CHANGING PATTERN OF FEDERAL FISCAL SYSTEM IN INDIA

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ABSTRACT

India is a union of states and this sentence of the preamble itself depicts the true nature of federal structure. There is a clear cut demarcation of areas in revenue as well as the expenditure side. Over a period of time, the fiscal system has undergone a significant change in terms of scope, procedures and also with respect to imbalance in fiscal system of states vis-à-vis centre. States are mostly reeling under fiscal crises and feeling constrained due to the increasing scope of work and Fiscal Responsibility Act. This review paper analyzes the changing pattern of country’s fiscal system for developing a better understanding amongst state policy makers in the newly emerged scenario.

KEYWORDS: Commission, Expenditure, Finance, GST, Planning, Revenue, Tax, VAT.

INTRODUCTION

Indian fiscal system is based on federal principles of a state. Therefore, there is a definite division of powers between central government and provincial (state) government. Over a period of time, the nature and scope of governments’ function has changed manifold. Resultantly, this has also changed the expenditure and tax pattern of governments whether at centre level or at state level. As far as the fiscal system is concerned, Centre has become stronger over the period of time. However, the states have a larger responsibility in the areas of education, health, infrastructure, social security and welfare (Lahiri, 2000). The situation in many states became very poor with rising fiscal deficit. The situation became further complicated with the onset of important legislations limiting the state’s expenditure. But without an improvement in revenue effort, the fiscal compression on expenditure could well in political turbulence (Rajaraman, 2006). In this scenario, fiscal situation is unlikely to be sustainable over the long run or even the short run, given the increased risk of crises that is associated with high deficit and debt levels (Patricia, 2001). More recently, there is an increasing focus on Central Sponsored Schemes (CSS) and states are becoming more dependent of central programmes. In this background, the paper tries to analyze the changing nature of fiscal system.

CONSTITUTIONAL PROVISIONS

The Indian Constitution has all the features of a federation with the specification of financial powers and functional responsibilities of the Centre and the States. It has provided the institutions for the federal structure and a well defined mechanism for inter- governmental transfers to address vertical and horizontal imbalances which characterise most federations (Bagchi, 2003). The Constitution provides for distribution of powers between the Union and the
States. It enumerates the powers of the Parliament and State Legislatures in three lists, namely Union list, State list and Concurrent list.

Union list consists of 97 items on which the parliament has exclusive power to legislate. The state list consists of 66 items and the states individually have the exclusive authority to legislate on items. Concurrent list consists of 47 items. Uniformity is desirable but not essential on items in this list. Though states have exclusive powers to legislation with regards to items on the states list, articles 249, 250, 252, and 253 state situations in which the federal government can legislate on these items. The subjects listed in the Union and the State Lists broadly define the expenditure responsibilities of the Centre and the States, respectively.

However, there is a clear demarcation of the taxation powers of the Union and the States in the Seventh Schedule of Constitution under Article 246 of the Constitution. In respect of the subjects listed in the Union List Centre has the exclusive power to make tax laws. Similarly, for the taxes listed in the State List, States have exclusive power to make laws. However, no taxes are listed in the Concurrent List. There are thirteen taxes which are listed in the Union List (Punchi et al, 2010). Nineteen taxes are listed in the State List. Apart from the taxes levied and collected by states, the constitution has provided for the revenues for certain taxes on the union list to be allotted, partly or wholly to the states as listed in following categories:

A) Duties which are levied by the Union Government but are collected and appropriated by the states.

B) Taxes which are levied and collected by the Union, but the entire proceeds of which are assigned to states, in proportion determined by the Parliament.

C) Central Taxes on income and union excise duties are levied and collected by the Union but are shared by it with the States in a prescribed manner.

D) Proceeds of additional excise duty on mill-made textiles, sugar and tobacco which are levied by the Union since 1957 in replacement of State sales taxes on these commodities are wholly distributed among the States in a manner as to guarantee their former incomes from the displaced sales taxes.

MECHANISM FOR INTER-GOVERNMENTAL TRANSFERS

From the division of subjects between the Union and the States, it is clear that there is an asymmetry between the taxation powers and the functional responsibilities. While the Centre is assigned with taxes with higher revenue potential, States are assigned with more functional responsibilities. To address the issue of a gap in the resources assigned to States and their expenditure responsibilities, the Constitution provides an institutional mechanism in the form of a Finance Commission and other enabling provisions for the transfer of resources from the Centre.

Articles 292 and 293 define the borrowing powers of the Union and the States, respectively. Article 293 empowers a State to borrow within the territory of India upon the security of the Consolidated Fund of the State.
The inclusion of corporation tax in the divisible pool of Central taxes followed with the 80th Amendment to the Constitution which provided for the sharing of net proceeds of all Union taxes and duties except those referred to in Articles 268 and 269 and cesses and surcharges referred to in Article 271. The States, by and large, have favoured the sharing of all Union taxes and their grievance is now restricted to the percentage share devolved to them.

Introduction of service tax in 1994 was a major development in the area of indirect taxation in the country. Services account now for over 50 per cent of the Gross Domestic Product (GDP) and its revenue from the tax improved from 0.29 per cent of GDP in 2003-04 to 1.22 per cent of GDP in the revised estimates of 2008-09 (Punchi et al, 2010). The share of service tax in the total gross tax revenue of the Centre improved from 3.10 per cent to 10.35 per cent in the same period.

Tax reforms in terms of introduction of Value Added Tax (VAT) with commonly agreed rates by States in 2005 were a major landmark in the history of State taxes. It put an end to the cascading effect of sales taxation and rate wars among States, which was a zero-sum game and heralded a spirit of cooperation among States.

Another major development is the proposed introduction of Goods and Services Tax (GST). The tax to be levied concurrently by the Centre and the States is likely to subsume a number of Central and State taxes making the tax administration less cumbersome, more industry friendly and more transparent. Furthermore, it is expected to do away with most of the tax exemptions involving huge revenue loss and improve voluntary tax compliance because of the input credit.

The rollout of the GST regime was originally slated from April 2010 and later extended to April 2012. But the process may further be delayed due to over compensation to the states on revenue loss due to a cut by half in the central sales tax (CST) from the present 4 per cent. The states are angry about having not received CST compensation for 2010-11.

**FISCAL RESPONSIBILITY LEGISLATION**

A major development in the management of public finances in the country was the enactment of Fiscal Responsibility and Budget Management Act (FRBMA) by the Centre and all the States with the exception of West Bengal and Sikkim, ushered in an era of rule based management of public finances. Since, the late eighties, the finances of the Centre and the States witnessed an alarming deterioration. The combined fiscal deficit of the Centre and the States reached an alarming level of nearly 10 per cent of GDP by 1990-91 from a level of 6.4 per cent in 1981-82. Alarmed by the deteriorating fiscal situation, Centre enacted the FRBMA in 2003, which became operational from July 5, 2004. The main obligations of the Centre under the Act and the rules framed under the Act are the elimination of revenue deficit by 2008-09 and reduction of fiscal deficit to not more than 3 per cent of GDP by 2008-09. The enactment of FRBMA has brought discipline in the management of public finances in the country. The aggregate revenue account of States turned into a surplus in 2006-07 ahead of the target year of 2008-09 prescribed by FC-XII. Even fiscal correction was achieved ahead of the target year of 2008-09. The global developments in 2008-09 and the resultant shortfall in tax revenue have resulted in partial reversal of the fiscal correction achieved till 2007-08.
BORROWINGS BY STATES

Following the recommendations of FC-XII, the Centre terminated on lending to States from 2005-06 on account Central Plan assistance. Prior to 2005-06, the Centre was dispensing normal plan assistance in the grant-loan ratio of 30:70 in the case of General Category States (GCS) and in the ratio of 90:10 in the case of Special Category States (SCS). States are now allocated additional market borrowings in lieu of loan component of normal Central assistance. Termination of lending by the Centre has cast a burden on the States in terms of shorter duration of the market borrowings. The Central loans had a repayment period spread over 25 years with a moratorium of five years in repayment. In contrast, the market loans have a repayment period of 10 years with a bullet repayment at the end of the tenth year. This will result in bunching of repayments for the States.

TRANSFERS FROM CENTRE TO STATES

In India, transfers from the Centre to States, comprising statutory and non-statutory transfers, take place through three channels, namely, Finance Commission, Planning Commission and the Central Ministries. Statutory transfers in the form of share in the proceeds of Central taxes and non-plan grants are on the basis of the recommendations of the Finance Commissions. Non-Statutory transfers in the form of plan grants take place through the channel of the Planning Commission and in addition there are both plan and non-plan grants from various Central Ministries.

Of the total transfers from the Centre, Finance Commission transfers are predominant. There has been an increase in the share of Finance Commission transfers from 60.13 per cent in 1984-89 to 68.03 per cent in the period 2005-10. The share of plan grants declined from 35.80 per cent in 1984-89 to 28.55 per cent in 2005-10. In recent years, there has been an increase in the share of plan grants to over 30 per cent of total transfers because of higher transfers through CSS. There has also been a marginal increase in the share of non-plan grants in total transfers in recent years. As a percentage of GDP, total revenue account transfers to States were 38.40% during FC-XII (2005-2010). The dependence of States on Central transfers can be analysed in terms of the share of the transfers in the total revenue receipts of States. The share of Central transfers in the aggregate revenue receipts of States remained 39.97 per cent during Twelfth FC (tax share 22.24; grants 17.68).

The dependence on Central transfers may vary across states depending on the capacity to generate own resources. For the high-income States, the dependence on Central transfers varies from one-fourth to one-sixth of their revenue receipts. In respect of the middle-income States, the dependence on Central transfers is between one-third to one-fifth except in the case of Chattisgarh and West Bengal, where the dependence is much higher (40 to 50 Per cent). The dependence of low income States is much higher and varies in the range of 42 to 80 per cent. The dependence on Central transfers is much higher in the case of special category States. In these States, the dependence varies from 64.98 per cent to 92.95 per cent of their revenue receipts.

Service tax is being levied since 1994 by the Centre under its residual powers relating to subjects that are not specified in any of three lists in the Seventh Schedule to the Constitution. Till now the sharing of the service tax is on the basis of the recommendations of the Finance
Commissions. FC-XII observed that the exclusion of the proceeds of service tax from the purview of the Finance Commission would amount to reversing the pooling of all Central taxes facilitated by the 80th Amendment of the Constitution. With the proposed introduction of GST, service tax will be subsumed under the GST.

CHANGING PATTERN OF PLAN ASSISTANCE TO STATES

There are two distinct changes in Central plan assistance to States in recent years. The first one is the reduced budgetary support to the State Plan and the second is the significant change in the pattern of plan assistance. At the time of the formulation of the Tenth Plan, the Centre's Gross Budgetary Support (GBS) to the Plan was distributed between the Central Plan and the State Plan in the ratio of 58:42. The actual support turned out to be 66:34, indicating a shortfall even in the lower level of support to the State Plans by a substantial margin. As indicated in the Eleventh Plan document, this was the result of increasing the resource transfers through Centrally Sponsored Schemes (CSS), especially in sectors like health, education and rural development. For the Eleventh Plan, the percentage of GBS envisaged for the State Plans is only 23 per cent. Central assistance to State Plans is envisaged to come down from 1.48 per cent of GDP during the Tenth Plan period to 1.20 per cent of GDP in the Eleventh Plan. In contrast, the gross budgetary support to the Central Plan is envisaged to go up from 2.77 per cent of GDP in the Tenth Plan period to 3.97 per cent in the Eleventh Plan.

Besides the reduction in the budgetary support to the State Plans, the composition of the budgetary support has undergone major changes over the years. The share of normal plan assistance in the total budgetary support to the State Plan has come down drastically and that of CSS, additional Central assistance and special plan assistance has gone up considerably.

Despite the diminishing role of public investment in the total investments in post-reform era, the practice of drawing detailed plans, both Five-Year and Annual continues unchanged. States are still required to get their annual plans approved by the Planning Commission. Declining share of public investment in total investment, the financial constraints emanating from the FRBM legislation is resulting in the Public-Private Partnership (PPP) as the preferred mode of project financing.

CHANGES IN INDIRECT TAX STRUCTURE

Union excise duties and sales tax are the two important indirect taxes on goods levied by the Union and the States, respectively. The tax system was characterized by cascading effects leading to distorted structure of production, consumption and exports and evasion. Currently, CENVAT is levied by the centre on the manufacture and production of excisable goods.

In order to deal with the problems with existing tax system, it is considered necessary to bring about two changes in the taxation of goods and services in the country. The first one is bringing services under the purview of State VAT and the second one is the extension of value addition up to the retail level under the purview of CENVAT. These changes basically amount to integration of goods and services for the purpose of taxation under the value added system.
There is a strong rationale for bringing services under State VAT. Service sector is the fastest growing sector in the economy presently contributing over 60 per cent to the GDP. The extension of service taxation will enable States to share the revenue buoyancy. It improves horizontal equity as taxation of goods and services will be at par. Taxation of services at the rates applicable to goods is likely to improve allocation of resources. Lastly, treating services and goods at par is likely to minimize classification disputes and compliance costs.

There are similar advantages in extending the taxation of goods up to the retail stage in respect of the Centre. Firstly, it will do away with the need to define manufacturing and eliminate valuation problems. Secondly, there will be symmetrical treatment of goods and services. Thirdly, there will be no revenue loss for the Centre for sharing the taxation of services with the States. Fourthly, taxation of goods all the way up to the retail stage will create a proper record of all goods leaving State boundaries making settlement of inter-state disputes far easier and will enable the realization of a destination based system of taxation.

Realising the need for reforms in the taxation of goods and services, the Government of India announced in February 2007 that a roadmap for the introduction of destination-based GST. Empowered Committee EC brought out the 'First Discussion Paper on Goods and Services Tax in India' (FDP) in November 2009. The FDP proposed dual GST, one levied by the Centre and the other levied by States. It also listed out the taxes to be subsumed under Central GST (CGST) and the State GST (SGST).

The Central Sales Tax (CST) on inter-State trade is an origin based tax leading to exportation of tax and taxation of non-residents of the State. Designed to regulate inter-State trade CST has emerged as a vehicle for States of origin to shift the tax burden to the residents of other States and given risen to inter-jurisdictional inequity in the sharing of tax bases. More importantly CST has created distortions in the free-flow of trade by denying input credit on inter-State sales and in the location of industry within the country. As a part of the transition to proposed GST tax rate on CST was reduced in phases from 4 per cent to 2 per cent. CST must be abolished as it is a pre-requisite for the introduction of GST. Exports from one State to another State should be effectively zero rated such that the revenues on inter-State sales accrue to the Destination State.

CONCLUSIONS

Though the Indian fiscal system has seen many challenges over the years but it has adopted many reforms in the fiscal system instantly. Status of welfare state has an important binding on governments’ expenditure obligations; therefore, there is now only a choice between expenditure on priority areas and less priority areas. Introduction of Public Private Partnership model in recent past is a good policy shift to curtail fiscal deficit. Fiscal Responsibility Act has made states more responsible in expenditure utilization. But sudden payment obligations after pay commissions are putting more pressure on state exchequer. Revenue side is still weakening especially after variations in central assistance from statutory and non-statutory institutions. Reforms in indirect taxation are a new hope of the states to gain some more revenue. Central assistance in terms of Central Sponsored Schemes is proving a major source for funding developmental and welfare schemes of the states but this should be supplemented with more
fund devolution to the states. It will not only help states to meet region specific expenditure requirements but also strengthen the federal fiscal system of the country.

REFERENCES


