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## **The Political Economy of India's Transition to Goods and Services Tax**

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# The Political Economy of India's Transition to Goods and Services Tax

## Abstract

What kept the Goods and Services Tax (GST) from becoming a reality in India for a quarter of a century after the adoption of the structural adjustment programme in 1991? What made it possible in 2016? To what extent the Indian model of GST reflects a compromise between the need to keep fiscal federalism intact and to respond to a more global economic imperative? To what extent India's transition to a concurrent dual GST has brought about a change in the principles, rules, frameworks, and institutions guiding intergovernmental fiscal interactions? This paper investigates these issues and shows that the shifts in the indirect tax regime in India since independence have taken place within the structural context of constitutional rules, the economic policy paradigm and political dynamics. Party congruence after 2014 helped to facilitate the introduction of the GST, but the shape thereof was strongly marked by path-dependent logics and the role of state governments as institutional veto players. In addition, the paper examines the ways in which India's transition to a concurrent dual GST has brought about a fundamental change in the principles, rules, frameworks, and institutions guiding intergovernmental fiscal interactions.

Keywords: India, fiscal federalism, indirect tax reforms, GST, intergovernmental relations, fiscal autonomy

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# **The Political Economy of India's Transition to Goods and Services Tax**

**Chanchal Kumar Sharma**

## **Article Outline**

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- 1 The Concept and the Context: The Economic case for a GST
- 2 The Impact of India's Federal System on Reforms to Indirect Taxation
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## **Introduction**

This paper seeks to investigate recent reforms in the system of indirect taxation in India, more specifically, the introduction of a land-mark Goods and Services Tax in 2017 and to assess its influence on the nature and dynamics of Indian fiscal federalism. In the process, it sketches the contextual constraints (institutional veto-points, and path dependent legacies) and the divergent actor preferences which had to be overcome to push through the GST, more than 25 years after it was first suggested. It illustrates the competing logics between keeping a basic

feature of fiscal federalism intact, i.e. the allocation of some sources of taxation to the sub-national level of government, and the need to respond to a more global economic imperative to simplify India's tax structure by doing away with a range of central and state sales taxes. The latter assumes a harmonizing and possibly centralizing direction; the former implies the continuation of divergent patterns in taxation across levels and across the states. The paper shows how policymakers in India eventually reached a precarious compromise. Although a range of sales and state taxes were replaced with a GST, its potentially centralizing implications for fiscal federalism is sought to be offset by mechanisms of intergovernmental coordination and dispute settlement on GST issues in an intergovernmental GST Council (GSTC) and by entrusting the states with a larger share of unconditional grants as recommended by the XIVth Finance Commission (FC).<sup>1</sup> State autonomy is further retained by accepting the states' demand to keep petroleum products out of the purview of the GST. Although this may not make the GST entirely fit for purpose from a viewpoint of economic efficiency, it preserves the fiscal autonomy of the states to a larger extent than would have been the case with a fully integrated and national GST. We argue that institutional veto-points required such a compromise (even in a context as in 2017 when most of the states were controlled by the same political party as the federal executive). In other words, party congruence surely helped to facilitate the introduction of the GST, but the shape thereof was strongly marked by path-dependent logic and the role of state governments as institutional veto players.

In what follows, we begin by highlighting the rationale for indirect tax reforms in India. Since the precise design of a tax system is not determined by economists' prescriptions alone but is also the product of the inevitable tension between what is economically desirable and what is politically feasible, we situate the concept of GST reforms in the context of India's federal market economy.

In the second section—drawing on the classic tenet that 'economic policy operates at the intersection of economics and politics' (Kelkar & Shah 2019)—we examine the hypothesis that the trajectory of taxation reforms in a federal system is determined by the interaction between the nature of the party system (one-party dominant versus multiparty coalition) and the economic paradigm of the day (command economy versus free-market economy). Under a centrally planned economic system, the tax system is likely to reflect the objectives of planned development. A transition from a centralized plan to a market economy necessitates comprehensive tax reforms. However, the fundamental choices for reforms are influenced by institutional veto players and are often path dependent.

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1 The Finance Commission is constituted by the President of India at an interval of five years. This constitutional body recommends the formula for distributing the tax proceeds between the Centre and states, and among the states. It also recommends the payment of grants-in-aid (revenue deficit grants) to states to cover deficits remaining after tax devolution. FC transfers as well as their inter se (horizontal) distribution are free from political interference.

The third section demonstrates that the Indian model of dual GST has been a product of intense bargaining between the Centre and States and it attempts to preserve the salience of States as sovereign entities.

Finally, we show that India's transition to a concurrent dual GST has brought about a fundamental change in the principles, rules, frameworks, and institutions guiding intergovernmental fiscal interactions. The overall direction has been from fiscal autonomy to centre-state financial coordination and collaboration.

## 1 The Concept and the Context: The Economic case for a GST

The concept of GST—a destination-based comprehensive tax on consumption of goods and services—gained popularity in many parts of the world in the late 1960s as a single (unified) tax levied by the national government at a uniform rate and collected on value added at each stage of sale and purchase in the supply chain (OECD 2016). This system eliminates input taxes, expands the tax base and minimises economic distortions and hence makes the tax system responsive to the requirements of the international competition.<sup>2</sup> Due to the IMF's consistent support and advocacy of this form of taxation in the emerging economies, VAT/GST reforms had become something of a litmus test for their greater integration into the global marketplace by the early 1990s (Bird & Gendron 2007). Generally, a single national GST is considered an ideal model for the establishment of a common market in a country. However, this 'ideal' model is not politically convenient for large federal countries like India, where sub-national fiscal autonomy is a sensitive issue. Thus, federal countries like Canada and Brazil have adopted either regional VATs or mixed 'dual' federal-regional VAT systems in which VAT is levied by both the national and subnational governments (Bird 2015). Even in these federal variants, implemented properly, the advantages accruing from a single national GST, such as the expansion of the tax base, abolition of distortionary input taxes, removal of trade barriers and avoidance of the cascading effect of taxation would remain intact.

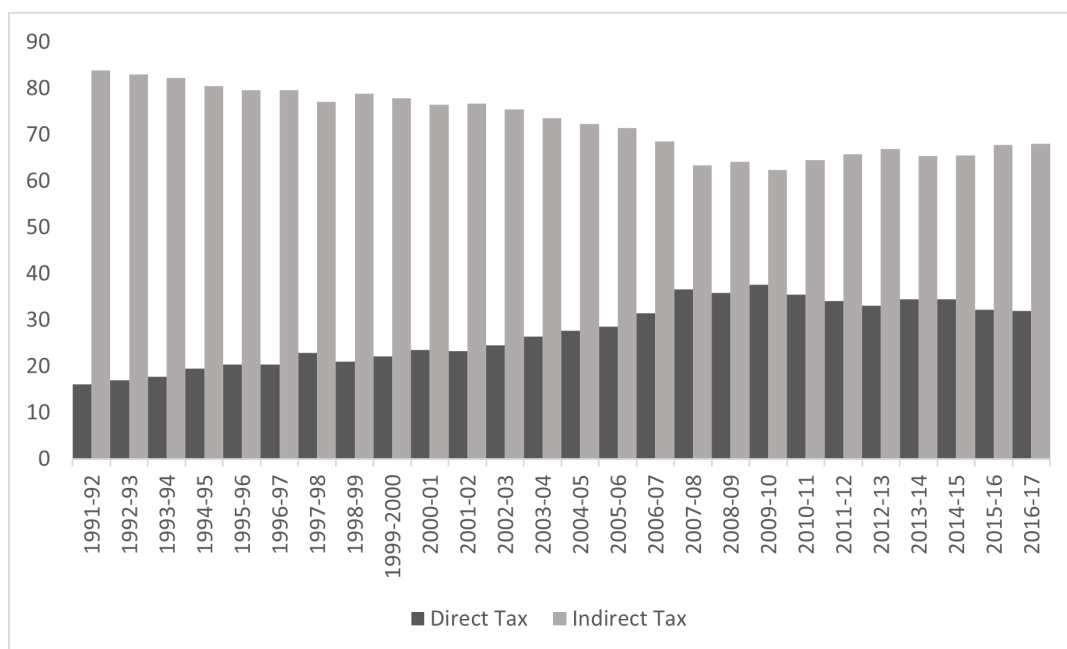
As early as 1977, the L K Jha Committee on Indirect Tax Reform recommended a manufacturing stage value added tax (MANVAT), entitling the manufacturer to claim an input tax credit. This was intended to provide relief to manufacturers whose inputs were taxed and then the final product was taxed again. If implemented, this policy could have enhanced the price competitiveness of Indian products in export markets. However, in a consistent violation of what had been recommended by the Jha Committee (GOI 1978), the Indian taxation regime continued to tinker with its own structural flaws. The large indirect tax base coupled with its

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2 A GST regime featuring a broad-based and low-rate taxation enhances competitiveness of domestic products vis-à-vis foreign producers. It facilitates exports by reducing input costs (only net 'value added' rather than gross value is taxed) and unlocks greater economic integration by minimizing inconsistencies in the indirect tax systems across countries (Krever & White 2007).

notorious cascading effect (tax on tax, as there was no mechanism to set-off for taxes paid on previous purchases as inputs) produced comparatively large revenue, while the disincentive effect of the high (almost confiscatory) direct tax rates on a small tax base lowered revenue collection.<sup>3</sup> In India, the direct to indirect tax ratio is 35:65 (Figure 1) which is quite low<sup>4</sup> and indicates that the government has failed to mobilise direct taxes, which have a known effect of reducing income inequality.<sup>5</sup> Overall, however, tax revenue (direct and indirect) has failed to keep up with public expenditure (Figure 2) and the ratio of tax revenue relative to its gross domestic product (GDP) is quite low at around 16.5 percent relative to the average of 34 percent in the OECD countries (Figure 3). One major reason is large scale tax evasion and avoidance (Jain 1987). As per the Central Board of Direct Taxes data released on 20 April 2016, only 3.8 percent of Indians pay income tax.

**Figure 1: Percentage of Direct and Indirect Taxes in Total Revenue**

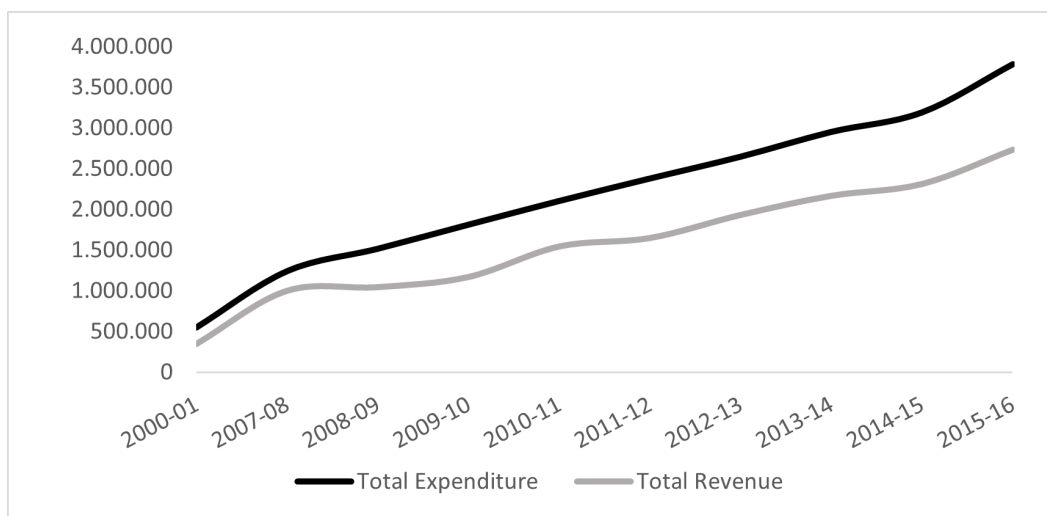


Source: Indian Public Finance Statistics, Ministry of Finance, Government of India.

3 The marginal tax rate in the 1970s was as high as 93.5 per cent (Toye 1989).

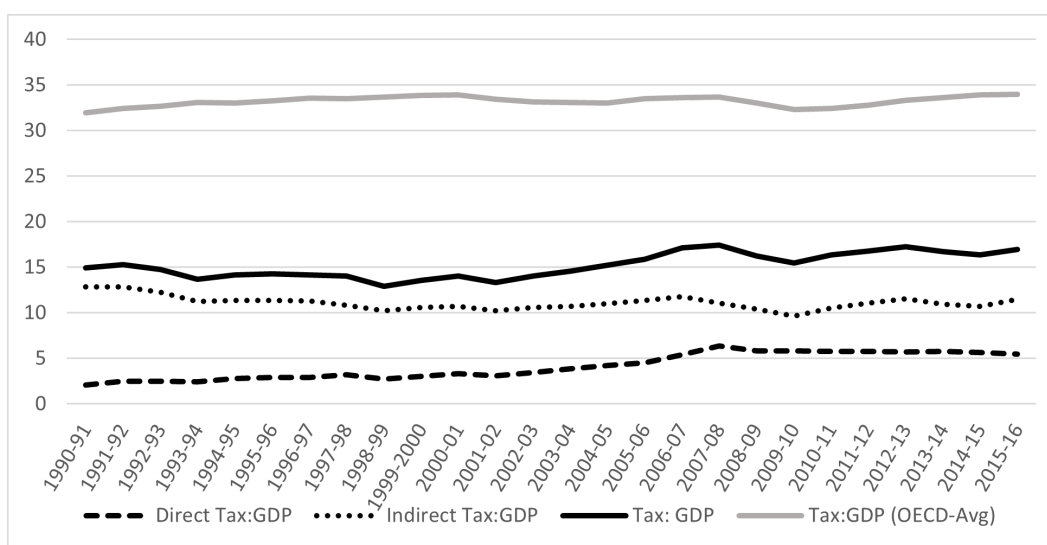
4 The direct-indirect tax ratio in India is the exact opposite of the ratio obtained in the OECD economies, which is 67:33. This ratio, however, is too high, potentially creating disincentives to labour market participation. In these countries a shift towards consumption taxes has been recommended to release latent productive capacities by increasing labour supply and demand. As a general prescription, any attempt to mop up higher revenues (from either direct or indirect taxes) should focus on expanding the tax base rather than increasing the tax rate. This is because increasing tax rates on goods and services beyond a certain point can discourage economic activity (substitution effect) in the same way that increasing direct tax rates does.

5 The Indian government relies heavily on indirect taxes as a major source of revenue precisely because it is easier to tax consumption than income/wealth. Indirect taxes are much less visible and thus excite less opposition. Direct taxes, in contrast, are unpopular by virtue of their visibility. Thus, revenue from indirect taxes tends to outpace revenue from direct taxes.

**Figure 2: Revenue-Expenditure Gap of Centre and States Combined**

Note: All figures are in INR Crore (1 crore is equal to 10 million).

Source: Indian Public Finance Statistics, Ministry of Finance, Government of India.

**Figure 3: Tax-GDP ratio: India versus OECD-average**

Source: Indian Public Finance Statistics (2017-18), Ministry of Finance, Government of India Revenue Statistics (2019), OECD.

The list of benefits that accrue for India as a result of the GST reforms is a long one (Rao, Mukherjee & Bagchi 2019). Most significant are the GST's potential to

- a) make India a common market and draw in more foreign investment by removing barriers to factor and product mobility;
- b) reduce complexity and hence compliance cost and litigation through a simplified GST structure with an uninterrupted chain of input tax credit transfers from one stage to another in the chain of value addition;



- c) make the Indian industry more export-competitive by removing the cascading effect of taxes and thereby reducing the overall cost of indigenous products and services; and
- d) accelerate economic growth by facilitating the more efficient allocation of resources and promoting trade, business and investment.

After 1991, the reform in the Indian tax system was rendered inevitable and indispensable by the paradigm shift in India's economic policy-making from a command economy to a free market economy. Although a national consensus had emerged in the 1990s on the broad direction of economic policy, differences remained on many aspects including the pace and details of indirect tax reforms (Ahluwalia 2019). In particular, the design of VAT/GST remained a major source of disagreement between the centre and states because the new tax regime proposed to subsume the sales tax, the only major revenue source for sub-national governments in India. The proposed reforms also sparked a debate between the supporters of fiscal restructuring (for macroeconomic stability and fiscal sustainability) and subnational fiscal autonomy. The diversity of thinking on the virtues of competing models of the VAT, despite a widely recognised need to overhaul India's indirect tax system, was reflected in the recommendations of the Tax Reforms Committee (Chelliah 1993) and the Bagchi Report (Bagchi 1994). While the former recommended a 'national VAT' for India, the latter took subnational revenue autonomy into account and recommended steps to transform State Sales Taxes into State VATs.

However, the nature, direction and extent of fiscal reforms at a given point in time are determined not just by their economic rationality but also by their political viability. To preserve and promote political stability, governments generally combine the fiscal instruments in ways that achieve the most desirable (economically as well as politically) combination of tax structures, systems of division of taxing and spending authority, revenue sharing and inter-governmental transfers. Thus, we expect the process of implementation of GST in India to impact and be impacted by the complexities of its federal system. In the next section, we discuss the impact of these complexities on the Indirect tax reforms.

## **2 The Impact of India's Federal System on Reforms to Indirect Taxation**

Centre–state relations in India have wavered from extreme centralization under one-party dominance (1952-1989), to considerable decentralization during the coalition era (1996-2013), to a tendency toward greater centralization under the BJP-led majority government since 2014. During the first term of the Modi government (2014-19), the process of recentralization was uneven and selective—strongest in the political domain and weakest in fiscal matters (Sharma & Swenden 2018). However, as the BJP was re-elected to the office with a greater majority, there has been a clear trend of ever-increasing centralization across all domains since 2019. To what extent has the indirect tax system during these periods mirrored this trajectory?

## 2.1 The Economic System, the Party System and the Indirect Tax Reforms until 1990

The constitution of India, well known for its centralising tendencies, creates incentives for the establishment of a centralised fiscal regime where the national government can use its higher revenue-raising powers to influence spending priorities of subnational governments (hereafter SNGs). Until the late 1980s, these tendencies were further reinforced by a combination of the centralising economic system and the centralising party system (Nayar 2014). The ruling party's dominance and its extensive control over public resources, legitimised by widespread agreement on the desirability of a command economy, enhanced the ability of the Congress party to make unilateral fiscal policy changes and to extract SNGs' acquiescence—by exercising its hierarchical control in the name of cooperative federalism—on the issues that affected the SNGs' finances (Sharma & Swenden 2020). A perusal of developments in indirect tax policies since independence shows that the national government attempted to increase its control over indirect taxes under the jurisdiction of the state government during the period 1952-1989. The Constitution (Sixth Amendment) Act, 1956 brought taxes on the sale or purchase of goods other than newspapers to the Union List<sup>6</sup> and enabled Parliament to formulate principles for determining when the sale or purchase of goods take place in the course of interstate trade or commerce.<sup>7</sup> This resulted in the enactment of the Central Sales Tax (CST) Act, 1956 which intended to trace and create an information base for interstate transactions. In 1957, the Congress Party chief ministers, at a single sitting of the National Development Council and without any consultation with the state legislatures, allowed the centre to take over sales taxes on textiles, sugar and tobacco in exchange for additional excise duties. In 1961, pursuant to the recommendations of the Railway Convention Committee, the tax on railway passenger fares, levied and collected by the Government of India but the proceeds of which were assigned to the states, was merged with basic fares. The estate duty on property/succession to property—another tax levied and collected by the centre but assigned to the states in full—was abolished in 1985.

The VAT/GST reforms were not on the cards in the period of Congress party dominance because export promotion or greater economic integration with global economy were not the goals. Rather, the tax policy since independence had two goals—(a) raising resources for the import-substituting industrialization strategy; (b) achieving redistribution of income to mirror a socialistic pattern of society (Bagchi & Nayak 1994). In keeping with the tax ideology, an attempt was made to favour the poor by taxing luxuries at a higher rate and exempting common use items. The principle of non-neutrality was extended to import duties which ranged from zero to 200 percent. In order to achieve high tax revenue, the domestic commodities were taxed repeatedly from the production to the final retail sales stage. In other words, inputs were taxed but no credits were given for taxes paid on inputs, generating the so-called cascading

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6 Entry 92A.

7 Art. 269 Clause (3).

effect. Similarly, the taxpayers could not avail the credit of tax paid on import along the supply chain. On the other hand, the marginal rates of income taxes were set at confiscatory levels while disregarding efficiency considerations. India's complex and distortionary tax system encouraged tax avoidance and evasion, depressed domestic savings, discouraged capital formation, and promoted unproductive investment and conspicuous consumption (such as gold, jewelry, real estate), giving rise to a black economy (Sinha & Srivastava 2020).

Although the Direct Taxes Enquiry Committee in 1971 and the Indirect Taxes Enquiry Committee in 1977 recommended reduction in marginal income tax rates and simplification of consumption taxes respectively, no major rationalization exercise was carried out until the mid-1980s when the ruling Congress party attempted to introduce principles of a Value-Added Tax (VAT) in Union excise duties. The so-called MODVAT (Modified VAT)—modelled on the recommendations of the Jha Committee on Indirect Taxation (1977)—came into effect on 1 March 1986. However, the process of long-term fiscal reform came to a grinding halt when Rajiv Gandhi abandoned his program of economic liberalization, tax reform included, in response to a political backlash against his policies and a series of defeats in assembly elections during his term in office (Kohli 1991).

### ***2.1.1 The New Economic Policy, Coalition Politics and Indirect Tax Reforms in the 1990s and the 2000s***

Discussion of replacing the sales tax with VAT resumed with the economic reforms of 1991. The structural adjustment program undertaken in 1991 aimed at removing distortions in resource allocation, minimising the fiscal deficit, accelerating economic growth and improving the efficiency of the economic system. Achieving these goals required a comprehensive reform of the Indian tax regime. Without a doubt, the shift in the economic paradigm in 1991 provided a powerful exogenous imperative to align the indirect tax system with international practices to facilitate India's integration into the global economy and to implement a comprehensive GST system. However, in a political landscape dominated by short-term, populist, and opportunistic politics that characterised most of the coalition era (1996-2013), the government was not able to go beyond a series of incomplete attempts at fixing the system.

The Chief Ministers' conference held in November 1999 considered all the competing models recommended by experts, following which the Central Government (a) extended MODVAT to all goods and rechristened it as Central VAT (CENVAT) in April, 2000 and (b) set up the Empowered Committee of State Finance Ministers (EC) on 17 July, 2000 to design and implement State VATs in India. In 2002, the Kelkar Task Force on Indirect Taxes (named after Vijay Kelkar, then advisor to the Finance Ministry) recommended a "grand bargain" between the centre and the states for exercising concurrent dual GST at all points in the supply chain, going up to the final consumer (Kelkar, Shome & Chelliah 2003), yet it could not be achieved due to the constitutional division of tax power between the centre and the states. The constitutional

amendment needed to overcome the constitutional constraints<sup>8</sup> required ratification by the legislatures of at least one-half of the states. Unfortunately, this level of consensus had become a luxury during the coalition era. Thus, the so called 'grand bargain' could not be achieved due to (a) the antagonistic politics of the coalition era and (b) the absence of an effective institutional mechanism for collaborative decision making.

Thus, a state-level VAT system was implemented in the country on 1 April, 2005. Although the CENVAT and the State VATs laid the foundation for more comprehensive tax reforms in the future, they did not remove the irritants that were discouraging new investment and keeping the Indian market fragmented, such as the continuation of the origin-based Central Sales Tax (CST) on inter-state sales; restricted input credit on inter-state transfers; wider exemptions under the CENVAT, service tax, and the State VAT, all of which contributed towards the cascading effect (Das-Gupta 2005; Mukhopadhyay 2000; Shome 2000) and poor infrastructure for tax administration, which increased the costs of compliance (Acharya 2005). Thus, the VAT system, despite being a considerable improvement over the archaic, irrational, and complex system that had existed until then, remained largely inefficient and complex (Kumar 2019). Worthy of note is the fact that even such an imperfect model of VAT could be implemented only after a decade of preparation and a great deal of consultation with the states. In fact, the practice of fiscal federalism in the era of de-facto decentralization of political and economic powers, generated a federal dynamic that prevented a move towards the levy of a comprehensive GST. Overall, genuine, broad-based tax reform continued to elude the Indian government while the tax system remained overly complex, inequitable, inefficient, and unsustainable.

### ***2.1.2 One Party Dominance Meets the Market Economy—A Fortuitous Encounter that Facilitated Tax Reforms in the Post-2014 India***

The consensus on contentious issues related to the GST, which had eluded the centre and states since the beginning of economic reforms in the 1990s, was finally achieved with the constitution of the GST Council (GSTC) in 2016. The consensus resulted from a combination of two factors—namely, the presence of an economic paradigm that supported the GST reform and a dominant party system, whereby the dominant national ruling party (which also controls a majority of states) could forge a political consensus to implement the GST. Consequently, the ratification of the GST Bill by more than half the states, as required under Article 368, clause (2), took place much earlier than the centre's targeted deadline. Thus, the constitutional constraints were overcome with the implementation of the 101st Constitution Amendment Act,

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8 In the Indian constitution, the Seventh Schedule had segregated the taxing powers of the central and the state governments into List I and List II, and no tax could be levied concurrently by the centre and the states. led to the exclusion of the centre from taxing sales and of the states from taxing services, precluding both levels from levying taxes on a comprehensive base of all goods and services, at all points in the supply chain. This has been amended by the 101st Amendment Act 2016.

2016. Article 246A now permits both the centre and the states to levy taxes on goods and services and to develop suitable laws for implementation of the Central GST (CGST) and State GST (SGST) respectively. However, the rates at which the CGST and SGST are to be levied will be jointly decided by the Centre and States in the GST Council— a unique institution for inter-governmental coordination. As far as the tax on interstate supply of goods and services (IGST) is concerned, the Parliament of India has the exclusive power to make laws. However, the tax proceeds from IGST are shared between the centre and the states, in accordance with the rules framed by the GST Council (Article 269A). Although the comprehensive concurrent dual GST introduced from 1 July 2017, took away from the states the most important source of their revenues, yet the dual GST, under which states retain some degree of control, was more preferable to states as compared to the unified GST under which tax rates, base and administration are completely harmonised and fiscal autonomy is severely compromised (Reddy & Reddy 2019).

Overall, the process of indirect tax reforms in India, after remaining blocked by opposition from states because of perceived revenue loss and loss of sales tax autonomy finally moved ahead as States reached a broad consensus on a number of contentious issues such as GST rates, list of exemptions, dual control, the legal framework, dispute resolution mechanism and last but not the least, the compensation formula. In fact, the 'guarantee' to compensate the states for the loss of revenue for five years, guaranteeing a 14% tax revenue growth, as per the methodology specified in the GST (Compensation to States) Act, 2017, acted as a major incentive that assuaged even the opposition ruled states.

Quite notably, after 2019, the dominant party was re-elected with a greater majority. With this the ruling party has confidently addressed the post implementation issues on its own terms (*The Financial Express* 2020a). The compensation issue is a case in point. In the 41st meeting of the GST council on August 27, 2020, the centre used the pandemic-induced slowdown as an excuse to rule out paying compensation to states, suggesting them to borrow instead. The opposition- ruled States demanded that the centre undertake all the borrowings to compensate states for the revenue shortfall. This demand was in the interest of all the States. But surprisingly, all the BJP ruled States decided to support the Centre's proposal, despite the realization that it will throw their finances into disarray. With 21 States agreeing to borrow to meet the shortfall in compensation from the centre amid the coronavirus pandemic, the central government hardened its stance against the opposition ruled states and flayed them for uncooperative attitude (*The Financial Express* 2020b). Overall, the Centre's proposal has finally prevailed (Bloomberg 2020). This shows that whenever the key institutional/partisan veto players—that is, national and subnational incumbents—belong to the same political party, generating compliance, which masquerades as cooperative federalism, becomes easy.

## 2.2 The Indian Model of GST: India's Federalism Imperative

The 'Indian model of GST' is far from the single, unified national GST. The national GST is levied on a comprehensive base at a single rate<sup>9</sup> with no exemptions except a zero-rate granted to exports. Such a unified model has a single source for administration, collection and refunds. When structured in this way, the GST/VAT eliminates economic distortions, compliance costs, classification disputes and barriers to trade (see Section: The Concept and the Context). India, however, has adopted a concurrent dual model with a differentiated rate structure and numerous exemptions. In addition to the problems associated with high and multiple tax rates, the dual administration of GST and a complex system of cross-border state refunds, increases difficulties for companies doing business in many states. It provides incentives for cash strapped states to delay refunds. Despite limitations, implementing a dual GST with multiple tax rates was the only way to assuage the states.

Amending the constitution to alter the distribution of tax powers required the consent of more than half of the states, so the national government could not override the GST related concerns expressed by the state governments. Even otherwise, a national GST doesn't exist in any federal country except Australia, where a unified GST is levied and collected by the Centre and revenues are returned to the states.<sup>10</sup> Therefore, the Indian model of GST bears the influence of India's federal governance in a variety of ways.

The first consequence of India's federal system for GST reforms was that India adopted a "Concurrent Dual GST" model. In this model the centre and the states levy CGST and SGST, respectively, on intra-state supplies of goods and services. In addition, the centre has exclusive power to levy and collect integrated GST (IGST) on all inter-state supplies of goods and services. IGST is then shared between the centre and the destination (consuming) state with jurisdiction over the consumer in accordance with the rules framed by the GST Council.

The second consequence was the passage of the GST (Compensation to States) Act on the recommendation of the GSTC. Compensation had remained one of the most contentious issues, leading to centre-state disagreement on the implementation of the GST. The state governments had made their support for the GST conditional upon compensation against any possible loss of revenue after GST roll-out. This demand led the centre to establish a compensation fund guaranteeing full compensation for any loss during the transition to GST for three

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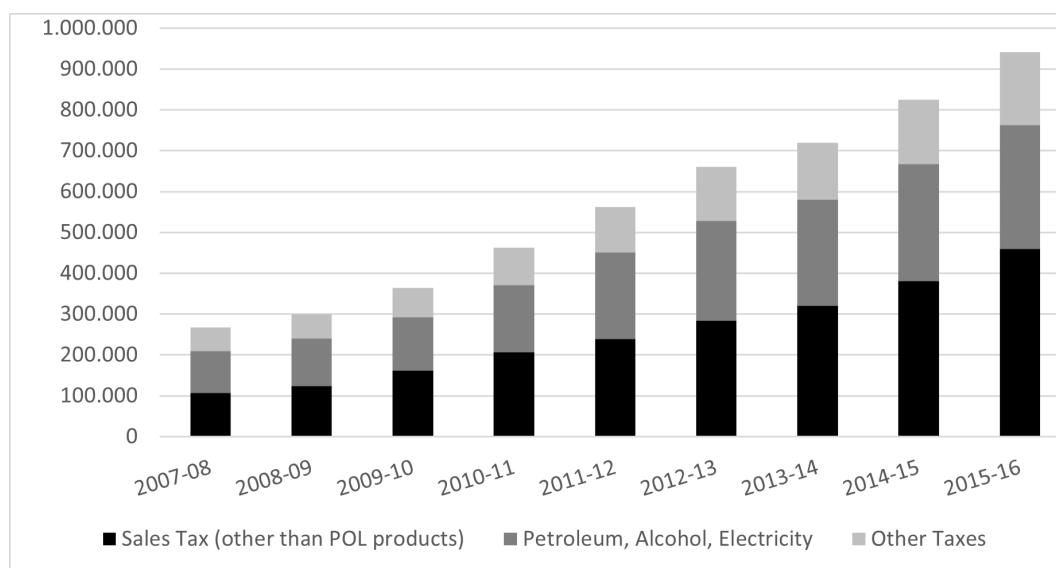
9 The differentiation of GST rates, such as a higher rate on luxury goods and a lower rate on necessary goods, makes sense from an equity point of view and it does not harm efficiency. Thus, a two-rate system—a standard rate and a reduced rate with minimal exemptions—should work well. However, problems arise when the equity argument is over stretched, and a multiple rate structure is implemented. Multiple tax rates increase compliance and administrative costs, encourage litigation, incentivise tax evasion, breed corruption (as firms attempt to misclassify goods), and last but not the least give rise to economic distortions which adversely effects economic activities on which incomes of the poor depend.

10 In Australia, the national government collects the GST and distribute revenues to the states and territories based on the recommendations of the Commonwealth Grants Commission. The formula for the distribution of revenues aims at plugging the need-capacity gap of each state and territory (Rangarajan & Srivastava 2004).

years, 75 percent compensation in the fourth year and 50 percent compensation in the fifth year. The central government also introduced a GST compensation cess on sin, demerit and luxury goods starting from the financial year 2017-18, the proceeds of which are credited to the compensation fund.

A third consequence is that a multi-rate structure has been adopted. The five tax slabs have been fixed at 0, 5, 12, 18, and 28 percent. This multi-layered rate structure has emerged from a consensus in the GSTC in which the central government's vote is worth a third of the total, while the votes of all the state governments put together account for two-thirds. The object is not only to ensure that products of mass consumption are not subject to the same rate as luxury items, but also to ensure that the fund required to compensate the losing states (producing states) is extracted not from the benefitting (consuming) states or by imposing additional tax burdens on the general public or by borrowing money, but by levying additional cesses on the demerit goods and luxury items alone.

**Figure 4: States' Indirect Tax Revenue from internal sources**



Note: Other taxes include the stamp and registration fee, the tax on vehicles, the tax on goods and passengers and the entertainment tax. Revenue from states' share of the union excise, custom duties and service tax is not shown. All Figures are in INR.

Source: Indian Public Finance Statistics, Ministry of Finance, Government of India; Petroleum, Planning and Analysis Cell (PPAC), Ministry of Petroleum and Natural Gas, Government of India, various issues.

Fourthly, the state governments were keen on keeping petroleum products, alcohol and electricity out of the ambit of the GST because taxes on these items contribute more than 35 percent of state governments' revenues (Figure 4). This was also a contentious issue because the centre wanted these products to be subject to GST. However, the centre ultimately gave in to the states' demand. At present, petroleum products (crude oil, natural gas, aviation fuel, diesel and petrol), alcohol, electricity and real estate have been kept outside the purview of GST. While this has helped persuade states to accept the GST regime, this also means that the pre-

GST taxation system (central excise and VAT) continues for these products, leaving ample scope for the cascading (tax on tax) phenomenon. Finally, although States cannot impose additional rates without the approval of the GSTC, they have been allowed to exercise their discretion to levy wholesale markets taxes and vehicle registration fees outside the GST and to raise the entertainment tax over and above the SGST. For instance, Tamil Nadu, Maharashtra, Gujarat, and Rajasthan are levying additional taxes on theatres at varying rates over and above the GST rate of 28 percent. Maharashtra has also increased the registration tax on private vehicles by 2 percent. Extra sales taxes that the states apply over and above the SGST are administered separately from the GST. They are like excise taxes in that they do not lead to input tax credits for those who pay them.

In a nutshell, the federal imperative led the central government to adopt a GST model that addressed all the concerns of the states and incentivised them to accept the GST— the very idea of which was vociferously opposed by the states during the previous Congress-led coalition government. Although a considerable improvement over the taxation system that preceded the GST regime, the present tax structure brings its own distortions. However, the problem lies not in the dual structure of taxation — unavoidable in Indian circumstances — but in the presence of multiple rates ranging from zero to very high rates, and a long list of exemptions (Rao & Chakraborty 2010). This approach, in addition to generating perverse incentives can lead to artificial barriers to trade and commerce, something that the GST reform is meant to remove (Krever & White 2007). Further, a higher GST rate negates what GST stands for — that is, a low indirect -tax regime. However, one needs to realise that this multi-layered rate structure is a consensus decision enacted in the GST council.

### **3 The Impact of the Indirect Tax Reforms on India's Federal System**

#### **3.1 From the Principle of Separation to the Principle of Concurrency of Tax Powers**

The framing fathers of the constitution embraced the principle of the separation of tax powers, which means the exclusive assignment of tax categories either to the centre or to the states.<sup>11</sup> The demarcation of the tax handles of the central and state governments enshrined in the 7th schedule of the Constitution of India (Part XII, Chapter I, Article 246) did not permit the centre to levy sales tax, nor did it allow the states to charge central excise duty or service taxes. The

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11 It has been argued that this exclusive assignment existed only in a legal, not an economic, sense. There was in fact considerable overlap in indirect taxes. For instance, the centre had the power to levy a tax (called excise duty on manufactured products) at the first point of sale and the states could levy sales taxes at subsequent stages (Rao 2008). After the 101st Amendment, such an anomaly was removed for indirect taxes but continues to exist in the realm of direct taxation, as the centre can levy taxes on non-agricultural income and wealth while states can levy taxes on agricultural income and wealth.



tax on services was inserted in the Constitution of India by the 88th Constitutional Amendment Act, 2003, formally placing it under the Union List.<sup>12</sup> Before this, Parliament invoked residual powers<sup>13</sup> to levy the service tax.

With the 101<sup>st</sup> Amendment Act, 2016, which led to a comprehensive overhaul of India's indirect tax regime, India embraced the principle of concurrence as it is followed in Canada. This means that Parliament and state legislatures have the power to levy and collect the CGST and SGST, respectively, on a common base of economic activity. CGST and SGST are levied on all transactions within a state at all stages from manufacturing to final consumption, with credit for taxes paid at previous stages available as a set-off.

Moving from the exclusive assignment of tax handles to the joint assignment of consumption taxes has strengthened the shared rule dimension of fiscal federalism. Although it came at the cost of surrendering subnational autonomy to determine the sales tax base and rates, the new paradigm is a classic case of the centre and the states pooling sovereignty over the taxes assigned to them. This fundamental reordering of federal fiscal relations has happened with the consent of the states, for the common cause of eliminating tax disharmony and promoting export orientation.

### 3.2 From the Principle of Origin to the Principle of Destination

Prior to the GST reforms, India followed the principle that all revenue accruing from tax on inter-state sales of goods should be collected and retained by the states which supply the goods (the origin principle). This was called Central Sales Tax (CST) and was levied at the rate of 4 percent. CST created incentives for dealers to evade tax by fraudulently declaring inter-state sales as stock transfers from one branch of a business to another. The states responded by erecting check-posts to prevent evasion of tax. But these check posts became a breeding ground for corruption and hindered the free movement of goods.<sup>14</sup> Furthermore, CST, being an origin-based tax (OBT), essentially exported a tax burden from rich, manufacturing states to consuming states, contributing to horizontal imbalances (Rao & Sen 1996).

As the Indirect tax system in India began to move towards a VAT system after 2005, CST rates were reduced from 4 percent to 3 percent in April 2007 and to 2 percent in June 2008. These amendments to the CST Act were intended to prepare the ground for the introduction of the GST— a destination-based tax with an inherent input tax credit refund. The 101<sup>st</sup> Amendment Act, 2016, established a unique integrated GST (IGST) mechanism moving India from an origin-based CST system to a destination-based consumption tax system. Under this

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12 Entry 92 c in the Union List specified in the Seventh Schedule.

13 Entry 97 of the Union List.

14 This was against the spirit of Article 301 of the Constitution which precludes imposition of restrictions or barriers to affect the movement of trade within a state or between states. Art. 301 states that "Subject to other provisions of the part XIII, trade, commerce and intercourse throughout the territory of India shall be free."

mechanism, the centre levies and collects IGST on all inter-state supplies of goods and services,<sup>15</sup> however, the funds collected are not credited to the Consolidated Fund of India, but rather apportioned between the Union and the destination states as per recommendation of the GSTC.<sup>16</sup> This system has implications for horizontal fiscal imbalances. By putting in place the destination principle for cross-border trading, the system ensures that the poorer, consuming, states benefit at the cost of more affluent and industrialized states. This was the reason why manufacturing states were so opposed to the GST regime. It was only when the states' grievance on account of falling revenues was taken care of by the centre by offering an overly generous compensation package, that their resistance melted away.

Furthermore, since under the GST states will collect taxes on services as well as goods, the revenue loss for industrialised states, because of the shift from the origin to the destination principle (from production-linked tax to consumption-based tax), will be made good by extra revenue from SGST on services, as the industrialized states have a higher share of services in the state gross domestic product (SGDP) than the consuming states. So, while manufacturing states reap the rewards of industrial development, including compensation packages from the centre and higher receipts from SGST on services, the less industrialized states get a larger share of revenue from IGST.

### 3.3 From Revenue Raising Powers to Revenue Sharing System

The GST regime has fundamentally altered the manner in which the state governments finance their expenditures. Note that there are two different approaches to design fiscal federal institutions: (a) the public choice approach which advocates granting independent revenue-raising powers to subnational levels (and matching them to their spending responsibilities) and (b) the public finance approach, which supports financing subnational expenditure via intergovernmental transfers (revenue sharing). The former perspective aims at splitting sovereignty between the levels of the government, while the latter perspective seeks to pursue pooling the sovereignty of the various levels of government. The framing fathers of the constitution avoided favouring one fiscal policy instrument over the other and used both to supplement subnational funds.<sup>17</sup>

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15 Article 246 A.

16 Article 269A.

17 The Constitution of India assigns most of the broad-based and productive tax handles to the Centre and a long list of tax handles to the states. However, for the states no other tax handle raises as much revenue as the sales tax. Since the revenue collection from sales tax was deemed inadequate to finance the expenditure responsibilities assigned to the states (states account for around 58 percent of the total government expenditure), the constitution provided for revenue sharing and grants to bridge the revenue expenditure gap. Thus, the India system combined the two instruments while allowing the states to control their own revenues at the margin by choosing rates of the taxes assigned to them.

Under the GST regime after 2017, states gave up their right to determine tax rates on the sales and purchases of goods within their jurisdiction. Now the tax rates on goods and services are determined jointly by the centre and the states in the GST Council. The tax revenue collected on intra-state transactions is equally divided between the centre and the concerned state: CGST and SGST are remitted to the central and the state governments, respectively in the ratio of 50:50. Since the 50 percent share of the central government becomes a part of the divisible pool (42 per cent of which is shared with the states), the latter get a share in the CGST as well. The tax revenue collected on inter-state transactions (IGST) is distributed between the centre and the states where the product is consumed (the exporting or the manufacturing state gets nothing). Again, the centre's share of the IGST becomes a part of the divisible pool (Art 270). In addition, the centre while acting "in the spirit of compromise" promised that it would compensate the states for five years in a row from 2017 onwards, for any shortfall between the revenues projected to have accrued in the pre-GST regime (assuming an annual incremental growth rate of 14 percent for all states) and the actual GST revenue realized in a particular year. Last but not the least, the Fourteenth Finance Commission's award enhanced the state share of net proceeds of the central tax receipts (the divisible pool), from 32 to 42 percent.

The new direction assumed by the Indian fiscal federal system seeks to supplement sub-national funds primarily via revenue sharing and grants (rather than by granting independent revenue-raising authority to the states) while limiting subnational governments' incentives to raid the fiscal commons in the two important ways:

- First, a significant 10 per cent increase in the states' share in the taxes of the central government (termed as the divisible pool), coupled with an expansion of the size of the pool itself,<sup>18</sup> sought to expand fiscal space for states to spend on development and fulfil substantial social spending obligations. In addition, enhanced revenue adequacy at the sub-national level (if the system works as intended) will ensure debt sustainability for states and reduce the mismatch between subnational responsibilities and the revenues they have with which to fulfil them.
- Second, the combined effect of the implementation of the recommendations of the Fourteenth Finance Commission and the government's attempt to rationalise and consolidate specific purpose transfers (central grants intended to encourage development spending in various sectors including those assigned to the states) has been that the "noncentralizing" component of transfers (the share in the net proceeds of central tax receipts) is increasing, while the "centralizing" components (non-statutory or discretionary grants), which im-

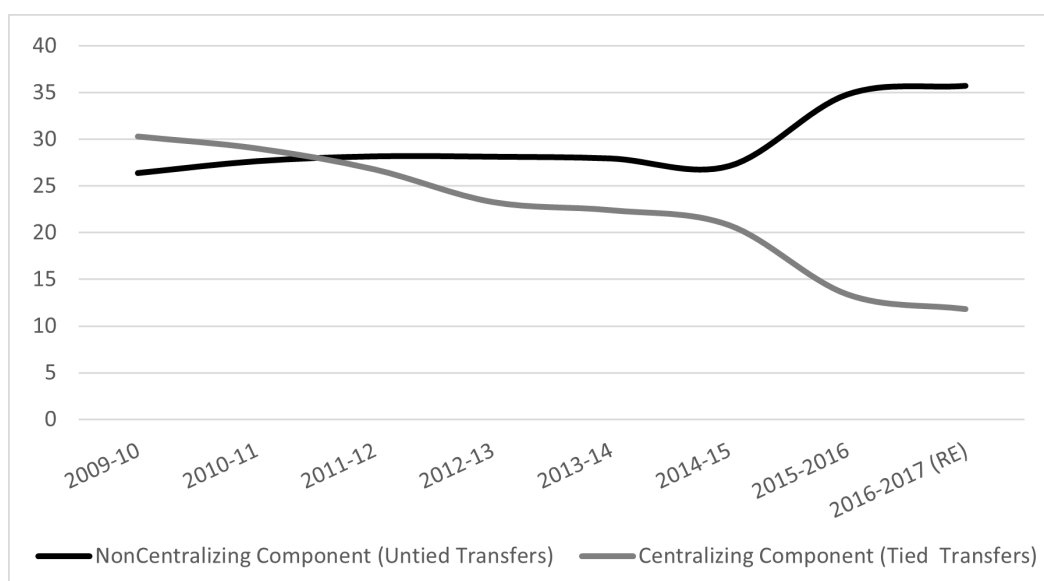
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18 The pool has expanded due to the inclusion of the Central GST (CGST) and the centre's share of IGST. Quite interestingly, the GST Council, in its meeting held in September 2016, made a recommendation that had the potential to expand the pool even further, viz., to subsume all existing cesses on indirect taxes under the GST. The cabinet approved the decision of the GST Council in its meeting in March, 2017.

pinge upon the financial autonomy of the states, are decreasing (Figure 5). Thus, State governments have greater autonomy and flexibility in designing, financing, and implementing development programmes.

Overall, the new system seeks to balance the loss of subnational fiscal autonomy (loss of control to set the tax base and rates) by the gain of financial flexibility and empowerment (higher share of unconditional transfers, enhancing each state's discretion to spend based on its own priorities).

**Figure 5: Centralizing and Non-Centralizing Components of Transfers (as per cent of centre's gross tax revenue)**

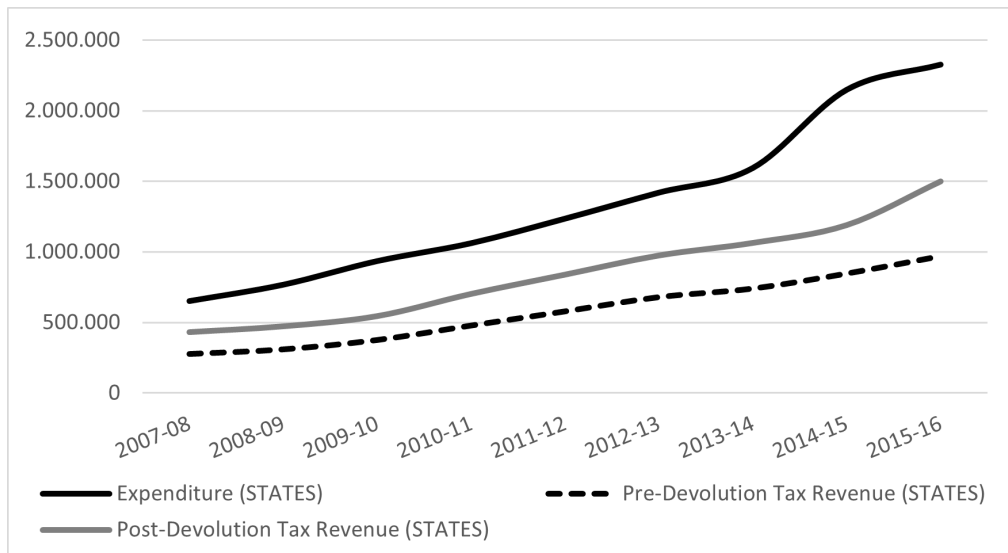


### 3.4 Strengthening of the Rule-based Fiscal Control

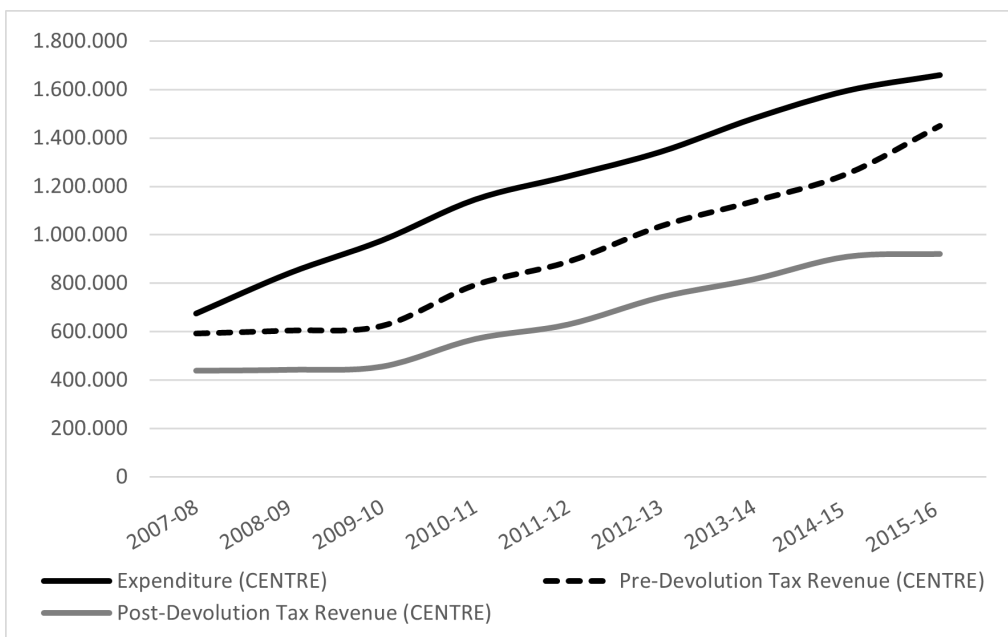
Note that one of the stated goals of implementing GST in India was to establish a common national market. However, according to the theory of Market Preserving Federalism (Weingast 1995), the success of a common market requires two supportive conditions: (a) independent revenue-raising authority at the subnational level and (b) a credible “no-bail-out” policy. Neither can be achieved under India's model of federal finance, which is based on the principle of centralization of taxing authority and decentralization of spending responsibility, with a concomitant system of devolution and equalization. Thus, the Fourteenth Finance Commission combined its recommendation (accepted by the government) of a generous revenue sharing system with a mechanism to impose rule-based fiscal control to minimize common pool problems. In fact, fiscal discipline measures assume a special significance in the context of a generous, untied transfer system, because this system can generate perverse incentives for soft budget constraints at the subnational level. Furthermore, since fiscal discipline is as important at the central level as at the state level, the Fourteenth Finance Commission has recommended an independent fiscal council for monitoring fiscal rule compliance at both the levels. In fact,

higher revenue-expenditure gap at the central level would make the exercise of devolving higher percentage of revenues an exercise in widening its own deficits and borrowing requirements, without closing the revenue-expenditure gap at the state level. Figures 6 and 7 show that the fiscal gap of the states is far from closed after devolution of funds from the centre, while the post-devolution fiscal gap at the central level has widened. Rao and Singh call such an exercise of distributing transfers as merely one of distributing deficits (Rao & Singh 2006). Thus, a rule-based fiscal discipline is indispensable for generating surpluses for investment and reaping the rewards of a common market. The 15<sup>th</sup> Finance Commission, set up in November 2017, has been given the mandate to prepare a fiscal consolidation roadmap for sound management of government finances.

**Figure 6: Pre and Post Devolution Gap at the State level**



**Figure 7: Pre and Post Devolution Gap at the Central level**



### 3.5 Towards Competitive Fiscal Federalism

In the reform era following 1991, there was a tendency towards inter-jurisdictional competition resulting in downward pressure on tax rates. The West Bengal Finance Minister announced a new package of investment incentives in 1999, proclaiming that it was intended to win the sales tax rate war with other states. In 2003 a large number of pharmaceutical units were attracted by tax incentives and subsidies provided by states such as Himachal, Sikkim, and Uttarakhand, causing pharma manufacturing hubs like Gujarat and Maharashtra to lose their competitive advantage. However, in the post-GST regime, fresh investments are again flowing to states like Gujarat and Maharashtra (Business Standard 2017). As the competition to offer lower tax rates loses its significance and relevance in the post GST period, a new model of competitive federalism has emerged. States are competing to offer a better business climate and engaging a local entrepreneurial spirit. Investors are also looking for locations offering better infrastructure for the industry. Although the states have less revenue-raising autonomy, they now have a larger amount of predictable revenue (due to the increase in the states' share in a divisible pool). Coupled with the autonomy to tap the market for resources (since the implementation of the recommendations of the Twelfth Finance Commission), the states have the autonomy to allocate resources and design and deliver expenditure programmes to match local preferences. This form of competition can strengthen laboratory federalism where experimentation, learning and adaptation lead to discovering how to enhance the efficiency of the public sector and the delivery of public services.

### 3.6 Towards Collaborative Fiscal Federalism

The compulsion to persuade and collaborate with the states to roll out a GST led to the establishment of the GST Council<sup>19</sup>—a new institutional mechanism for intergovernmental fiscal collaboration, bargaining and conflict resolution. Prior to the establishment of the GST Council, the Inter-State Council, constituted under the Union Home Ministry, was the only permanent constitutional body for promoting intergovernmental political coordination. However, its potential to strengthen vertical and horizontal cooperation remained untapped.

In this scenario, the GST Council has emerged as a unique constitutional body through which the centre and the states pool the legislative sovereignty of Parliament and the state legislatures to make decisions related to the GST in India. Intense centre-state consultations in GST Council meetings led to the implementation of the concurrent dual GST and a multi-layered rate structure as a grand bargain between the centre and the states. The GST Council requires a three-fourths majority (75 percent) of the weighted votes of the members present and voting to adopt a proposal. The central government's vote is worth a third of the total (33

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19 The GST Council was established under Article 279(A) inserted by the 101st Constitutional Amendment Act, 2016.

percent), while the votes of the state governments put together account for the rest (66 percent). This means that the centre cannot impose its will on all states single-handedly unless it has the support of at least 19 states, which jointly have a weightage of 42 percent. However, the states collectively cannot impose their will on the centre because the centre can veto any proposal the states put forward. Thus, no change can be made to the GST base, GST rate or GST revenue sharing arrangement without the consent of both sides. Furthermore, the centre's veto power gets diluted by the fact that the GST Council is a recommendatory body, and its decisions are not binding on the States (Section 12 (4) of the GST Act). However, to make urgent decisions on short notice, a GST Implementation Committee (GIC) has been constituted under the chairmanship of the Union Finance Minister.

In the event of any dispute between the central government and the states, or between states, arising out of the council's recommendations or implementation thereof, the GSTC can establish a mechanism to adjudicate the dispute. However, the provision regarding 'dispute resolution' has not yet been invoked. All states have passed their own GST Acts, yet all have identical provisions because they adhere to the model GST agreed upon by the GST Council. Indeed, the GST Council has emerged as an example of a collaborative approach to managing intergovernmental relations and has strengthened the 'shared rule' dimension of fiscal federalism.

Having said this, a cautionary word about the potential of the GST Council is in order. As with all institutions, the capacity of the GST Council to function effectively as an institution for inter-governmental bargaining, coordination and conflict resolution will depend to a large extent on how important actors (national and subnational incumbents) engage in the politics of collective action. If, for instance, the State governments take positions based on their party affiliation, and partisanship remains the basis of centre-state interactions, the capacity of the council to function autonomously will be compromised. Partisanship based interactions pose a threat to federalism under a situation when a single party dominates at the centre and governs most of the states—all the more so when the dominant party is not committed to federal principles, but only interested in increasing access to power.

## Conclusion

This paper has shown that the shifts in the indirect tax regime in India since independence have taken place within the structural context of constitutional rules, the economic policy paradigm and political dynamics. It has presented an overview of centre-state transactions leading to the evolution of an Indian model of GST on the one hand, and the modifications in the rules of the game of intergovernmental transaction itself on the other. In the process, it has demonstrated the interplay between political and fiscal structures within India.

The tax system that evolved in India after independence was a product of the design considerations of the national political incumbents. The system's subsequent trajectory was

shaped by contingent choices as the dominant ruling party at the centre (the Indian National Congress) tried to achieve economic goals through centralised planning. However, as the command economy paradigm gave way to the free market economy paradigm in 1991 and the Congress system gave way to a coalition system in 1996, the equilibrium framing intergovernmental interactions was disrupted. The new form of political and economic interactions led to the implementation of CENVAT at the national level and state VATs at the subnational level. A high level of fractionalised multipartism, throughout the 1990s until 2013, reshaped the relationship between national and regional governments in a way that precluded the possibility of wider constitutional reforms that would have made possible a concurrent dual GST.

However, the formation of a one-party majority government by the BJP after 2014, and victories in state assembly elections that put the party in charge of 22 states by 2017, made centre-state cooperation on such a contentious issue easier to achieve. This shift virtually transformed the practice of intergovernmental relations, and it became feasible to forge political compromises on constitutional settlements. Furthermore, the biggest-ever increase in vertical devolution of the states' share in the divisible pool of Union taxes, as recommended by the Fourteenth Finance Commission, and a generous compensation package made the transition to a concurrent dual GST less intimidating to them. Apparently, a further strengthening of the one party dominance after 2019 has enhanced the willingness of the national ruling party to exercise hierarchical control over states and settle centre-state issues on its terms. The manner in which the centre outmaneuvered States on the compensation issue illustrates this.



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