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Explaining the problem of low own tax revenues in Jammu & Kashmir

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Abstract
One of the important clues to understand development issues in Jammu & Kashmir is the state's revenue generation and expenditure pattern, which also provides valuable insights into the acute 'dependency syndrome' faced by the state. Low own tax revenue-GSDP ratio is the main characteristic of the fiscal scenario of Jammu & Kashmir. The absence of the private sector due to infrastructural bottle necks and security problems has meant a low tax base and the burden of generating economic activity has to be borne almost exclusively by the public sector. Excessive and prolonged dependence on central assistance has led to a complacent attitude towards resource generation, fiscal responsibility and accountability. The present study deals with the structural deficiencies of J&K state finances and attempts to understand the reasons for these features which underlie the fiscal stress in the state of Jammu & Kashmir.

Keywords: Own tax revenue, dependence, central assistance, resource generation, fiscal problem

1. Introduction

One of the important clues to understand development issues in J&K is the state's revenue generation and expenditure pattern, which also provides valuable insights into the acute 'dependency syndrome' [1] faced by the state. Low generation of internal resources in J&K is a key economic disadvantage having substantial implications for development. The absence of the private sector due to infrastructural bottle necks and security problems has meant a low tax base and the burden of generating economic activity has to be borne almost exclusively by the public sector. Excessive and prolonged dependence on central assistance has led to a complacent attitude towards resource generation, fiscal responsibility and accountability [2]. Keeping aside the economic and political considerations due to which J&K receives financial assistance as a Special Category State [3], it is important to see how the state uses these resources in building a self-reliant economy (Puri, What Is Wrong with Kashmir's Finances?, 1981) [3]. There is need to restructure public finances for generating growth augmenting avenues for development. The present study deals with the structural deficiencies of J&K state finances and attempts to understand the reasons for these features which underlie the fiscal stress in the state of Jammu & Kashmir.

2. Data and Methodology

Data on revenue receipts, revenue expenditure, own-tax revenue (OTR), own- non tax revenue (ONTR), central transfers and grants referred to as revenue transfers (RT) has been used for the period 1980-2010. The data have been principally sourced from Reserve Bank of India (RBI)'s series of the annual publication 'State Finances: A study of budgets', which is tabulated from the budget documents of state governments and various Finance Commission

[1] The term dependency syndrome in context of state of finances of J&K was first used by Prof. Nisar Ali in 1990's. See, 'Macroeconomic Perspective of Dependency Syndrome: Serious Concerns in Jammu and Kashmir Economy', 2007.
[2] See 'Report of the Task Force on Development of Jammu & Kashmir', Government of India, 2006.
[3] J&K became a Special Category State in 1969, when the 5th Finance Commission sought to provide certain disadvantaged states with preferential treatment in the form of central assistance and tax breaks. For the special category states, 90 percent of central assistance was given as grant and 10 percent as loan.

Reports. Shares, proportions, Compound and annual growth rates have been used to explain various findings in this study.

3. Revenue generation and development

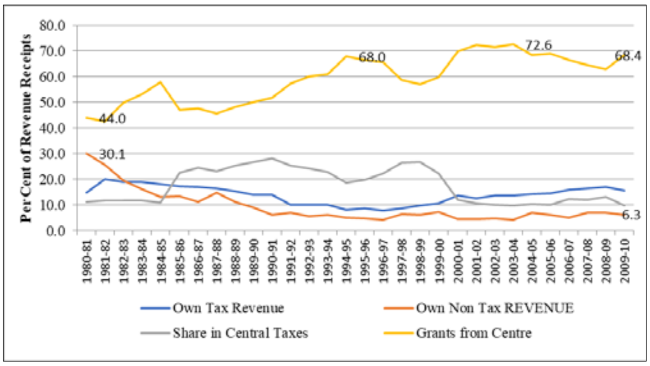
Revenue may be defined as the funds required by the government to finance its activities. Revenue generation is the path to economic development and a tool for the government to finance development activities from domestic resources (Rosen & Gayer, 2007). Revenue can either be obtained internally or externally. Two major sources of revenue for a government are taxation which is an internal source obtained within the domestic economy and borrowing from external sources. The economic and social progress of a country depends largely on its government's ability to generate sufficient revenues to finance programs of essential public services (Todaro & Smith, 2011) [1].

A tax policy is designed to raise the marginal propensity to save of the economy without discouraging work effort and ensuring equity. How much revenue an economy can generate through taxation depends on two factors: the taxable capacity and the tax effort made in relation to its taxable capacity. The taxable capacity of an economy depends on the factors like per capita income, distribution of income, urbanization, the size of the industrial sector, natural resource base, amount of investment etc and the tax effort depends on the extent to which these tax bases are exploited. As income increases with time, it should lead to an automatic increase in the tax revenues under progressive structure of tax rates. In developing countries tax revenue as a percentage of the national income is typically low. Thus the nature of the tax system and the revenue generated thereby is partly a reflection of the stage of development an economy is in (Todaro & Smith, 2011) [1].

4. Fiscal Scenario of Jammu & Kashmir

The state resource mobilization in India consists mainly of 'internal resource mobilization' that is, tax and non-tax revenue and 'central devolution' that is state's share of union excise duty and grant-in-aid by the central government. Thus, the revenues of the state governments are divided into: Tax revenues and Non-Tax Revenue. The Tax revenue consists of Own Tax Revenues and the state's share in the Central taxes, while as the Non-Tax Revenues consist of the state's Own Non-Tax Revenues and Grants from the centre [4]. Non-Tax revenues of the government mostly have fixed rates of increase over time; it is the category of Tax revenue which is likely to show sensitivity to the performance of economy (Dholakia & Dholakia, 2000) [3].

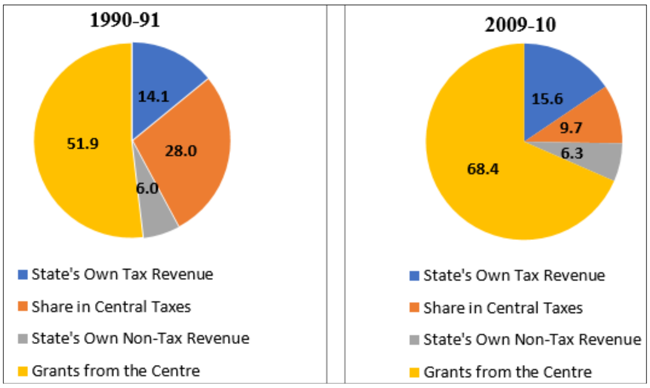
One of the characteristics of finances in J&K is low resource mobilization, which has been a characteristic feature right from the start of the Planning period in 1951. The revenue of the state was the lowest as compared to other states of India like Hyderabad, Mysore, Assam, Bihar and Uttar Pradesh, though its expenditure would compare favourably with them (Kaul, Finances of Jammu and Kashmir State, 1956) [2]. The tax revenue accounted for only 17.5 per cent of the total revenue which was again the lowest as compared to other states. The internal resource mobilization through tax and non-tax revenue has sharply gone down in the last 35 years. During the fiscal year 2001-02 state's internal resources were about 15 per cent of the budgetary resources while it was dependent upon the centre to the extent of 85 per cent for resources, though during the last one decade there has been a slight increase in state's revenues (Author's own compilation from 'State Finances: A Study of Budgets, Reserve Bank of India (RBI)', various issues). The precarious dependence of the state on revenue transfers is evident from data.



Source: State Finances: A Study of Budgets, Reserve Bank of India (RBI), various issues

Fig 1: Composition of revenue receipts 1980-2010

Further, as is clear from Figure 1 the state's Own Tax revenue as a proportion of revenue receipts has declined from 20.1 per cent in 1981-82 to 10.5 in 1999-00, increasing slightly to 15.6 per cent in 2009-10. The state's share in central taxes shows a sudden surge in 1984-85 till 2000-01, settling to a little below 10 per cent in 2009-10. The share of grants from centre in revenue receipts has shown a consistent rise from 1987-88, increasing from 44.0 per cent in 1980-81 to 68.4 per cent in 2009-10. It is clear that the slow growth in revenue mobilization over the years has led to an excessive dependence on the centre.



Source: State Finances: A Study of Budgets, Reserve Bank of India (RBI), various issues

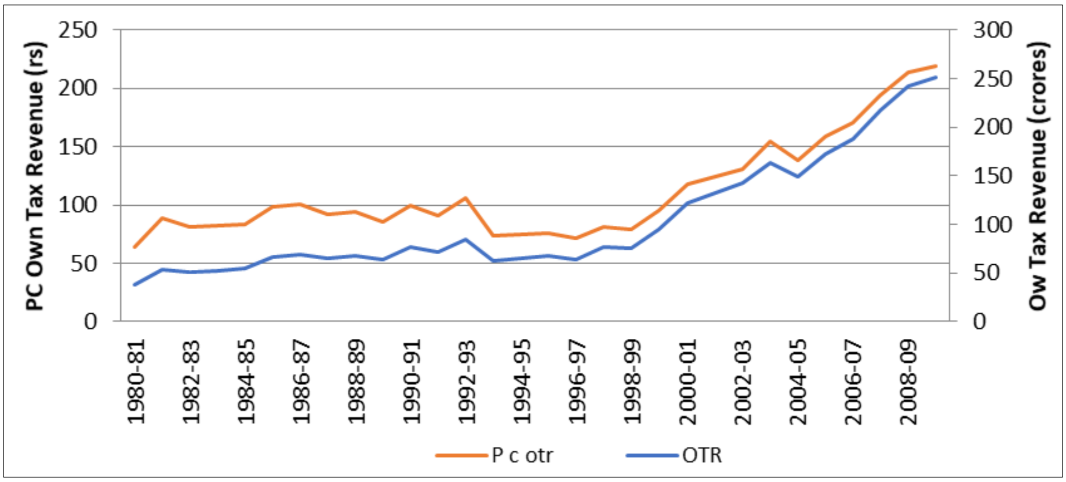
Fig 2: Composition of Revenue Receipts of J&K in 1990-91 and 2009-10

Figure 2, shows the composition of revenue receipts and the changes therein between 1990-91 and 2009-10. It is evident that clear that Grants from the centre form a major component of revenue receipts for the state showing an increase of 16 per cent in the said time period. Between 1990-91 and 2009-10, the state's own tax revenue has increased marginally by around one percent. State's own non-tax revenue has remained virtually stagnant during the

[4] State's Own Tax revenues consist of taxes on income, property, capital transactions, commodities and services, while Own Non-Tax revenues generally include interest receipts, dividends and profits, fees, fines and prices of various social and economic services provided by the government.

same period while as the state's share in central taxes has decreased significantly from 28 per cent in 1990-91 to 9.7 per cent in 2009-10. The decline in revenue receipts of the state from 1992 to 1998 was led primarily by the fall in the OTR and revenue transfers from the centre (as percentages of NSDP). However after 1998-99, the rise in revenue receipts is a result of rise in the OTR of the state, while revenue transfers have decreased.

Figure 3 shows the trend in Per Capita own tax revenue and own tax revenue from 1980 to 2010. As is clear from the figure they have grown slightly in the 1980's, remained virtually stagnant in the nineties, and have shown an upward trend only from the late nineties. Between 1980 and 2010, own tax revenue has grown at a compound growth rate of 5.60 per cent while as per capita own tax revenue has grown 3.05 per cent. Thus as we see the growth of per capita taxation has not been commensurate with the growth of revenues. Between 1980 and 2010, per capita NSDP has grown at a compound growth rate of 10.87 per cent while as per capita own tax revenue has grown 3.05 per cent, again reflecting on the low levels of per capita taxation in J&K (Author's own compilation from 'State Finances: A Study of Budgets, Reserve Bank of India (RBI)', various issues).



Source: State Finances: A Study of Budgets, Reserve Bank of India (RBI), various issues

Fig 3: Per Capita OTR and OTR of J&K: 1980-2010

Own Tax collection (OTR) and Own Non-Tax(ONT) collection together measure the revenue raising efforts of a state in relation to its revenue expenditure and thereby indicate the so called degree of fiscal discipline[5]. Their composition in indicates the quality of fiscal resource generation by a state, it is equally relevant to know whether the rupee collected by a given state, comes from taxes or non-tax sources (Sarma & Dholakia, 2000).

The early period of 1980's shows a negative growth rate in ONTR which after rising for a while again falls in the period 1987-1996. ONTR's growth rate shows slight increase for the rest of the period except in 2000, when it falls to -41.0 per cent. The growth rate of OTR has shown a increasing trend in the early 1980's, falling steadily after 1985.It had the lowest growth rate in 1989 of -3.6 per cent and showed low growth till 1996. The growth in OTR has picked up in the late nineties and the period after that.

The revenue receipts (RR) of J&K as a proportion of NSDP is greater than all Special Category States (S.C.S) taken together (Author's own calculations). It would be interesting to see the difference in the major components of revenue receipts that is OTR and RT from the centre (which consists of the share of tax and grants from the centre). The gap between the revenue transfers of J&K and all S.C.S became significant from the year 1988-89, which was the beginning of political instability in J&K. The revenue transfers to J&K have been increasing over time from 57 per cent of total revenue receipts in 1973 to 83 per cent in 1990 and around 80 per cent in 2010. J&K receives the highest amount of grants from the centre amongst all special category states. Revenue transfers form around 40 per cent of the share of NSDP from the 1990's.

5. Explaining the problem of OTR-NSDP Ratio in J&K

The composition of the OTR in J&K shows that the biggest components of the total OTR of the state is commodity and services tax accounting for 96 per cent of the total tax revenue in 2010-11 followed by the property and capital transaction tax accounting for 3.46 per cent of the total own revenue in 2010-11 (Table 1). It would be interesting to have a look at the movement of both these taxes. In 2010-11, 72.12 per cent of CST is accounted for by sales tax only, making it the most prominent determinant of OTR. The taxes collected by the state governments in India can basically thought to be a variety of expenditure taxes which are incurred in various sectors of the economy, having different sectors as the tax base (Dasgupta, 2012) [4]. Thus, it would be important to understand the structural change in the J&K economy to understand the movement of OTR.

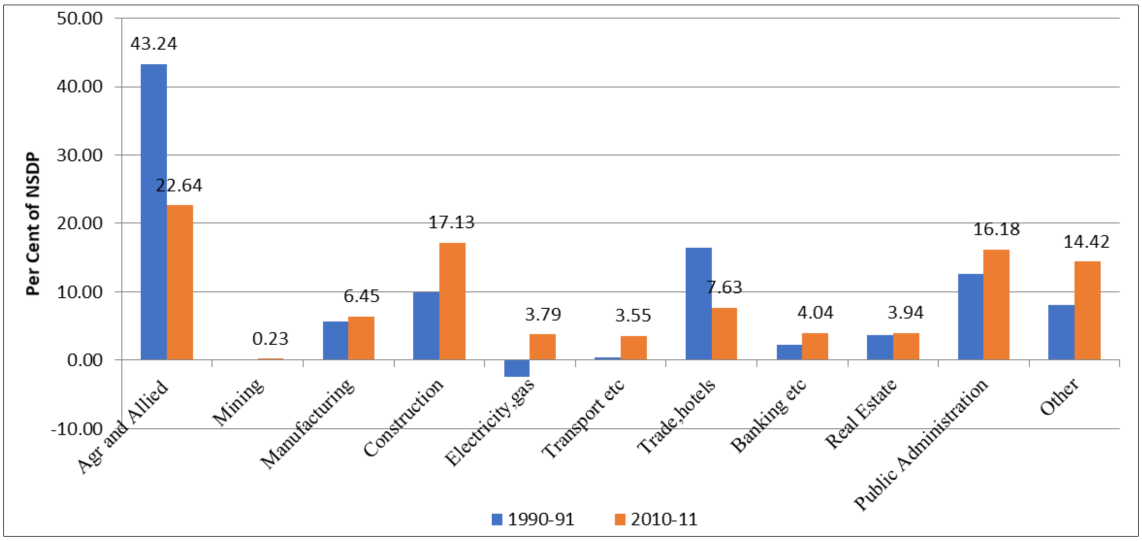
Table 1: Composition of Own Tax Revenue for J&K (in %)

Years	Income Tax (IT)	Property and Capital Transaction Tax (PKT)	Commodity and Services Tax (CST)
1990-91	17.56	2.35	80.09
2010-11	-	3.46	96.54

Source: State Finances: A Study of Budgets, Reserve Bank of India (RBI), various issues

[5] Own Revenue Effort Index (OREI) as defined by the Eighth Finance Commission and Tenth Finance Commission is constructed out of the following two indicators; Own tax collection as a proportion of revenue expenditure(OT/REX) and Own non-tax collection as a proportion of revenue expenditure (ONT/REX). See, A. Dholakia 'Measuring Fiscal Performance of states: An Alternative Approach' 2005, pg 342

As is seen in Figure 4, the structural change in J&K economy has been such that the most prominent increase has been in the share of Construction. The share of agriculture has decreased substantially while that of manufacturing has remained more or less stagnant between 1990-91 and 2010-11. The share of electricity, banking and public administration has increased.



Source: State Domestic Product Series, C.S.O

Fig 4: Sectoral Composition of J&K NSDP

As is evident the proportion of construction sector has increased significantly in the NSDP of J&K. The Property and Capital Transaction tax (PKT) basically consists of stamp duties and registration fees, land revenue and urban immovable property tax, which is dependent on the performance of the real estate and the construction sector (Chowdhury & Dasgupta, 2012) [4]. The movement of PKT to NSDP ratio is dependent on the share of real estate and construction in the NSDP and the effective tax rate from the real estate and the construction sector i.e PKT/RE.

The effective tax rate from the real estate and the construction sector is very low and falling from the early nineties and has shown marginal increase over the years. This is a reflection of existing revenue leakages in the system, which as seen earlier is because of the nature of construction sector in the state of J&K. Construction industry relies on huge imports of capital and labour, emerging as a sector causing the leakage-effect.

The other major source of revenue for the state is the sales tax (ST), which is mainly collected from the industry and the manufacturing sector (Rao, 2001). It would be worth to have a look at the movements of Manufacturing-NSDP ratio and the Sales tax-NSDP ratio for J&K (Rao & Sen, 2010).

The share of sales tax in NSDP increased till 2003-04 in spite of a steep decline in the share of manufacturing in NSDP. This is possible only if the growth rate of effective tax rate is sufficiently high (Chowdhury & Dasgupta, 2012) [4]. The problem with J&K is that the share of manufacturing in NSDP has witnessed a steep fall from the nineties, and if analysed at two time periods of 1990-91 and 2010-11, has remained stagnant at around 6 per cent of NSDP. With the share of manufacturing being stagnant it is not sustainable to have an increase in the ST-NSDP ratio. The share of Sales tax in NSDP can show a robust increase only with the recovery of the share of manufacturing sector in the NSDP.

Thus the reasons for a low OTR-NSDP ratio in J&K economy seem to be emanating from two reasons. First, a stagnant manufacturing sector of the state resulting in a low manufacturing base and second the revenue leakages that exist in the high performing Construction sector of the economy.

6. Conclusion

The present study has looked into the problem of low own tax revenue-GSDP ratio faced by the state of Jammu & Kashmir. It is concluded that over time the state economy instead of becoming self-reliant has shown increased dependence on the funds from centre to finance its expenditures. J&K receives the highest amount of revenue transfers from the centre in form of grants as a percent of revenue receipts amongst all Special Category states. The growth rate of OTR has lagged behind that of NSDP in the period 1980-2010. It is seen that the reasons of low OTR-NSDP in J&K are twofold. First, the manufacturing sector of the state has had consistent low performance, with the share of the manufacturing in NSDP declining sharply. Secondly, the revenue leakages that exist in the construction sector facilitate low own tax revenues in the state of Jammu and Kashmir.

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