Balancing Federal Fiscal Relations

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What the future holds for India's tax structure and balance of powers between the Union and states is something which the Indian polity shall decide over time. However, the last word may not have been heard over GST and states, seeking to augment their resources may well seek changes in the law in the not too distant future

By giving away their constitutional ability to tax, states have bet big time on the success of the new all-India tax Goods & Services Tax.

However, to guard themselves against GST failing to deliver the promised increase in revenues, states had fought long and hard to get the Centre to bring in a cess which is expected to raise about Rs 50,000 crore to be divided among states to compensate for any loss in revenues.

The thinking behind this is that, in case the economy goes through another slowdown induced by an oil shock or another bout of recession globally, neither will the economy grow at the promised 7.5-8 per cent rate nor will revenues grow as promised.

The problem with GST is that, the tax, like all taxes, is dependant on the economy doing well. Conceptually, the GST should broaden the tax base. The tax GDP ratio could increase to 16 per cent from the current 10 per cent. However, whether this would be achieved, would depend on the next year or so. Specially on how the government and industry manage to work in tandem to smoothen the overall transaction and rate of compliance.

The RBI itself, in a report on state finances, has warned that "Due to prevailing uncertainty about the revenue outcome from the GST implementation, the outlook for revenue receipts of states could turn uncertain."

States, on the other hand, face an ever increasing cost curve. With the 7th Pay Commission being implemented, their wage bills are expected to go up considerably. A rush to write off farm loans started by Uttar Pradesh, has till now seen three state governments agreeing to write off loans.

The problem for the states and the centre is that already a debt time bomb is ticking, which risks turning India into another Greece. India's public debt, which is the sum total of central and state debt, as a percentage of GDP already stands at 67 per cent, the highest among major Asian economies, except for Japan.

This time round if all states were to write off farm loans, and pay for this act by taking fresh loans, their new debt would amount to Rs 3 lakh crore, finance ministry officials have calculated. This kind of debt taking is unsustainable at any given time, but at this juncture when we are experimenting with a new tax structure and do not know how state finances will behave- whether they will go up or down, this is obviously even more risky and the states know so.

Reserve Bank of India (RBI) has reported that the debt-to-state GDP ratio

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of as many as 17 Indian states increased in the past year. The RBI report said "The consolidated finances of states has deteriorated in recent years… information on 25 states indicates that improvement in fiscal metrics budgeted by states for 2016-17 may not materialise."

The Gross Fiscal Deficit-GDP ratio in 2015-16 has already breached the 3 per cent ceiling considered fiscally prudent for the first time since 2004-05.

Under these circumstances, inability to meet the states' demands for cash to pay for wages, development expenses and the loan waivers they are announcing, may see the states going on the warpath against the centre.

However, officials also point out that 45 per cent of the indirect taxes are not covered by GST such as items like real estate, petroleum products, alcoholic beverages etc., and the state will have the ultimate right to tax them and even increase taxes on them.

The GST Bill promises that in time the GST Council will move these items into the GST fold. However, it is more than likely that states will in time realise that they do need to have some measure of financial independence. This, coupled with the need to build a financial cushion, would possibly see them working actively to retain these items of taxation in their portfolio.

One may recall, that when the issue of division of financial powers between the Union and provinces came up in the Constituent Assembly, many MPs including from the Congress had argued in favour of giving more powers to states. However, the fear of excessive federalism was cogently argued as being against the spirit of One India and the framework which thus came out tended to focus legislative and taxation powers with the centre rather than with the states.

Some constitutional experts rightly point out that this bias will be even more pronouncedly be in the Centre's favour with the implementation of the

GST. Observers point out that if states were to give away their freedom to increase taxes in respect of at least some goods, their ability to raise resources to address problems unique to them would be compromised. The State of Tamil Nadu, which opposed many clauses in the GST had a point when it said that it had implemented wide ranging social sector reforms on the back of cash generated from its taxation programme.

It is true that the Southern state has done remarkably well in its social parameters – its health and education parameters have helped catapult it way ahead of its rivals and are comparable to that of Organisation for Economic Co-operation and Development (OECD) countries. In the words of economist Jean Dreze "Kerala and Tamil Nadu routinely come at — or near — the top in rankings of summary development indexes, they also surpass other States in terms of the speed of improvement."

Legally speaking the GST Amendment Act effectively transfers the power of taxation over large swathes of possible taxation to an unelected body. Effectively, the GST Council, set up by the Act, takes on the power of deciding tax rates from both the Parliament and State Legislatures and these have to be implemented across the country. Without going into the issue of weightage of voting powers within the GST Council, the fact remains that this Council will now be the Supreme legislative body in determining tax rates on all goods and services through the length and breadth of the country and not the directly or indirectly elected Members of Parliament and State legislature. In essence, this will be like an educated super-body elected by Electors, without any direct responsibility to citizen-voters.

States would also like to retain some powers of taxation as the passage of GST places them, in some ways, at a disadvantage with respect to subordinate bodies like Municipal bodies etc., who have now more power to increase their quantum of taxes!

Entry taxes by municipal bodies, entertainment tax levied by local bodies, stamp duties, products such as alcohol and fuels, and electricity cesses are still not covered by GST. This gives them the right to increase or decrease these taxes and thus build greater financial independence from state governments. While the reverse would be the case for states, who

would be bound by the decisions of the GST Council as far as the bulk of their revenues is concerned.

It would do well to remember that in most countries where deferral authorities have the right to determine indirect taxes and enjoy the right to raise them, provinces have the right to direct taxes. In Canada where the GST was introduced in the last century, the provinces have the power over direct taxes, while the federal Government has the power to tax indirect taxes, which is why the change over to GST did not entail any impact on state powers. In India, however, the Centre not only enjoys sole rights over direct taxes, a portion of which it may give to states, but it also now enjoys the exclusive right to nearly half of the GST proceeds.

It is yet to be seen how the Indian polity will respond to the challenge to the eventual implementation of the Goods and Services tax. It could well accept the taxation powers which have now evolved or chaffe at the bit and seek a change from the new status quo.

In case, states eventually decide to seek a fiscal arrangement which is less straight-jacketed they could then either chose the Australian model, where 75 per cent of all taxes are raised by the federal or commonwealth government and distributed through a very sophisticated mechanism akin to that established.

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