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TAX CONTRIBUTION BY STATES NEEDS TO BE REVISITED

Relevant for: Indian Economy | Topic: Issues relating to Mobilization of resources incl. Savings, Borrowings & External Resources

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The Finance Commission's important job is to recommend a distribution formula specifying each State's share in the part of the Union tax revenue assigned to States. Such distribution formulas have a few weighted determinants. Since the 1st Finance Commission, some States have been arguing that their contributions to the Union tax revenue have been higher than others and, therefore, they rightfully have higher shares in the Union tax revenue. In the first eight Finance Commissions, tax contribution with very little weight was a determinant in the distribution formula. Since the 10th Finance Commission, this tax contribution was dropped from the distribution formula. Here, we argue that tax contribution by each State is a good measure of efficiency, and the Goods and Services Tax (GST) regime creates an opportunity for its inclusion in the distribution formula.

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Two important tasks of the Finance Commissions are (i) to recommend the proportion of the Union tax revenues to be assigned to States and (ii) to recommend the share of each State in the assigned tax revenue. Till 2000, that is, the 10th Finance Commission, the States' share was restricted only to personal income tax and Union excise duties and after that, all the Central tax revenues were pooled, and States' shares were decided. With reference to the second task, the Finance Commission devises a distribution formula to arrive at a share for each State, and it is based on the principles of equity and efficiency. Equity stipulates that the revenue-scarce States and States with higher expenditures get larger shares of Union tax revenue than others. Efficiency is to reward the States that are efficient in collecting revenue and rationalising spending. The trade-off between equity and efficiency is normative and remains dynamic in successive Finance Commission recommendations.

States from which large volumes of income tax revenue have been collected argued to consider and assign a higher weight to 'tax collection' as an indicator of tax contribution. The origin of income is essential to estimate States' contributions to income tax revenue, which is difficult to identify, as a person may pay income tax from one State though the income earning is from other States. Successive Finance Commissions have assigned 10% to 20% weight to income tax revenue collection/assessment in the distribution formula for income tax revenue because collection is not a good indicator of contribution. In the case of Union excise duties, the value of taxable products consumed in a State is essential to decide its contribution. Due to the unavailability of proper consumption statistics, contribution was never a determinant in the distribution formula for Union excise duties.

We should note that tax contribution is an efficiency indicator because a State's level of development and economic structure decides its tax contribution. However, Finance Commissions had assigned only 10% to 20% weight to this efficiency indicator. Population, a chief indicator of the expenditure needs of the State, was given 80% to 90% weight in the first seven Finance Commissions as far as income tax distribution was concerned. In the case of distributing revenue from Union excise duties, the entire distribution was based on population or other indicators of expenditure needs such as area, per capita income, proportion of Scheduled Caste/Scheduled Tribe population, and some indicators of social and physical infrastructure needs. Since the 10th Finance Commission, the Commission has recommended a single distribution formula for both income tax and Union excise duties. Thus, the Finance Commissions have always favoured assigning more than 75% weight to equity indicators.

Since 2000, the formula for the distribution of pooled Central tax revenues included tax effort and fiscal discipline as efficiency indicators with a weight of around 15%. Tax effort is broadly defined as the ratio of own revenue of a State to its Gross Domestic Product. Fiscal discipline is the proportion of own revenue to the revenue expenditure of a State. In the 15th Finance Commission, the distribution formula had tax effort with a weight of 2.5%, and demographic performance, an indicator of efficiency in population control, was given a weight of 12.5%. The remaining 85% weight was distributed among equity indicators of per capita income, population as per the 2011 Census instead of the conventional 1971 Census, area, forest cover, etc.

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Even though some States have been arguing for increasing the weightage for efficiency indicators such as tax effort and fiscal discipline, these indicators have received lower weights as they are unstable. The tax effort is affected by discretionary tax policies and unexpected changes in actual tax bases. The fiscal discipline is affected by contractual payments such as salaries, pensions, and interest payments, as well as the tied-grant-induced expenditures of States. An objective measure of tax contribution by States, given the stability in tax structure, should be a good indicator of efficiency and be assigned a larger weight. GST satisfies this criterion.

GST is a consumption-based destination tax that is equally divided between the State and Central governments. In other words, the State GST accrual (inclusive of Integrated GST settlement) to a State should be the same as the Central GST accrual to the Union government from that State. Therefore, accurately estimating the tax contribution from a State to the Union exchequer is feasible under GST. Since GST is a unified tax system, the calculations by these authors show that there is not much of a variation in the tax efforts of States. However, the absolute amount of GST revenue generated from each State would differ by the size and structure of States' economies, and this marks the importance of the inclusion of this tax contribution as an efficiency indicator in the distribution formula. A State's GST contribution is not affected by discretionary tax policies of the State; it only reflects the accurate tax base of the State that is being exploited for the national good.

In addition to GST, petroleum consumption is also an indicator of tax contribution to the national exchequer. The Union excise duty and sales tax on petroleum products are outside GST. The cascading tax burden of these two taxes in addition to the burden of customs duty on petroleum imports falls on the final consumers of petroleum products in a State. Just like GST, the relative shares of petroleum consumption vary across States, but such shares are stable over time for every State. Therefore, the relative share of a State's petroleum consumption reflects the relative contribution of the State to the national exchequer in the category of Union excise duties and customs duties on petroleum products.

Including the relative GST contribution and petroleum consumption of a State in the distribution formula is irresistible for yet another reason, that is, both these two ratios indicate the relative differences in the incomes (both personal and corporate) accrued to the residents of a State because consumption is a function of income. The share of CGST and Union excise duty is about 30% of States' share in Central tax revenue in 2021-22 and the similar ratio for personal and corporate income taxes is 64%.

Thus, the two relative contributions, namely GST revenue and petroleum consumption, of States are fair and accurate measures of States' contributions to the national exchequer and a good measure of efficiency. There is a persuasive case for the 16th Finance Commission, recently constituted by the Union government, to debate and include these ratios as a measure of efficiency with a weightage of at least 33% in the distribution formula.

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