Subnational Revenue Challenges in India

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I. Introduction

Assignment of tax powers to subnational governments is extremely important in all multi-level fiscal systems for reasons of both efficiency and accountability. A number of federal countries and even some unitary countries have undertaken decentralization reforms for a variety of reasons including dissatisfaction with the prevailing standards of service delivery. While these reforms have increased the expenditure responsibilities of state and local governments, their inherent disadvantage in raising tax revenues have resulted in either significant under provision of local public services or excessive transfer dependency or when substantial tax powers are assigned to them, significant disharmony in the tax systems.

Despite the importance of tax assignment to subnational governments in enhancing efficiency and accountability in public service delivery on the one hand and requiring harmonization in the tax systems on the other, there has been very little analysis in the literature. The importance of adequacy of revenues to link revenue – expenditure decisions at the margin is important for both accountability and efficiency. Adequacy and clarity in assignments are important to ensure hard budget constraint at subnational governments which is necessary for efficiency. Levying the residents of the jurisdiction to pay for the services delivered to them will increase accountability.

An implementable rule of fiscal decentralization is that finance should follow functions (Bahl, 2002). However, comparative advantage for raising revenues is with the centre as all broad based and progressive and mobile tax bases cannot be effectively

taxed by subnational governments. This means that the sub-national governments end up either with only narrow, immobile tax bases assigned or there will be significant distortions and disharmony in the tax system. This can happen due to mobility of tax bases in search of lower taxing jurisdictions or strategic games played by the sub-national jurisdictions to maximize revenues or attract capital/businesses into their jurisdictions. Indulgence in such predatory and unstable competition (which is termed as "race to the bottom") and protectionist measures does not lead to efficient outcomes. In such situations, gains from fiscal autonomy arising from the assignment of taxes to subnational jurisdictions must be weighed against the distortions arising from subnational tax disharmony. The final solution thus would be sub-optimal.

Assignment of revenue powers to match expenditure functions and minimizing distortions in the levy of taxes is thus, a major challenge in all multilevel fiscal systems. The principle of tax assignment is that all broad based and mobile tax bases should be assigned to the Centre and sub-national governments should have the power to levy only user charges and taxes on immobile bases which should be 'residence based' (as against resources based) taxes. To the extent sub-central governments have to levy taxes on mobile bases, it should be designed according to the benefit principle. These constraints place a distinct advantage to the central government in levying taxes on broad-based and mobile bases. Surely, subnational taxation on mobile bases, even when designed according to the benefit principle could result in significant distortions and evasion and avoidance of the tax as the base could migrate to tax havens (Musgrave, 1983, Breton, 1996). Similarly, central government has a distinct advantage in borrowing from the market or creating resources through seignorage.

The objective of this paper is to analyze the issue of raising revenues by subnational governments in India. The next section analyzes the evolution of Indian fiscal federalism and presents its salient features. Section 3 presents the prevailing system of financial arrangements in India between the centre and states. In all multilevel fiscal systems, assignment of significant revenue powers to subnational governments to substantially match expenditures involves a trade-off between fiscal autonomy and tax disharmony. Therefore, section 4 analyses the economic consequences of subnational tax

assignments in India. Section 5 brings out the important issues involved in reforming subnational taxes. The concluding remarks are presented in section 5.

II. Evolution of Indian Federalism

After over 200 years of British colonial rule, India became independent in 1947 and the Constitution of India as a federal Republic with Westminster type parliamentary democracy was adopted in 1951. The Constitution of India describes India as a "Union of States". It is inhabited by over 1.22 billion people spread over 28 states and 7 Union Territories. The federation is marked by sharp economic, social, religious, cultural and linguistic diversities. People in the country speak 256 languages and several dialects in addition, though the number of officially recognized languages in the 8th schedule of the constitution is 22. Sharp economic heterogeneity is seen by the fact that per capita income in the poorest state was one-sixth of that of the richest; it ranged from Rs. 14654 in Bihar to Rs. 77878 in Haryana in 2009-10.

Historical factors have played an important part in the adoption in India of a federal Constitution with strong unitary features. During the British rule, administrative and fiscal centralization was a colonial imperative. At the same time, the difficulty of administering a large country with a number of principalities, divergent languages, cultures and traditions did call for some degree of decentralization. Indeed, for a period of about two decades in British India prior to the enactment of the Government of India Act 1935, the system required the provinces to make financial contribution to the Union. Although there were strong arguments for decentralization before independence, and even though the Cabinet Mission sent by the imperial government in 1946 envisaged limited powers for the Union in a three-tiered federal structure, the constitution that was eventually adopted by the Indian Republic closely followed the Government of India Act, 1935, with pronounced "quasi-federal" features. The shift in thinking probably occurred for two reasons: First, once the Muslim majority areas opted out of India to form a separate country, the principal rationale for a loose federal structure no longer existed. Second, a strong Centre was found desirable to safeguard against fissiparous tendencies among constituent units (Rao and Chelliah, 1991) particularly, the erstwhile princely

States. The federal framework provided by the founding fathers of Indian Constitution was an experiment in adopting the federal idea to a large and extremely diverse economic, cultural, social, and linguistic society.

There is considerable debate as to whether Indian fiscal system should be considered federal at all. The strong centripetal bias in the Constitution has made many astute observers to designate India as "quasi-federal". The Constitution of India characterizes India as a "Union of States" and not as a "federation". The centripetal features of the constitution are seen on many counts. Entry 97 in the Union List specifies that any matter not enumerated in the State and Concurrent Lists will vest with the Central government; Article 2 states that the Union Parliament has powers to admit new States into the Union and Article 3 specifies that the Parliament can alter the areas and the boundaries and change the names of the states, and the only thing that the central government is required to do is to refer the Bill to the relevant States' legislature for eliciting its view. Article 356 of the constitution empowers the President of the country to dismiss an elected state government if he/she, on receiving the report from the Governor of the State s (appointed by the President of India on the advise of the Union Cabinet). or otherwise, is satisfied that the constitutional machinery has broken down in the state.

The high centripetal bias in the constitution was reinforced over the years by a variety of factors. The most important factor was "Economic and Social Planning" placed in Entry 20 of the concurrent list, provided the powers to the central government to centralize powers in the name of development planning. The central government under Jawaharlal Nehru, the first Prime Minister adopted centralized planning with public sector dominated, heavy industry based import substituting industrialization strategy. Centralized planning is a negation of federalism and as the entire resource allocation exercise was done by the central Planning Commission, the states lost substantial powers on matters related to even the state subjects. Furthermore, with the nationalization of insurance and the banking sector, the financial sector was substantially brought under the control of the central government.

Until 1992, India evolved as a two-tier federation. Although the local governments at both rural and urban areas existed, they did not have any constitutional status. With the 73rd and 74th amendment of the constitution in 1992, local governments in rural and urban areas were recognized as a third tier of government. With this, separate Schedules – 12th and 13th – listing the 29 and 18 functions respectively for rural and urban local bodies are listed and these functions are to be devolved to them. These functions are to be undertaken by the rural and urban local governments concurrently with the State governments and the extent of devolution would be done by the State governments at their discretion. They were however not assigned separate tax powers and the states were required to assign some taxes in the State List.

III. Subnational Tax Assignment in India.

(i) Assignment between Centre and States

This section analyzes the nature of subnational tax assignment in India in terms of adequacy of revenues, coordinated calibration of tax reforms and the disharmony and distortions in the tax systems. The analysis is carried out for the state tax powers mainly because, the volume of revenues raised by local governments – both urban and rural is negligible in India. According to the 13th Finance Commission, the internal resources raised by the local bodies in 2007-08 were just about 0.3 per cent of GDP of which the contribution of taxes was even lower. Nevertheless, important issues relating to local taxation are also discussed.

The Seventh Schedule to the Indian constitution specifies the functions and the sources of revenues of the Central and State Governments. The Schedule has three lists – Union, State and Concurrent. While the expenditure functions are put under the three lists, while assigning tax powers, the principle of separation is followed placing the tax powers either in the Union or the State lists. In fact, the tax powers of the local governments - both urban and rural are included in the State list as a part of its own powers; the State governments define the powers of local governments at their discretion.

Although the adoption of the principle of separation is an attempt to bring in clarity in assignments, given the interdependence of tax bases, separation cannot be done in the economic sense. Not surprisingly, the arrangement has not helped to develop the tax system on scientific lines and has created substantial overlap in the tax systems of Central and State governments. The exemption of agricultural income tax has prevented the central government from using the comprehensive concept of income as the base for taxation and this has opened up avenues for large scale evasion and avoidance of taxes. This has also brought in a sense of horizontal inequity. In the case of consumption taxes the arrangement has entailed large scale overlapping of the tax system. The Centre is allowed to levy excise duties on manufactured goods and the tax on the sale or purchase of goods is assigned to the States and both are taxes on consumption. Whereas the excise duty on manufacturing products is actually the sales tax at the first point of sale, the sales tax is a levy that can be levied at any or all the sale points. In other words, both the taxes fall on the same base and in a system where there is no harmonization, this has led to the evolution of non-transparent consumption tax system. Similarly, the centre can levy taxes on services, but the states cannot, and this constrains the States from transforming their sales tax on goods into a broad based goods and services tax (GST) services tax. Thus, the attempt to separate the tax powers of the Centre and States in the Constitutional assignment has not helped the governments to develop the tax systems which are comprehensive and harmonious.

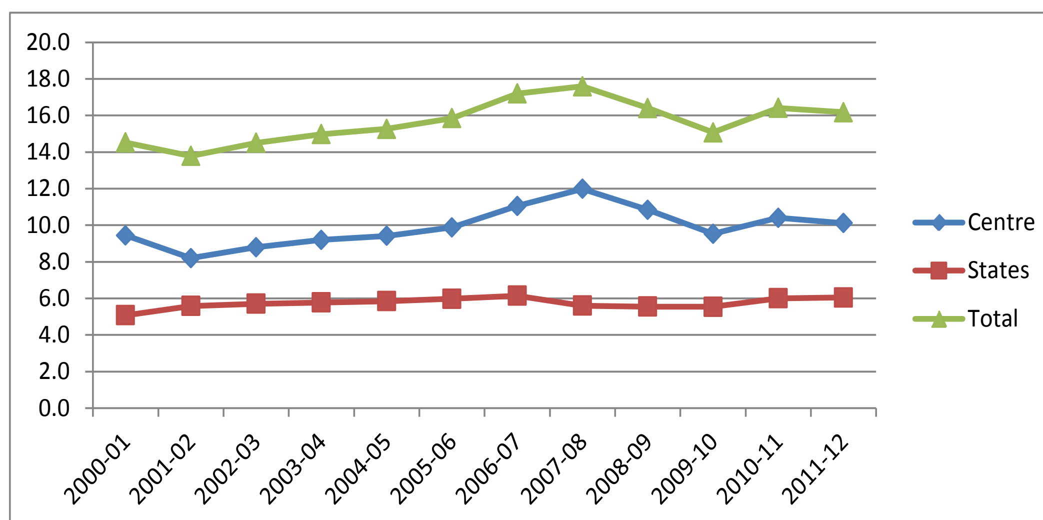
Table 1
Tax - GDP Ratios of Central and State Governments in India

	Centre	States	Total
2000-01	9.4	5.1	14.5
2001-02	8.2	5.6	13.8
2002-03	8.8	5.7	14.5
2003-04	9.2	5.8	15.0
2004-05	9.4	5.8	15.3
2005-06	9.9	6.0	15.9
2006-07	11.1	6.1	17.2
2007-08	12.0	5.6	17.6
2008-09	10.8	5.6	16.4
2009-10	9.5	5.5	15.1

2010-11	10.4	6.0	16.4
2011-12	10.1	6.1	16.2

Source: Budget documents of central and state governments.

Figure 1
Tax-GDP Ratios of Central and State Governments in India 2000-11



Source: table 1

Table 1 (Graph 1) presents the ratio of tax revenue to GDP at central and State levels. While the central tax revenue showed a sharp increase after 2004-05 to 2007-08 from 9.4 per cent to 12 per cent, but thereafter declined to 10 per cent in 2011-12 partly due to the reduction in the tax rates as a part of the stimulus and partly due to slowdown in Indian economy. In contrast, the tax –GDP ratio in the states increased from 5.1 per cent in 2000-01 to about 6 per cent in 2005-06 and remained steady at that level thereafter in spite of the major tax reform introducing the value added tax on goods in the place of cascading type sales taxes.

The share of the states in total revenues and expenditures are presented in Table 2. With central revenues, particularly tax revenues showing high buoyancy, the share of states' own revenues in total revenues showed a steady decline from 41.4 per cent in 2000-01 to 32.6 per cent and thereafter recovered to 38.5 per cent in 2011-12. However, that constitutes only about 57 per cent of the revenues accruing to them and the remaining 43 per cent comes from shared taxes and grants given by the central government. The own

revenues of the state governments is adequate to meet just about 55 per cent of current as well as total expenditures aggregated for centre and States and the ratio has been broadly stable over the decade beginning 2000-01 which implies that the state has to either depend upon the centre to finance the remaining 45 per cent of its expenditures by way of grants or borrow the money. This large dependence has two important implications. First, it reduces the autonomy of the states to allocate expenditures according to their preferences since a significant proportion of the grants received are in the form of specific purpose grants. Second, it reduces efficiency and the accountability of the states' expenditure implementation as the severing of the link between revenue and expenditure decisions tends to soften the budget constraint.

Table 2:
The Shares of Central and State Governments in Revenues and Expenditures
(Per cent of Total)

Year	Share of States' Own Tax Revenue in Total	Share of States' Own Revenues to Total revenues	Share of Own Revenue to Revenue Accrual	Share of States' Current Expenditure in Total Current expenditure	Share of States' Total Expenditure in Total Expenditure
2000-01	35.0	41.4	59.7	56.0	55.5
2001-02	40.5	40.1	61.2	56.9	55.5
2002-03	39.4	39.0	62.6	54.3	54.1
2003-04	38.6	38.6	62.0	56.3	56.6
2004-05	38.3	37.9	61.8	56.3	55.5
2005-06	37.7	37.5	60.1	55.2	55.4
2006-07	35.7	36.9	59.6	55.3	56.3
2007-08	31.8	32.6	55.7	53.5	53.2
2008-09	33.9	34.5	55.7	49.3	51.7
2009-10	36.8	37.9	58.9	51.2	54.0
2010-11	36.6	35.5	57.4	54.1	55.6
2011-12	37.4	38.5	57.2	54.2	56.3

Source: 1. Public Finance Statistics, Ministry of Finance, Government of India.
2. Budget documents of central and State governments.

The taxes levied by the state governments in India include: (i) Taxes on the sale and purchase of goods which has been converted into an intra-state value added tax; (ii)

Excise duties on alcohol; (iii) taxes on transportation of goods and passengers (iv) taxes on motor vehicles; (v) Stamp duties and registration fees on the transfer of property; (vi) Tax on agricultural incomes and land revenue. (vii) Other smaller taxes such as the taxes on professions, trades, callings and employment and luxury taxes.

Of these only, the sales tax on goods is a broad based tax with significant revenues as may be seen from Table 3. In general, of the total tax revenue of 16.2 per cent raised in the country, the central government raises two-thirds and the states, the remaining one-third. The states' share of tax revenues raised by them in total tax revenues was about 38 per cent in 1992-93, increased steadily thereafter to about 45 per cent during the period 2002-03 to 2006-07and declined thereafter to 37.5 per cent primarily due to the high buoyancy of income taxes raised by the centre.

Table 3
Tax Assignment in India 2011-12

	Tax	Per Cent of GDP	Per cent of Total Tax Revenue
I	Central Taxes*		
1	Personal Income tax	1.93	11.9
2.	Corporation Income tax	3.68	22.7
3.	Central excise duties	1.69	10.46
4.	Service Tax	1.07	6.59
5.	Customs duty	1.72	10.62
6.	Other taxes	0.05	0.24
I.1	Total -Central Taxes (Gross)	10.12	62.56
I.2	Total – Central Taxes (Net)	7.21	44.56
II.	State Taxes**		
1.	Tax on incomes	0.05	0.29
2.	Taxes on transfer of Property	0.79	4.89
3.	Sales tax	3.75	23.78
4.	State excise duties	0.78	4.84
5.	Taxes on transport	0.45	2.75
6.	Others	0.24	1.49
II.1	Total – State taxes (Own)	6.05	37.44
II.2	Total –State taxes (Accrual)	8.92	55.16
	Total taxes	16.17	100

* Revised Estimate. ** Budget Estimate.

Source: Central and State government budget documents**,** Ministry of Finance, Government of India, and compiled from State government budgets.

It is very well recognized that while the central government has comparative advantage in raising revenues, the states are better placed to implement expenditure programmes. The central government has predominant responsibility to undertake stabilization and redistribution functions and therefore, most broad based taxes and borrowing powers rest with it. In contract, for reasons of responsiveness when the preference are diverse and for accountability, the subnational governments are better placed to implement expenditures. Fiscal assignment in India follows a broadly similar pattern. Besides macroeconomic management and redistribution, the public services with nation-wide benefits are assigned to the centre and those with state-wide benefits are assigned to the states. Most public services the provision of which can be confined to the states but with substantial nation-wide social benefits are kept in the concurrent list.

(ii) Tax assignment to local governments:

After the 73rd and 74th amendments to the constitution in 1992, the functions of the third tier of governments have been specified in Schedules 11 and 12 of the constitution. Schedule 11 specifies 29 functions to rural local governments and Schedule 12 specifies 18 functions to urban local governments. The tax powers of local governments, however, have not been separately specified and the states are required to assign appropriate tax handles to them from the state list.

There are two important problems with respect to the assignment of tax powers to local governments. The first is that although in terms of numbers there are quite of few taxes, none of the tax handles is significant from the viewpoint of generating revenues except the property tax. Some states allowed the urban local governments to levy "Octroi", the tax on entry of goods into a local area for consumption, use or sale until recently. However, all the states except Maharashtra have abolished the tax due to their distortionary effects and even in the latter the tax is levied only by municipal corporations. The most important levy by the local bodies continues to be the property tax, but the amount of revenue collected is estimated at less than 0.3 per cent of GDP.

A more serious problem however, is the capacity of the local governments to administer the property tax. The states on their part, instead of assisting the local governments to design and implement levies to augment their resources have not only been callus, but even have gone about abolishing local taxes. In the case of property tax, there is a crying need to assist the local governments with the design and capacity building to administer and enforce the tax. Some large municipal corporations like Bangalore have reformed their property tax systems to intorducee area based taxation with self-assessment to enhance the revenues. In contrast, there are states like Punjab, Haryana and Rajasthan that have effectively abolished the property tax leaving the municipal corporations with no worthwhile revenue powers.

Unfortunately, reliable information on the revenue collections by local governments is not available. According to the information collected by the 12th Finance Commission, the revenue collection by urban and rural local governments in 2002-03 was just about 0.35 per cent of GDP and the situation has not improved since then. The absence of clearly defined tax base assignment in the Constitution and reluctance on the part of the State governments to assign any broad based taxes to local governments on the one hand and poor capacity of the local governments to collect substantial revenues from the taxes (particularly property tax) assigned to them has resulted in insignificant revenue collection from the tax.

In most countries, urban agglomerations are the engines of economic growth and municipal governments provide the necessary services and environment for them to be the engines (Rao and Bird, 2011). In India, however, inadequate revenue assignment on the one hand and inability to effectively utilize the revenue handles assigned to them on the other has been a major constraint in the municipal governments acting as galvanizers. While the infrastructure demand and the financial requirements to provide the required minimum services are large and growing, the resources actually available with the urban local governments constitute only a fraction of the requirements. A recent study for the period 1999-2000 to 2003-04 which analyses the expenditures in 30 large municipal corporations in India concludes that on average, actual spending is only about 24 per cent of the requirements or the extent of under spending on urban services is as high as 76 percent (Mohanty et. al, 2007). The study also shows that of the 30 municipal

corporations, the extent of under-spending was over 75 per cent in 17 municipal corporations, and over 50 per cent in another 10.

IV. Economic Consequences of Tax Assignment in India:

The principle of separation followed in the constitutional assignment taxes between the central and State government was to ensure clarity and avoid overlapping in the tax powers. It was also done at a time, economic activities did not have the complexity seen now and the technology was not available to track complex economic activities. For example, agriculture was a localized activity tied to land, largely of subsistence nature and it was thought that the states would have a comparative advantage in taxing this. But, the states have found it politically difficult to levy the tax and except in the case of some plantation crops, the income from agriculture has continued to be exempt. Over time, however, significant expansion of cash crops and expansion of horticulture, floriculture, contract farming has made it application of comprehensive income tax feasible, but political difficult. At the same time, continued exemption of agricultural incomes has led to mushrooming of farm houses, often with a view to misclassify the non-agricultural incomes and evade the tax.

The principle of separation followed in the tax assignment has constrained the reform of consumption tax in India as well.

Development of the tax system on modern lines calls for a paradigm shift in tax assignments. It is necessary to recognize that Central and State tax bases are interdependent and enable concurrent tax powers to Centre and States in respect of both income and domestic consumption taxes. In the case of personal income tax, as mentioned above, separation of tax powers between the Centre and States based on whether the income is from agricultural or non-agricultural sector has been a major source of tax evasion. As agriculture is transformed into a business it is important to levy the tax on incomes received from all the sources both for reasons of neutrality and to minimize tax evasion. At the same time, the Centre, States and even the major metropolitan cities could be allowed to levy the tax with both the States and the cities allowed to piggyback their levies on the tax base determined by the Centre and subject to ceiling rates. This will empower both the States and the metropolitan cities with own

revenue handles and provide the much needed resources to provide State level public services as well as civic amenities and avoid resorting to inefficient taxes like octroi[1]. On the indirect taxes front, the attempt to levy the goods and services tax (GST) by the Centre and States will go a long way in harmonizing the consumption tax system. Harmonizing the tax system on the lines indicated above is important in a globalizing environment not only to develop a tax system which minimizes distortions and compliance costs but also to provide sufficient resource handles to the subnational governments to provide efficient levels of public services assigned to them.

As mentioned earlier, the adoption of the principle of separation in the constitution while assigning taxes was an attempt to bring in clarity. However, given the interdependence of tax bases separation cannot be done in the economic sense and not surprisingly, the arrangement has not helped to develop the tax system on scientific lines and has created substantial overlap in the tax systems of the Centre and States. The exemption of agricultural income tax has prevented taking the comprehensive concept of income as the base for taxation and this has opened up avenues for large scale evasion and avoidance of taxes. This has also brought in a sense of inequity in the horizontal equity sense. In the case of consumption taxes the arrangement has entailed large scale overlapping of the tax system. The Centre is allowed to levy excise duties on manufactured goods and the tax on the sale or purchase of goods is assigned to the States and both are taxes on consumption. Whereas the excise duty on manufacturing product is a levy at the first point of sale the sales tax is a levy that can be levied at any or all the sale points. In other words, both the taxes fall on the same base and in a system where there is no harmonization, this has led to the evolution of non-transparent consumption tax system. Thus, the attempt to separate the tax powers of the Centre and States in the Constitutional assignment has not helped the governments to develop the tax systems which are comprehensive and harmonious. In contrast, in countries like the United States and Canada,

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[1] "Octroi" is a tax on the entry of goods into a local area for consumption, use or sale. It is collected at the points of entry into the municipal areas.

both income taxes and taxes on consumption are levied concurrently by the Centre and States and in the United States, even by some local governments. Yet, these countries have been able to work out a much more harmonized system, often with the Centre determining the base and the States and local governments piggybacking their own rates on this base.

IV. Coordinating Tax Reforms: Introduction of GST at Central and State levels

An important issue in calibrating tax reforms in a federal system is the need to coordinate the reforms at central and state levels. Efficacy of tax reforms will be greater when the reforms are carried out in a coordinated manner. As mentioned earlier, with globalizing reforms introduced in 1991, when the import duties were reduced, there was a significant decline in central revenues. In contrast to many other countries which undertook domestic indirect tax reforms to recoup revenue loss from import duties, given that the power to levy sales taxes rest with the states, the lack of coordination in tax reforms between the Centre and states prevented simultaneous calibration of reforms in tariffs and domestic trade taxes. Thus, even as the central government undertook significant tax reforms following the report of the tax reform committee (India, 1991), the gross tax revenue of the central government relative to GDP declined from 10.2 per cent in 1991-92 to 8.2 per cent in 2001-02.[2]

The principle of fiscal federalism requires linking of revenue-expenditure decisions of sub-national governments at the margin. It is important to ensure that the states do not indulge in exporting the burden of financing their services to non-residents which implies that the state taxes should be destination based. It is also important that the taxation is not used as an instrument to erect protection nor should it be employed to indulge in predatory competition either to export the tax burden to non-residents or attract capital into the jurisdictions by indulging in "the race to the bottom". Furthermore, the

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[2] Ironically, revenue from even the central indirect taxes too declined during the period. While the tax reforms in direct taxes resulted in an increase in the tax revenue as a ratio of GDP by one percentage point, the revenue from union excise duties declined by the same magnitude, and the revenue from import duties declined by two percentage points resulting in the net decline by that amount.

states' policies do not violate the principle of the common market by impeding mobility of factors and products. However, sub-national governments may not consider the overall interest of the economy while exercising their tax powers and this may result in significant predatory behavior, erection of various types of protective measures leading to distortions and inequity.

Tax harmonization, both vertically between the centre and states and horizontally among different state governments, is important from the viewpoint of minimizing the collection cost, compliance cost and cost to the economy in terms of the distortions it creates. Of course, a uniform tax system is the most harmonious as it minimizes all the three costs mentioned above. However, the very principle of fiscal federalism entails the choice to the states to vary their public service levels and tax rates. Thus, tax harmonization in fiscal federalism involves a tradeoff between welfare (efficiency) gains from fiscal autonomy and welfare (efficiency) loss from tax disharmony. While assignment of tax powers is important to link revenue-expenditure decisions, it is important to ensure that individual states' tax policies do not pursue policies that will have adverse impact on other states, do not violate the common market principle and do not impede the development of markets. Any attempt to compare a federal tax system with that in in unitary countries, therefore, is inappropriate.

In India, the state tax system in India is beset with a number of shortcomings. As mentioned earlier, the states have found it politically difficult to levy taxation of agricultural incomes except in the case of a few plantation crops and this has prevented the levy of comprehensive taxation and has opened up avenues for evasion and avoidance of taxes on incomes. The long term reform in this area should essentially do away with the distinction between the sources of income. The states could be provided with concurrent tax powers to piggyback their levy on the base determined by the centre. Of course, there should be allowance to offset losses and deduction of payment of insurance against fluctuations in agricultural incomes. On the indirect taxes side, the state sales taxes, even after the reforms to convert them into value added taxes (VAT) have a narrow base as consumption of services is excluded and the continuation of the central sales tax makes them predominantly origin based. Furthermore, the entire indirect tax regime at the state level is segmented with a number of taxes coinciding such as purchase taxes,

motor vehicles tax, passengers and goods tax, electricity duty, entertainment tax and stamp duties and registration fees which need to be unified into the goods and services tax. Finally, the state and local taxes impede the free flow of goods and services across the country. While the central sales tax is a tax on the export of goods from one state to another, levies such as entry tax and octroi are in the nature of taxes on import of goods into a local area. Administration of these taxes requires the erection of check-posts or physical barriers and this violates the principle of common market within the country. Coordinated calibration of tax reform therefore, is extremely important to evolve a competitive tax system in the country.

Of course, for reforming the tax system to transform the cascading type sales taxes into a value added tax, the central government had to provide an insurance by agreeing to compensate any losses the states incur on account of the reform. By all accounts, this was a resounding success as the number of tax rates was substantially brought down to two, and significant degree of uniformity in the thresholds, items exempted and the rates of tax were brought about. Interestingly, as the economy during 2005-08 experienced high growth rates averaging more than 9 per cent, and due to better tax compliance resulting from the introduction of VAT, actual compensation paid to the states in four years beginning 2006-06 amounted to about Rs. 10095 Crore which is less than 0.1 per cent of the sales tax collection.

However, despite these reforms in terms of the introduction of VAT, a number of infirmities in the domestic trade taxes levied by the states have persisted. The non-inclusion of services has rendered the tax base narrow. A number of other consumption taxes co-exist and that includes, entertainment tax, luxury tax. electricity duty, motor vehicles tax, passengers and goods tax, entry tax, octroi[3] and purchase taxes on some commodities on which the state has an oligopolistic power. Further,, diesel and motor spirit are kept out of the VAT and a separate sales tax at a minimum rate of 20 per cent is

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[3] Octroi is a tax on the entry of goods into a local area for consumption, use or sale. The tax is collected by erecting barriers at the entry points to various municipal areas. All the states have abolished this tax except Maharashtra which has empowered the municipal corporations to levy the tax.

levied by the states on these items. More importantly, the states continue to levy inter-state sales tax at one per cent which makes the system substantially origin rather than destination based. In additional to these, the lists of exemptions for VAT are large in every state. Despite the attempt to bring about homogeneity in the tax systems, there are differences both in the structure of the tax and its administration. Considering these and based on the recommendations of the Task Force on Indirect taxes (India, 2003) and later, the Report of the Task Force on the implementation of FRBM Act, the Union Finance Minister, in his budget speech of 2006 stated, "…It is my sense that there is a large consensus that the country should move towards a national level Goods and Services Tax (GST) that should be shared between the Centre and the States. I propose that we set April 1, 2010 as the date for introducing GST". Unfortunately, forging a consensus among the states on the structure and operational aspects of the new levy as well as the mechanisms to resolve Centre-state and inter-state has not been possible though, the attempt continues.

It is generally presumed that the GST will be a game changer and the tax reform needed make the tax system efficient and productive. Therefore, the 13th Finance Commission, in its TOR was required to take into account, "…the impact of the proposed implementation of Goods and Services Tax with effect from 1srt April, 2010, including the impact on country's foreign trade". Although the Commission was not specifically asked to work out the detailed structure and modalities of implementation, it went about detailing the outline of "the model GST" – with features such as minimum exemptions, a single rate of tax on all goods and services uniformly levied across States, zero-rating of exports, and ensuring destination based tax to ensure seamless trade across the country. It also recommended the "grand bargain" to be conducted between the Centre and States' with six elements namely, the design of GST to evolve the model GST, operational modalities, binding agreement between the Centre and States with contingencies for changing rates and procedures, implementation schedule, disincentives for non-compliance and the procedure to claim compensation. It recommended a compensation package of Rs. 500 billion for any loss of revenue and if all elements of the grand bargain are not satisfied the compensation will not be payable.

Any desirable tax reform should minimize the cost of compliance as well as the distortion cost while not increasing the cost of collection (Bird and Zolt, 2004) and GST

reform is expected to minimize all the three costs though, the claim made by the NCAER study that the levy will result in a gain in an estimated GDP increase in present value terms between Rs. 147 million and Rs. 288 million seems to be much too exaggerated. Although the detailed methodology of the study is not available even in the NCAER study report, the very fact that the study is based on 2003-04 input- output table indicates that the productivity gains since 2003-04 including those arising from the introduction of VAT replacing the cascading type sales tax has not been taken into account. This is not to state that the reform is not important. It will make the tax system cleaner and less distorting and supply chains more efficient and render the tax system destination based.

It is important to note that the consumption tax reform at the state level will have to make a compromise between tax uniformity and fiscal autonomy. While the aim should be to get the fundamentals of the reform right, compromise is unavoidable and the solution may have to settle at less than the best from the point of view of tax uniformity but allows some measure of fiscal autonomy. To state that the "GST grant compensates for the seeming limitation in fiscal autonomy by enhancing expenditure autonomy through compensation payments and additional formulaic transfers" (p. 71), would be misleading. First, compensation is given against the loss of revenues and not a bribe for adopting the GST reform. Second, fiscal autonomy under fiscal decentralization means maneuverability to change standards of public services by changing tax rates and not simply softening the budget constraint to spend more money.

Indeed, ideal design should be the goal, but in many states the socio-political considerations may not allow them to adopt uniform minimum exemptions and a single uniform rate. In fact, even as economists recommended moving over to a single rate of VAT in Sweden recently, the government found it impossible to change over to a single rate. Everyone knows that equity is better served by better targeting public expenditures and not by having high and multiple rates and yet, political perceptions are hard to change. Bird and Gendron (2007, p. 13) show that in European Union the standard rate of VAT varied from 15 to 25 per cent with a mean of 19.4 per cent and except for Denmark, every other European country has one or more rates in addition to the standard rates. It is not to argue that having multiple rates is desirable and surely, every effort should be made to minimize rate differentiation from the viewpoint of reducing the

collection cost, compliance cost to the taxpayers and distortions in the economy. But these are political decisions and compromises are unavoidable. Therefore, Bird and Gendron conclude, "GST is neither a gorilla nor a chimpanzee, but a genus like primate".

The recommendations of the 13th Finance Commission have pushed the States to a defensive position and each state has been increasing the tax rate on the prevailing VAT with a view to secure assurance on adequate compensation if and when the reform is undertaken. However, the appointment of Mr. Sushil Modi, the Finance Minister from Bihar, the opposition ruled state as the Chairman of the Empowered Committee of State Finance Ministers in 2011 is a welcome move and will help in forging consensus on a number of contentious issues and will help to build consensus faster and hopefully, GST in some form will be implemented in not too distant a future.

V. Concluding Remarks:

The issue of subnational taxation is of paramount importance in fiscal federalism. The essence of fiscal federalism lies in the ability of subnational governments to vary the public service levels and taxes according to the preferences of the residents of different jurisdictions and this depends critically on the ability of subnational governments to vary revenues from taxes. Therefore, assignment of tax powers is the essence of fiscal federalism. However, the extent of actual tax assignment in any federation depends on the way intergovernmental finance is structured. Every country has to find solutions to the problem of tax assignment depend on a variety of factors that determine the nature and degree of fiscal decentralization.

In any federation, the tax assignment is a compromise between ensuring subnational fiscal autonomy and achieving a measure of uniformity or harmonization in the tax systems. It is also important to ensure that, in a globalizing market economy, subnational tax assignment does not result in unstable competition by the subnational governments to pass the tax burden to non-residents, a "race to the bottom" to attract capital into their jurisdictions, creates tariffs zones within a federation, erects impediments to the movement of factors and products and creates other forms of distortions. Safeguarding against these is a major challenge. Equally important is the

need to coordinate the reforms of different levels of government and this is particularly true of calibrating reforms of tariffs with domestic trade taxes.

Harmonization and coordinating tax reforms between the centre and the states has been a major problem in India. Although over the years, with the reforming of cascading type sales taxes to an intra-state value added tax, considerable harmonization has been achieved, the road to ensure efficient and productive tax system at central and state levels is long and arduous. In the past, the lack of coordination between the centre and states in the calibration of tariff reforms and reform of domestic trade taxes has led to a sharp decline in the revenues during the decade 1991-2001. Although considerable harmonization in states' sales taxes have been achieved with the introduction of VAT in 2005-06, significant reforms need to be done both in expanding the tax base, simplifying and harmonizing the domestic trade taxes between the centre and states and among the states inter-se. The issue of harmonization is not merely confined to the structure of the tax; even more daunting is the need to harmonize tax administrations to reduce the collection, compliance and distortion costs of the tax system.

All these in a complex multilevel fiscal system in India imply that the next stage of tax reform to evolve a GST involves a series of compromises. In the process, it would be unwise to expect that an ideal GST will be put in place when the reform is accomplished. Surely, there will be several shortcomings even after agreement to transform the existing VAT on goods to GST is reached. Nevertheless, it is important to keep the fundamental principles of GST while arriving at the compromise solutions so that the issues can be discussed and reformed over time. After all, tax reform is not an event; it is a process and the levy of GST after the agreement is reached should be the starting point for future reforms in domestic trade taxes in India.

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Table 3:
Trends in Vertical Fiscal Imbalance

Year	Per cent of States' own current revenues total current revenues	Per cent of States' current expenditure to total current expenditure	Per cent of States' own current revenues to States' current Expenditure	Per cent of States' expenditure* to total expenditure*
1960-61	36.6	59.9	63.9	56.8
1970-71	35.5	60.2	60.6	53.9
1980-81	35.6	59.6	60.1	56.0
1990-91	35.2	54.6	53.1	51.7
2000-01	37.8	56.0	48.6	56.1
2005-06	38.1	55.2	60.9	56.2
2006-07 (RE)	38.0	57.0	60.7	58.4

* Current + capital expenditures. RE: Revised Estimates
Source: Public Finance Statistics, Ministry of Finance, Government of India (relevant years).

Table 4
Selected Fiscal Indicators of States

	Percapita GSDP	Percapita Development Expenditure	Percapita Own revenues	Per capita Transfers	Percent of Own Tax to GSDP
Non-Special Cat. States					
Andhra Pradesh	32533.0	4977.2	3788.0	1768.1	9.6
Bihar	10286.0	2105.3	530.9	1952.9	4.8
Chhatisgarh	26125.1	4439.6	2974.4	2279.7	9.0
Goa	95663.5	15460.0	9446.7	2886.7	8.3
Gujarat	44332.5	4558.4	4056.2	1432.1	7.5
Haryana	48213.8	5717.8	5736.0	1008.9	9.3
Jharkhand	23591.2	3992.0	1542.9	1888.3	4.5
Karnataka	36037.8	5173.7	4567.3	1733.4	11.7
Kerala	39742.1	4243.7	3841.6	1773.4	9.0
Madhya Pradesh	18984.1	2872.0	1863.2	1841.9	8.0
Maharashtra	46307.9	4587.2	4235.6	1383.3	8.2
Orissa	25997.6	2649.9	1945.3	2568.5	5.7
Punjab	43436.1	4885.9	4362.7	1612.2	8.5
Rajasthan	22210.8	3201.1	2301.3	1735.7	8.1
Tamil Nadu	37635.2	4698.3	4729.4	1454.0	11.4
Uttar Pradesh	16308.2	2368.9	1607.7	1631.9	8.1
West Bengal	30739.3	2419.5	1598.7	1550.0	4.8
Average: Non. Spl. Cat States	28867.0	3606.4	2790.6	1691.0	8.3
Special Cat. States					
Arunachal Pradesh	27747.5	16941.7	2316.7	17625.0	2.1
Assam	21947.7	4579.9	1793.1	3749.5	5.6
Himachal Pradesh	43535.4	7541.5	3690.8	6996.9	5.4
Jammu & Kashmir	26334.2	8067.3	2279.1	8611.8	6.6
Manipur	27992.3	9821.7	1195.7	11795.7	1.7
Meghalaya	28342.6	7399.5	1772.5	8102.9	3.8
Mizoram	27820.5	16250.0	1820.0	18100.0	2.3
Nagaland	27740.1	9209.1	918.2	11545.5	1.9
Sikkim	34820.6	22764.5	4488.1	21177.5	6.4
Tripura	29500.1	6600.0	1247.1	8108.8	3.5
Uttarakhand	30956.0	6426.9	3203.2	4154.8	8.2
Average: Special Cat. States	27189.0	6729.8	2197.1	6375.8	5.6
Average: All States	28762.5	1962.0	1421.2	1023.9	8.1