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Fiscal Federalism in the context of India's Post-Goods and Services Tax(GST) Era

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Abstract:

One of the numerous changes that Goods and services tax(GST) implementation was anticipated to bring about was to give Indian federalism a more "Cooperative" feel. The states were wary of the GST infringing on their financial independence, much like they were when Value Added Tax(VAT) was introduced in 2005. GST finally went into effect on July 1st, 2017, after 11 years of preparation. This essay seeks to assess how Goods and Services Tax (GST) has affected fiscal relationships between Indian Union Territory (UT) and States. This essay aims to provide an evaluation of the GST Council's structure, the various GST rate slabs, and a comparison of the devolution of taxes under pre- and post-GST regimes. The report also discusses the different vertical and horizontal fiscal imbalances that predated GST and their effects after GST. Along with additional government statistics in the form of the Economic Survey 2017–18 and other Government Committee reports, a thorough analysis of the budget documents from the previous three years has been conducted. The financial independence of the states is infringed upon by the GST, it has been discovered. Additionally, it has been demonstrated that several decisions appear to have been made haphazardly and are not compatible with the VAT or GST regimes in other regions of the world. The study highlights a few unsettling tendencies in taxes and devolution

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that have further weakened the spirit of collaboration within the Indian federation. In conclusion, some corrective actions have been recommended.

Keywords: GST, VAT, Fiscal federalism, and India

Introduction

P. Chidambaram, the former Union Finance Minister, first proposed the Goods and Services Tax (GST), as it is now known, during his budgetary statement in 2006. The establishment of the framework for the implementation of the Goods and Services Tax took place on April 1, 2010. Nevertheless, parliamentary approval for the Goods and Services Tax Act was not obtained until March 29, 2017. The legislation was enacted on July 1st, 2017, subsequent to the effective resolution of numerous technical and political challenges. The Goods and Services Tax Law in India is a comprehensive and multi-stage tax structure that operates on the basis of the destination premise. A tax is imposed on each incremental value generated throughout the stages of production and distribution. The implementation of the GST (Goods and Services Tax) served as a comprehensive tax reform initiative, entailing the substitution of a collective total of seventeen individual taxes. The aforementioned taxes encompassed service tax, central excise duty, and additional excise duties imposed at the state level. In addition, the implementation of the Goods and Services Tax (GST) resulted in the substitution of other taxes, including value-added tax (VAT), sales tax, purchase tax, admission tax, luxury tax, as well as numerous taxes levied on lotteries, betting, and gaming at the national level. The enactment of the Goods and Services Tax (GST) Act, considered as a momentous tax reform since 1947, signifies a substantial advancement towards the establishment of a cohesive market throughout the entire country. It is envisaged that tax compliance will experience an increase as a result of the

anticipated elimination of the cascading cost [1]. This is expected to contribute to a rise in GDP and a decrease in the tax burden shouldered by consumers. Prior to the adoption of the Goods and Services Tax (GST), the predominant approach to taxation was through indirect means.

The allocation of tax imposition authority was distributed among the states in accordance with the requirements outlined in Part twelve of the Constitution previous to the enactment of the Constitution (101st) Amendment Act of 2016. This amendment granted the Center and the states the ability to levy the Goods and Services Tax (GST). The constitution explicitly delineated the allocation of financial resources between the central government and the states, while also providing provisions for the central government to distribute a portion of tax revenue to the states. The formula employed by the Finance Commission was utilized to ascertain the proportion of vertical devolution from the central government to the states, as well as the subsequent horizontal allocation among the several states. Furthermore, as stipulated by the constitution, it is mandated that the president shall appoint a finance panel at five-year intervals, with the identical purpose. The tax allocation outlined in the constitution exhibited a significant bias towards the federal government, primarily attributable to the prevailing political landscape during its drafting. Consequently, the central government was endowed with a considerably higher portion of the tax burden compared to the individual states. Consequently, the states were compelled to depend on the federal government for the settlement of their financial shortfalls and implementation of their strategies for state-level progress. The primary source of financing for this endeavor was predominantly derived from government grants and subsidies, which were commonly contingent upon certain policies and programs such as the centrally sponsored MGNREGA plan. Despite a scarcity of financial resources, the states faced significant constraints in their ability to independently enact and execute their respective policies and

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initiatives. In recent times, there has been an observed growth in devolution of power to the states, primarily attributed to the efforts of progressive finance commissioners. Notably, the fourteenth Finance Commission has allocated a significant portion, up to 42 percent of its budget, towards this devolution process.

The Central Value Added Tax (CENVAT) was introduced in the fiscal year 2000-01, whereas the Service Tax was imposed in 1994, preceding the adoption of the Goods and Services Tax (GST). The user has provided a reference to support their statement. The tariffs in question distinguished between products and services, as the value-added tax (VAT) did not encompass services. Consequently, it was not feasible to assert an input tax credit for a service utilized in the production of a good, or vice versa. Moreover, the process of tax submission and return requests posed significant challenges. Moreover, due to the origin-based nature of these taxes, the state in which the manufacturing or production occurred was responsible for paying them. Consequently, the state in which the consumption took place was not allowed to provide input credits for the taxes paid in the other state. The resolution of these challenges was intended to be achieved through the implementation of a more dependable and technologically advanced integrated destination tax, commonly referred to as GST.

The GST framework encompasses three distinct forms of taxes, namely the SGST, CGST, and IGST, which are explicitly forbidden. In the context of intrastate transactions, it is important to note that the federal government is responsible for the imposition and collection of the federal sales tax, while the states are tasked with evaluating and collecting the state sales tax. To facilitate the distribution of the state's portion of tax revenue to the respective state where the goods or services are consumed, the Center will impose the Integrated Goods and Services Tax (IGST) on the inter-state transactions involving the supply of products and services. As per the

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statutory provisions, it is mandated that the Centre is obligated to compensate the states for any financial deficits they incur during the initial two years of the execution of the Goods and Services Tax (GST).

The Challenges after the Implementation of Goods and Services Tax (GST)

The GST Council, constituted under Article 279A, has bestowed the federal government with a significant veto power, thereby positioning it as the primary decision-making authority for the Goods and Services Tax (GST). The Center possesses one-third of the voting rights inside the council, whereas the state retains the remaining two-thirds of the votes. Nevertheless, due to the requirement for approval by three-fourths of the states, it becomes exceedingly challenging for any subset of states to modify the tax rates applicable to any given commodity or service. This stance contradicts the fundamental tenets of federalism, which advocate for the allocation of a certain level of autonomous governance to each state.

The value-added tax (VAT) rate was initially set at 14.5% for 75% of taxable items. However, it has now been reduced to 9%, which represents 50% of the standard rate under the GST system, where the standard rate is 18%. It is worth noting that the allocation of the GST rate between the central government and the states in a 50:50 ratio has led to a decrease in the rate by 5.5% for the states [4]. The incorporation of services into the state tax framework will exacerbate the vertical fiscal imbalances existing between the federal government and the states. The user did not provide any text to rewrite.

Furthermore, upon doing a comprehensive analysis of state budget documents, it is evident that during the initial year of implementing the Goods and Services Tax (GST) in 2017-2018, there was a decline of 0.4% in the Gross Domestic Product (GDP). This decline can be attributed to

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the inadequate compensatory effect of the increased GST revenue in offsetting the reduction in sales tax revenue for the states. The following table (Table 1) presents the relevant data. The user's text does not contain any information to rewrite. Ultimately, it will be up to individual states to enhance their income growth autonomously, notwithstanding the commitment made by the central government to compensate them for any shortfall in revenue growth amounting to 14 per cent over the subsequent five-year period.

In addition, it is worth noting that a limited number of states, namely Delhi, Haryana, Maharashtra, Punjab, Tamil Nadu, and Karnataka, continue to derive the majority of their revenue from taxation. Conversely, several other states, such as Jammu and Kashmir, Assam, and Bihar, are only able to generate approximately 20 percent of their income through tax sources. (Refer to Figure 1) The ability of these states to exercise self-determination is further weakened due to their heightened reliance on transfers from the central , specifically through the decentralization of central taxes and subsidies.

The States persist in depending on the Central government for around 48 per cent of their financial requirements. A total of 20 percent of the funds are acquired through grants-in-aid for various schemes and initiatives, while an additional 26 per cent is allocated as the states' share of federal taxes. On the contrary, grants are characterized by their restricted nature, which means they are required to be allocated for specific purposes determined by the Center. This stands in contrast to the monies allocated by the Center as the state's portion of taxes, which are discretionary funds that states have the freedom to allocate as they deem fit. This stance contradicts the fundamental tenets of genuine power decentralization. However, with the implementation of the Goods and Services Tax (GST), the states would experience a reduction in their authority over locally generated taxes. This is because of the influence of the GST Council,

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which is primarily governed by the federal government and possesses the power to veto decisions made by the states. Consequently, the government's lack the autonomy to autonomously determine the taxing rate for certain goods or services. The persistently centralized inclination of the colonial rulers is still apparent in this uniform approach. The right to increase tax rates is vested in the GST Council, a body established under the provisions of the Constitution. However, this exercise of power is subject to constitutional limitations, as the Constitution stipulates that the imposition of taxes requires the agreement of the legislature.

Furthermore, it has been observed that the government has implemented several additional charges and levies, such as the 10% surcharge on personal income tax, the krishikalyancess, the road cess (also known as fuel cess), the infrastructure cess, the clean energy cess, and the swachhbharatcess. According to Article 270 of the Constitution, it is explicitly stated that the distribution of income from cesses and levies among the states is not obligatory. The central government's discernible inclination significantly diminishes the tax revenue available for distribution, hence augmenting the proportion of funds allocated to the central authority. This violates the concepts of democratic decentralization and cooperative federalism.

Ultimately, the responsibility lies with the GST Council to ascertain the appropriate timing for the inclusion of petroleum goods within the ambit of the GST. The inclusion of these products in GST has the potential to result in a substantial decline in revenue for some states. This is mostly due to the likelihood of tax rates being lowered from their existing levels, which exceed the 20 percent for sales tax in 25 states and over 24 per cent for excise duty on gasoline.

Conclusion

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In contrast to the 46 per cent in 2014–15 (the final year of the thirteenth Finance Commission), states are anticipated to spend 72% more than the federal government in 2018–19. Therefore, a lot of the spending that has an impact on citizens is decided at the state level. As the GST is implemented, however, decisions about revenues are becoming more centralized at the level of the Center. Before the Center ceases providing compensation for revenue losses caused by the GST, States still have three years to close the gap and raise their revenue growth to sustainable levels. The burden of needing to spend more than they take in is also asymmetrically placed on the states. This is partially a result of implementing social sector programs and partly a result of building infrastructure. The finances of the states are further impacted when they are asked to carry out the directives of the Centre through programs like UDAY and 7th Pay Commission recommendations, where they are required to incur excess expenditures without additional means of raising money. Furthermore, because the states are required to maintain a low revenue deficit, the FRBM statute has severely restricted their ability to borrow money.

The GST Act's current format doesn't appear to be sufficient to address the problems posed by India's distinctive federal polity in light of these limitations and the rising weight of public welfare. In addition to giving the states greater money and power than is now provided for in the GST Act, the Center needs to engage in vigorous cooperative federalism. More resources, tasks, and employees need to be planned from the federal level to the states so that they can implement Panchayati Raj at the state level. The states have not yet benefited from increased tax base elasticity and tax base efficiency.

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TABLES AND APPENDICES

Table 1: States' own tax revenue, disaggregated:

Item	2014-15	2015-16	2016-17	2017-18 (BE)	2017-18 (RE)	2018-19 (BE)
Total Revenue	12.6	13.3	13.4	14.9	14.7	15
Tax Revenue	9	9.8	10	10.6	10.4	10.8
State's own Tax Revenue	6.3	62	6	6.6	6.3	6.4
Of which						
a. Taxes on property and Capital Transactions	0.8	0.8	0.7	0.7	0.7	0.7
b. Taxes on Commodities and Services	5.4	5.4	5.3	5.8	5.5	5.7
Of which Sales Tax	4	3.8	3.9	4.1	2.6	1.6
State Excise	0.7	0.7	0.7	0.8	0.7	0.8
Taxes on Vehicles	0.3	0.3	0.3	0.4	0.4	0.4
SGST	0	0	0	0.3	1.5	2.6

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Source: Budget documents of state governments

Table 2: GST Collection

	2017-18 (RE) (RS Billion)	Number of States Reported	2018-19 BE (Rs Billion)	Number of States Reported
SGST	2559.3	12	4845.8	28
CGST	523.7	21	2036.7	23
IGST	642	24	675.9	25
Compensation Cess	22	4	36.1	4

Source: Budget documents of state governments.

Chart 1

The following abbreviations are used for the states in the charts throughout the report.

State	**Abbreviation**	**State**	**Abbreviation**	**State**	**Abbreviation**
Andhra Pradesh	AP	Jammu & Kashmir	JK	Punjab	PB
Assam	AS	Jharkhand	JH	Rajasthan	RJ
Bihar	BR	Karnataka	KA	Sikkim	SK

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Chhattisgarh	CG	Kerala	KL	Tamil Nadu	TN
Delhi	DL	Madhya Pradesh	MP	Telangana	TS
Goa	GA	Maharashtra	MH	Tripura	TR
Gujarat	GJ	Mizoram	MZ	Uttarakhand	UK
Haryana	HR	Nagaland	NL	Uttar Pradesh	UP
Himachal Pradesh	HP	Odisha	OD	West Bengal	WB

Sources: State Budget Documents; PRS Legislative Research

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