

## DEVOLUTION : AN ALTERNATIVE SCHEME

**13.1** We have indicated earlier in our approach that we favour a system of vertical resource sharing in which central taxes are pooled and a proportion devolved to the States. In the context of the current economic reforms, this new arrangement is likely to have distinct advantages over the present system. We now set out our alternative scheme of devolution.

**13.2** The main benefits resulting from this new arrangement may be listed as below:

- a) With a given share being allotted to the States in the aggregate revenues from central taxes, States will be able to share the aggregate buoyancy of central taxes.
- b) The Central Government can pursue tax reforms without the need to consider whether a tax is shareable with the States or not.
- c) The impact of fluctuations in central tax revenues would be felt alike by the Central and State Governments.
- d) Should the taxes mentioned in articles 268 and/or 269 form part of this arrangement, there will be a greater likelihood of their being tapped.

**13.3** In the framework of cooperative federalism, the Constitution currently provides for sharing of two taxes, income tax and Union excise duties, with the States. India's economic space is occupied in common by the Centre and States. Recent economic reforms including tax reforms, have underlined this fact. The progress of reforms will be greatly facilitated if the ambit of tax sharing arrangement is enlarged so as to give greater certainty of resource flows to, and increased flexibility in tax reform for, the two layers of government. The Indian tax system, heavily dependent on indirect taxes, with Union excises and State sales taxes comprising the core of the domestic trade taxes, suffers from many deficiencies like high and multiple tax rates, taxation of inputs and cascading, exclusion of services from the tax base, multiplicity of exemptions and concessions through notifications and lack of harmony in the tax systems of States. The country needs a climate in which there is greater harmonisation of State taxes in terms of their rates, structure and procedures as also greater Centre-State harmonisation in domestic trade taxes.

**13.4** The relevant ratios determining the vertical allocation in tax devolution have remained at 85 per cent in the case of income tax and at 45 per cent for Union excise duties for the past ten years. As the share of the Central Government in income tax is only 15 per cent it has often been claimed that the Centre has shown lack of interest in tapping this source of revenue fully. A similar lack of interest is adduced as a reason for the tax sources under articles 268 and 269 remaining unexploited or underexploited. Similarly, it is believed that the large share of Union excise duties accruing to the States has reduced the flexibility of the Centre in the choice of tax measures. The Ministry of Finance itself has said in its memorandum: "If the Central Government raises more through personal income tax... as much as 85 per cent of the increase will go to the States. Similarly, in the

case of the Union excise duty, 45 per cent of any increase in the yield will accrue to the States. Hence, if the Central Government wishes to raise Rs. 100 crores for itself, through Union excise duties, it would have to raise around Rs. 182 crores. To get the same Rs. 100 crores through a rise in the personal tax yield, the Central Government would have to raise Rs. 667 crores!"

**13.5** Of the major Central taxes, the two taxes presently shareable seem to be less buoyant than the other two as is evident from **Table 1**. An advantage of pooling these Central taxes would be that both the Centre and the States would share in the buoyancy of aggregate revenues. This would be of particular advantage in a period of tax reform, when relative buoyancies undergo changes.

**Table 1**

### Revenues from Major Central Taxes: Growth Rates

	Average Annual Growth Rates		
	70/71-79/80	80/81-89/90	70/71-89/90
Corporation Tax	14.42	17.15	15.79
Income Tax other than Corporation tax	12.76	14.83	13.80
Customs Duties	20.96	20.03	20.49
Excise Duties	14.10	14.31	14.20

**Source:** *Interim Report of the Tax Reforms Committee, Ministry of Finance, Government of India, page 24*

**13.6** In their memoranda to us, States have generally urged us to move towards a larger pool of revenues from which they can be assigned a share. Many States have urged that corporation tax and income tax should be pooled together and then distributed. Orissa has suggested the inclusion of receipts from penalties, interest recoveries and surcharges on income tax in this pool. Rajasthan has suggested that capital receipts accruing from pre-emptive purchases and sale of immovable properties should form part of the income tax proceeds. Tamil Nadu has suggested that proceeds from the pre-emptive purchase of properties, penalties and interest recoveries, tax on Union emoluments, cost of collection and miscellaneous receipts should be included in the pool. Karnataka and Uttar Pradesh have suggested that all Central taxes should be made shareable.

**13.7** The Ministry of Finance, Government of India, at one stage, made the suggestion that in the longer term context, we may wish to examine the desirability of changing the pattern of tax sharing such that the entire tax revenues of the Centre (except Union surcharges) become shareable. It also said, however, that the percentage may be pitched at 22-23 per cent and that it should remain fixed for 20 years.

**13.8** Notwithstanding the present Constitutional position, Finance Commissions in the past have noted, with concern, that a share was not being assigned to the States in the proceeds of the corporation tax. The Third and Fourth Commissions took this factor into account for raising the States' share in income tax from

60 to 66 2/3, and to 75 per cent, respectively. The Third Commission had also raised the number of items of excise to be shared to compensate for the loss. The Sixth Commission had suggested a review of this issue by the National Development Council and the Seventh Commission had also suggested that the Centre may hold consultations with the States in order to settle the point finally. The Eighth Commission had expressed the view that since the corporation tax had shown a high elasticity, it would seem only fair that the States should have access to such a source of revenue.

13.9 The Sarkaria Commission had also examined this issue at length. It favoured bringing the corporation tax into the divisible pool as part of permissive participation like that of the Union excise duties. It suggested that this may be accomplished by a suitable Constitutional amendment.

13.10 The Chelliah Committee on Tax Reforms (1991) has expressed the view that the present Constitutional provisions regarding tax sharing need to be re-examined. In this context, the Committee observed in its Interim Report (p. 45) as follows: "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. ... The percentages of the taxes to be shared with the States are not specified in the Constitution, but are left to be decided by the President after he considers the recommendations of the Finance Commission in this regard. At present tax devolution to the States constitutes around 24 per cent of gross Central Government tax revenues. With the consent and cooperation of the States the relevant constitutional provisions could be amended to the effect that 25 per cent of the aggregate tax revenues of the Centre shall be shared with the States. There would be certainty then for the States and the Union regarding what revenues would accrue to their respective budgets and the Centre would not have to distort its pattern of taxation by being virtually compelled to raise non-shareable taxes."

13.11 The Constitution provides for the division of functions and sources of revenue between the Central and State Governments vide three lists contained in the Seventh Schedule, viz. Union List, State List and Concurrent List. Article 270 makes it mandatory to share income tax with the States. Article 272 provides for a discretionary sharing of Union excise duties. The sharing of corporation tax has, however, been excluded by a specific provision in Article 270. In addition, the following proceeds of income tax are excluded from being shared with the States:

- i) proceeds attributable to the Union Territories;
- ii) taxes payable in respect of Union emoluments;
- iii) surcharge.

Duties set out in article 268 are such as may be levied by the Centre but the States collect and appropriate the proceeds within their respective areas. Article 269 specifies taxes that are to be levied and collected by the Government of India but the proceeds are wholly assigned to the States.

13.12 Assigning a share in the total proceeds from central taxes to the States would require suitable amendments to the Constitution. While doing so, the power of the Union to levy and collect all taxes in the Union list should not be qualified by the proposal to transfer a certain percentage of specified central taxes to the States. In other words, while all List I taxes remain Union taxes and the proceeds of no particular tax shall be deemed 'divisible', the States will be entitled to a prescribed percentage of the tax receipts of the Union.

13.13 We are proposing a share of the States based on the amounts currently accruing to the States. For this purpose we have distinguished between shares in income tax, basic excise duties and grants in lieu of tax on railway passenger fares as a proportion of central tax revenues (s1) on the one hand and the share of additional excise duties on the other (s2). The share of the States in these taxes is given in Table 2.

**Table 2**

**Share of States in Aggregate Central Tax Revenues**

	S1	S2	S
1979-80	25.66	2.92	28.58
1980-81	26.00	2.94	28.94
1981-82	24.11	3.00	27.11
1982-83	23.57	2.78	26.35
1983-84	22.27	3.16	25.43
1984-85	21.15	3.56	24.71
1985-86	23.26	3.20	26.46
1986-87	22.85	3.25	26.10
1987-88	22.53	3.20	25.73
1988-89	21.29	2.91	24.20
1989-90	22.77	3.04	25.81
1990-91	22.60	2.90	25.50
1991-92	22.90	2.85	25.75
1992-93	24.69	3.01	27.70
1993-94 (RE)	26.20	2.98	29.18
1994-95 (BE)	25.15	3.02	28.17
Average:			
1979-84	24.32	2.96	27.28
1984-89	22.22	3.22	25.44
1990-95	24.31	2.95	27.26

**Notes:** S1 = Share of States in income tax, Union excise duties, estate duty, and grant in lieu of tax on railway passenger fares as percentage of total Central tax revenues (incl. AED).

S2 = Revenue from additional excise duties transferred to the States as percentage of total Central tax revenues.

S = S1 + S2

**Source:** Finance Accounts, Government of India.

Receipts Budget, Central Government, 1994-95.

13.14 It will be noticed that during the period covered by the reports of the Seventh, Eighth and Ninth (1990-95) Commissions, the average value of s1 has been 24.32, 22.22 and 24.30 per cent and that of s2 2.96, 3.22 and 2.95. Having regard to these values, and the fact that we are recommending inclusion of some taxes under article 269 in the central pool, we recommend that the share of States in the gross receipts of central taxes shall be 26 per cent. We further recommend that the tax rental arrangement should be terminated, and additional excise duties merged with basic excise duties. These three commodities should not be subject to States sales tax. Having done so we recommend a further share of three per cent in the gross tax receipts of the Centre for the States in lieu of additional excise duties. These shares of twenty six and three per cent respectively should be suitably provided for in the Constitution and reviewed once in 15 years. We have used the criterion of revenue equivalence only for the initial fixing of the

above ratios. We are not recommending revenue equivalence as a principle. It would not be relevant to consider in future what the share of the States would have been had they been getting shares individually in income tax and Union excise duties as at present.

**13.15** The proceeds of taxes under articles 268 and 269, except in so far as they relate to the Union Territories, do not form part of the Consolidated Fund of India, and are wholly assignable to the States. There is a distinction between articles 268 and 269 in so far as this assignment is concerned. In article 268, the Constitution provides that the proceeds of taxes leviable within any State shall be assigned to that State. Article 269 provides that: "The net proceeds....shall be assigned to the States within which that duty or tax is leviable in that year, and shall be distributed among those States in accordance with such principles of distribution as may be formulated by Parliament by law". Among the taxes covered by article 269, estate duty has now been abolished. The tax on railway passenger fares was also repealed in lieu of which the States are given a grant. The important taxes, from the viewpoint of revenue, are the central sales tax, and the consignment tax.

**13.16** With the Central Sales Tax Act, 1956, the power to levy the tax on inter State sales has been effectively delegated to the States. A State levies tax on inter-State sales originating in its territory and retains the proceeds. The maximum rate of tax, currently 4 per cent, is prescribed by the Central Government. Such a tax is viewed as fragmenting the national market, and may be considered as an inefficient source of raising revenues. The consignment tax raises similar problems. The very reason why the power to levy these taxes was vested in the Centre was to avoid their misuse or overuse at the cost of fragmenting and distorting the domestic market.

**13.17** We believe there is some advantage in retaining a system such as in article 268, where a tax is levied by the Union

Government but collected and retained by the States, in the interest of uniformity of rates. Because Central sales tax, already being levied, and consignment tax, if and when levied, are similar to the taxes under article 268, we have decided to keep them out of the pool of central taxes. All other taxes in article 269 shall form part of the central pool.

**13.18** In recommending that these taxes form part of the pool, we are guided by the consideration that this will induce the Centre to exploit these tax bases which are not currently being tapped. States will also benefit from such exploitation of tax bases. We are of the view that while article 268 taxes may be kept out of the arrangement of fixing a common share for all central taxes being suggested here, all article 269 taxes except Central sales tax and consignment tax should be brought within the purview of these arrangements.

**13.19** There has been occasion in the past when the Centre had to augment its revenue for meeting emergent but temporary needs. In such circumstances a surcharge on income and corporation tax was imposed. Such occasions may arise in future also. The Centre should, therefore, continue to have the power to levy surcharges for the purposes of the Union and these should be excluded from the sharing arrangements with the States which are recommended above.

**13.20** We have recommended the share of States in income tax, Union excise duties, additional excise duties and grants *in lieu* of tax on railway passenger fares in accordance with our terms of reference. However, we would recommend that the alternative scheme of resource sharing suggested by us may be brought into force with effect from 1st April, 1996 after necessary amendments to the Constitution. This should not affect the inter-se shares and grants recommended by us.