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ORIGINAL ARTICLE

PRAGMATIC APPROACH OF FISCAL FEDERALISM IN INDIA

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Abstract:

As pointed out in the Document on 'Centre-States Relations' adopted by the States who are opposite political view indicated that the structure of the Indian constitution is more unitary than federal. By vesting all residuary powers in the Centre and by keeping 47 items in the concurrent list it strengthened the base of Central control and vested the Central governance with practically unlimited powers to interfere in the governance of states.

India has completed more than sixty five years of federal finance. The states are facing fiscal deficits. The center has got more elastic and productive taxes. The states are more dependents on the center. Being federal financial country constitutionally there is a separate provision for the Finance Commission recommendation- appointed by the President of India

KEYWORDS:

Approach , Federalism , Relations , Constitutionally.

INTRODUCTION

Apart selected countries like USA, Canada, Australia, and Brazil, India is the country having federal financial system. In view of keeping interest of unity of the nation and maintaining disparity between the regions, the founder fathers of the constitution have strongly focused on the strong centre concept. Federal Finance refers to central government and state governments finance and their mutual relationship. There are four principles of federal finance

1.Principle of Freedom
2.Principle of Uniformity
3.Principle of Adequacy and Elasticity
4.Principle of Administrative economy and efficiency.

“The strong Centre and weak States” arrangement was introduced intentionally in the founders of the Constitution in a big to stall the divisive forces operating in the economy. The partition and its after effects created a strong public opinion in favors of such an arrangement. The one-party rule at the Centre and States further cemented this relationship and the role of States became more and more secondary. As pointed out in the Document on 'Centre-States Relations' adopted by the States who are opposite political view indicated that the structure of the Indian constitution is more unitary than federal. By vesting all residuary powers in the Centre and by keeping 47 items in the concurrent list it strengthened the base of Central control and vested the Central governance with practically unlimited powers to interfere in the governance of states.

India has completed more than sixty five years of federal finance. The states are facing fiscal deficits. The center has got more elastic and productive taxes. The states are more dependents on the center.

Being federal financial country constitutionally there is a separate provision for the Finance Commission recommendation- appointed by the President of India. The Commission recommends to the President. Principle of distribution between the Union and the States, taxes which are to be or may be divided between them. Generally there is a tradition to accept the recommendations of finance commission. Resources allocated not on the basis on the recommendations of the Finance Commission but on non-constitutional basis. There are four ways in which centre-state financial relations take place in India.

1.Tax devolution and deficit-filling grants under Article 275 (1) of the constitution as per the Finance Commission award.
2.Normal plan assistance under the Gadgil formula, as also additional central assistance for externally aided projects.
3. Non-plan loans and grants of which the main elements are center's contribution to the state's calamity relief fund, and the loans out of the net small savings mobilized from the states'.
4.Assistance for centrally sponsored schemes.

RESOURCES MOBILIZATION EFFORTS- CENTRE AND STATE

The resources mobilization efforts by centre and states are given below, it indicate the role of centre to mobilize tax revenue with the comparison with states tax resources mobilization.

Table-1

Average annual resource mobilization by the centre and state (2001 - 2010).

(Rs. Crores)

Nature of resources	Centre	States	All	% of GDP
Own Tax Revenue	306236	191895	498131	16.32
Own Non-Tax Revenue	049072	039673	088745	06.22
Total Revenue	355308	231568	586876	22.54
Capital Receipts	107246	82679	189925	9.26
Total	817862	545815	1363677	31.8

Sources: RBI Bulletin (Various issues) . Excludes the gross loans from the centre.

Resources mobilization efforts in one of the indicators of fiscal management following table gives on average annual resources mobilized during the period 2000-2010. It is to be seen that on an average 22.54 percent of GDP a tax was collected by the center and State governments during this period. Thus center collected 63.2 percent of the total tax revenue and the balance 36.8 percent was collected by the states.

Tax Assignment: A sound system of intergovernmental fiscal transfers serves a two-fold purpose to disparities in the revenue capacity of the constituents units of the federation.

(i)To address the vertical imbalance, i.e. the inadequacy of revenues of sub-nationals governments to meet their expenditure liabilities, arising from asymmetrical assignment of functional responsibilities and financial powers among different government levels.
(ii)To alleviate horizontal imbalances.

The division of revenue sources among Central and State governments is normally referred to as the tax assignment problem.

1.In the first place it should be recognized that assignment of taxing powers is closely linked to the issues of expenditure assignments among different levels of government.
2.The second option for tax assignment is to assign all powers of taxation to the central government, the expenditure responsibilities of the sub-national governments being taken care of by either tax sharing or grants.

3.The third option which is both followed by several countries and supported by literature on fiscal federalism is the assignment of own sources of revenue to each level of government, in combination with various types of intergovernmental transfers to bridge any resulting gap between revenue and expenditure assignments.

Musgrave has suggested the following broad principles for tax assignment-----

·Progressive redistributive taxed should be central.
·Taxes suitable for economic stabilization should be central and lower level taxes should be cyclically stable.
·Tax bases which are distributed in highly unequal manner between different jurisdictions should be centralized.
·Taxes on mobile factors of production should be central as they are best administered at the centre.
·Residence based taxes such as sales of consumption goods to consumers or excises are suitable for states.
·Taxes on completely immobile factors are best suited for local level.
·Benefit taxes and user charges might be appropriately used at all levels.

Since principles of tax assignments rarely leave resources at different levels of government in consonance with the expenditure responsibility arising out of functional obligation, revenue sharing mechanisms are invoked. Often they attempt to address multiple objectives, namely, revenue sharing, equalization, regional development, earmarking etc.

The financial arrangements under the Constitution of India have two main aspects. They provide the division of functions and tax powers between the centre and the state with the objective of achieving maximum operational efficiency. The Constitutions is its Schedule VII provides in its Lists I and II, separate heads of taxation for the union and states. There is no head of taxation in the concurrent list. This means, the union and the states have no concurrent powers of taxation. The residuary power of taxation vests in the union. There are thirteen taxation heads comprising Entries 82 to 92B in the union list and nineteen taxation items comprising Entries 45 to 63 in the State list. Amongst the 13 types of taxes vested with the central government the most important taxes are tax on income other than that from agriculture, corporate income tax, custom duties and excise duties on most goods. Among the 19 taxes placed under the control of state governments are direct taxes on land and agricultural income, excise duties on alcohol and certain other goods, sales tax on all goods except newspaper, taxes on mineral rights, taxes on vehicles, taxes on sales of electricity, luxury taxes and various others. It is generally perceived that the state's taxation powers are inadequate in relation to their expenditure responsibilities and that this imbalance has been worsening over time.

The allocation of beads of taxation between the union and the states is based on the broad principle that taxes which are location-specific and relate to subjects of local consumption have been assigned to the states. Those taxes which are of interstate significance and where the tax-payer caqn gain or evade tax by shifting his habitat, or where the place of residence is not a correct guide to the true incidence of tax, have been vested in the union.

VERTICAL TAX REVENUE SHARING

There are two approaches to vertical tax revenue sharing Viz., sharing of selective taxes and sharing of all tax revenues in a fixed proportion. Both the approaches suffer from certain drawbacks. In the system of sharing of selective taxes, there is an incentive for central government to depend on non-shared taxes or those taxes with lower sharing requirements. On the contrary, the statutory requirements for sharing revenue for all taxes in a fixed proportion, makes macro economic adjustment more difficult to achieve, since additional revenues required for a fiscal correction would accrue also to the lower levels that might not be interested to reduce their own expenditures. Thus, a much greater fiscal effort is required by the central government than would be the case without automatic revenue sharing with lower levels of government.

The shared taxes in India were put into three categories according to their nature prior to the introduction of a fixed shared of all union taxes. These were

a)Obligatory and voluntary shared taxes
b)Assigned taxes
c)Agreed taxes/duties

The tax on n on-agricultural income (Article 270) and union excise duties (Article 272) were the major selective tazes tobe shared with the states. Appendix I and II show that while the divisible pool of income tax witnessed gradual increases from 55 per cent in 1952 to 85 per cent under the recommendations of various finance commissions.

Tax Reform Committee i.e. Raja J. Chelliah Committee had expressed the view that per cent constitutional provision regarding tax sharing needed to be re-examined. The Committee observed, "The task of fiscal adjustment at the centre has been rendered more difficult because of the compulsions arising from the formula of tax sharing with the states." Now a day the states have been demanding that Corporate Profit Tax should also be brought within the divisible pool.

Horizontal Tax Revenue Sharing

Having examined the issue relating to the vertical tax revenue sharing, it would be interesting to study the horizontal aspect of tax revenue sharing among the states. It may be stated here that the distribution of shared taxes among the sub-national governments is often made on a derivation basis, with each jurisdiction getting the share of revenue collected in its territory. This principle cannot be applied for corrected in its territory. This priciple cannot be applied for correction of horizontal imbalances. This is because, under these arrangements, the level of transfer from the centre to states is positively correlated with their taxing capacity. In countries with vast disparities in levels of development and special problems, it is necessary to evolve appropriate redistribution criteria to apportion the revenues. It may be pointed out here that while equalization grants may take care of the problem of horizontal imbalance, it is better to evolve suitable criteria for distribution of shared tax revenue among the state for addressing the horizontal imbalance. This is particularly important in a developing country like India.

The Finance Commissions has used its own criteria for fixation of the shares of individual states. The criteria have differed between income tax and union excise duties. In case of Income tax first to twelve Finance Commissions have recognized "Population and Contribution" to be the relevant factors, though they have differed on the relative weightage to be accorded to these two factors. The weightage assigned to two factors by first to fourth Finance Commission was 80:20 After fifth to seventh Finance Commission increased it 90:10 and then afterward the Finance Commission change their view not concentrating only on population but on many other facts. The twelth Finance Commission recommended the criteria for determining the inter se shares of states in the shareable proceeds of income tax on the basis of.

(i)10 per cent on the basis of population.
(ii)62.5 per cent on the basis of income.
(iii)7.5 per cent on the basis of area.
(iv)7.5 per cent on the basis of index of infrastructure.
(v)5.0 per cent on the basis of tax effort.
(vi)7.5 per cent on the basis of fiscal discipline.

Thus the Twelve Finance Commission reduced the weight of population from 20 per cent to 10 per cent and marginally increased the weight of income, area infrastructure tax efforts and fiscal discipline.

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