance on their part will be a burden on their own people. Moreover, the disharmony between the functions and resources of the state governments can be resolved only by such transfers. As G.L. Wood has put it. "In a modern common wealth such a theory (that the authority which spends money should

have the responsibility of raising it) is no longer applicable. The grants method has proved that the authority which is fitted by place or competence to administer a public service is not necessarily the one which can find the money to finance services of national importance.”

**(VII) The Problems of Federal Finance:**

In a federal set up there has to be division of functions and resources between federal government and the states. This inevitably leads to the problem of imbalance between the centre and the states on the one hand and among the states on the other. It is highly unlikely that the functions or the duties and the financial powers would be in harmony at different levels of government. At the aggregate level, i.e. for the economy as a whole, it is unlikely that the needs and the available resources will match. There are many reasons for this:

First, as Wagner's Law and the Wiseman-Peacock hypothesis show, there is an upward trend in public expenditure. The balance between the revenue and the expenditure, even if attained, is not likely to stay over a period of time.

Secondly, cyclical and other fluctuations in prices, income and employment, natural calamities and other emergencies such as floods, wars, etc., are likely to cause imbalance between the two. Even if there exists an over all balance of the needs and resources, this is unlikely to prevail at the federal and the state levels separately. As D.A. Lakadawala has pointed out, “If so happens that the distribution of functions by performance criteria and of powers of economic allegiance tests do not lead to even a roughly satisfactory balance between own revenue and expenditure of most of the federations”. This means that the nature of revenue resources best suited for one level of government need not necessarily conform to the nature of requirements of other level of government. Similarly, even with the same financial powers one state may find the resources inadequate while the other may not.

In most of the federations there is a great discrepancy between the resources available to the centre on the one hand and the states on the other. This discrepancy goes on increasing with the passage of time because on grounds of efficiency, economy or any other criteria, the central government, generally, gets resources which are more elastic in nature whereas the states are assigned inelastic sources of revenues. For example, in India, the income and corporation taxes and also the union excise duties means elastic resources are with the Central Government, whereas land revenue and similar other relatively inelastic sources are with the states. Even among the States, various factors contribute to the discrepancy between their revenue resources. For example, the level of income and its composition in different States may vary. Such States which are industrially advanced would be able to collect larger revenues by way of sales taxes -etc.; whereas States depending mainly on

agriculture may not receive as much revenue. Moreover, the intensity of trade, commerce and allied services differ from State to State and this affects their revenue position.

It may be noted that in every federal set up, there are some units which are more developed and others which are less developed. Now in the relatively less developed states there is an all round need for improving social services, providing social overheads, improving health establishing industries etc. Since less developed backward state needs much larger amount of those services, marginal social utility from governmental services is much larger. Hence in the backward states of a federation, the public expenditure must increase. It follows that the balanced regional development necessitates transfer of resources from the more developed to the less developed states. The federal government itself must have resources large enough to enable transfer some of these resources to the poorer states and thus reduce regional disparities within the federation.

From the above discussion it follows that the chief problem of federalism is the problem of financial adjustment which normally implies assignment of sources of revenue centre government and to state governments and transferring resources from the central government to state governments and from states or regions of the country to the other lower level of government. In this connection, two issues in particular have to be sorted out.

First, the relative needs of the central government on the one hand and the states on the other have to be determined. Also a scheme has to be evolved whereby the relative needs of the different states are quantified.

Secondly, the precise methods and techniques of resource transfer have to be decided and implemented. Both these issues involve numerous practical difficulties. For example, defence against external aggression is almost, everywhere a central subject. But it is difficult to determine the proper amount of defence expenditure. It will depend upon the total resource availability, the international political conditions etc. Similarly, it is very difficult to determine a suitable criterion for the inter-state distribution of resources. Earlier, the relative shares of the states were determined on the basis of their population. But realising that population alone is not a sufficient indicator of the needs of a state, factors like state domestic product, per capita income, topography of the region, standard of living, tax effort, index of infrastructure have also been taken into account in some countries. This becomes important particularly in those federations where there are great regional disparities in the areas of economic development.

#### **(VII) Fiscal Federalism in India :**

India has also chosen a federal structure. Our constitution contains a clear bifurcation of sources of revenue between the federal government and the federating units. Broadly speaking, taxes with an inter-state base are under the legislative jurisdiction of the Union Government whereas taxes with more or less localised base have been assigned to the States. The Constitution also contains a scheme of fiscal

transfers from the Union to the States. Thus, there are taxes like stamp duties which are levied by the Central Government but are collected and appropriated by the States. There are other taxes such as succession and estate duties on property other than the agricultural land which are levied and collected by the Central Government but the proceeds of which are assigned to the states within which they are leviable. There are taxes like income tax and union excise duties which are levied and collected by the Central Government but are shared with the States.

Like other federations, in India also the scheme of distribution of resources has created a gap between the needs and resources of the state governments. As is well-known, with the overall development of the society the duties and the functions of the State increases with the rise in, demand for social and development services goes on increasing. These services can be more efficiently provided by the state governments and are thus assigned to them. But they lack the capacity to finance these services because the more promising sources of revenue are with central government. Thus, we also face the problem of bridging this gap between the functions and resources of the states. To overcome this problem, a two fold scheme. has been adopted. First, the states are entitled to a share in federal taxes, namely income tax and the union excise duties. Secondly, the constitution provides a system of grants which may be conditional or in form of aid of general revenue to states.

The chief machinery that describes the scheme of actual devolution is the Finance Commission. It is a semi-judicial body, appointed after almost every five years to quantify the shares in the shareable taxes of the Union Government on the one hand and the States on the other and also among the States. The Finance Commission also formulates the principles governing grants-in-aid under Article 257. The provision for fiscal transfers and the institution of the Finance Commission have provided much needed flexibility to India’s fiscal system. These indicate that in a developing economy like India with vast regional disparities, no fixed distribution of resources is likely to satisfy the demands of a changing situation. Therefore, periodical review and adjustment is called for. In view of the needs of the States for more fiscal-resources successive finance commissions have increased the share of the shareable taxes and have also proposed larger grants-in-aid.

**Self-Check Exercise-2**

- Q.1 Write the problems of federal finance.
- Ans: .....
- .....
- .....
- Q.2 What is the role of finance commission in Indian federal structure?
- Ans: .....
- .....
- .....

**(B) EVOLUTION OF FEDERAL FINANCE IN INDIA**

The present system of federal finance in the country is result of gradual evolution from a centralised authority. Broadly speaking the history of Centre states financial relations

in India can be divided into two periods of (1) Pre Independence period and (2) Post-Independence period. In the present lesson, we are concerned with only the pre-independence history of federal finance in the country. For the convenience of study, the discussion can be sub-divided into four periods of (i) Centralisation upto 1871, (ii) Beginning of Decentralisation in 1871, (iii) Government of India Act. 1919 and (iv) Provincial Autonomy under Government of India Act, 1935.

**(i) Centralisation upto 1871**

The British had established themselves in India separately in Bengal, Madras and Bombay up to 1833 and these three Presidencies were independent in their finances. In 1833, a high degree of centralisation was introduced in all matters, primarily on the administrative grounds. The process of centralisation was completed after the mutiny. The Provincial Governments had no independent sources of revenue and they received fixed grants from the Central Government to meet their expenses. This lent uncertainty to central finance and wasteful expenditure by the Provinces because of the absence of responsibility. However, it was soon realised that such system was unsuited to a country like India with vast continental dimensions and with great diversity in local conditions. The first high official to give expression to this feeling was Mr. James Wilson the first Finance Member of the Indian Government. He was also supported by his successors. But the Secretary of state opposed the decentralisation of finances.

**(ii) Beginning of Decentralisation in 1871**

The first step towards financial devolution was taken in 1871 by Lord Mayo, the then Governor General. Under the new arrangement, certain heads of expenditure such as police, jail, education, medical services, registration, roads, civil works, which were regarded as local in character, were made over to the Provinces. For the management of these departments the Provinces were given annual fixed lump-sum-grants and some limited powers of taxation. In 1871, under the vice royalty of Lord Lytton, the functions of Provinces were increased and some more heads of expenditure as land revenue, excise, stamps, general administration and law and justice were made over to them. To augment their resources, the Provinces had also assigned new taxes such as excise and stamps, in addition to the departmental receipts and lump-sum grants.

Another important change was introduced in 1882 by Lord Ripon. The system of fixed grants was abolished and the allocation of revenue was revised. The revenue was divided into three classes Imperial, Provincial and Divided. The 'Imperial' heads consisted of profits from commercial departments and revenue from opium, salt and customs. The 'Provincial' heads consisted of receipts from law and justice and public works. The 'Divided' heads consisted of excise, assessed taxes, stamps, forests, and registration. These were to be equally divided between the Centre and the Provinces. It was found that the Provinces would still face financial difficulties and hence they

were also given a percentage of the land revenue which was a central source of revenue. This financial settlement was made for a period of five years and fresh settlements were made in 1887, 1892 and 1897. In each of these settlements, certain changes were made but the basic principles remained the same.

The periodical revision interfered with the continuity of financial administration. There was also an element of uncertainty in the system. The Central Government was still financially supreme. Moreover, the Central Government took over the balance of funds remaining with the provincial Government at the end of a five year period. This encouraged extravagance on the part of the Provincial Governments. Realizing that the short period settlements did not lead to a sense of security and certainty and that the periodical revisions were a source of constant controversy and discontent, Lord Curzon made the arrangements in 1904 called semi-permanent settlement. The financial settlement then made was to continue to operate unless some emergency necessitated a change. The heads of revenue were still classified as Imperial, Provincial and Divided. The chief advantage of the semi-permanent settlement was that there was a greater financial continuity than before. But the ultimate financial control still rested with the Central Government. Provincial revenue continued to be insufficient. Thus, in 1919, the Government of Lord Hardinge, on the recommendations of the Decentralisation Commission, made the settlement permanent. Some sources of revenue such as forests which had been till then divided, were now completely provincialised. Excise which had been imperial was half-provincialised in Bombay, U.P. and M.P. This was also done in case of land revenue and irrigation in the Punjab.

### **(iii) Government of India Act, 1919**

An important landmark in the history of the Centre-States financial relations in India was the Government of India Act, 1919; which was based upon the Montagu Chelmsford Report on the Constitutional Reforms. This Report emphasised larger financial freedom for the Provinces.

As a result of the Act of 1919 which came into force in 1921, various matters of local and regional importance such as education, health etc went to the Provincial Governments. But matters of national importance like defence, currency and mint and foreign affairs were left with the Central Government. The new financial scheme also lacked equivalence between the functions and resources assigned to the Provincial Governments. Whereas the functions assigned to the Provinces were of ever expanding nature, the resources given to them were relatively inelastic and inadequate. The resources of the Provincial Governments included land revenue, irrigation receipts, excise duties, judicial stamps, forests registration. All based on what was called the "initial contributions" and the 'standard contributions' to be attained over a period of seven years. The Meston Award maintained that the Provinces would acquire larger revenues on account of the abolition of the scheme of divided heads. They were, therefore,

expected to be able to make contributions to the Central Government out of their surplus revenue receipts, starting from the lower initial contributions in 1921-22 and rising up to the standard contributions in seven years. The initial contribution was calculated on the basis of the increased spending power of each Province resulting from the separation of the source of revenue. The standard contributions were calculated on the basis of such factors as population, income tax receipts, consumption of certain essential articles and agricultural as well as industrial wealth.

The Meston Settlement was strongly criticised by the Provinces, particularly Bombay, which was already making a large contribution to the Central revenue through the Central Taxes, and Bengal, whose land revenue was a very inelastic source of revenue on account of the permanent land settlements and which made a large contribution to the Central revenue through the jute export duty. The Provinces demanded a share of the income tax, and Bengal claimed a share of the jute export duty. However, the Meston Award was incorporated, with some modification, in the Devolution Rules under the Government of India Act, 1919. Devolution Rules 14 and 15 provided for Provinces to receive a part of the receipts from income tax. Rule 15 laid down that a Province should receive 3 pies in each rupee of the amount by which the assessed income of a year exceeded that of the year 1920-21. However, the actual financial developments in the subsequent years revealed that the financial position of the Central Government improved as the other sources of revenue such as income tax, salt and opium revenue, customs, contributions from the railways, posts and telegraphs and currency and mint were with the Central Government. It was estimated that on the basis of the new distribution of fiscal resources, the Central Government would face a deficit and the Provinces would have surplus funds. Thus, as transitional measure, a system of contributions from the Provinces to the Centre was also proposed.

With a view to study the above mentioned proposals and suggest adequacy of funds to the central and provincial governments, a Financial Relations Committee, presided over by Lord Meston, was appointed. The report of this committee is popularly known as the Meston Award. This Committee endorsed, with some modifications, the allocation of resources between the Central and the Provincial Governments proposed in the Montagu Chelmsford Reforms Report. It examined the claim of Industrial Provinces, especially Bombay, to a share of the income tax proceeds, but it came to the conclusion that the income tax should be a Central head. The committee also recommended that stamps be made a wholly provincial head instead of being divided between the centre and the provinces. This would help the poorer provinces and would also finally end the system of divided heads.

One of the chief recommendations of the Financial Relations Committee was related to the Provincial contributions to the centre. The Committee suggested a scheme which was compared with that of Provinces. This facilitated the task of reducing the provincial contributions and these were finally abolished in the year 1928-

29. The great Depression of 1929-33 weakened the revenue position of the Provinces and they had to be helped by the central government. Consequently in 1934-35, The Central Government made a provision for helping the Provinces and also agreed to assign 50 percent of the net proceeds of the export duty on jute to the jute growing provinces of Assam, Bengal, Bihar and Orissa.

**(iv) The Government of India Act, 1935.**

The demands for further constitutional changes in the country led to a large number of financial enquiries e.g. by Sir Walter Lyton (1930), the Federal Finance Sub-Committee of the Round Table Conference (1931) and the Federal Finance Committee (1932). In 1933 a White Paper was issued containing the British Government proposals which were later examined by a Joint Parliamentary Committee.. All this resulted in the Government of India Act, 1935, which came into force in 1937. This act provided for the establishment of a federal system of government at the Central level and autonomy to the Provinces in certain subjects assigned to them. In this Act, the functions of the Central and Provincial Governments were classified so that the Provincial Legislative List contained 94 entries. The Federal Legislative list contained 59 entries and a third list contained the concurrent legislative powers and had 35 entries. In the same way, the financial resources were also divided into three categories namely (a) Federal, (b) Provincial and (c) Jointly-Federal and Provincial.

Under the Act, the sources of revenue assigned to the Provinces included land revenue, irrigation charges, taxes on agricultural income, stamps and registration, excise duties on alcoholic liquors, opium and narcotic drugs, and medicinal and toilet preparations containing alcohol or narcotics. The resources to be assigned wholly to the federal government included corporation tax, customs duties, railways, telegraphs, telephones and broadcasting, currency and coinage and military receipts. The Act also provided for certain taxes which were to be levied and collected by the Centre but the proceeds of which were to be distributed to the provinces. These comprised succession duties other than those in respect of agricultural land, rates of stamp duty in respect of bills of exchange, cheques etc., terminal taxes on goods and passengers carried by railway or air and taxes on railway fares and freights. In addition to these, the Act also provided for certain taxes which were to be levied and collected by the Centre but the receipts from which were to be shared between the Centre and the Provinces. This group consisted of taxes on income other than agricultural income, salt duties, duties of excise on tobacco and other goods produced in India except those wholly assigned to the Provinces, and export duties with special provisions for jute export duty. Some of these taxes had not been levied before and the Central legislature got power under the Act to impose them.

**NIEMEYER AWARD**

A provision was made in the Government of India Act, 1935 for another financial enquiry to be made before the introduction of Provincial Autonomy. Accordingly Sir Otto Niemeyer was appointed to inquire into the financial relations between the Centre and the Provinces in respect of transfers from the former to the latter of parts of the

proceeds of income tax and jute export duty. Payment of grants-in-aid and the existing liabilities of the Provincial Government, the inauguration of Provincial autonomy, each should have a reasonable prospect of maintaining equilibrium and should be placed on more or less equal footing. He also emphasised the importance of maintaining financial stability at the Centre. With these objectives, he examined the existing and prospective financial resources of the Provinces to determine the extent of assistance necessary. He recommended the following measures of assistance of the Provinces:

**Cancellation of Provincial Debts:**

Sir Otto Niemeyer recommended the cancellation of the outstanding provincial debts to the Central provinces of Bengal, Bihar, North West Frontier Province and Orissa, contracted before the 1st of April, 1936. It also recommended a reduction in the outstanding debt of the Central Provinces.

**Distribution of the Income Tax Proceeds**

This issue involved a two-fold problem: the distribution of the total income tax proceeds between the Central Government on the one hand, the Provincial Governments on the other and the basis of distribution among the Provinces of their total share. Sir Otto Niemeyer recommended that 50 percent of the income tax proceeds should be made over to the Provinces. As regard the distribution of the share among the Provinces he recommended that it should be partly on the basis of population and partly on the basis of collections in each of the Provinces. He made the recommendations with regard to the division of the total income tax proceeds among the Provinces as follows:

<b>Provinces</b>	<b>PERCENTAGE OF THE TOTAL SHARE</b>
Bengal	20
Bombay	20
Madras	15
United Provinces	15
Bihar	10
Punjab	8
Central Provinces	5
Assam	2
Orissa	2
Sindh	2
North West Frontier Province	1
	100

**Share of Jute Export Duty:** Niemeyer also recommended that the share of Jute-growing Provinces (Bengal, Bihar, Assam and Orissa) in the jute export duty be fixed at 62.5 percent of the net proceeds.

**Grants-in-aid to Provinces:-** In accordance with the Section 142 of the Act after considering the assistance likely to be received by each Province as a result of the above measures. Sir Otto Niemeyer recommended the following annual grants-in-aid to the various Provinces:

Province	Grant Per annum (Rs. in lakhs)	Remarks
United Province	25	For a fixed period of 5 years.
Assam	30	Subject to the proposal that Assam Government would bear Rs.5 Lakhs towards the cost of Assam Rifles.
North West	100	Subject to reconsideration Frontier Province after 5 years.
Orissa	40	With Rs.7 Lakhs additional in the first year, and Rs. 3 Lakhs additional in each of the four years.
Sindh	105	For 10 Years with Rs.7 Lakhs additional in the first year, then falling gradually until grant ceases entirely in 45 years.

The above mentioned recommendations made by Sir Otto Niemeyer were accepted by the Government and the allocation of resources between the Centre and the Provinces was resulted on this basis until the partition of the country in 1947. Indeed, owing to the increasing expenditure of the Central Government during world war- II, it was decided in 1940-41 that the Central Government should be permitted to retain a fixed sum of Rs. 45 crores out of the Provincial share of income-tax. This arrangement lasted till 1945-46.

It may be noted that the Govt. of India Act, 1935, laid down a firm foundation of federal finance. It was in fact this structure that formed the main basis of the fiscal federalism after independence. At least two features of the Act are particularly noteworthy. First, it provided for tax sharing. Secondly, It provided for grants-in-aid from the Central Government to the Provinces. Indeed, the Act contemplated a financially strong Centre.

**Self-Check Exercise-3**

Q.1 How do Government of India Act 1919 influenced the system of centre state financial relations?

Ans: .....

Q.2 Write about the Niemeyer Award in brief.

Ans: .....

**Fiscal Federalism in India:****Assignment of Functions and Sources of Revenue**

- I. Introduction
- II. Objectives
- III. Fiscal Federal system in India: Division of Powers
- IV. Centre-state Financial Relations in India: Problems and Prospects
- V. Summary

**I. Introduction**

Governments are of two types-unitary and federal. This classification depends upon the concentration and distribution of power, functions and the relations between the central and local authorities. Under the unitary system, whole power of government is conferred by the constitution upon a single central organ and local governments derive whatever authority they possess from this central organ. This system of governments exists in UK, France, Germany, Austria and most of the countries of Asia. As against the unitary system, federal system provides for a distribution and division of government power between the central government and the governments of the individual states of which the federation is composed. In this system, there is a clear-cut division of legislative, executive and financial powers between the two layer of government i.e., the centre and the states. Each derives its powers from a written constitution. Federal governments exist in USA and Canada. In India, too, we have adopted the federal system of government with three layers of government-Central, States and Local bodies. Till the 73rd and 74th Amendments of the constitution passed in 1993 of India, only two layers of the government, viz. Central and the State governments were recognised in so far as the financial autonomy was concerned. Local-self-governments, (municipalities, panchayats, municipal corporations and boards etc.) depended solely on the discretion of the states. However, with these 73rd and 74th amendments, local bodies viz Panchayati Raj Institutions (PRIs) and Urban Local bodies - Nagarpalika (ULBs) have been accorded a statutory status.

In this chapter, we shall discuss the division of power between the two sets of governments in India and their financial relations with each other.

**II. Objectives:** After having gone through this lesson, you would be able to: understand the system of constitutional division of financial powers between the union and state; know the magnitude of transfers from the centre to state through Finance Commission; explain the problems and prospects to centre-state financial relations in India.

**III. Fiscal Federal system in India: Division of Powers:** The division of functions and resources differ from country to country. In India, we have taken care to

divide the functions and resources in such a way that functions and resources of national level have been assigned to the union government and of local nature have been assigned to the state governments. It was felt that states can do more justice at local level and other functions like defence, international trade, currency etc. can be performed more efficiently by the union government.

There are certain conditions for the successful operation of the federal form of government. These are:

- (i) each Government should have independent sources of revenue over which it should possess absolute, and unrestricted power;
- (ii) the sources of revenue assigned to the Centre and the States should be adequate to enable them to fulfil the functions allotted to them. However, in modern states, it is frequently not possible to ensure this and it is highly unlikely that the needs and resources of each government will be exactly balanced. Therefore, it becomes necessary to evolve a mechanism of adjustments so that shortages and surpluses are evened out;
- (iii) a certain level of uniformity should be ensured in all areas of the federation so that no preference is given to one state over the other as regards payment of federal taxes;
- (iv) economy; flexibility and administrative workability are other conditions.

In India, we have tried to satisfy all the conditions so that federal system could work properly. It is said that no other federal constitution makes such an elaborate and comprehensive provisions as in the constitution of India with respect to the Union and State financial relationship has been made. Professor D.K.Sen has rightly said that, "The financial provisions of the Indian constitution clearly show that constitution follows primarily the principle of rigid separation in the matter of distribution of taxing powers between the Union and the member states. The two fiscal spheres are distinct from each other, whatever constitution allots to the states is withdrawn from the hands of the Union. On the other hand, the states are not entitled to encroach on any fiscal matter which the constitution has not particularly assigned to them. For all matters not specifically earmarked for the states by the constitution, fall exclusively within the sphere of the Union."

In India, the division of functions and resources as between the centre and states is governed by the provisions of the constitution (the local bodies are assigned duties and resources out of the share going to the states and some direct share from the centre finance commission too). The constitution of India came into effect from the 26th January, 1950. India was declared to be a union of states. The character of the constitution of India is unitary in spirit and federal in structure.

#### **Constitutional Division of Financial Powers between the Union and the States:**

The constitution seeks to make a clear division of financial resources between the centre and the states.

**(a) Sources of revenue for the Centre :-** The sources of revenue for the centre can be divided into two parts, viz. (i) sources of tax revenue, and (ii) sources of non-tax revenue.

The sources of tax revenue include corporation tax, custom duties, taxes on income other than agriculture etc.

The non-tax resources for the centre include borrowings, income from government undertakings and monopolies, income from government property and income arising out of the exercise of various governmental functions and rights, fees etc.

**(b) Sources of revenue for the States :-** The sources of revenue for the states can be divided into two parts, viz. (i) sources of tax revenue, and (ii) sources of non-tax revenue. Under the constitution, the states have been given independent tax powers. There is no overlapping of tax jurisdiction. The underlying principle which determines this division is that taxes which have an inter-state base are generally levied by the union, while those with a local base are levied by the states. The state list contains items like land revenue, taxes on agricultural income, sales tax etc. The sources of non-tax revenue include borrowings from within the country, grants-in-aid from the central government, fees taken in all courts except Supreme Court, income from undertakings owned partly or fully by the state governments.

The aforesaid division of taxation powers between the centre and the states describes only the actual levying and collection of taxes. The appropriation of the tax proceeds, however, does not follow exactly the above division. An important feature of the division of powers to tax in our constitution is that an operational distinction has been made between the levying, collection and appropriation of tax proceeds.

The various taxes imposed by the central government are divided as follows:

- (i) Taxes and duties which accrue wholly to the union government.
- (ii) Taxes levied and collected by the union but the proceeds of which are shared with the states.
- (iii) Taxes and duties levied and collected by the centre but the proceeds of which are assigned to the states (Articles 270 and 272).
- (iv) Taxes and duties levied by the centre but collected and appropriated by the state concerned.

In addition to this, Article 275 of the constitution provides for grants-in-aid to the states in need of assistance. Different amounts can be fixed for different states, so that the weaker states can be given specific assistance to meet the necessary expenditure in the proper discharge of their duties to the people. Article 282 provides for grants by the union government to the state governments for any public purpose. Under Article 275, grants-in-aid are fixed on the advice of the Finance Commission. While under Article 282, grants can be fixed by the central government on its own direction.

Thus the transfer of resources from centre to the state governments were made through Finance Commission and other transfers through Planning Commission until 2014 when planning commission was not abolished, but there after Finance commission and central ministries are transferring resources.

Resources transferred from the Centre to the states increased and reached to the level of 40 percent upto but declined to 35 percent during X and XI FC. The share of the expenditure of the state governments has varied between 35 per cent and 40 per cent. This clearly brings out the heavy dependence of the state governments on the Centre.

The relative contribution of the sources of transfer-taxes and duties, grants other transfers in total transfers is shown in Table-I.

**Table-1****Transfers from Union to States as Percentage of Gross Revenue Receipts****(Finance Commission Period Averages)**

Finance Commission	Finance Commission Transfers			Other Transfers			Total Transfers
	Share in Central Taxes	Grants	Total Transfers through FC	Plan Grants through Planning Commission	Non-Plan Grants (Non-Statutory)	Total other Transfers	
FC VII	22.39	1.96	24.35	12.11	1.66	13.77	38.12
1984-89 FC VIII	20.25	2.52	22.77	13.56	1.54	15.10	37.86
FC IX 1989-95	21.37	3.42	24.79	14.49	1.06	15.55	40.33
FC X 1995-2000	22.22	2.34	23.56	10.57	0.67	11.24	35.79
FC XI 2000-2005	20.59	3.88	24.47	10.10	0.70	10.80	35.27
FC XII 2005-10	21.75	4.45	26.20	10.99	1.32	12.31	38.51
FC XIII 2010-15	23.95	3.93	27.87	12.87	0.59	13.45	41.33

Source : (i) Union Government Finance Accounts (Various Issues)

(ii) 14th Finance Commission Report

To the question whether the centre has been making adequate transfers to the states, the Sarkaria Commission concluded : "The Union Government is already transferring substantial resources to the states."

Under the present circumstances, there is need to pay attention to structural changes in transfers for which there is apparently greater scope.

**Resources Transferred from the Centre to the States**

The basic principle of federal finance is that all the constituents of federal unit should have adequate sources of revenue. It has been further realised that the states, left to themselves, cannot raise sufficient revenues to meet their financial needs. There is a chronic gap between the revenue assigned to the states and their expenditure potential. Whereas they are assigned to take upon themselves more and more functions especially of the social and developmental nature, their resources cannot be correspondingly increased, because their taxing powers are either assigned by the constitution or by the realities of the situation.

The Indian constitution provides for the rectification of the imbalance between the resources and responsibilities of the states. Thus, to cover the gap in state's resources, balancing devices like tax-sharing and grants have to be provided. Our financial system has provided for the transfer of resources from the centre to the states through (i) the recommendations of the Finance Commission i.e. statutory transfers, (ii) the Planning Commission, a non statutory agency upto 2014 and (iii) discretionary grants from the centre to the states. Last two sources of transfer have contributed

substantially more resources than statutory transfers which are transfers through the Finance Commission and reflect the considerable power that the central government enjoys in influencing the decision-making process at the state level. For most of the period of planning upto late 1960s statutory transfers which have remained less than one-third of total transfers, the remaining two-third having been contributed by the planning commission as assistance for plan purpose or by the central government under the head discretionary grants. There was no objective criteria to decide the distribution of non-statutory transfers and this introduced an element of arbitrariness in the whole Scheme.

It was from 1969-70 onwards that objective criteria were adopted , for the plan assistance among the states. The formula used for this Purpose was known as the Gadgil formula which gave 50 per cent weightage to population, 10 percent to per capita income if below national average, 10 per cent to tax effort in relation to per capita income, 10 per cent to continuing major and medium irrigation projects, and 10 percent to special problems of individual states. In its meeting held in August 1980, the National Development Council accepted a modified Gadgil formula raising the percentage of resources to be transferred to the states whose per capita income was less than the national average from 10 percent to 20 percent. Under the modified Gadgil formula 60 percent of the assistance is to be given on the basis of population, 20 percent to the states having per capita income below the national average, 10 percent on the basis of per capita tax effort and 10 percent for special problems.

Planning commission has been replaced by NITI Aayog. The distinction between plan and non plan expenditure has been removed.

The Constitution provides for the appointment of a Finance Commission every five years or earlier to determine the distribution of union tax proceeds between the union and the states, and giving of grants-in aid to the needy states. The Finance Commission is an adhoc body. Fourteen Commissions have so far reported and made recommendations to the government under this provision. The important recommendations of all the commissions have been accepted and acted upon by the central government in the spirit of the Constitution. The recommendations of the Finance Commissions can be grouped under three heads viz. A- Tax-Sharing, B- Grants-in-aid, and C- Central loans to the states. So far, fourteen Finance Commissions have done remarkable work and made major contributions to the theory and practice of public finance in this country. Fifteenth finance Commission was constituted in Novermeber 2017 to give recommendation on the transfer of resources from the centre to state. It will give recommendations for the period 2020-25.

### **Transfer of Resources from Union and States to Local Bodies**

Since the 73rd and 74th Constitutional Amendments, the Central Finance Commissions have been exclusively devoting attention to the transfer of resources directly to the local bodies – Panchayats and Municipalities. To encourage the decentralisation process and strengthen the local bodies financially the Eleventh Finance Commission decided to determine the inter-se share of states in the grants provided for

the Panchayats and Municipalities by giving 20 percent weightage to the index of decentralisation and 10 percent to the revenue efforts of the local bodies. It has now become obligatory for every state to appoint the State Finance Commission to determine the transfer of resources from the states to local bodies on the pattern of Central Finance Commission.

### **Magnitude of Transfers from the Centre to the States through Finance Commission**

Table-2 reveals the substantial increase in resources transferred from the centre to the states. From Rs. 421 crores under the award of the First *F C*, the resources transferred increased to Rs 1019 crores under the Second *Finance Commission*, Rs. 1,317.9 crores under the Third *F C* and so on and Rs. 434905 crores under the award of the Eleventh *F C*. The total transfers recommended by the Twelfth *F C* were higher by 73.8 per cent over those recommended by the Eleventh *F C*. Tax devolution to states has constituted over 80% of the total transfers to states. The estimated amount recommended by The Fourteenth *FC* is Rs. 4485541 crore.

Parliament passed the 73rd and 74th Amendments which require that the States should also appoint Finance Commission to deal with the questions of devolution of finances to local governments. Under Article 243-1, the governor of each State has to constitute State Finance Commission. This together with Article 243- Y, deals with these matters at the local government level.

**Table - 2**  
**Resources Transferred from the Centre to the States through Finance Commissions.**

(Rs. in crores)

	<b>Tax Devolution</b>	<b>Grants</b>	<b>Total</b>
First Finance Commission (1952-57)	371.30	50.00	421.30
Second (1957-62)	822.40	197.20	1019.60
Third (1962-66)	1067.50	250.40	1317.90
Fourth (1966-69)	1328.00	421.80	1749.90

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Fifth (1969-74)	4643.00	710.70	5353.80
Sixth (1974-79)	8250.06	2509.60	10760.20
Seventh (1979-84)	19297.06	1609.91	20906.97
Eighth (1984-89)	35683.60	3769.00	3942.00
Ninth (1989-90)	11785.64	1876.78	13622.42
(1990-95)	878882.00	18154.43	106036.43
Tenth (1995-2000)	206345.00	20300.30	226643.30
Eleventh	376318	58587	434905
Twelfth (2005-10)	613112	142640	755752
Thirteenth (2010-15)	1448095	258581	1706676
Fourteenth (2015-20) Estimated	3948187	537354	4485541

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**Sources :**

- (i) H. L. Bhatia, Centre-State Financial Relations in India (New Delhi, 1979), Table 47, p. 127.
- (ii) Government of India, Reports of various Finance Commission

Under the present circumstances, there is need to pay attention to structural changes in transfers for which there is apparently greater scope.

In the wake of the new economic policy, Centre-State financial relations have come into focus for two reasons:

- (1) The centre has realised that its writ does not run in many areas of government activity where expenditures are booming and if it wants to get its fiscal house in order, it can do so only if the states cooperate.
- (2) India's federal structure was conceived of mainly in terms of cooperative parameter, not withstanding the fact that this has a certain in built impulse towards central dominance. But what has emerged over the last four and a-half decade is a centralised federal system. In the wake of recent economic reforms and new philosophy of deregulation, an increasing need is being felt for federal reforms.

First, efforts should be made to strengthen resource position of the state Governments. The central government should curtail domestic expenditure as a proportion of the central budget, and the money thus saved can be used for larger devolution to the states. Further changes need be brought in the arrangements relating to changes in economic planning system.

#### **IV. Centre-State Financial relations in India: Problems and Prospects**

In the previous part of this lesson we have discussed the Constitutional provisions which demarcate the functions and financial resources between the Centre and the States. We have also studied the different channels which the Constitution provides for such transfers. Now, we will study the fundamental problems which have cropped up in area of Centre-State financial relations in India.

In recent years, the Union State financial relations have become the centre of controversy. The demands of the States are very high, and the capacity of the Centre is very limited. There have been growing conflicts and tensions between these two sets of governments. The conflict is more severe where different political parties are in power at the Centre and the States. Some of the fundamental problems are as follow:

##### **(1) State Autonomy:**

First of all, there is the problem of State autonomy. Our Constitution has provided for a clear division of functions, powers and sources of revenue of the Central and State Governments. All the constituent units in the federal structure have been designed to be independent, autonomous units in their respective assigned areas. The Finance Commission (FC) has been conceived in the Constitution as a mere instrument to fill the resource gaps of the States. The FCs have been asked to recommend the general principles underlying the transfer of resources from the Centre to the States. These have included both divisible and 'permissible' resources. While divisible resources are statutory in nature, 'permissible' resources are only discretionary. Over the years, the relative position of permissible resources has increased, whereas that of divisible resources fallen. This is an index of the growing dependence of the States on the Centre. The enthusiast of State autonomy are very bitter at this strong position of the Centre and weak position of the States, under which States have always to look up to the Centre and beg for assistance. Without financial resources autonomy is merely in name. Autonomy is a myth and federation a misnomer. The dependence of the States on the Centre not only violates their autonomy but makes them financially irresponsible also. The continuous flow of funds from the Centre to the States without any check on their productive use constitutes a serious inflationary impact in the national economy. Recently, demands for increase in State autonomy have been raised by various quarters. While no one denies the importance of strong Centre for preserving the integrity of the nation, it is necessary to give a serious thought to these demands. Grants of a certain

amount of autonomy, at least in the sphere originally contemplated by the Constitution, is necessary to fulfil the democratic ambitions of the people. A strong Centre without 'Strong States' is not conceivable.

**(2) Inadequacy of Resources :**

Secondly, the problem of inadequacy of resources at the disposal of the States has been assuming serious dimensions in recent years. From the point of view of fiscal self-reliance, the allocation is defective because the States resources are inadequate to meet their requirements. The Centre has kept with itself all the important taxes from the point of view of yield and influence and the States have been 'assigned traditional revenue resources which have a low aggregate yield.

Looking at the expenditure side, the centre has a few, though important, heads of expenditure, such as defence, foreign trade, regulation and development of large-scale industries, public sector enterprises, banking system, railways, means of communication, etc. Many of these heads are also revenue yielding. But the picture of the States regarding their responsibilities and heads of expenditure is entirely different. Besides maintaining law and order, the States have to look after the development of agriculture and rural sector, construct irrigation projects, supply power and maintain and develop means of transport etc. The States have to make provisions for education and look after the health of the people. They have to promote many industries such as agriculture, forestry, horticulture, sericulture, and small and medium-scale industries. The States have also to carry out plan projects. Considering the importance and vastness of these functions, the revenue resources left to the States remain inadequate.

**(3) Elasticity Responsiveness:**

The Centre has resources with expanding yield but the States resources are relatively stationary because of the nature of taxes. The states have 'land' as the main source of revenue which is more or less fixed, even other sources of revenue of the States, like taxes on agricultural income, excise duties on intoxicants, taxes on motor vehicles, entertainment, etc., are also comparatively less elastic than the taxes assigned to the Centre. Sales tax now replaced by value added tax is the only tax levied by the States which has substantial elasticity. Because of the economic progress registered by the country in the last three decades, the base of income tax, union excise duties, custom duties and other important Central taxes has expanded considerably. This has given immense powers to the Central government to increase its resources with the passage of time. This structure of financial relations between the Centre and the State governments places the States at a distinct disadvantage.

**(4) Existing Arrangements:**

This existing system of Centre-States transfers exhibits certain inherent weaknesses that discourage fiscal discipline at the State level. These are:

1. The Finance Commission determines grants on the basis of revenue

shortfalls of States. Purpose grants like disaster relief and grants for local bodies are also recommended by FFC. This leaves little incentive for States to increase tax revenue.

2. Central plan loans in the case of several States are far more than their plan capital expenditure. It means that these States actually borrow from the Centre to incur expenditure.

**(5) Rates & Base:**

Even where the entire amount is distributed among the States, the rates and base are wholly decided by the Centre regardless of the wishes and requirements of the States. It has resulted in, on the one hand, the system of spoonfeeding the States and on the other inadequate resources.

**(6) Indebtedness :**

The increasing indebtedness of the States to the Centre is not a healthy development in federal finance, because loans are outside the scope of recommendation of the Finance Commission. These loans are given to States by the Centre at a low rates without reference to the criteria of productivity in use, ability and willingness to pay interest and repay the principal.

**(7) Role of Finance Commission :**

There was the problem connected with the role of the Finance Commission itself. The FC was overshadowed by the Planning Commission. The simultaneous existence of these two bodies, both covering a great deal of common ground, has created an anomalous situation for long.

Transfers through the Finance Commission contribute only about one third of total transfers from the Centre to the States for a long period. This means that about two-third of the transfers were channelled through the Planning Commission or the Central Government directly. For a considerable period of planning, the Planning Commission was not guided by any objective criteria to determine the share of different States in its assistance and this created for long aura of arbitrariness in the whole transfer mechanism. Since the Centre contributed a large amount of resources in the form of discretionary grants to the States, it acquired considerable powers to affect the decision making processes at the State level. This led to a further erosion of autonomy of the States. But , Since FC VIII, out of total revenue transfers, more than 60 percent transfers are made through finance commissions. But after 2014 with the abolition of planning commission, Fc and central ministries are transferring resources.

**(8) Inter-State Disparities:**

There is the problem of inter-state disparities. The problem arises from the conflict between the objectives of growth and equalisation. The growth objective requires that the total available resources in the national pool should be so spent as to yield the maximum output, i.e. increase in national income should be primary concern of policy makers. The equalisation objective, on the other hand, would require that the resources should be so distributed that economically poor regions may get a larger slice of the cake. The successive Finance Commissions have given a consideration to the equalisation argument ever hence the weightage given to the 'backwardness' criterion in resources transfers. The ultimate result was that the advanced States cornered a major share of the actual devolution of resources from the Centre.

(9) Taxes of the States and their share in the Central taxes being inadequate; the States for long depended greatly on loans and grants-in aid from the Centre. This has resulted in to growing indebtedness and interest payements The Sates have lost autonomy and initiative.

(10) The monetary and fiscal policies (deficit financing) have accelerated inflationary pressure on the country which has led to an enormous rise in the dearness allowance paid to the government employees. Whereas the Central government can meet their additional financial burden, the States are left in an embarrassing position, they find it difficult to meet their growing expenditure on wages and salaries.

(11) Transfer of funds from the Union Government is not based on functions. It is the states which have to carry all developmental work in the states where as funds placed at their disposal and transferred to them are not sufficient. For example, every Finance Commission adopts its own criteria for the recommendation of grants. Same is true with other agencies. This adhocism is not good. It is also said that there is no co-ordination between these agencies. Therefore, it becomes a political game and as a result few states suffer and others gain.

(12) Surcharge is kept by the centre. Union government can impose sur-tax and surcharge for its exclusive use. States feel that instead of raising tax rates, union government would impose Surcharge and in this way deprive the States from revenue sharing and states receive less revenue from divisible pool.

(13) States feel that state governments make special efforts in the development and promotion of corporate production. However, union government recovers the cost through corporate tax and it is not shared with states.

**Suggestions:**

Some suggestions have been made to place the Centre-State financial relations on a harmonious footing. It is pointed out, that a doctor recipient mentality should be eradicated.

1. The Finance Commission should study the resource position of the

economy as a whole. Only on the basis of such a study it should attempt to determine the ways in which these resources should be distributed among the constituent Governments, including the Central Government having regard to the question of efficiency, allocation of functions and others.

2. The Finance Commission should interpret the needs of the states liberally and pursue a deliberate policy of increasing the statutory transfers as a proportion of the total. The commission should try to ensure a “comfortable resource cushion” to the states.
3. The Finance Commission should prepare a measure of resource effort in relation to taxable capacity, and the performance of respective states should be estimated. Having determined the grants for individual States, the Commission should revise them. The revision may be upward or downward with respect to the measure of performance.
4. The scope of the Finance Commission should be enlarged, since it is a statutory body. Representation from each states should be there while appointing the members of this body.
5. The States should also set their own house in order. Not only should they practise a more vigorous fiscal discipline but they should also exploit fully their tax and non-tax resources, including those of the agricultural sector.
6. The RBI should refuse to honour the states overdrafts beyond a limit. At the same time the necessity of the States to resort to overdrafts should be removed by releasing to them more resources.
7. More weightage should be given to backward States while giving grants considering their level of backwardness, illiteracy level, existing hospital beds, schools, colleges, etc.
8. The demands of the States for a permanent Finance Commission needs consideration. This would reduce the arbitrariness in Central assistance during the tendency of the appointment of the new Finance Commission after every five years.
9. The Central Government should exercise economy in its expenditure, a possible area is that of subsidies e.g. on fertilisers. If the Centre can save itself of this expenditure, it will command more resources for distribution among the States.
10. It is necessary that both the Centre and the States should feel firmly committed to their respective obligation to society as a whole and there should be an atmosphere of mutual goodwill and trust.
11. Corporate tax should be included in the divisible pool of income tax.

**V. Summary**

However, in a developing economy there is a need for a constant constructive reappraisal of Centre-State financial relations. In a welfare state, with a planned economy the dependence of States upon the centre will increase with the increase in the field of State activities. Besides, in a democratic country with increasing responsibilities at every level, financial dependence also increases and therefore a constant re-adjustment is always needed. It should always be kept in mind that Federation is a compromise between national unity and regional interests and this compromise should be properly maintained.

### **FINANCE COMMISSIONS IN INDIA**

In this lesson, we shall discuss the role and functions of Finance Commissions in India. This would be followed by the review of actual recommendations of various Finance Commissions constituted so far.

Indian Constitution divides the functions and financial powers of the Government into Central and State spheres together with the concurrent areas. After 73rd and 74th Amendments of the constitution in 1993, there is no separate allocation of functions and resources for local bodies has been made. The Constitution has tried to adhere to the criteria of economy and efficiency in allocating functions and resources to both has been made the Centre and the States. Now the criteria which guided the Constitution makers in assigning the functions and financial resources to the Centre and the States could not guarantee that the resources assigned in a given layer would be adequate to meet its financial needs also. Those functions which are important for the country as a whole like Defence, Foreign affairs, Communication and Currency are obviously central subjects. But the picture of the States regarding their responsibilities and heads of expenditure is entirely different. Besides maintaining law and order, the States have to look after the development of agriculture, construction, irrigating projects, supply power, maintain and develop means of transport, etc. The States have to promote many industries and make provision for education. Considering the importance and vastness of these functions, the revenue resources left to the States appear to be inadequate. Thus, there is a chronic gap between the revenue resources assigned to the States and their expenditure potential. The gap is also growing with the passage of time. Whereas the States are called upon to take themselves more functions, especially of the social and development nature, their resources cannot be correspondingly increased because their taxing powers are either limited by the Constitution or by the realities of situation. Hence, there is need to bridge the gap between financial needs of the States and their revenue resources.

With the economic development of the country, the resources of the Centre are expanding enormously, whereas the sources of revenue of the States have tended to be less elastic and stationary. The result of all this is that there is an inherent financial imbalance between the Centre and the States. The States are financially weaker but their needs continue to increase faster than the resources available to them. This, therefore requires that there should be a provision for transfer of resources from the Centre to the States to correct this inherent imbalance. The Indian Constitution does

not merely mark out the channels through which resources can flow from the Centre to the States, it also provides a machinery for regulating the flow of its resources in the form of the Finance Commission.

The Finance Commission is a salient feature of the Indian Constitution. It is a statutory body which is quite independent of the Government. Its objective is to review and adjust the working of centre state financial relations in the light of changing circumstances.

Under Article 280, a Finance Commission was to be appointed within two years of the commencement of the Constitution. The Article further lays down that the president has to appoint a Finance Commission every five years or, if need arises, earlier. The Finance Commission shall consist of a Chairman and four other members to be appointed by the President. Thus, every five years, a Finance Commission has to be constituted by the President. Parliament has been given powers to prescribe qualifications for members of the Finance Commission to be constituted.

The Functions of the Finance Commission so constituted has to make recommendations to the President regarding the following financial matters:

- (a) The distribution between the Union and the States, of the net proceeds of taxes, which are to be or may be divided between them and their allocation among the States;
- (b) The principles, which should govern the grants-in-aid to the States out of the Consolidated Fund of India (i.e. from the revenue of the GOI);
- (c) The continuance of modification of the term of any agreement entered into by the GOI with the States; and
- (d) Any other matters referred to the Commission by the President in the interests of sound finance.

And once the Finance Commission has been constituted, the President can issue relevant orders covering the financial matters, only after considering the recommendations. The President however, can ask the Commission to consider specially the certain matters, while making its recommendations. Finance Commission winds up after completing its task and submitting its report.

The provision for a Finance Commission is of great significance as it makes for elasticity in the financial relations between the Union and State Governments and enables the adjustment in their finances according to their changing needs and circumstances. The real significance of the Finance Commission lies in making recommendation on the sharing of duties and taxes that is the allocation of distributable tax pool among the States and to determine grant-in-aid to be allocated to them. But the recommendations of the Finance Commission do not deal with total resources transferred to the States. The distribution of resources for development purposes were earlier fixed by the Union Government in consultation with the Planning

Commission. But now planning commission has been replaced by NITI aayog. In spite of this limitation, the scope of the Commission has been widened. The main function of the Finance Commission now consists in determining the revenue gap of each State and for filling up the gap by scheme devolution partly by a distribution of taxes and duties and partly by 'grant-in-aid. The Finance Commission does not cover the loans, which the Centre advances to the States though it may be asked to consider the problem of indebtedness of the States to the Centre and any relief which may be granted to them. Out of total liabilities of state governments, loan and advances from the centre constitute less than 4 percent.

The Indian Constitution has empowered the Finance Commission (FC) to make recommendations on the divisible pool. This includes two major instruments :

- (i) distribution of income-tax and excise duties; and
- (ii) grants-in-aid.

In all, fifteen Finance Commissions have been constituted till now, the, President of India has so far appointed these commissions in 1951, 1956, 1960, 1964, 1968, 1972, 1977, 1982, 1987, 1992, 1998, 2002 and 2007, 2013 and 2017.

The first Finance Commission was appointed in Nov. 1951 under the Chairmanship of K.C. Niyogi and submitted its report at the end of Dec. 1952. Similarly, other Finance Commissions submitted their reports on different dates. The Ninth Finance Commission was appointed on 17th June, 1987 under the Chairmanship' of Shri N.K.P. Salve, it was asked to submit two reports. The first report was submitted in July 1988 and covered 1989-90. The second report was submitted on 31st Dec. 1989 covering 1990-95. The tenth Finance Commission was constituted on 15th June, 1992 with Shri K.C. Pant as its Chairman: It submitted its report and covered a period of five years from 1st April 1995 to 31<sup>st</sup> March 2000. The Eleventh Finance Commission (2000-05) under the chairmanship of A.M. Khusro submitted its report on 5th July, 2000. The Twelfth Finance Commission under the chairmanship of Dr. C. Rangarajan submitted its report on November 30, 2004 covering the period 2005-10. The Thirteenth Finance Commission was constituted under the chairmanship of Vijay L Kelkar. The recommendations of the commission covered five years period 2010-2015. The Fourteenth Finance Commission was constituted under the chairmanship of former RBI Governor Y.V. Reddy and submitted its report on 15th Dec. 2014. The fifteenth finance commission has been constituted in 2017 and NK Singh is the chairman.

The Indian Constitution provides three channels for transfer of resources from the Centre to the States namely tax sharing, loans and grants-in-aid.

#### **1. TAX SHARING:**

The constitution provides for compulsory sharing of income tax with the States.

However, a tax on agricultural income can be levied and collected only by the States. If any surcharge is levied on income tax for the purpose of the Union, it is not to be shared with the States, corporation tax (a category of income tax) is also fully retained by the Centre. The proportions, in which the net proceeds of income tax are shared between the Centre and the States on the one hand and among the States on the other hand are determined on the recommendations of the Finance Commissions.

Union excise duties are shared on a permissible basis. Sharing of these duties started with only three commodities with the First Finance Commission, but now all the union excise duties are shared by the Centre with the States. The actual percentage to be transferred to States is also decided on the recommendations of the Finance Commissions.

## **2. GRANTS-IN AID:**

The second instrument provided by the Commission for bringing in financial balance between the Centre and the States is that of grants-in-aid as a revenue of the states. The Constitution provides for various types of grants from the Centre to the states which are both statutory and discretionary in nature. Discretionary grants are those which the Centre can make to the States for any public purpose on its own without referring the same to the Finance Commission. Statutory grants are those, which are determined on the recommendations of the Finance Commission. The grants-in-aid revenues of the States can be discriminatory and need not be of the same amount for each State. Under substantive portion of Article 275, the centre gives grants to the States on the recommendations of the Finance Commission for meeting their revenue gaps. Similarly, Article 282 allows the Central and State Governments to make discretionary grants for any public purpose.

Finance commissions recommended grants in aid for revenue deficit disaster relief, local bodies, sector-specific-scheme and state-specific schemes.

### **RECOMMENDATIONS OF FINANCE COMMISSIONS**

Now we will discuss the actual recommendations of Finance Commissions in regard to sharing of income-tax, union excise duties, grants-in-aid and loans.

## **1. INCOME TAX**

The net proceeds of income tax (excluding surcharge on it) is shareable with the States on a mandatory basis. The Finance Commission (FC) makes recommendations regarding (i) the combined share of States out of the divisible pool' of the income tax proceeds, and (ii) the proportionate share of each individual State within the combined share of all States.

In view of the expanding needs of the States in terms of their increasing commitments for economic development, and social services, the first Commission recommended that the share of the States in the net proceeds of income tax be raised from 50% to 55%, the Second F C raised this share to 60%. Third F C raised this share to 66.2/3 and the Fourth F C to 75%. The Fifth F C retained the States share of income tax at 75%. The Sixth F C accordingly raised it from 75% to 80% of the net proceeds. The Seventh F C raised the share of the States to 85% of the pool. The Eighth and Ninth F C retained the States share of income tax at 85 % The share was reduced to 77.5% by Tenth F C. The Eleventh F C recommended that 29.5% and the twelfth F C 30.5% and the thirteen FC raised it to 32 percent and Fourteenth FC to 42 percent of the net proceeds of all shareable taxes and duties be transferred to states.

As regarding the criterion for determining the share of each state in the total divisible pool, the First Finance Commission proposed that 80% of the States shares' of the divisible pool of income tax should be distributed among the States on the basis of their relative population according to the census of 1951 and 20% on the basis of the relative collection of income tax in the different states. The Second Finance Commission had fixed 90% on the basis of population and 10% on the basis of assessment. The Third and Fourth Finance Commissions followed the First Finance Commission. The Fifth, Sixth and Seventh Finance Commissions recommended the distribution as 90% on the basis of population and 10% on the basis of assessment. The Eighth Finance Commission also recommended the allocation of income tax to the States as 90% on the basis of population and 10% on the basis of assessment. Ninth Finance Commission recommended 10% on the basis of 'contribution' as measured by the assessment of income tax during the years 1985-86 to 1987-88. The remaining 90% of the States share was divided between individual States on the basis of distance (45%), population (25%), composite index of backwardness (12.5%) and inverse of per capita income (12.5.1%) criteria.

The Tenth Finance Commission (TFC) introduced the following formula/criteria to determine the shares of the different states in the shareable proceeds of income tax.

20 percent on the basis of population of 1971; 60 percent on the basis of distance of per capita income of a state from that of the state having the highest income; 5 percent on the basis of area adjusted; 5 percent on the basis of index of infrastructure and 10 percent on the basis of tax efforts.

Population and area have both been adopted by Thirteenth Finance Commission as criteria in the horizontal devolution formula, with the same weights as those used by FC-XII. These are equity-neutral measures of fiscal need. The income distance criterion used by FC-XII, measured by per capita GSDP, is a proxy for the distance between states in tax capacity. A single average tax to GSDP ratio to determine fiscal capacity distance between states has been used by FC-XIII.

The criteria and relative weights for determining the share of different states in the shareable proceeds of income tax recommended by Eight FC, Ninth FC and Tenth FC are given in Table-I, Eleventh FC to fourteenth FC are given in Table 2.

For determining the inter-se share of states, 17.5 percentage weight to populations; 50 percent to income distance method; 15 percent to area; 10 percent to demographic changes and 7.5 percent to forest cover has been recommended by XIV FC.

## **2. UNION EXCISE DUTIES:**

The First FC recommended that the revenue from excise duties on only three items namely, tobacco, matches and vegetable products should be shared and the States should get 40% of the net proceeds on the basis of their population and not on the basis of consumption of these goods in the respective states. The Second FC reduced the share of the States from 40% to 25% of the net proceeds, but widened the range to include eight articles. The Third FC expanded the list of items for sharing excise duties from eight to thirty five and the percentage share to be distributed was reduced from 25% to 20%. The Commission observed that while determining shares of individual States, in addition to-population, relative financially weak position of a State and the percentage of scheduled tribes and backward classes in the population must also be taken into account. The Fourth FC kept the share of States in the excise collection as 20% of the net proceeds on all commodities. Furthermore, while determining the share of the state vis-à-vis each other, the Commission disclosed the weightage given by it to population and economic and social backwardness, viz. 80% on the basis of economic and social backwardness. The fifth FC retained the existing arrangement, viz. 20% of the net proceeds to the Union Excise duties to be distributed among the States. The Sixth FC had not recommended any change in regard to the sharing of the basic excise duties, but changed the pattern of distribution, in that 75% were to be distributed on the basis of population and- 25% on the basis of economic backwardness. The Seventh FC recommended the States share in Union excise duties to double from 20% to 40% and the distribution between states should be made by assigning 25% weightage equally to population, the increase in per capita income of a State, percentage of the poor in each State and revenue equalisation formula. Beginning with the Eighth FC, two changes occurred. First, there was a move towards unifying duties and secondly “a portion of the union excise duties was kept aside for the formulae for the interse distribution of both income tax and union excise distribution according to ‘assessed deficits’ of States after the devolution of Central taxes. The unified formulae used by the Eighth, Ninth and Tenth Commissions are given in Table 1 and by the Eleventh FC to Fourteenth FC

in Table 2.

**Table - 1**

<b>Criteria for Inter-Se Sharing of Union Taxes</b>									
Finance Commission	Population	Distance	Inverse of	Poverty ratio	Index of Back-wardness	Area	Index of Infrastructure	Tax Efforts	Applicable
Eighth	25	50	25	-	-	-	-	-	90% of shareable IT
Ninth (I Report)	25	50	12.5	12.5	-	-	-	-	40% of Union excise duty
Ninth (II Report)	25	50	12.5	-	12.5	-	-	-	90% of shareable IT
Tenth	20	60	-	-	-	5	5	10	100% of shareable IT and 40% of UED

The basic emphasis of Eleventh F C was to evolve a suitable structure of incentives in all mechanisms of fiscal transfers. In Terms of Reference (TOR) for better fiscal management, the use of an index of fiscal discipline was suggested. For working out this index, the improvement in the ratio of own revenue receipts of a State to its total revenue expenditure related to a similar ratio for all states as a criterion for measurement was adopted. The XIV FC (FFC) has incorporated two new Variables: 2011 population and forest cover and excluded the fiscal discipline variable.

**Table-2**

**Criteria and relative Weights for Determining Inter Se Shares of States in Union taxes: XIth FC, XIIth FC and XIIIth FC**

Criterion	Weight (Percent)			Relative
	XIth FC	XIIth FC	XIIIth FC	
1. Population (1971)	10.0	25.0	25.0	17.5
2. Income (Distance Method)	62.5	50.0	--	50
3. Area	7.5	10.0	10	15
4. Index of infrastructure	7.5	--	--	--
5. Tax effort	5.0	7.5	--	--
6. Fiscal Discipline	7.5	7.5	17.5	--
7. Fiscal Capacity /Income Distance	--	--	47.5	--
8. Demographic Change (Population 2011)	--	--	--	10
9. Forest cover	--	--	--	7.5

**Table - 3**  
**SHARE FOR THE STATES IN THE PROCEEDS**

Finance Commission	Income Tax (%)	Basic Excise Duties (in %)
First FC	55	40 of 3 duties
Second FC	60	25 of 8 duties
Third FC	66.7	20 of 35 duties
Fourth FC	75	20 of 45 duties
Fifth FC	75	20 of 45 duties
Sixth FC	80	20 of 45 duties
Seventh FC	85	40 of all duties
Eighth FC	85	} (larger relief to the poorer states) 45 of all duties
Ninth FC	85	
Tenth FC	77.5	47.5 of all duties
Eleventh FC	29.5	of all taxes and duties
Twelfth FC	30.5	of total shareable central taxes
Thirteenth FC	32%	from the central divisible pool.
Fourteenth FC	42%	in the central divisible pool.

### 3. GRANTS:

Another very important instrument of transfer of resources from the Centre to the States is the system of grants. The First FC gave three types of grants namely increased grants-in-aid to jute-growing States, additional general grants-in-aid to certain States and special grants to certain less-developed States. The Second FC recommended grants-in-aid payable to the jute-growing States in lieu of a share in the export duty on jute and jute products and substantial grants-in-aid to 11 out of 14 States under Article 275(1) of the Indian Constitution. The Third FC recommended an annual payment of total grants-in-aid of Rs.110 crores to all States of which Rs.52 crores meant for budgetary deficits. The Fourth FC recommended an annual payment of total grants-in-aid of Rs.122 crores as well as statutory grants. The Fifth FC recommended grants only to 10 States of Rs.637.65 crores, as other States were expected to have a revenue surplus. The Sixth FC recommended larger grants-in-aid to States having larger non plan gap and also for weaker states for upgrading their

standards of administration and social services. The Seventh FC recommended grant-in-aid to the States, which had also fulfilled the additional resources mobilization target. It also recommended separate grants amounting to Rs.437 crores for upgrading standards, non-developed sectors and services in the State backward in general administration to fill their revenue and capital expenditures. The Eighth FC recommended a grant of Rs.1556 crores for the period 1985-89.

The Ninth FC endorsed the three principles while recommending grants: (i) estimates of fiscal needs (If the States should be modified by the factors of tax effort and economy in expenditure, (ii) standards of social services provided by States should be equalised, (iii) States should be enabled to meet their special burdens and provide primary services. These principles had not been adhered to by earlier Commissions. The Ninth FC emphasized that -it was recommending grants not on the basis of budgetary gaps, but normative gaps, that is budgetary gaps as estimated on normative basis. The Commission recommended as grants total Rs. 4352.30 crore for 1989-90.

The amount covered Non-plan revenue grants to 13 States, Plan revenue gap grants to all 25 States. Grants for upgradation of administration to 19 states, Rs.537 crores. Grants for special problems to 21 States. Margin money for relief expenditure to 25 states, Grants to 8 states for balance of works under special problems for which grants were recommended by the Eighth FC.

In its second report, Ninth FC recommended a total of Rs.15,017 crores for the five year period 1990-95 as the general purpose grants-in-aid of revenues to 21 states (nine states with only non-plan revenue deficit of seven States with only plan revenue deficit; and five states with deficits of both varieties). Further Ninth FC adopted a normative approach in assessing the receipts and expenditures of both the Centre and States. The norms only determined its entitlements to transfers and nothing more.

The recommendations of Tenth Finance Commission on the grants-in-aid covered Grants-in-aid about Rs. 7,580 crores to cover deficits on revenue account during 1995-2000. Upgradation grants of about Rs.1360 crores for such selected items as police, fire services, jails, promotion of girls' education, additional facilities for upper primary schools, drinking water facilities in primary schools, etc. Grants to solve special problems of states; Calamity relief and Grants of to local bodies, viz. Panchayats, and municipalities. The total amount of grants recommended was Rs.2,0300 crores.

Apart from the statutory grants recommended by the Finance Commission, the states were getting discretionary or development grants by the Planning Commission. These grants were far bigger than those recommended by the Finance Commission. Also the resources transferred on the recommendations of the Finance Commission form a small portion of the total transfers. The Centre uses its discretionary powers for resource transfers, partly on its own and partly in consultation with the Planning Commission. Even some non-plan heads of expenditure were kept out of the purview

of the Finance Commission.

Eleventh Finance Commission identified sectors for upgradation grants, these were district administration, police administration, prison administration, fire services, judicial administration, fiscal administration, health services, elementary education, computer training for school children, public libraries, heritage protection and augmentation of traditional water resources. These upgradation grants were not linked to the assessed deficits of the states nor limited to the deficit states alone. The surplus states have also been given these grants. In addition, grants for certain special problems to states were provided. In all Rs.4972.63 crores had been provided towards upgradation and special problem grants. The twelfth finance commission recommended that the centre should confine itself to extending plan grants and leaving it to states to decide their borrowings. Grants recommended by FC-XII amounted to 18.9 percent of total transfers.

The Thirteenth Finance Commission recommended the amount of Rs. 318581 crore as grant in aid for the states. The Fourteenth Finance Commission has recommended Disaster relief, local bodies and revenue deficit grants to states; and Rs 194821 crore revenue deficit grant for 11 states.

#### **4. LOANS:**

Another device used for transfer of funds from the centre to the States are loans. The domain of resources transfers recommended by the Finance Commission do not include Central loans to States. However, the Government of India has been seeking the advice of the Finance Commission on the issues pertaining to loans to the States. Finance Commissions have been making valuable recommendations to the Central Government to streamline the budgetary and debt position of the States. The second Finance Commission was asked to go into the question of Central loans to states. The fifth Finance Commission recommended that the states should balance their budgets instead of making resorts to overdrafts. The Sixth Finance Commission was asked to review the debt position of the States. It recommended a total debt relief Rs. 1,970 crores to all the States. The Seventh Finance Commission recommended a relief to the states to the extent of Rs.2,150 crores in their loan repayment liability to the centre during 1979-84. The Eighth Finance Commission recommended a debt relief of Rs.2,285.39 crores.

The Ninth Finance Commission made the following recommendations:

- (a) The direct Central loans of States plans should have a maturity period of 20 years with 50% of the loans enjoying a period of five years.
- (b) The loans and grant portions of World Bank assistance to be passed on to the States should be in the ratio of 70:30 as in the case of general plan assistance.

The Ninth Finance Commission had recommended the transfer of Rs.10,603.64 crores from the centre to the States over 1990-95. Tenth, Eleventh, Twelfth Finance Commission recommended that central government should not act as an intermediary

for future lending to states, except in case of weak states, which were unable to raise funds.

#### **Eleventh Finance Commission: Other Recommendations**

The Eleventh Finance Commission suggested (I) Institutional reforms regarding (i) federal fiscal reforms in order to reduce vertical imbalance and (ii) management and control of Debt and (II) Constitutional and legal changes mainly by (i) bringing services under the concurrent list and (ii) taking nominal limits for profession tax out of the constitution. The total share of the states in the net proceeds of central taxes and duties assigned was be 29.5 percent for the period of 2000- 05.

Eleventh Finance Commission emphasised the need for :

- widening the tax base by bringing services fully under tax net.
- using profession tax and also taxation of farm incomes to augment tax revenue in states.
- ensuring better exploitation of the tax bases without increasing the tax rates.
- relying on user charges for enhancing non tax revenues.
- building up infrastrucutre in every state.
- cutting subsidies.
- transferring centrally sponsored schemes to the states along with funds.
- resizing the governments at all levels.
- improving public expenditure programme.
- introducing comprehensive structural reforms for public sector undertakings.
- restructuring financing of the special category states.
- strengthening the local bodies (Panchayats and municipalities) in the states).

**Twelfth Finance Commission (TFC)** was constituted with Dr. C. Rangarajan as Chairman, with three other members and submitted its report on covering the period 2005-10. The main recommendations were:

- It enhanced the share of states in the net proceeds of the shareable central taxes to 30.5% from 29.5% but the share fixed was 29.5% for the states that levied sales tax on sugar, textiles and tobacco.
- Raised the indicative limit of the revenue transfers to the states to 38 per cent of the centre's gross revenue receipts from 37.5 per cent recommended by the Eleventh Finance Commission.
- Changed the formula for tax devolution with reallocation of weight in favour of population and efficiency factors and dropped one of the factors (index of infrastrucutre) used by EFC.
- XII FC recommended increasing the weight of total population of the

states to 25 percent, as against the weight of 10 percent recommended by the XI FC. In addition, weight given to per capita income has been reduced from 62.5 percent to 50 percent. The weight to the geographical area of the State has been recommended to be increased from 7.5 percent to 10 percent. TFC thus tried to consider the requirements of the states based on their geographical size and population.

- TFC also recommended a debt write-off scheme linked to the reduction of revenue deficit of the states in place of Fiscal Reform Facility.
- The Twelfth Finance Commission suggested the measures on fiscal consolidation by the Centre and State Governments. Following this recommendation, the Government of India had set up a Debt Consolidation and Relief Facility and enactment of Fiscal Responsibility and Budget Management.

**Thirteenth Finance Commission :** The Thirteenth Finance Commission (FC XIII) to made recommendations regarding devolution of central tax receipts between union and the state government, grants-in-aid to states, and measures needed to augment the Consolidated Fund of a State to supplement the resources of the Panchayats and Municipalities for the period 2010-15. Dr. Vijay Kalkar was the Chairman.

**Main Recommendations :**

- The share of states in the net proceeds of shareable central taxes was raised from 30.5 percent to 32 percent. However, majority of the states had sought an increase from 30.5 percent share in net tax revenues of centre during of FC XII to 50 percent during FC XIII. The total grant of Rs. 3185.81 billion to be provided by the centre to the state governments during the FC XII award period was more than twice the amount recommended by the FC XI.
- Upto 2.5 percent of divisible pool to be transferred as grants to local bodies.
- Total transfers to states on the revenue account be capped at 39.5 percent of the centre's gross revenue receipts.
- Combined debt of centre and states should be capped at 68 percent of GDP by March 2015.
- Single rate for goods and services proposed.
- The Government must cut its fiscal deficit to 3.1 percent of the GDP by the end of fiscal year 2013-2014 and eliminate its revenue deficit in 2014-15.
- Both the centre and the states should conclude a Grand Bargain to implement the Model Goods and Services Tax (GST). The Central GST portion would subsume the following taxes : (i) Central excise duty and additional excise duties, (ii) service tax, (iii) additional Customs duty, (iv)

All surcharges and cesses. The state GST portion would subsume value added tax, central sales tax, entry tax, luxury tax, entertainment tax, stamp duty, taxes on vehicles etc.

**Fourteenth Finance Commission (FFC):** The 14th FC under the chairmanship of former RBI Governor Y.V. Reddy submitted its report in Dec. 31, 2014 for the period 2015-16 to 2020-21. Apart from its recommendations on the sharing of tax proceeds between the Centre and the States, the Commission has suggested steps for pricing of public utilities such as electricity and water and also looked into issues like disinvestment, GST compensation, Sale of non-priority PSUs and subsidies. The Commission has reviewed the State finances, deficit and debt levels of the Centre and States of India.

**The major recommendations are as follows:**

> The FFC raised the share of the states in the central divisible pool by 10 percentage points from the 32 percent to 42 percent which is the biggest ever increase in vertical tax devolution.

> The FFC proposed a new horizontal formula for the distribution of the states, share in divisible pool among the states.

There are changes both in the variables as well as the weights assigned to them. The FFC has incorporated two new variables: 2011 population and forest cover while it excluded fiscal discipline variable. In the case of implementation of GST, the revenue compensation for the states should be provided for five years. FFC recommended that 100 percent compensation should be paid to the states in the first three years, 75 percent in the fourth year and 50 percent in the fifth year.

> Reduce fiscal deficit to 3% of GDP by 2016-17 and revenue deficit to zero by 2019-20

> Replace the FRBM Act with a Debt Ceiling and Fiscal Responsibility Legislation.

> Do away with the distinction between special category states for tax devolution purpose, but provide grants to 11 revenue deficit states.

> Do away with plan and non-plan distinction in revenue expenditure of state governments.

The fourteenth FC has considered the whole revenue requirements of the states, both plan and nonplan in its recommendations due to abolition of the planning commission in August 2014.

**INDIAN TAX SYSTEM (SALIENT FEATURES)**

"Taxes are like hails which destroy the crop\_ \_ \_ \_ \_ The best tax system is that which has the least bad economic effects."

Thus tax policy of a country must be very sound and in the context of developing countries like India it must be geared towards accelerating the rate of economic growth. Taxation must raise the level of savings and investible resources. In the words of Dr. Raja J. Chelliah, the best tax system is that which mobilises the existing and potential economic surplus. By existing economic surplus we mean excess of current income from current consumption. If this surplus is not used or channelised for productive investment the tax system must mobilise the same and use it for productive purposes. Potential surplus is the difference between current income and minimum consumption. A sound tax system must also help in increasing the amount of economic surplus. Further, as the economy develops and per capita income increases because of the high MPC, increase in consumption is likely to follow the increase in income. Sound tax system should not allow it to happen as then little will be left for investment. Therefore, the general emphasis in tax system must be curtailing consumption standards. Moreover, whenever savings are promoted through tax system, they should also be diverted in the desired productive channels.

A necessary feature of all developing countries is the increasing inequalities in the distribution of income. The process of changes from the present developed countries from developing to development has resulted into wider inequalities so these countries have seen suffering from growing inequalities. So increasing inequalities are inter-woven with the development process. But excessive inequalities are the potential sources to generate political and social instability. Moreover, they are no longer tolerable in the present democratic world. Therefore, as far as possible a sound tax system must make-up attempt to reduce these inequalities. For this progressive direct tax system may be more appropriate than the indirect taxes which are basically regressive. However, care should be taken that tax rates are not unduly high which discourage the incentives to work, save and invest.

Further, since the development needs of developing countries are insatiable, therefore in these countries even the poorest will have to pay taxes. However, as far as possible, the principle of ability to pay must be observed while collecting taxes from different individuals. A person's ability to pay taxes can be measured in terms of that part of economic surplus accruing to him which he is not utilizing for productive investments. The greater the surplus which a person has above his

minimum necessary requirements, the greater should be his contribution.

Another important objective of a sound tax policy in a developing economy is to check inflationary tendencies. Inflation is inherent in all developing countries. In the initial stage of economic development since large investments are undertaken and there is always a time lag between investment and output, the prices rise in the mean time. It is now generally believed that taxation can play a vital role in checking these inflationary tendencies; particularly if these are of demand pull types. Taxes both direct as well as indirect, by reducing the disposable income can exercise restraints on demand. In the words of Taxation Enquiry Commission (1953-54)

“Taxes that fall directly on the large additional income, and commodity taxes that fall on the increase in general purchasing power resulting from inflation have a significant part to play in anti-inflationary policy.”

Finally, in a sound tax policy no one should feel that he is being discriminated. There should be no tendency for tax evasion. Tax system administration should not unnecessarily harass the honest tax payers.

In the light of above discussion we will now examine the salient features of the Indian tax system. If we carefully study the Indian tax system, the following features will emerge:

### **1. India is a highly taxed nation**

Contrary to common belief, India has emerged as one of the highly taxed nations in the world. Ever since advent of planning we have been imposing new taxes and raising the marginal rates of existing taxes. The rates of existing taxes sometimes have been raised to astronomical figures. For example, in the mid seventies the highest marginal rate of income tax had touched the figure of 97.5 percent. Apart from Central and State taxes which an average Indian has to pay, he has also to feel the pinch of deficit financing. Deficit financing is infact a form of concealed taxation, whereby the government gets hold of the resources by reducing the real income of the people as a consequence of rise in prices, associated with deficit financing. Then sometimes government resorts to compulsory borrowings, another form of concealed taxation. Thus an average Indian has to pay both open and concealed taxes. The latter being mostly unthinkable in other countries. Realising the fact that in India tax burden is high, in the post-90's period, there is trend to lower the highest tax rates both for direct as well as indirect taxes.

### **2. Multiplicity of Taxes**

During the Five Year Plans, taxation in India has been used as one of the main instruments to raise revenue and to achieve the various socio-economic objectives. Now taxes have been imposed and tax rates have been increased to mobilize a large part of the income created as a result of economic development. Tax structure in India has been formulated in such a manner that all relevant ability indices are taxed in so far as direct taxes are concerned. A tax payer has to pay income tax when

he earns income, he has to pay wealth tax if he accumulates income and he has to pay gift tax when he transfers that income to others. If he sells the accumulated wealth he has to pay capital gain tax and if he dies and leaves his accumulated wealth to his heirs, estate duty (abolished in 1986) will have to be paid. During 1957-58 to 1961-62 and 1963-64 to 1965-66, he had also to pay expenditure tax if he spent more than the specified amount. This might appear as taxation with vengeance. In the field of indirect taxes also, duties have been levied on new items and increased on old items so as to tax more heavily those commodities which are consumed by the relatively well-to-do classes.' Taxes on the production of commodities (Union excise duty) as well as on sales or consumption of commodities (Sales tax or value added tax) are imposed. But it is a dichotomy of the Indian tax system that while the former is imposed by the central government, the latter is levied by the State governments. Recently, on the basis of input tax credit method, GST has been levied. It is a comprehensive indirect which has merged various types of taxes into single system of taxation.

### **3. Budgetary Trends-Surpluses or Deficits**

Another note-worthy feature of Indian tax system has been excess of its collections than requirements till mid-seventies. To be specific we had been having surpluses on revenue account and those surpluses were often used to finance capital expenditure. It was only on capital account that our budgets were in deficits. On both the accounts taken together, however, our budgets turn out to be deficits. It may be emphasised that lately even on revenue account our budgets are turning deficits because of the rapid growth of non-plan expenditure. Combined fiscal deficit of states and the centre remained more than 9% during 1990-91 and 2000-01 and it constituted more than 9.4 percent of GDP in 2009-10. but it has been varying between 6 percent to 7 percent since 2012-13

### **4. Complicated Tax Structure:**

As already stated, years after years, we have been imposing new' taxes and raising the rates of existing taxes. Consequently our tax structure has become very complicated. It lacks the canon of simplicity and certainty. In the words of Raja J. Chelliah our knowledge about taxes becomes obsolete with a remarkable speed. On the other hand, our population is illiterate. Majority of the people cannot understand this complicated tax structure. This has led to various malpractices. Tax administration has become dishonest and corrupt. An average tax payer has become victim to the corrupt tax officials who earn huge tax amounts of black money. In fact, even if an honest tax payer wants to pay tax honestly he is not allowed to do so. He is harassed by officials. Most often the tax administration in collusion with the tax payers exploit the government treasury. Various commissions/committees have been appointed to suggest change in our tax structure so as to simplify the same. Taxation Enquiry Commission (1953-54), Kaldor's proposals (1956-57), Bhoothalingam's Committee Report on Direct Tax Reforms (1968), Wanchoo Committee commonly

known as Direct Taxes Enquiry Committee (1972), Raj Committee on Taxation of Agriculture Wealth and Income (1972), Indirect Taxes Committee or Jha Committee Report (1978), Choksi Committee Report (1978), etc., Raja J. Chelliah's Committee (1993) are some of them in this regard. Kelkar Committee on Tax Reforms (2002), suggested various reforms in direct tax and indirect tax system. Kelkar Task Force (2003) suggested a comprehensive Goods and Services Tax (GHST) based on VAT principle. The Empowered Committee (2008) recommended Goods and Services Tax (GST) and it has been implemented in July 2017.

### **5. Inequitable Tax Structure**

Although we impose a large number of taxes yet our tax structure lacks equity. According to Raja J. Chelliah our tax system neither have horizontal equity nor vertical equity. Horizontal equity mean that all tax payers with the same level of income, irrespective of the sources of income, must pay the same amount of taxes. But we know that our agricultural sector pays less taxes than the non-agricultural sector. Persons working in the non-agricultural sector have to pay many direct taxes such as income tax, corporation tax, etc. from which the agricultural sector is exempted. It is true the agriculture sector has to pay land revenue (and in a few states agricultural income tax also) but its share hardly constitutes a fraction of the total tax revenue. Whereas income tax and corporation tax now occupy an important place in our direct tax structure. Further, even in case of indirect taxes agricultural sector pays less taxes because it consumes only those commodities which it produces. Naturally, these commodities do not carry any tax burden.

According to Raja J. Chelliah, even vertical equity is conspicuous by its absence from our tax structure. By vertical equity we mean persons having different levels of income must pay different amounts of taxes, i.e. persons with higher income must pay higher amount of taxes and persons with lower income must pay lower amount of taxes. But this is not the case in India. Here generally tax burden is low for the upper classes and high for the lower classes i.e. tax burden is not positively but inversely related to income. The main reasons for this regressive tax structure are: First, our tax structure is heavily biased in favour of direct taxes which are generally regressive. Secondly, even in case of direct taxes a large number of incentives for tax saving are offered which are generally availed by the richer sections of the society. Thirdly, the incidence of land revenue the only direct tax on the agricultural sector is fixed in amount for per acre of land. Since the per acre amount of land revenue does not increase with the size of holding or income, its burden is felt more by the poor farmers than by the richer farmers.

### **6. Imbalance between Direct and Indirect Taxes**

The main reasons for our inequitable tax structure is preponderance of indirect taxes. It is generally believed that due to illiteracy, small scale of production and lack of trained and efficient tax administration the importance of direct taxes is generally

low in the initial stages of economic development, but as economic development picks up and the society moves to modernity as a result, the ratio of direct taxes to total tax revenue increases. But in India this has happened in the reverse direction. While in 1950-51 the proportions of direct taxes and indirect taxes to total tax revenue were 37 percent and 63 percent respectively, these ratios were 22 percent and 78 percent respectively in 1991-92 and 30 and 69 respectively during 1995-96. Thus during first five decades of planned economic development, India has witnessed a substantial fall in a share of direct taxes. But as a result of tax reforms, the share of direct taxes in total tax revenue of the consolidated government could be increased to 32 percent during 2015-16 and as per Indian Public Finance Statistics Report 2017-18, budgeted estimates reveal that it would be only 33 percent. In developed countries like U.S.A., U.K., Japan, etc. the proportion of direct taxes is much higher. The burden of indirect taxes we know mostly falls on the poor. Consequently, inequality in the distribution of income has increased in India.

It may be mentioned that indirect taxes, which are mostly taxes on commodities, add to inflation. As prices increase the amount of indirect taxes such as Union excise duty, sales tax, value added tax etc., also increases. This further increases the prices of the commodities and thus we are caught in a vicious circle.

#### **7. Our tax structure is not anti-inflationary**

As already stated in the introduction, inflation is in-built in the development process of a developing economy. An ideal tax structure must cure this evil. Unfortunately, because of the preponderance of indirect taxes, our tax structure is not anti-inflationary. Rather, it has added fuel to the fire of inflation.

#### **8. Imbalance in the Tax Sources of States Vs. Union Government**

Another unhealthy feature of our tax system is the increasing dependence of the states on the Union Government for their resources requirements. There is no denying the fact that of all the federal countries in the world (U.S.A., Australia, Canada, etc.) Indian federal system is the best in the sense that there is a clearcut division of resources between the Centre and the States. But while demarcating these resources our constitution makers appeared to have forgotten about the development needs of the States. While the states have to incur increasing amount of expenditure on such items as education, medical and public health, agriculture, industry, etc. but they do not have enough resources. The elastic sources of revenue like income tax, corporation tax, capital gains tax, custom duties, excise duty on production, etc., are in the hands of the Centre. Consequently, the States have to look towards the centre for more and more resources. The Central government often discriminates one state from the other while of allocating funds.

#### **9. Apathy of the State Governments to exploit the Tax Resources:**

The fault does not lie entirely with the Centre. Even the State governments do not exploit the tax resources assigned to them in the Constitution. For example, taxes on

agricultural income or any other tax on the agricultural sector lie in the sphere of the State governments. But the State governments do not levy these taxes due to the fear of losing votes. During elections, on the other hand, even many tax concessions are announced so as to brighten the prospects of winning elections. Thus, the state governments too are to be blamed of the imbalance in the tax sources of the States Vs. Union governments.

#### **10. Lack of Economy**

Another drawback of the Indian tax system is that it lacks economy. The per unit cost of tax collection has been rising very fast. The rise in cost has been particularly, witnessed in case of administrative expenditure, which has been rising due to ever increasing price level.

#### **11. Buoyant but lacks Elasticity**

As a large chunk of National Income (i.e. income from the agriculture sector) lies outside the scope of income tax, our tax system lacks elasticity. Land revenue (which is the only tax borne by the agricultural sector directly) being fixed in amount per unit of land does not respond to income.

Likewise the burden of indirect taxes, which forms about 67 or 68 percent of the tax revenue of the general government falls heavily on the low income people and as their income rises relative tax contribution falls.

However, it must be emphasised that though our tax system lacks elasticity but it is buoyant in nature. By buoyancy we mean the responsiveness of tax revenue to National Income; including the change occurred due to change in tax rate and coverage. But by elasticity of tax we mean the responsiveness of tax revenue to National Income keeping the tax structure and coverage as constants. What has been happening in India is the increase in tax revenue due to ever widening tax coverage and astronomical tax rates.

#### **12. Tax Evasion:**

As already stated the government has been under the illusion that higher taxes mean more resources. But this has proved to be a myth. Higher taxes coupled with many factors such as corrupt tax administration, multiplicity of taxes, etc., have generated a considerable amount of tax evasion in our tax system. Tax evasion is an illegal attempt to reduce the tax payable by deliberately under reporting or not reporting taxable incomes or concealing one's true state of affairs from tax authorities.

It is different from tax avoidance. Tax avoidance means preventing or reducing one's tax liability through manipulations within the framework of existing tax legislation. It is almost impossible to ascertain correctly the extent of tax evasion in the country because of numerous difficulties involved in the process. Any such estimate can only be a guess and would involve an element of subjectivity. However, the Wanchoo Committee estimated that on account of income tax alone, the tax evasion was to the extent of Rs.470 crore during 1968-69. Even in case of indirect taxes, tax evasion widely prevails. Business men keep two different types of account books one for the tax officials

and one for self use. National Institute of Public Finance and Policy (NIPFP) in a report estimated black money to GDP in the range of 15 to 18 percent in 1975-76, and 18 to 21 percent in 1980-81 and 19 to 21 percent in 1983-84. Although many times concessions/ tax amnesties like Voluntary Deposit Scheme, 1991, Gold Bond Scheme 1993 and Voluntary Disclosure Income Scheme 1997, are announced to unearth the black money, which is mostly due to tax evasion, this menace of tax evasion is on the rise. In 1999, Raja J. Chelliah estimated that black money had reached the level of 25-30 per cent of National Income. A Committee headed by the Chairman of CBDT was constituted on 27th May 2011 for examining ways to strengthen laws to curb the generation of black money in the country. In the year 2011-12, a larger number of 3706 surveys were conducted and Rs.6572 crore undisclosed income was detected. A number of steps recently have been taken in order to create an appropriate legislative framework for preventing the generation of black money and for its detection. Strengthening Direct Taxes provisions (Finance Act 2011, Finance Bill 2012), is one of the important measures. Constitution of SC monitored SIT on black money; renegotiation of tax treaties. the black money and Imposition of Tax Act 2015 for foreign black money; Income Declaration Scheme 2016 for unearthing black money, penalty on Real Estate Transactions undertaken in cash exceeding Rs. 20000 are the measures recently taken against black money. The two largest notes of Rs 500 and Rs. 1000 together comprising 86 percent of all cash in circulation were demonetised on Nov. 2016 in order to reduce corruption as a long term benefit which could eventually lead to higher GDP growth, better tax compliance and greater tax revenues.

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**MAJOR TAXES IN INDIA**

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**Structure of the Lesson**

- I. Introduction**
- II. Objectives**
- III. Indian Tax System**
- IV. Analysis of Major Taxes**
- V. Summary**
- VI. Glossary**
- VII. Questions for your Practice**
- VIII. References**

**I. Introduction**

In this lesson students will know the details, including theoretical part, about some important taxes which are levied in India. Therefore, under different tax heads, the economic implications of these taxes have been explained.

**II. Objectives**

The main objective of the lesson is to acquaint students about some of the important taxes which are presently levied in India, viz., income tax, corporation tax, central excise duties, custom duties, value added tax, service tax, etc. Since India has moved towards VAT system and its next attempt is to have an integrated tax on goods and services (GST) on VAT-principle, therefore these two taxes viz., VAT and Service Tax have been discussed both from the theoretical and empirical points of view.

**III. Indian Tax System**

The Constitution of India provides for a financial division of resources to meet the requirement of political and administrative federalism among the Union Government, State Governments and Local Self-Governments. Indian taxation system is also federal in nature. There is clear cut division of taxes to be levied between the Centre and the States. With the 73<sup>rd</sup> and 74<sup>th</sup> Constitutional Amendments even the local bodies i.e., Panchayati Raj Institutions (PRIs) and Urban Local Bodies (ULBs) have been assigned independent functions.

The Constitution of India demarcated the taxation sphere of the Central and State Governments in the following ways. First, taxes which can exclusively be levied, collected and retained by the States are sales and purchase tax, (now called VAT), all

taxes pertaining to agricultural sector (including tax on agricultural income), excise duty on intoxicants, taxes on goods, and passengers carried by road or on inland waterways, taxes on vehicles, animals or boats, tolls, taxes on luxuries including taxes on entertainments, amusements, betting and gambling, taxes on profession, trades callings and employments, stamp duty and registration fee, taxes on the consumption or sale of electricity, etc. In the second category comes those taxes and duties which are levied by the Centre but collected and appropriated by the States, e.g., stamp duties and duties of excise on medicinal and toilet preparations which are mentioned in the Central List. In the third category comes taxes which are levied and collected by the Centre but assigned to the states such as duties in respect of succession to property other than agricultural land, estate duty in respect of property other than agricultural land, terminal taxes on goods and passengers carried by railway, sea or air, taxes on railway fare and freights, etc. Fourthly comes taxes which are levied and collected by the Centre but are to be shared between the Centre and States. Income tax and Union excise duties are important such examples, though distribution of the latter is not mandatory. But since recommendations of the Tenth Finance Commission, the Centre now has been sharing the proceeds from all taxes (except surcharges and special levies) with the States. In the fifth category those taxes fall which are only levied and collected by the Centre but whose entire proceed the Central government can retain for its use, e.g. corporation tax, custom duties, etc. It is worth mentioning here that what ever is not mentioned in the Constitution belongs to the Centre. It is under this clause that service tax is levied.

#### IV. Analysis of Major Taxes in India

Of the various taxes mentioned above following are the important ones:

1. Income Tax
2. Corporation Tax
3. Central Excise Duties
4. Custom Duties
5. Value Added Tax
6. Service Tax
7. GST

#### Income Tax

Direct taxes like income tax and corporation tax are more equitable. They can be related to ability to pay and can take into account differences in the circumstances of tax payers. Income is a very satisfactory index to measure ability. If ability to pay taxes varies with the size of income it also varies with the demand made on that income. Therefore, while levying tax on income, allowances may be made for the number of dependents in a family, number of old or chronically sick persons in the family, etc. Further distinction should also be made between earned and unearned income. Out of earned income, one has to save as it may cease due to old age, ill health, or death. Obviously ability to pay tax is less in case of earned income than in case of unearned income.

Under a progressive tax system there is a strong case for treating the separate

incomes of husband and wife as a joint income. The Indian income tax makes a fine compromise on this point. A married working woman is taxed separately on her wage or salary, but her investment income is treated as joint income unless it can be proved that it is related to savings from her salary or money received from her parents.

Since taxes on income are general it is not possible to evade them through a change of occupation. Therefore, enterprises or occupations which involve less risks are preferred to those carrying high risks. Thus, income tax “reduces the reward of risk-taking without reducing risks.”

Taxes also reduce the capacity to save. Persons with higher income possess greater capacity to save. Sometimes they are completely exempted from tax to the extent of income they save. However, care should be taken that since ability to save increases with increase in income, tax concessions on savings should be progressively reduced. Otherwise, problem of inequality in the distribution of income will be compounded. Sometimes, to minimize the adverse effect of income tax on savings, it has been suggested that the government may resort to expenditure tax in place of income tax (Nicholas Kaldor).

Since minimum income is required for subsistence a minimum exemption limit from income taxes is generally prescribed. Further, income tax is imposed either on ‘step’ basis or on ‘slab’ basis. Under the ‘step’ system income groups were taxed at different rates so that the rate of tax rose sharply from one group to the next higher group. The slab system is more equitable. Under it the total income is divided into different slabs and each slab is taxed at a different rate. The highest slab is taxed at the maximum rate. This is based on the assumption that the law of diminishing marginal utility applies to money and that the earlier units of income are more valuable even to rich persons. Income tax is a tax on income of individuals, firms etc. other than companies under the Income Tax Act, 1961.

The income tax rates for below 60 years of age for financial Year 2017-2018 and assesment year 2018-19 are as follows :

<b>Income slab</b>	<b>Tax rate</b>
Up to Rs. 2.5 lacs	Nil (No tax/exempt)
Rs. 2.5 lacs to 5 lacs	5 percent
Rs. 5 lacs to 10 lacs	Rs. 25000+20 percent of the amount by which the total income exceeds Rs. 5 lacs.
Above Rs. 10 lacs	Rs. 1,25,000+30 percent of the amount by which the total income exceeds Rs. 10,00,000.

Surcharge: 10% of income tax, where total income exceeds Rs. 50 lakh upto Rs. 1crore.

Surcharge: 15% of income tax, where the total income exceeds Rs.1 crore.

Cess: 3% on total income tax + surcharge.

For senior citizens of the age 60 to 80 exemption is upto Rs. 3 lacs and for 80 or more is upto Rs. 5 lacs Surcharge and cess are the same for the first category.

### **Corporation Tax**

Corporation tax is imposed on the income of companies (corporations), both Indian and foreign. In India trading expenses and depreciations are allowed to be deducted from the gross incomes of the companies. Under the Indian Income Tax Act the Company was supposed to have paid this tax on the distributed profits on behalf of its shareholders, who were given credit for the tax in their assessment. This procedure was given up in the budget of 1959-60 when the scheme of reform in company taxation was introduced. A corporation tax was then levied on the same income and neither was allowed as rebate in assessing the other. Since the reforms in company taxation, both the taxes paid by companies are called a corporation tax.

It must, however be noted that unlike personal income tax, corporation tax carries different rates for registered firms, corporate societies, companies and local authorities.

#### **Self-Check Exercise - I**

- 1 Explain the imposition of income tax and corporation tax in India.**

### **Central Excise Duties**

Union excise duties or central excise duties are levied at the stage of production. An excise duty raises the price and tends to discourage consumption and therefore, the production of the taxed commodity. Excise duties have, therefore, been strongly criticized when they are levied on protected commodities, even if accompanied by an equivalent increase in import duties. In order that excise duty may be productive they have to be levied on commodities of general consumption. But a commodity of general consumption is usually a necessity. If they are levied on necessities they impinge on the poor. The choice of commodities to levy excise duties is therefore, often difficult in a poor country like India, where the capacity of the poor to pay taxes is limited.

As per the Constitution of India, the provision has been made under articles 269 and 270, for levying Central excise duty on all commodities produced anywhere in India, except alcoholic liquors and opium, narcotics and narcotic drugs (which are within the purview of the state governments). Further a part of the net proceeds from Central excise duties is distributed among the States.

Further excise duties are levied both on advalorem and specific rates. Advalorem duties are preferable to specific duties as they ensure buoyancy in revenue on account of increase in prices, and the Jha Committee Report recommended switching over to advalorem rates for a number of commodities. It also recommended that where specific rates are retained, the same should be revised every year taking

into account the price and inflation. Centre lived GST in July 2017 and exise duty along with many other taxes is subsumed GST.

- (i) Norminal basic exise duty on petroleum crude and various tobacco products and
- (ii) Special additional exise dity is lived on petrol ad diesel.

### Custom Duties

Import duties and export duties are usually called custom duties or simply customs. Even when duties on imports or exports are levied for revenue purposes they tend to be protective. This advantage and their productivity and convenience make them a popular source of revenue. Their yield, however is extremely susceptible to movements in the international sphere. In times of war, the revenue from their source suddenly contract. So also in a depression, when domestic producers demand is restriction on imports. In India the history of protective duties dates back to the policy of 'discriminating protection' which was adopted as a result of the recommendations of the Indian Fiscal Commission.

It sometimes believed that through customs the foreigners are made to contribute to the revenues of the home government. But this is not always correct. In general, price in the international marked is determined by the world demand and supply. And one country cannot secure higher prices by levying export duties, or purchase foreign products at lower prices through imposing duties.

Import duties on luxury articles are generally higher than those on capital goods or raw materials. On the whole our duties have been, hitherto, much higher than those prevailing in other countries, sometimes touching an astronomical figure, as high as 300 per cent. However, with the globalisation drive import duties have been slashed and peak import duty (in 2007-08) was 10 per cent.

Presently some export duties are levied on a large number of commodities like tea, jute, cigarette, textiles, manganese ore, hides and skins, raw wool, etc. Apart from earning revenue, the objective of levying export duties are to achieve stability of domestic prices in the internal market, to reduce export of raw material, to face foreign competition, etc.

#### Self-Check Exercise - II

- 1 **Explain the importance of custom duties and union excise duties in the present scenario.**

### Value Added Tax

Considering Value to be Added Tax (VAT) to be a panacea for all the ills, from which our commodity taxation had been suffering was implemented on 1 April 2005.

Before the imposition of VAT the system of domestic trade taxation was **complex** and characterized by **multiplicity and non-uniformity** of rates, **increasing compliance cost both on the part of the Government and the tax** payers, and

**cascading** effect of taxes which discourages specialisation.

In the pursuit of resource mobilization both the Centre and States have been taxing different commodities at different rates and even the same commodity at different stages. Then different States try to tax the citizens of other States by exporting tax burden by taxing commodities on the origin principle, which create **artificial channel of distribution** by sending goods through consignments. Often different States offer large number of incentives to woo the producers and in the process those States, themselves suffer because the moment incentives are withdrawn production is stopped and the allocation of resources again follow the natural economic principles. The present system of trade taxation has also led to an **increasing compliance cost** for the tax payers particularly in respect of inter-State trade and even for the Government it does not achieve the principle of economy. However, the greatest drawback of the present system of commodity taxation is that it has cascading effect, i.e., tax on tax, which discourages specialisation by promoting vertical integration of industries and firms. Even the recent Report of the **Task Force on Implementation of the Fiscal Responsibility and Budget Management Act, 2003** commonly known as, Kelkar Committee Report II, has remarked that “ These difficulties have led to substantial distortions .... and the choice of production technologies and inputs in the country has become distorted.”

It is not for the first time that these and many other problems have been realized. In the past also many attempts have been made from time to time to rectify these ill-effects. As far back as in 1957 the additional excise duties on three key commodities, viz., tobacco, sugar and textiles were imposed in lieu of the sales tax on the pretext of simplicity and uniformity. Later on in 1986 Mr. V.P. Singh, the then Finance Minister tried to extend this list, but he had to retreat before the stiff opposition of the State Governments. However he succeeded in introducing modified form of VAT (MODVAT) by granting credit on certain central excises already paid on inputs so as to avoid the cascading effect of central excise duty.

VAT is preferred because unlike excise duty it is levied not only at production stage but also at different stages of value addition. In the modern days when many durable commodities are sold for prices which include service, warranty and installation charges, VAT would fetch considerably more revenue than general sales tax. Having uniform rate structure throughout the country, it would encourage the free flow of internal and inter-State trade, besides promoting optimum allocation of resources and plugging the artificial channels of distribution of goods which are a consequence of non-uniform commodity taxation. Having no cascading effect of taxes it would improve the production efficiency. Presently more than 100 countries in the world have opted for VAT and European Economic Committee members are the fore-runners.

But before we go for full fledged VAT system in India, comprising both states and the centre, many issues have to be debated. First of all, it must be borne in mind that there are a number of alternatives to arrive at the value added component

on which the tax is to be levied. And each alternative has its own administrative and economic implications.

Almost there are eight forms of VAT. Briefly it is a tax levied on business on the value they add to their purchases of raw materials, and goods and services, (leaving aside the problem of capital and stocks). We can represent this by writing value added (V/A), as total output (O) minus total input (I), i.e.,

$$V/A = O - I \quad (i)$$

Clearly, the difference between output and the inputs of raw materials, energy interest and rent paid, etc., is the payments of wage & salaries (W), and the residual, which we call profit (P), i.e.,

$$O - I = W + P \quad (ii)$$

$$\text{Or } V/A = O - I = W + P \quad (iii)$$

That is value added can be derived either by subtraction (O-I) or by addition (W+P). These forms of calculations sometime are called subtractive method and additive method.

The tax rate (t) on value added i.e. t (V/A) can then be applied in atleast four ways.

$$\text{ie. } t (V/A) = t (W + P) \quad (a)$$

$$t (V/A) = tW + tP \quad (b)$$

$$t (V/A) = t (O - I) \quad (c)$$

$$t (V/A) = tO - tI \quad (d)$$

The last one (d) is the most common method used. It is also called (sometimes) the credit method because from the final amount of tax on output, credit is given for the already paid taxes on input. MODVAT or CENVAT is based on this principle. According to this method gross tax liability ( of business) is calculated by applying the pertinent statutory rate to total sales or output or turnover. From this figure, the amount of tax already paid on the purchase of inputs or intermediate goods is deducted.

Coming back to 'a-d', though they appear mathematically identical, i.e. (a) = (b) and (c)=(d), yet administratively they are not. Take for example the case of (c) & (d) ; while in (d) indirect method called invoice method is used to work out the tax liability, in (c) tax is applied directly to the component of (V/A).

The following Table will explain the distinction between addition and subtraction methods:

Distinction between addition and subtraction methods:

	Price (Rs.) excluding	VAT Rate	VAT Paid (Rs.)	Price including tax (Rs.)
<b>Input</b>				
Raw Materials.	100	20%	20	120
Energy, etc.	100	20%	20	120

<b>Total Input</b>	200		40	240
<b>Value Added</b> (Wages and Profit)	100	20%	20	120
<b>Output</b>	300	20%	60	360

The above Table shows that the tax liability by additive method  $t$  (W+P) or subtractive method  $t$  (O-I) and by commonly used invoice or credit method (tO-tI) would be the same, i.e., Rs. 20. But the most serious problem arises when VAT is imposed on price of inputs which may include some element of tax. For example, if VAT on various farm products (floor, bread, biscuits, etc) made from wheat which includes market fee, rural development charges, etc, is imposed, then the effective rate would be different from and higher than the nominal rate (20 per cent). Amongst the EEC members France has adopted this method. Thus the above mentioned four forms of VAT (a-d) would give birth to eight forms of VAT.

It may be added that there is no difference of opinion insofar as the subtractive method is concerned and this may be the reason for its wide spread acceptability. The only variation is whether to adopt direct approach, i.e.,  $t$  (O-I) or indirect approach, i.e., tO-tI. But while calculating the VAT liability via, additive procedure, some fiscal experts prefer to treat sum of the firm's payments to the factors of production used in producing the goods. Under this scheme VAT rate is applied to the firms costs in terms of wages, interest, rent and profits.

#### **Self-Check Exercise - II**

- 1 Explain the different forms in which VAT can be levied.**

Now coming to the *various issues which* need to be debated in the Indian context. Apart from the form of VAT in a federal set-up like ours where lies its place? Should it be a Centre's subject? is an important issue to be discussed. States would not agree to this proposal, as this will deprive them of their legitimate power . If it were a States' subject, it would lead to the similar problems which we have been facing now. It has no place in the concurrent list because the same commodity/ service cannot be taxed twice. Then another problem which agriculturally dominated States would be facing is that here value addition component is very small. Therefore, the imposition of VAT would mean an immediate fall in their revenue. Who will compensate such States? Whereas coastal States, would gain if import duty is replaced by VAT,

Then there may be a large number of small-scale producers in the un-organised sector who may not be approachable for the levy of VAT. For such producers and the agricultural sector some countries like Canada has found a solution where VAT is accompanied by last stage sales tax.

The most important thing to remember is that VAT means there is only one tax on different stages of the production, transaction and distribution of goods. In the Indian federal set-up there is a clear-cut division of tax items between the Centre and the States. While commodity taxes like union excise duty (at the production or manufacturing stage) and import or export duty are levied by the Centre, a large number of taxes at the distribution/sale, and entry, stages of the commodity are levied by the States. With effect from 1994, the Centre has also introduced tax on services which has widened its net to cover nearly 100 services. Besides, the inter-State trade is governed by the uniform central sales tax. Thus, there is plethora of taxes on goods and services, which have to be abolished and replaced by VAT. Besides, there is jurisdictional problem, ie, constitutional bottlenecks, of dividing these taxes between the Centre and the States.

Realising the constitutional bottleneck, the Union government in 1986 introduced MODVAT (later on called Cen-VAT), whereby the credit was given for already paid union excise duty on selected intermediate goods while calculating the total excise burden of final output. The Centre persuaded the States to make a beginning with the introduction of State-VAT in lieu of sales tax, with effect from 1 April 2005.

Then it is the problem of integration of goods tax with service tax which is becoming the major source of revenue. The proposed dual model of Cen-VAT and State-VAT would keep out the taxation of services. Thus, cascading effect of taxation would continue to operate. A way out has been suggested by the **Task Force on Implementation of the Fiscal Responsibility and Budget Management Act**, commonly known as Kelkar Committee Report II. The Task Force recommended that both the Central Government and the State Governments should come to an agreement in respect of a comprehensive tax on goods and services. There should be a “ concurrent but independent jurisdiction over common or almost common tax bases comprehensively extending over all goods and services and in both cases going up to the final consumer” .

However, the proposal of the Task force has been criticised on two accounts. First of all, the integration of taxes on goods and services (GST) and its enactment both by the Centre and the States assumes that the States would give up their taxation powers in exchange of taxing services. Secondly, there would be an agreement on the part of all the States to have a uniform rate of taxation. Otherwise, the enactment of

different rates by different States, though within the suggested rate structure, would effect our domestic trade with all the ills from which it is suffering now. Then there is problem of double taxation.

It may be concluded that VAT has certain inherent advantages. In the changed domestic and global economic scenario, countries have to adopt it sooner or later. Let the Centre continue to levy VAT up to the production base and manufacturing stage and the States at subsequent stages. States must agree to adopt a uniform VAT policy so that the allocation of resources throughout the country is optimum. All the taxes including service tax have to be abolished. Since, this was step towards a complete switchover to full fledged imposition of Goods and Services Tax (GST).

**Service Tax**

The service sector is important for accelerating the growth process in the economy as it helps agriculture and industry. 'Services' constitute a very heterogeneous spectrum of economic activities. Today services cover wide range of activities such as management, banking, insurance, hospitality, administration, communication, entertainment, wholesale distribution, and retailing including R and D (Research and Development) activities. Service sector is now occupying an important stage of the economy so much so that in the contemporary world, development of service sector has become synonymous with the advancement of the economy.

Broadly defined, the service sector includes all economic activities whose output is not a physical product. This sector encompasses the major areas of trade, finance, insurance, communications, public utilities, transportation, government administration, healthcare, education, business accountants, consultants and personal service. There are three sectors in an economy, viz. Primary sector, Secondary sector and Tertiary sector or Service sector. Primary sector includes agriculture, forestry and fisheries. Secondary sector includes mining, manufacturing and electric supply and construction. Tertiary sector or Service sector covers trade, transport, communication, finance, real estate and community, social and personal services.

Economists say that as the economy develops, the share of primary sector in GDP declines and that of secondary and tertiary sector increases. The growth of service sector and its contribution to income and employment generation are indicators of economic development.

**International Comparison (1991 and 2011)**

Country	Share of Different Sectors in GDP (%)					
	Agriculture		Manufacturing		Services	
	1991	2017	1991	2017	1991	2017
India	31	15	19	23	40	54
China	27	8	38	40	31	45
Indonesia	22	14	20	41	38	45
Malaysia	21	9	19	38	44	53
Mexico	9	4	23	34	61	62
Brazil	10	6	26	21	51	73
United States	2	0.9	17	19.1	69	80
Japan	3	1.1	28	20.1	56	68.7

Table gives a cross-section view of the countries to reflect the level of development. It depicts the sectoral shares in GDP. It shows clearly that as income rises, the share of agriculture declines, as income increases further, the share of manufacturing sector increases at a lesser rate while that of services increases rapidly.

**Shares of Different Sectors in GDP in India**

YEAR	PRIMARY	SECONDARY	TERTIARY/SERVICES SECTOR
1950-51	55.80	15.20	29.00
1960-61	45.80	20.70	33.50
1970-71	44.50	23.60	31.90
1980-81	38.10	25.90	36.00
1990-91	30.90	30.00	39.10
1999-00	23.50	27.40	49.10
2010-11	22.26	27.25	50.49
2018-19	18	27	55

**Source :** Government of India, Economic Survey: Various Issues

The service sector in the Indian economy accounted for 29 per cent of the GDP in 1950-51. This share increased to around 32 per cent in 1970-71 and to 36 per cent in 1980-81. This was as high as nearly 55 per cent in 2018-2019. The primary sector accounted for around 56 per cent of the GDP in 1950-51. This share decreased to

44.5 per cent in 1970-71 and 38.10 per cent in 1980-81. This was 23.5 per cent in 1999-2000 and declined to 18 percent. The secondary sector accounted for around 15 per cent of GDP in 1950-51. This share increased to 23.60 per cent in 1970-71 and to around 27 per cent in 1980-81. It became nearer to 27 per cent in since 1999-2000. This means that the service sector has been the major beneficiary from the falling share of the agricultural sector.

The service sector as a whole has been growing at more than 7-8 per cent a year since the nineties. What is more important is the fact that where as the primary and secondary sectors witnessed a lower growth rate than the overall growth rate, the service sector always outshined the national average growth rate. However, this was never visualized by our Constitution framers and policy makers with the result that tax on services does not find any place in the Constitution of India. And any tax, which has not been mentioned in the Constitution belongs to the Union government.

From a modest beginning in 1994-95, service tax has grown into a significant source of revenue, with Rs. 14,200 crore realised in 2004-05. It was reached at Rs.167969 crore in 2014-15 and constituted 13 per cent of total tax revenue of the union government. A part of the budgeted growth is attributable to the 2-percentage point increase in the rate of tax. Continuing with the practice of bringing additional services in to the tax net, the Budget for 2005-06 added the following 9 items to the list of taxable services: transport of goods through pipeline or other conduit; site preparation and clearance, excavation, earth moving and demolition services other than those provided to agriculture, irrigation and watershed development; dredging services of rivers, ports, harbours, backwaters and map making other than by government departments; cleaning services other than in relation to agriculture, horticulture, animal husbandry or dairying; membership of clubs or association; packaging services; mailing list compilation and mailing; and construction of residential complexes having more than twelve residential units of apartments together with common areas and other apartments.

Besides, the scope of existing services has also been expanded. These were: commercial or industrial construction service to include renovation of such building or civil structure, post construction completion and finishing services for such building or civil structure construction, repair, alteration, renovation or restoration of pipeline or conductions; erection, commissioning or installation services to include specified installation services; maintenance or repair services to include maintenance or management of immovable properties, maintenance or repair including reconditioning or restoration undertaken as part of any contract or agreement; broadcasting services to include charges recovered by broadcasting agencies from multi-system operator and provision of direct to home signals to the customers; sound recording to include recording of sound on any media and includes post production services such as sound mixing or re-mixing; video-tape production to include recording of any programme, event or

function on any media and includes post production services; taxable services provided by authorized service station to include reconditioning or restoration of motor-cars, two wheeled and light motor vehicles, beauty parlours service to include all services provided by beauty parlours, manpower recruitment service to include supply of manpower, temporary or otherwise; franchisee service to cover all agreements by which, the franchisor grants representational rights to franchise to sell or manufacture goods or provide services identified with the franchisor; business auxiliary service to include production or processing off goods for or on behalf of the client; and outdoor catering service, to include catering from a place or premises provided, by way of tenancy or otherwise by the person receiving such services. Such measures at widening the tax base and procedures that facilitate voluntary compliance, going forward, would make service tax a buoyant source of revenue commensurate with its high share in GDP. The Budget 2006-07 besides increasing in the rate of service tax from 10 to 12 per cent, brought additional services under the tax net. These services are: ATM operations, maintenance and management, registrars, share transfer agents and bankers to an issue, safe of space or time of other than in the print media, for advertisements, sponsorships of events, other than sports events by companies, international air travel excluding economy class passengers, container services on rail excluding the railway freight charges; business support services, auctioneering; recovery agents, ship management services, travel on cruise ships and public relation management services. In the years 2009-10 and 2010-11, 2011-12, the rate of service tax was retained at 10 percent. But in 2012-13, the rate has been increased from 10 percent to 12 percent. There has been increase in the number of services over the years. During 2011-12 the total number of services under the tax-net were 119. As against the usual practice of expanding the list of services, the Budget for 2012-13 introduced a 'negative list' approach effective from 1 July, 2012.

However, considering the growing importance of service tax, the states have started demanding the right to tax the sale and purchase of services just like the sale and purchase of goods. Therefore, as an integrated tax on goods and services in the country as a whole, called Goods and Services Tax (GST) has been imposed.

#### **7. GST:**

GST stands for Good and Services Tax, which is implemented in India on 1st July 2017, is the biggest indirect tax reform since independence. It is a consumption based indirect tax. Being a consolidated tax, it has replaced the previous structure of multiple taxes levied by the state and central government. It developed developed on the notion of 'one market one nation one tax' in order to convert India into a unified market. It has subsumed 17 central and state levies. Central taxes like Central excise duty, service tax, additional custom duty, special additional duty of customs are merged under GST. State taxes like VAT, Central sales tax, Octroi and entry tax, purchase tax, tax on lottery, betting and gambling and entertainment tax are merged under it. Export

duty, basic custom duty, toll tax, stamp duty, property tax, road and passenger tax, electricity duty remain out of GST ambit. GST has lower rate of taxes and lesser slabs. In 2017-18, there were four tax rate slabs of GST: 5%,12%, 18% and 28%. On few essential goods and services,there is no tax.

**GST Tax Slabs and Few Examples in India.**

	<b>Goods</b>	<b>Services</b>
No Tax	Milk, Fruits, Vegetables etc.	All hotels that carry a tariff below Rs. 1000
5%	Sugar, tea etc.	AC and Non AC restaurants etc.
12%	Ghee, Butter, Almonds etc.	Business class Air tickets etc.
18%	Biscuits, Cakes, Pasta etc.	IT services, telecom services etc.
28%	Paint, Automobiles, Washing Machines etc.	Five Star hotels etc.

There is a separate tax for precious metals. Education and health care are exempted from the tax regime. The majority of the goods and services form the part of the 18% tax slab. GST is levied on supply of goods or services. Input tax credit facility is provided on all procurements. Compensation for loss of revenue to states for five years will be provided.

**Benefits of GST**

It is expected that GST would result into fewer tax filings, transparent rules for manufacturers and traders, lesser tax burden on consumers and more revenue to the government.

**Other benefits expected from GST are:**

1. Overall reduction in prices for consumers.
2. Reduction in multiplicity of taxes, cascading and double taxation.
3. Uniform rate of tax and common national market.
4. Comprehensive tax base and decline in black transactions.
5. Non interfering electronic tax compliance system.
6. Free flow of goods and services.
7. Transparency in taxation system.
8. Simple tax regime as there is no need to make a distinction between goods and services.
9. The system will make Indian products competitive in the demestic and international market.
10. Easier to administer: Before the implementation of GST, the power to levy tax on sale of goods was under the purview of the state government. In case of inter-state sales, the centre had the power to levy a tax, but the tax was collected and retained enirely by the originating states. As for services, it was the centre alone that was empowered to levy services tax. Since a large number of central and state taxes are amalgamated into the single tax i.e. GST, so it is easier to

administer.

#### V. Summary

It may be summarized that income tax, corporation tax, union excise duties, custom duties, value added tax (Cen-VAT and State- VAT) and service tax are some of the important taxes levied in the country. Of the commodity taxes VAT replaced the old taxes. While State-VAT has replaced the state general sales or purchase tax and Cen-VAT was imposed in place of union excise duties on some commodities. In view of the unprecedented growth of service sector, the Centre has started levying service tax w.e.f. 1994. The country has implemented an integrated goods and services tax, called GST from July 2017.

#### VI. Glossary

**Ad valorem tax:** A tax that is calculated as percentage of the price or value of the item subject to tax.

**Capital gains tax:** A tax on the gains from the sale and purchase of an assets, i.e., the price at which an asset was purchased and the price at which it was sold, of course making allowance for the expected inflation.

**Cascading of tax:** A tax that is imposed at more than one stage of production and distribution. It is a tax on tax.

**Custom duties:** Taxes imposed by the Union government on import (called import duties) and export (called export duties).

**Depreciation:** Type of allowances made that permits the reduction in the value of an asset to take place for tax purposes over the asset's useful life-time.

**Estate duty/ tax:** A tax on the transfer of accumulated wealth to one's heirs at the time of death, also known as inheritance tax.

**Excise duty/tax:** Tax imposed on a specific item or service, such as gasoline, tobacco, or alcohol. Union excise duty is imposed by the Centre on the production of specific items.

**Exemptions in income tax:** An amount per person or dependent that is subtracted from adjusted gross income before computing tax liability.

**Fiscal or Financial Year:** Period covered by a government's budget, i.e., 1 April to 31 March.

**Inheritance tax:** A tax imposed on the receipt of wealth from a deceased person. It is also known as estate duty.

**Lump-sum tax:** The fixed amount of tax, irrespective of the level of production, sales, or income.

**Marginal tax rate:** The additional percent of tax on an additional increase in income.

**Poll tax:** A per capita or per-household tax at a flat rate, simple to administer

but highly regressive.

**Proportional tax:** A tax that takes a fixed percentage of one's income

**Retail sales tax:** A broad-based consumption tax levied at different stages of sale or only at final sale of goods and services by most of the States.

**Specific tax:** A tax that is expressed as a functions of some physical measure of quantity ( litre, kg., dozens) rather than as a percent of the price.

**Tax credits:** Reductions in tax liability for specific kinds of expenditure or circumstances, e.g., in case of VAT, tax credit is given for the tax already paid.

**Value-Added tax:** A tax collected at every stage of value added (production and distribution) with a credit for taxes already paid at the preceding stages so that no cascading of taxes occur.

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#### VII. Important Questions for your Practice

##### Long Question

- 1 Explain the applicability and importance of VAT in the Indian context.
- 2 Should India move towards an integrated G.S.T. How should it be levied in a federal set-up where there is division of resources between Centre and States.

##### Short Questions

- 1 Why are custom duties on the decline?
- 2 What are the merits of VAT system?
- 3 Write a short note on GST.
- 4 Explain the present income tax structure.

**PUBLIC DEBT AND PUBLIC EXPENDITURE IN INDIA**

- I. Introduction**
- II. Meaning of Public Debt**
- III. Public Debt before Independence of India**
- IV. Public Debt since Independence**
- V. Classification of Public Debt**
- VI. Growth of Public Debt in India**
- VII. State Government Debt**
- VIII. Importance of Public Debt**
- IX. Burden of Public Debt**
- X. Conclusion**

**I. Introduction**

In modern times, the public debt is considered as a kind of income of the state. It is a method by which government can make the public finance available for public service. Like all other countries, in India also the government has been borrowing funds under Article 292 of the Constitution, upon the security of the Consolidated Fund of India. The Govt. can borrow within such limits as may be fixed by the parliament. Actually no such statutory limit has yet been fixed. Similarly, a state government may borrow within such limits as may be fixed by the legislature and no state government can raise any loan without the consent of the government of India. Public debt in India has been growing rapidly since independence. Large fiscal deficits and deficits in revenue budgets are held to be mainly responsible for the growing public borrowings. While a part of the capital expenditure has always been financed out of borrowing, revenue deficits signifying financing of current expenditure also by borrowing have become a significant feature of the Central budgets since 1979-80.

Initially the Government borrowed mainly for financing development schemes. What is really alarming now is that the Central Government is forced to borrow even to meet its current revenue expenditure. In other words, Government has been living beyond its means.

**II. Meaning of Public Debt**

Public debt may be defined to include internal and external debt of central government, state governments and union territory governments, local

authorities (municipalities, trusts, etc.) and public undertakings. Many of these agencies borrow from each other. Government can borrow internally as well as from external sources. Internal sources refer to sources within the country such as individuals, financial institutions, commercial banking institutions etc. External sources refer to loans from friendly countries, foreign governments and the financial institutions such as the International Monetary Fund (I.M.F.), the International Bank for Reconstruction and Development (I.B.R.D.) and the International Development Association (I.D.A.) etc. In India, public debt refers to borrowings by the Union Government which includes such items as market loans, special bearer bonds, treasury bills and special loans and securities issued by the Reserve Bank. It also includes the outstanding external debt.

### **III. Public Debt before Independence of India**

In fact in India, it was the East India Company that seriously started borrowing funds from internal and external sources as the company was involved in frequent wars which were responsible for deficit budget.

The public debt in the country upto the First World War was mainly for unproductive purpose. Later, the Government of India followed a policy of converting the unproductive debt into productive debt. Budget surpluses were utilised for paying off the unproductive debt. At the same time, an equivalent amount was borrowed for productive purposes such as construction of irrigation works, rail transport etc. During world depression of thirties, the government began to have deficit budgets, as a result unproductive debt began to increase once again.

During the Second World war, a number of loans were raised to finance war efforts. The total interest bearing obligation of the Government of India was Rs. 1205.76 crores at the end of 1938-39, it rose to Rs. 2038.39 crores in 1945-46. Towards the end of the war, the loans were raised to nullify the inflation caused due to war. In March 1947, the total public debt of undivided India amounted to Rs. 2381.39 crores.

### **IV. Public Debt since Independence**

Since Independence, the importance of public debt has been increasing considerably in India in view of not only the large developmental programmes undertaken by the government but also to meet current account expenditure. In a poor country the amount of revenue that can be raised through taxation is limited. Heavy taxation also produces injurious effects on enterprise and effort. Since ours is a mixed economy and the role of the private sector is still dominant. It is essential to keep taxation within the limits of tolerance. Hence, public debt has to be used to meet financial requirements of the government.

Thus, the Government of India has tried to borrow the maximum amount consistent with the availability of funds and the needs to maintain stability in the prices of government securities till 1951, the government followed a cheap money policy (about 3 per cent rate of interest). The Bank Rate was raised, for the first time to 3.5 per cent in November, 1951 and was further raised in 1957, 1963, 1964, 1965 and 1971. The Bank Rate was 6 percent per annum in 2005. The weighted average interest rate on market borrowings increased from 7 per cent in 1980-81 to peak level of 13.8 per cent in 1995-96. Thus, with the Government borrowings at market determined rates of interest the average cost of borrowing considerably increased in the 1990s. In 2001-02, the weighted average interest rate on market borrowings came down to 9.4 per cent. The average cost of borrowings has been varying between 7 percent to 8 percent since 2004-05.

#### V. Classification of Public Debt

The public debt system of the Government of India can be mainly divided into three categories. They are internal debt, external debt and other outstanding liabilities.

**1. Internal Debt :** Internal debt constitutes borrowing through market loans, treasury bills, special securities issued to R.B.I., special bearer bonds and other bonds and securities issued to international financial institutions. Thus the categories which constitute the internal debt are discussed below :

- (a) **Permanent Debt :** They may also be called term loans, dated loans, or funded loans. Permanent loans have a maturity of 12 months or more at the time of issue.
- (b) **Floating Debt :** A floating debt is purely temporary in nature and it is repayable within twelve months of the date of issue. It includes such loans as the ways and means advances from the Reserve Bank of India, Treasury bills, Special Floating Loans, and Treasury Deposit Receipts.
  - (i) *Ways and means advances :* They are taken from the Reserve Bank of India and for meeting temporary requirements of finance. However, since 1983 the government had not availed of this facility.
  - (ii) *Treasury bills :* Currently floating debt exists only in the form of Treasury bills. Usually, they are for three or six months.
  - (iii) *Special Floating Loans :* It includes adhoc treasury bills issued by the government to RBI, State Governments, State Bank of India and other parties of the public and are non-negotiable. It also

includes non-interest bearing securities issued to IBRD, IMF, IDA and ADB. (International Bank for Reconstruction and Development, International Monetary Fund, International Development Association, Asian Development Bank.)

**2. External Debt :** External debt includes loans taken by the Government of India against the non-negotiable, non-interest bearing securities issued to external financial institutions like IMF, IBRD, IDA etc. The government has also raised loans from other friendly countries in addition to the loans borrowed from above noted international institutions, loans from foreign countries and prominent among whom are West Germany and Japan. By far the largest share of India's external debt is provided by the United States of America. External debt also includes loans taken from the IMF, Trust Fund. The sum of internal and external debt is officially called public debt.

**3. Other Outstanding Liabilities :** Other liabilities include borrowing through small savings, provident funds, and reserve funds and deposits like income tax, deposits of local funds and civil deposits.

#### **VI. Growth of Public Debt in India**

Public debt as a ratio of gross domestic product generally increases during abnormal circumstances mainly during war and during the conditions like famine and political instability and either declines/stabilises during normal conditions. If public debt GDP ratio grows in abnormal conditions and stabilises during normal conditions then public debt may be regarded a temporary disequilibrium in government finance. The current world wide debt upsurge is, however, not a consequence of war or other abnormal conditions. Except a few countries, it has grown during more or less normal circumstances. In most countries it has shown an upward trend and India is no exception.

But in our country public debt has risen particularly since the start of economic planning when public borrowing came to be used as an important fiscal tool for raising resources to finance development schemes. In terms of the level of outstanding debt India ranked as eighth in 2002 from among the top fifteen debtor countries of the world. The rank was third from this aspect in 1991. Table 1 shows overall picture of Central Govt.'s debt in India. The total outstanding liabilities of the Central Government of India amounted to Rs. 2865 crores in 1950-51. Since then it has risen progressively.

**Table—1**  
**Over all Picture of Central Government's Debt (Rs. Crore)**

Item	1950-51	1960-61	1970-71	1980-81	1990-91	2000-01	2010-11	2017-18(R.E)
a. Internal Debt	2022	3978	7062	30864	154004	803698	2675823	6424917
b. Other Internal Liabilities	811	1575	5066	17587	129029	298898	579249	1564628
II. External Debt	32	1001	6485	11298	31525	65945	278877	8239635
III.Total Outstanding Liabilities	2865	6544	19193	59749	314558	1168541	3533950	252090

**Source :** (i) Indian Economic Statistics, Ministry of Finance, Dec., 1988.  
(ii) Various Issues of Economic Survey

The amount of total liabilities of the Central government of India as a result of public borrowing was estimated of the order of Rs.314558 crores at the end of March 1991. Thus the nominal value of total liabilities had increased more than 100 times between 1950-51 to 1990-91. The figure reached at a mounting level of Rs.1168541 crore in 2000-01 reached at Rs. 3533950 crores in 2010-11 and at Rs. 8239635 crore in 2017-18. The total internal public debt of India increased 362 times in fifty years from Rs.2022 crores in 1950-51 to Rs.803698 crores in 2000-01. It reached to the level of more than Rs. twenty six lakh crores during 2010-11 and to the level of Rs. 64.2 lakh crore in 2017-18. The total external public debt of India increased from Rs.32 crores in 1950-51 to Rs.31525 crores in 1990-91. The burden of external debt reached at Rs.65945 crores in 2000-01 and reached at Rs. 278877 crores in 2010-11 and at Rs. 2.5 lakh crore in 2017-18. The relative magnitude of the public debt and the national income should be taken into consideration for assessing the burden of public indebtedness. The Table 2 indicates the position of public debt in relation to GDP.

**Table—2**  
**Outstanding Liabilities of the Central Government as percentage of GDP**

Item	1980-81	1990-91	2000-01	2010-11	2017-18(R.E)
I. Internal Liabilities	35.6	49.8	52.8	48.5	47.6
a. Internal Debt	22.7	27.1	38.5	34.2	38.3
b. Other Internal Liabilities	12.9	22.7	14.3	14.3	9.3
II. External Debt	8.3	5.5	3.2	2.0	1.5
III. Total Liabilities	43.9	55.3	55.9	50.5	49.1

The outstanding liabilities of the central government were 55.3 percent of GDP in 1990-91, 55.9 percent in 2000-01, and declined to 50.5 percent of GDP in 2010-11 and further to 49 percent in 2017-18. While internal liabilities increased from 35.6 percent of GDP in 1980-81 to 48.5.1% of GDP in 2010-11 and to 48 percent in 2014-15, there was a decline in the external liabilities from 8.3 percent to 1.5 percent of GDP in the same period. Some public finance experts opine that the debt GDP ratio is less as compared to the position of debt liabilities of some other countries. A study by Jonathan Levin in 1993-94 pointed out that, the domestic public debt as a percent of GDP was 78 percent in U.K., 68.7 percent in Ireland, 41.2 percent in United States, 40 percent in Australia while it was only 26.2 percent in India. The rate of growth of public debt is higher than the rate of growth of GDP, in India, the increasing trend in internal liabilities is a matter of serious concern. This has not only raised the interest burden, but also raised concerns about the sustainability of the growing internal debt. Hence the burden of public debt is said to be very heavy.

#### **VII. State Government Debt**

The states can not meet their entire fiscal needs merely by tax revenue. They have to tap other sources of revenue as well. Loan finance is one of the sources on which the state governments have depended heavily. Since independence the total debt of the state governments has risen rapidly. But the scope of raising the debt by state government is limited, the State Government can borrow only within its territory. No State Government can borrow without the permission of the Central government. In this regard, Reserve Bank of India acts as a sole banker and agent for the debt operations of the state Government. Debt is defined to include internal debt, loans and advances from the centre and all public accounts liabilities such as provident funds, reserve funds and deposits. The major heads of debt are : (i) Internal Debt, (ii) Loans and advances from the Central Government and (iii) Provident Funds. It was hardly Rs.118 crore in March, 1948 but increased continuously and reached to Rs.2739 crore in 1961 and jumped to Rs.8749 crore in 1971. In 1981, the total debt was Rs.24002, in 1991 the debt was Rs.107860 crore but the amount of debt reached to the level of Rs. 594147 crore in 2001 and Rs. 1993940 crore in 2012 and Rs. 4292495 crore in 2018. The state governments have mainly relied on the Central government loans instead of market loans upto 2001, but thereafter, the picture is quite different.

The debt position of the states has been shown in Table 3.

**Table 3 : Liability position of State Governments****(in Rs. Crore)**

	2006-07	2011-12	2018
I. Public Debt (a to f)	910510 (73.3)	1466430 (73.5)	3119303 (72.7)
(a) Market Loans	242780 (19.6)	741150 (37.2)	2206106 (51.4)
(b) Borrowings from NSSF	425310 (34.3)	486420 (24.4)	475675 (11.1)
(c) Loans and Advances from Centre	146650 (11.8)	143550 (7.2)	162011 (3.8)
(d) Loans from banks and other financial institutions	69340 (5.6)	83080 (4.2)	211944 (4.9)
(e) Power Bonds	26050 (2.1)	11540 (0.6)	-
(f) Ways and Means Advances & others	380 (0.0)	690 (0.0)	1775 (0.0)
II. Other Liabilities (a to d)	331070 (26.7)	527510 (26.5)	
(a) State Provident Funds	149920 (12.1)	253450 (12.7)	440484 (10.3)
(b) Reserve Funds	78760 (6.3)	91940 (4.6)	176143 (4.1)
(c) Deposits and Advances	101070 (8.1)	178980 (9.0)	390465 (9.1)
(d) Contingency Fund	1320 (0.1)	3140 (0.2)	4087 (0.1)
III. Total Liabilities	1241580	1993940	4292495
I + II	(100.0)	(100.0)	(100)

**Note:** Figures in Brackets represent percentages of the total

Over the years the share of Central loans in the states debt has declined. One important reason is debt swap scheme initiated in 2002-03 under which the states have been permitted to prepay their high cost loans to the Centre

through additional market borrowings and a portion of small savings receipts. Loans from centre have declined from 11.8 percent to 7.2 percent and then to 3.8 percent during the period from 2006-07 to 2011-12 and 2018.

The increase in the total debt of the state governments has also been mainly due to heavy capital expenditure in development schemes. But it is pointed out that states resources had failed to keep pace with their growing needs on revenue account and most of the state governments were dependent upon the centre's transfers to cope with their revenue requirements. The need to codify the loans was recognised by the successive Finance Commissions. The peculiarity of the state debt is that the share of internal debt has tended to increase and reached to 72 percent, but that of Provident Funds has declined.

Thus, the State Governments find their investment income and tax resources insufficient to meet their needs. Since they are not able to borrow enough from the market, their dependence upon resource transfers from the Centre remained over 60 percent till 1991 but now it is very less.

### **VIII. Importance of Public Debt**

Public debt has assumed great significance in every modern economy and particularly in developing economies. In countries like India, one of the prime tasks of the Government is to stimulate the growth of the economy with stability. For the purpose of rapid development of the economy certain minimum conditions are essential such as abundant natural resources, skilled and trained manpower and dedicated civil services etc. At the same time, a fundamental factor is the capital formation or resources mobilisation. A growing public debt also provides the people opportunities to hold their wealth safe and stable earning assets, namely government bonds. This encourages savings and investment in the economy. In case of India, it has helped the industrial and agricultural development of the country and also the development of means of transport and communication. In this way it has helped in raising the national income and output. But providing an opportunity for the relatively well-to-do sections of society to invest their funds in the government securities, it has encouraged thrift and promoted savings. It has also helped in widening of the employment opportunities for the people. The public debt has helped our country to modernise her army and strengthen her defence. The external loans also have facilitated the availability of various kinds of machinery and equipment, skill and know-how. Foreign loans have also been used for electricity generation, railways, roads, fertilizers etc.

**IX. Burden of Public Debt**

Let us now look that whether the Government of India's Debt is burdensome or not. At first we shall compare internal and external debt.

The growth of external debt is a more serious matter than internal debt. Internal debt can be deferred or even repudiated at some political cost. The same for external debt would not only affect country's international relations but also may upset further inflow of capital and disturb trade flows. Secondly, internal debt can be mobilised i.e. repaid by printing money, the external debt cannot. Thirdly, internal debt can be repaid by privatisation. But selling of assets to foreigners to repay external debt may jeopardise country's sovereignty. Finally and most important, internal debt can be serviced if the return on capital invested is more than cost of borrowing and amortisation. In the case of external debt, however, this will not be adequate. In addition it has to be ensured that foreign exchange earnings (through exports or otherwise) should rise in relation to external debt servicing.

In order to assess the burden of public debt in any country, we have first to see the nature of the debt, whether it is productive or unproductive and whether it is internal or external. If the funds have been borrowed for productive purposes, it can not mean any burden. The unproductive loans definitely mean a burden. In the case of internal debt, the annual interest paid by the Government in lieu of debt increased is known as debt servicing burden. The interest cost for internal debt of Government of India has risen over the years.

The annual interest paid by the government in lieu of debt incurred is known as servicing debt burden. The ratio of interest payments to national income, increased from 0.35% 1950-51 to 2.34% in 1980-81. It was estimated at 7.36% in 1990-91 and 11% in 1993-94, As a proportion of GDP, interest payments fell in the post FRBM period and have continued to be low at around 3.1 percent in recent years.

Interest payment is also non-plan expenditure which should be paid out of current revenue. More than one fifth of government of India's Tax revenue now is spent as interest-payment of past debt and less than fourth fifth is available for all other non-plan expenditures like Defence, civilian administration, subsidy etc. What is worse is that as interest burden increases, the government is forced to resort to deficit financing in current account which, in turn, raises debt and further-interest payment. There has been a substantial decline in interest rates in our country. This has brought down the cost of debt servicing on fresh loans.

The external debt, on the other hand, involves both a money burden and real burden on the community. The repayment of loan and the payment of interest would involve a drain of wealth out of the country. The interest payments of foreign debt also create the problem of foreign exchange. The debt service payment is increasing very rapidly.

However, the burden of public debt should not be considered only by taking into account the interest burden charges. Much depends on how the funds mobilised through public debt are used. If public debt is wasted on unproductive activities it becomes a dead weight. On the other hand, if the resources raised by the government through borrowings are spent on developmental activities, they raise the productive capacity of the country, and are thus not burdensome. In India, a considerable amount of external loans has been used for general purposes and maintenance of imports. As a result, our productive capacity has not increased as much as was possible with the appropriate utilisation of external resources. Under some circumstances, the burden of servicing has become very heavy, and at times one feels that it would have been better had the country not gone for foreign loans. While considering the internal public debt of the Government of India we find that a substantial part of this has been used for productive purposes.

A significant proportion of this was utilised for the development of industry and minerals, power projects, railways, postal and telecommunication services etc. This indicates that public debt has not always been wasted on unproductive activities. It has definitely contributed to the growth potential of the country.

## **II - Public Expenditure in India**

Public expenditure is an essential part of the welfare states. Since independence, public expenditure has gained a significant place in the country to pull the economy out of turmoils. Public expenditure regulates the economic activities and helps to attain the long-run and short-run objectives of economic development. This is the reason that there is a continuous upward trend in both revenue and expenditure of the Indian Government. Actually, the government has been widening its activities in social and economic spheres to bring economic growth as early as possible. Even in the post reform period public expenditure on social sector has been on the rise. Government can not leave the provisions like education, medical and public health, social security and poverty alleviation programmes in the hands of the private sector. Broadly, public expenditure in India can be classified into two parts:

- A. Expenditure on Revenue Account.
- B. Expenditure on Capital Account.

**A. Expenditure on Revenue Account of the Central Government:**

Generally, major heads of revenue expenditure are being shown in the budget of the Central Government as defence services, civil services, grants-in-aid, interest payments, fiscal services and economic services. Revenue expenditure are generally met out of the revenue receipts of the government like tax revenue and non-tax sources. However, since eighties an unhealthy trend has developed whereby even capital account receipts like borrowings and disinvestment proceeds are used for meeting revenue expenditure needs.

- (a) **Defence Expenditure:** According to Adam Smith, “ Defence is more important than opulence.” Therefore, it is the most important item in the case of every government. For national wealth to save against external aggression and internal disorder, defence expenditure is must. It is constantly increasing as the modern warfare instruments are becoming costlier and more sophisticated.
- (b) **Civil Services:** Before independence, the aim of the government was the maintenance of law and order whereas after independence, it was sought to change from “law and order state” to “welfare state”. Thus, expenditure in this sector has been rising continuously. It includes expenditure on general administration, justice, election and on the Office of Comptroller and Auditor General. Besides, other types of expenditure are on Secretariat and attached offices of Ministries of Education and Social Welfare, Health and Family Welfare, etc.
- (c) **Grants-in-Aid to States:** State governments cannot work properly without the help of central government as the expenditures of state governments have gone up because of the factor that most of the welfare programmes fall within the jurisdiction of the states, whereas all elastic and growing sources of revenue rest with the Central government.
- (d) **Interest Payments:** This includes expenditure on the payment of interest on the outstanding debt. In the recent years, these payments have shown the rising trend on account of the fact that the government borrowed extensively in the past, which has necessitated the 'interest payment' now.
- (e) **Fiscal Services :** Collection of taxes and other duties also entail huge public expenditure. Directorate of Customs and Excise Duties, and Directorate of Income Tax are the two major departments of the central government involved in the collection of taxes.
- (f) **Economic Services:** After Independence, it has become the foremost need of the government to spend on economic services to develop the economy at a rapid speed. In includes the expenditure on Department of Commerce, Shipping and Transport, Irrigation, Energy, Chemicals and Fertiliser, Company Affairs and Electronics, Industry, Agriculture, etc.

**(B) Expenditure on Capital Account:**

Expenditure on capital account consists of expenditure for the acquisition of assets such as land, buildings, machinery, equipments, etc. Expenditure on renewals and repairs of machinery, increase in food grain stocks and inventories, commuted pensions, etc. also constitute capital account expenditure.

Here, we must remember that the division of public expenditure into revenue and capital account expenditure is known as economic classification. As already mentioned this economic classification can be converted into economic and functional expenditure depending upon the break-up of total expenditure into various functions like civil, fiscal, economic, etc., performed by the Government.

A brief break-up of the data on total public expenditure into revenue account and capital account is given in the following table :

It may also be mentioned that public expenditure in India sometimes is also divided into plan and non-plan expenditure or/and development and non-developmental expenditure.

Control of Public Expenditure: In order to reduce non-development expenditure the government has setup Expenditure Reforms Commission (2000).

**X. Conclusion**

Finally, it can be said that the under-developed country will have to depend upon internal borrowings, foreign assistance and external borrowing. Domestic resources like taxation and borrowing have their own constraints and under such circumstances, deficit financing can also not be recommended because of its inflationary effects. So, foreign loans can act as an important instrument for raising additional financing within a short span of time. This assistance can help in achieving the objective of developing economy i.e. economic stability and growth if the funds are properly utilised for productive purposes.

**FISCAL CRISIS AND FISCAL SECTOR REFORMS IN INDIA**

- I. Introduction.**
- II. Objectives**
- III. Fiscal Sector Reforms in India.**
- IV. Summary**
- V. Technical Terms.**
- VI. Questions for your Practice**

**I. Introduction :**

The Indian economy was in deep crisis in the first year of the 1990s. Such a situation arose 'mainly' because throughout the 1980s the growth of current expenditure outstripped the growth of current revenues, leading to widening of the governments' budgetary deficit on revenue account and growing recourse to borrowing from domestic and external sources to finance this deficit as well as the expenditure on capital account. Besides it, there were less profit making public enterprises and less return (only 2 per cent) on public sector investment. This resulted in creating several adverse situations for the economy. A reversal of the trend of fiscal expansion was essential to restore macro-economic balance in the economy. Since then, successive Governments have carried forward the economic reforms covering industrial sector, financial sector, fiscal sector and external sector.

Fiscal sector reform was the key component of the economic reform programme started by the government after the 1991 economic crisis. Fiscal sector reforms targeted reforms in taxation structure, public expenditure pattern, public borrowing process, reduction in fiscal deficit, reforms in public sector undertakings of the central government and fiscal sector reform initiatives of state governments.

**II. Objectives :** After having gone through this lesson, you would be able to :

- highlight the importance of fiscal sector reforms as the most critical part of the economic reform package of India.
- identify changes in tax measures taken by the central government of India.
- understand the reforms in public expenditure pattern and public borrowing process.
- explain the need of reforms in public sector undertakings.
- know the initiatives taken by state governments on the fiscal front.

**III. Fiscal Crisis and Fiscal Sector Reforms in India :**

The need for comprehensive fiscal reforms in India was apparent during the

1980s as there was rapid deterioration in Government finances. During this period, the expenditure of the Central Government rose much faster than its revenue leading to a steep rise in the Centre's fiscal deficit to GDP ratio. For the States, given the restrictions on their capacity to borrow, the increase in expenditure was relatively aligned to the corresponding rise in revenue. Consequently, the rise in the fiscal deficit of States was relatively less steep. The sharp increase in revenue deficit of the Central Government and the emergence of such deficits in State finances were the most worrisome developments in the fiscal scenario during the 1980s. As a result there was a sharp increase in the outstanding liabilities of both Central and State Governments as ratio to GDP from 41.6 per cent and 16.7 per cent respectively in 1980-81 to 55.3 per cent and 19.4 per cent respectively in 1990-91. This mounting stock of public debt led to burgeoning of interest payments on the Governments' revenue account deficit and pre-empting an increasing fraction of expenditure for meeting such debt service obligations. The widening gap between the income and expenditure of the Central Government in the federal structure resulted in a widening gap between the income and expenditure of the State Governments and ultimately of the economy as whole. This was reflected through grave balance of payment crisis and macro economic imbalances in 1990-91. The performance on the fiscal sector front has also become very grim. The gross fiscal deficit (of the consolidated general government) stood at 9 per cent of the gross domestic product (GDP) and the revenue deficit on the current account at 4.19 per cent in 1990-91. (See Table-1) Besides it, there were budgetary deficits, less profit making enterprises, less return (only 2 per cent) on public sector investment, widespread evasion and avoidance of taxes, complex tax administration procedures and practices and build up of external debt.

Thus in order to improve the situation of the economy, the economic reform package was introduced in 1991-92, though it was first commenced on a modest scale in 1985. The need of fiscal restructuring programme, can be well defined from the Report of the Eleventh Finance Commission, " The structure of public finance in an economy is defined by the level and composition of expenditure of the government (current and capital) and the instruments relied upon to finance them, viz. the tax and non-tax revenue sources and borrowing. The excess of government expenditure over current revenues and other non debt receipts gets reflected in fiscal deficits financed either by way of borrowings from internal and external sources or through seignorage, that is money printing. If expenditure persistently exceeds revenues, fiscal deficit, to the extent, it is not covered by seignorage steadily adds to outstanding debt, resulting in increasing interest payments. Unless met with larger revenue receipts, this gives rise to a self perpetuation spiral of debt and deficit . In the absence of commensurate increase in domestic savings, deficits in government budgets tend to spill over to the external

sector in the form of current account deficit leading to adverse balance of payments. This, in turn, jeopardise the macro economic stability, judged by stability of prices consistent with growth at attainable full employment levels. The solvency of the economy also comes under doubt. A restructuring programme is called for to steer public finances away from such a spiral towards sustainable levels of debt and deficit.”

**Table-1**

Deficit of the Central Government, States and Consolidated General Government of India as percent of GDP

Year	Central Government		States		Consolidated General Government	
	GFD	RD	GFD	RD	GFD	RD
1980-81	5.71	0.52	2.55	-0.60	7.42	0.08
1990-91	6.42	3.17	3.17	0.87	9.10	4.04
2000-01	5.46	3.91	3.90	2.30	8.95	6.22
2010-11	4.80	3.24	2.03	0.21	6.80	3.03
2014-15	4.05	2.86	2.9	0.10	6.95	2.96
2017-18	3.5	2.6	3.0	0.4	6.4	2.9

**Note**

1. GFD (Gross fiscal deficit) is aggregate disbursements (net of debt repayments) less revenue receipts, non-debt capital receipts and recovery of loans and advances.
2. RD (Revenue Deficit) is the difference between revenue expenditure and revenue receipts.
3. Negative (-) sign indicates surplus in deficit indicators.
4. Economy's fiscal position is shown through consolidated general government.

**Source :** Various issues of (i) Handbook of Statistics on the Indian Economy and (ii) Indian Public Finance Statistics, 2015-16

The fiscal sector reform was the most critical part of this economic reform package. Fiscal sector reforms include:

1. Tax Reform measures.
2. Reforms in Governments' Borrowing Process.
3. Expenditure Reforms.
4. Public sector restructuring.
5. Fiscal Reform Initiatives of the State governments.

**Self Check Exercise - 1**

**1. "Fiscal Sector Reform is the key component of the economic reform programme." Comment.**

**Ans** .....

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**1. Tax Reforms :** Tax GDP ratio was certainly growing and quite creditable even before fiscal crisis. The problem however was that the share of direct taxes stagnated during that period; it started out at 2.47 per cent of GDP in 1950-51 but after touching 3.26 per cent in 1963-64, it had gone down to 2.49 per cent of GDP in 1989-90. Thus, the entire increase in the tax GDP ratio was brought about by exploiting indirect taxes. In 1950-51, direct taxes accounted for a sizable 36.8 per cent of total tax collections. However, their proportionate share declined over the years and it was as low as 19.1 percent in 1990-91, making the tax system lopsided and inequitable. Restructuring of the tax system thus constituted a major component of fiscal reforms with the aim of augmenting revenues and removing anomalies in the tax structure.

In the process of fiscal reforms the Government of India constituted a Tax Reform Committee 1991 (TRC, Chairman: Raja J. Chelliah) to recommend a comprehensive reform of both direct and indirect tax laws. The committee submitted its report in three installments: -

- (i) An Interim Report in December 1991,
- (ii) Final Report Part I in August 1992 and
- (iii) Final Report Part II in January 1993.

The main objectives have been simplification of the tax system, rationalisation of the tax system, rationalisation of tax rates, fairness in tax system, improvement in tax administration and above all providing a growth promoting tax structure.

**The key tax reform measures include :**

**In the case of Direct taxes :**

Moderation of tax rate;  
Widening of tax base; and  
Strengthening of enforcement.

These reports contained recommendations for restructuring and rationalisation of personal income tax, corporate income tax, wealth tax, tax administration and enforcement machinery. Since then, the reform agenda targeted at

- (i) reduction in direct tax rates coupled with attempts to broaden the tax base.
- (ii) lowering personal income rates to even below Tax Reforms Committee's target.

- (iii) reduction of maximum marginal income tax rates from 60 percent in 1980-81 to the level of 33 per cent.
- (iv) lowered corporate tax on both domestic companies and foreign companies.
- (v) abolition of dividend taxation at the individual income tax level. (vi) abolition of interest tax on Government securities deducted at source.

**In the case of Indirect taxes :**

The reforms were also made on the indirect taxation front.

Reduction in multiplicity of rates;

Rationalisation of the rate structure;

Drastic reduction in the scope for discretionary changes;

Uniform floor rates for sales tax by the States. The TRC has also recommended extension of the excise system to certain services. Reform of the custom tariff was high on the agenda of the Tax Reforms Committee (TRC, 1991). Since then, many reforms are introduced which are:

- implementation of Modified Value Added Tax (MODVAT);
- transformation of multiple rate excise structure into a single rate Central Value Added Tax (CENVAT);
- reduction of highest tariff rates;
- The introduction and expansion of service tax is also one of the most important taxation reform.
- A movement from excise duties and sales taxes to VAT at both the central and state levels to avoid cascading and very high and variable effective rates of indirect taxation.

The Tax Reform Committee had also recommended minimising exemptions and concessions, development of modern computerised information systems and improvements in administration and enforcement.

Now national level Goods and Services tax (GST) is a part of the major tax reforms. In the Union Budget for the year 2006-07, this tax was proposed to introduce in April 1, 2010 but it has been implemented in July,2017 (Detailed explanation on GST in L. No. 9). In most of the countries of the world, goods and services attract the same rate of tax. that is the foundation of a GST, a comprehensive indirect tax levy on manufacture, sale and consumption of goods and services at a national level.

**Self Check Exercise - 2**

**Q.2 What is the role of tax reforms in the process of fiscal reforms?**

**Ans** .....

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**2. Reforms in Governments Borrowing Process :**

The mounting stock of public debt led to burgeoning of interest payments on the government's revenue account, consequently exacerbating the problem of revenue account deficits and pre-empting an increasing fraction of expenditure for meeting such debt service obligation.

The significant changes in the process of Central government borrowings to meet the budgetary deficits and temporary mismatches have been part of the fiscal sector reforms.

Major reforms on this front are :

- Switch over to borrowings by government at market related interest rates;
- abolition of the system of automatic monetization of the budget rates;
- implementation of a new system of ways and means advances.
- developing as well as deepening government securities market.
- Debt Swap Scheme was started by Eleventh Finance Commission.

**3. Expenditure Reforms :**

Since 1980's the public expenditure has been rising much faster than public revenue leading to a steep rise in the fiscal deficit to GDP ratio. The situation worsened in 1990. Fiscal reform programme thus alongwith tax reforms and other measures targetted expenditure pruning. Successive Central Government budgets in the 1990s contemplated a host of measures to curb built growth in expenditure and to bring about structural changes in the composition of expenditure. To carry the process of reducing the growth in non-developmental expenditure, the government has set up an Expenditure Reforms Commission in Feb; 2000). The commission has already submitted to the government a few interim Reports. These expenditure reforms included:

- Subjecting all ongoing schemes to zero base budgeting.
- assessment of manpower requirements of Government departments.
- Review of norms for creation of posts and fresh requitment and introduction of a Voluntary Retirement Scheme (VRS) for surplus staff.
- With a view to promoting transparency and curbing growth of contingent Government liabilities, a Gurantee Redemption Fund has been set up as a part of expenditure management strategy.

To improve the situation, the Government further enacted the Fiscal Responsibility and Budget Management Act, 2003, that envisaged the reduction in fiscal deficit by 0.3 percent of GDP and revenue deficit by 0.5 per cent of GDP every year. Recently, New Fiscal Responsibility and Budget Management (FRBM) architire with debt and fiscal deficit path has been implemented

**Self Check Exercise -3****Q3. Mention two reforms in Government's borrowing process.**

**Ans** .....

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**Q4. Write down two reforms in public expenditure pattern.**

**Ans** .....

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**4. Public Sector restructuring/Disinvestment :**

The most serious criticism against the public sector is the low rate of return, a large number of loss-making units and accumulation of losses which have ultimately to be paid out of the general revenues of the state exchequer.

Thus the poor performance (reflected in mounting losses) of some public enterprises upset fiscal balance of the Government because these losses are eventually met from budgetary resources. Lamenting the performance of public sector enterprises, the Eighth Five Year Plan (1992-97) observed, "The public sector, as envisaged by Jawahar Lal Nehru, was to contribute to the growth and development of the nation by providing surplus reinvestible resources. This has not happened as it should have. Many PSUs make substantial losses and have become a continuing drain on the exchequer, absorbing resources which are withdrawn from sectors where these are desperately needed to achieve other development goals. Apart from the fact that the present fiscal situation does not permit any more accumulation of unsustainable losses, there is also the fact that many loss making PSUs do not serve the goal for which they were set up." This situation led towards public sector restructuring.

The strategy towards public sector enterprises reform encompasses a judicious mix of strengthening strategic units, privatising non-strategic ones through gradual disinvestment or strategic sale and devising viable rehabilitation strategies for weak units.

These reforms include:

- Restructuring and revive potentially viable PSUs;
- Close down PSUs which can not be revived.
- Bring down equity in all non-strategic PSUs and
- Fully protect the interests of workers.

The process of fiscal reforms influenced the public sector disinvestment for which Rangarajan Committee on Disinvestment of Public Sector Enterprises Shares in November 1992, and Disinvestment Commission was constituted in August 1996 to advise the government on its long term disinvestment policy with the aim of reduction

of budget deficit. During the reform period thus, there has been a distinct change in the public perception in favour of reducing the size of public sector and improving private participation. For example during 2002-03, some of the equity shares of Hindustan Zinc Limited, Maruti, IPCL, Modern Food Industries Ltd. and Indian Tourism Development Corporation (ten hotels) were disinvested.

In 2017-18, some percentage of government of India's shares of Hindustan Copper Limited, NALCO, HUDCO, Oil India Limited, NTPC and many other companies were disinvested Government garnered Rs. 40230 crore from disinvestment.

<b>Self Check Exercise - 4</b>	
<b>Q.5</b>	<b>What is disinvestment?</b>
<b>Ans</b>	.....
	.....
	.....

**5. Fiscal Reforms Program for the States :**

It actually took long to realize, formulate and initiate fiscal sector reforms at state government levels despite the need for a well synchronised mechanism for reforms.

Several state governments have been facing acute financial problems. In the process of fiscal reform package, Thirteen States have entered into an agreement with the Centre for an appropriate time bound fiscal reform program. These States are Punjab, Rajasthan, Himachal Pradesh, Manipur, Nagaland, Mizoram, Orissa, Sikkim, Uttar Pradesh, Madhya Pradesh, Assam, Andhra Pradesh and Jammu & Kashmir.

**Fiscal Reform measures taken by the States on different fronts**

**(i) Resource Mobilisation Front :**

Recognising the need for strengthening their finances, States have initiated measures towards enhancement of various taxes within their fold, such as, land revenue, vehicle tax, entertainment tax, sales tax, betting tax, electricity duty, tax on trades, professional tax and luxury tax. With a view to harmonising inter-state taxes and ultimately switch over to State level Value Added Tax (VAT), States introduced uniform floor rate during 2000.

- Introduction of VAT in April 2005.
- Set up a Board for Financial and Managerial Restructuring (Maharashtra).

States have also undertaken measures to enhance non-tax revenue by reviewing the royalties payable to them, including those on major and minor minerals, forestry and wild life, revision of medical fees, tuition fees, irrigation water rates and tariffs on urban water supply.

**(ii) Expenditure Management :**

The State Governments' measures to contain expenditure include:

- Setting up of expenditure reforms Committees.
- Reduction in Non-merit subsidies
- Revision of user Charges.
- restrictions on fresh recruitments/creation of new posts.

**(iii) Borrowing Front :**

- Setting up of Consolidated Sinking Fund for retiring public debt (Andhra Pradesh Arunachal Pradesh, Goa, Maharashtra, Mizoram, Nagaland and West Bengal.)
- The setting of ceiling on guarantees to place a cap on contingent liabilities (Gujarat and Karnatka)
- The establishment of guarantee redemption funds (Rajasthan).

**(iv) Public Sector Restructuring :** Several States have shown interest in undertaking a comprehensive review of the functioning of the State Public sector undertakings (SPSUs), including the possibility of closing down of non viable units after providing for suitable safety nets to the employees including VRS. States such as Tamil Nadu, Kerala, Haryana, Karnataka, Himachal Pradesh, Goa and Orissa have encouraged private sector participation in the transport and power generation sectors.

**Major Fiscal Measures Taken by State Governments in 2000**

States	Fiscal Reforms
Andhra Pradesh	To identify performance indicators to assess the quality of expenditure restructuring. To also carry out the exercise of Zero Base Budgeting.
Arunachal Pradesh	Sales tax levied for first time on five items.
Assam	Proposed to introduce Assam Taxation Bill to expedite collections.
Bihar	Proposed to incorporate codes to the sub heads in various accounts to avoid financial irregularities.
Goa	Proposed to Levy entry tax. Also proposed to levy cess on milk for dairy development.
Gujarat	Revision of user Charges/fees by Government departments.
Haryana	Fiscal restructuring measures through downsizing the government.
Himachal Pradesh	White Paper on fiscal position and emerging fiscal scenario prepared.

Karnatka	To ensure that the borrowing programme would be confined to priority sectors and used for capital expenditures. Abolition of 80 per cent of vacant posts in the government.
Kerala	Restructuring of Revenue Department completed. Computerisation of treasuries strengthend.
Madhya Pradesh	Economy in administrative expenditure
Maharashtra	Restriction on filling up of vacancies occurring due to retirement. Borrowing to be used only for investment purposes.
Manipur	Cost based user charges proposed. All schemes subject to Zero Based Budgeting Scrutiny.
Mizoram	Proposal to stop diversion of Plan Fund for meeting non-plan deficit. Reduction of non-plan non-developmental expenditure.
Nagaland	Enforce a 50 per cent cut in plan expenditure, excluding priority areas. Implement the fiscal reform program as incorporated in the MOU with the Government of India.
Orissa	State administration to be pruned by 20 per cent to contain non-plan revenue expenditure. Introduction of a Profession tax
Punjab	Indexation of user charges and fees for transport, power sectors to cost of fuel, salaries, electricity etc. Curb in non-productive expenditure through ban on creation of new posts, redeployment of Surplus staff, ban on purchase of new vehicles and cap on expenditure on petrol, telephones etc.
Sikkim	Revision of user charges, thrust on rightsizing the government and containment of expenditure.
Tamil Nadu	To enhance transparency, information relating to government activities have been put on website.
Tripura	Enhancement in power tariff, leading to 30 per cent increase in revenues of the department.
Uttar Pradesh	A medium-term fiscal policy has been prepared. Simplification in tax procedures.
Delhi	Set up an expenditure review committee to review non-plan expenditure.

**Present Fiscal Scenario :**

The stabilisation measures and economic reform measures taken since 1991 after the economic crisis had an encouraging impact in correcting the fiscal imbalances, particularly during the first two years. The trend, however, could not be maintained. Budgetary imbalances have widened again

**IV. Summary :**

Indian economy was in deep crisis in 1991. The root of the economic crisis can be traceable to the large and persistent fiscal deficit. The Government of India initiated various fiscal measures to reduce the fiscal deficit. Fiscal reform was the key component of the economic reform programme of 1991.

Fiscal reforms targeted reforms in taxation structure including direct taxation and indirect taxation system; expenditure pattern, public borrowing process and reforms in the public sector undertakings of the central government and fiscal reforms undertaken by the state governments. The measures include imposition of fiscal discipline by both Central and State Governments, moderation of tax rates, widening of tax base, rationalisation of excise and custom duties rate structure, implementation of VAT at both the Central and State levels; and GST; Debt swap Scheme; Expenditure Reform Commission; streamlining the working of State and Central public sector enterprises, disinvestment of sick public sector undertakings, rationalisation of tariff structure of State Electricity Boards, and levying user charges etc.

**V. Technical Terms :**

1. **Fiscal System** - refers to the mechanism through which financial resources for the government and its agencies are procured, channeled or raised, and the scale and pattern of allocation of such resources is determined.
2. **Fiscal Crisis** - Fiscal Imbalance. The basic problem of Indian fiscal system is that the government expenditure is rising faster than the government income.
3. **Tax buoyancy** - refers to the change in tax revenue with respect to change in tax base (income). When it is one, tax revenue is buoyant; when more than one it is highly buoyant; and less than one is less buoyant.
4. **Disinvestment** - Selling of Government equity shares to private sector companies. The government decided to disinvest Public Sector enterprises shares in selected units phase by phase.

**VI. Questions for your Practice**

1. Explain in detail major fiscal reforms undertaken in India.
2. Make an assessment of fiscal crisis and fiscal reforms in India.
3. Write short answers of the following :
  - (i) Taxation reforms
  - (ii) Reforms in Public expenditure pattern
  - (iii) Disinvestment.
  - (iv) Fiscal sector initiatives of state govts.

**SUGGESTED QUESTIONS****Section B**

1. Discuss the meaning and theory of federal finance.
2. Explain the problems of Federal Finance.
3. Discuss the chief issues of Federal Finance with particular reference to India.
4. Discuss briefly the evolution of Federal Finance in India independence period.
5. Discuss briefly the Centre-States financial relations in India in pre independence period.
6. What do you know about the financial relations between Union and the State Governments?
7. Why is there a need to transfer resources from Centre to the States? Describe briefly the various channels of such transfers.
8. Give an overall assessment of the working of our Centre-State financial relations and the extent to which they have been a handicap for the States.
9. What do you know about the federal problems in India?
10. Give some suggestions to resolve the conflict between the Centre and States.
11. Discuss the role and functions of Finance Commission in India.
12. Explain the salient features of Indian Tax system.
13. What should be the characteristics of an ideal Tax Structure in a developing country like India?
14. Critically examine the salient features of Indian Tax System.
15. Do you subscribe to the view that agricultural sector in India should be taxed? Give reasons for your answers.
16. Write a detailed note on the role of custom duties for mobilising additional resources.

**SHORT ANSWER TYPE QUESTIONS**

1. Define Federal Finance.
2. Imbalance between Direct and Indirect Taxes.
3. Tax evasion and tax avoidance.
4. Tax buoyancy and Tax elasticity.
5. Agricultural Taxation.
6. Sales taxes in India.
7. VAT
8. Main recommendations of twelfth Finance Commission.
9. Who is Chairman of thirteenth FC.
10. Horizontal and Vertical Imbalance.
11. Criteria for devolution of resources among states.
12. Service tax
13. Fiscal crisis

14. GST
15. Fiscal Reforms
16. Major Tax Reforms

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