How to Increase Fiscal Autonomy of Sub-National Governments in India with GST?

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Abstract

With the introduction of the Goods and Services Tax (GST) bill in 2006, it took 11 years for its implementation to finally occur in 2017, which accompanied a lot of debates. With the GST, the central government has granted lot of taxation power over states. It becomes difficult to understand why the lower tier of government, which deals mainly with the citizenry, has the lowest tax base amongst all the tiers of government, hampering their fiscal autonomy. Providing sub-national governments with fiscal autonomy guarantees a higher degree of human development, as found in the existing literature. The paper analyses GST tax structure and fund transfer, considering variables like population, demographics, environment, fiscal efforts by the 15th Finance Commission, GDP per capita, HDI and employment rate. The paper is based on data collected from various sources such as the Census (2011), Handbook of Statistics on Indian States by (Reserve Bank of India) RBI and state statistics by (National Institute for Transforming India) NITI Aayog. The paper proposes structural changes to India's taxation system, including altering the GST council and fund transfers, to increase fiscal autonomy for states and sub-national governments. The key recommendation is to replace the majority voting system with a consensus approach, reducing the ruling party's veto power and empowering states in taxation decisions. The paper found that states with lower HDI, receive lower per capita fund transfers and states

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with higher HDI receive relatively higher per capita fund transfer from the central government.

Keywords: Finance commission, GST, Fiscal Federalism, Tax Transfer, HDI

1. INTRODUCTION

In recent years, India's fiscal environment has witnessed a significant impact due to the introduction of the Goods and Services Tax (GST). The implementation took place in July 2017, facilitated by the execution of the Constitution (One Hundred and First) Amendment Act of 2016, and received subsequent approval from the parliament and all related legislative bodies (Maheshwari & Gandhi, 2021).

To simplify the present taxation structure and promote the "one-nation, one-market, one-tax" policy, the GST combines 15 additional indirect taxes and charges. The introduction of the GST was intended to boost centre-state transfers and raise the tax-to-GDP ratio.

1.1 Constitutional articles relating to GST

The following constitutional provisions provide a clear picture of the country's present tax distribution status and demonstrate the absence of fiscal federalism in the tax system:

1. *Levies enforced and gathered by the Union and apportioned between the Union and States:*

All levies and tariffs outlined in the Union List, excluding the designated impositions, shall be levied and collected by the Central authority as per the provisions in Article 270 of the Constitution of India. Additionally, these shall be apportioned between the Central authority and the individual States (Saha, 2019).

2. *Distribution of IGST among the Union and States-According to Article 269A(1) (inserted with effect from September 16, 2016):*

The distribution between the Union and States of the IGST (Integrated Goods and Services Tax) collected by the Union takes place based on the legislation passed by Parliament following the recommendations of the GST Council. (Saha, 2019)

3. *Article 269A of the Indian Constitution (inserted with effect from September 16, 2016):*

The outcome of this amendment entails that the division between the Union and the States of the IGST, accrued from the interstate transactions of goods and services and collected by the Union, will be dictated by the legislation enacted by Parliament, which derives from the proposal put forth by the GST Council. This amendment specifies that the Center will be responsible for imposing and collecting the GST on interstate trade or commerce, and subsequently, this levy will be shared between the Centre and the States as stipulated by law, based on the recommendation presented by the GST Council (Saha, 2019).

The articles mentioned are further speculated, it becomes evident that the states and the Centre share responsibility for collecting the Goods and Services Tax (GST), but that when it comes to tax distribution, the states lose their independence of distribution and the GST Council and parliament take over.

1.2 The Vertical and Horizontal devolution (sharing of taxes)

The sub-national government (state and local governments), which is closer to knowing the local requirements and goals of the inhabitants living in that region, should have more fiscal autonomy in distributing the fund towards diverse applications to achieve optimal allocation of resources. Taxes are to be passed from the federal government to the state and municipal governments vertically, according to this theory (from centre-to-state-to-local government). When taxes are distributed horizontally, a portion of the central government's overall tax income is distributed to the states while keeping in mind the values of equality and efficiency (S. Hajra et al., 2008, p. 90).

Both vertical and horizontal tax sharing require transferring funds from the national government to local and state governments, which results in an imbalance because these government entities are better positioned to comprehend the needs of the populace.

More dependent on the system of intergovernmental payments to meet their spending requirements, the states have lost their fiscal independence since the GST was implemented. Throughout time, on the advice of the Finance Commission, the federal government has been distributing tax income to the state governments (Maheshwari & Gandhi, 2021).

The primary objective of this research paper is to analyse the allocation of government funds to sub-national governments in India, with a specific emphasis on promoting fiscal federalism. The study aims to compare and contrast various tax devolution approaches and propose strategies for enhancing the effective allocation of taxes. By doing so, this research seeks to contribute to the scholarly understanding of how fiscal autonomy can be strengthened for sub-national governments, thereby fostering their independent fiscal decision-making within the Indian context.

By thoroughly analysing the data provided by the Government of India and the Finance Commission reports to understand how we can inculcate Fiscal Federalism in our sub-national governments especially focusing on disbursement of GST.

2. LITERATURE REVIEW

Various papers have shown reforms in fiscal federalism policies through India's journey after independence. The existing literature clearly points towards the importance of a good fiscal federal structure which can be seen by the success of East Asian Nations and the fall of the Soviet Union; countries such as India, Brazil, South Africa and many more developing nations are continuously trying to make reforms to their federal systems. Many sub-national governments in developed and developing nations have given their sub-national government free spending authorities which have led to fiscal indiscipline amongst the lower tier of government and piling debts. With piling debts, the central governments give their sub-national governments bail outs which are costly to the taxpayer as a whole (Rodden, 2002). India being a developing nation has tried to transfer fiscal responsibilities vertically which has led to the centre giving well over a third of states' expenditures (Rao & Singh, 2006). "For an economist, nearly all public sectors are more or less federal in the sense of having different levels of government that provide public services, irrespective of formal constitution" (Oates 1999). Federal structures aim to restrict the power of the central government by shifting fiscal powers vertically. With the central government here in India having explicit power over the GST council's decision making processes and an absolute majority in the Lower house of Parliament which not only induces fiscal imbalances but fiscal indiscipline as well (Rao & Singh, 2006).

Financial relations between centre and the states are defined in Part XII of the Constitution, and items of taxation of centre and states are provided in the Seventh Schedule. In terms of the union-state relationship in the financial sphere, the Constitution of India goes above and beyond other federal constitutions in its comprehensive provisions.. In addition to its role in tax collection, the Goods and Services Tax (GST) is perceived as a tool to enhance India's sub-national fiscal performance.

After an extensive review of the existing literature and identifying the gaps, the study elaborates on how to use GST to bring in better fiscal discipline, and shows that much work has to be done in this field. Academicians have worked to show the importance of fiscal federalism and autonomy and ways to do it but without GST as this new form of taxation is being levied. Finance commission must be restructured by giving the states representation in the central body of the GST Council. There is also a need to create a zonal level planning body as the sole planning body in India is the Planning Commission (Sud & Kumari, 2013). By exploring the relationship between the Human Development Index (HDI) and the per capita grants received by the states, this review aims to shed light on the potential implications of GST on developmental outcomes. The HDI serves as a comprehensive indicator, encompassing various dimensions such as education, healthcare, and living standards, which are critical for assessing the overall well-being and progress of a state, and analysing the current tax distribution system and its ineffectiveness in reducing regional disparities.

3. METHODOLOGY

The study examines state-wise GST collection data from 2017-2022 and its correlation with central government disbursements to evaluate the effectiveness of the Finance Commission's disbursement weightage pattern. It also analyzes the relationship between state funding and their Human Development Index (HDI) ranks. By collecting granular GST data, the study aims to identify any discrepancies between states' contributions and funds allocated. It seeks to uncover anomalies in the disbursement methodology, particularly situations where high GST-contributing states receive disproportionately low disbursements, or where states with lower HDI ranks lack commensurate financial support. The study proposes potential solutions to address these identified anomalies, potentially refining the weightage formula or suggesting procedural improvements for fair and equitable fund distribution. This data-driven approach aims to contribute to the enhancement of the Finance Commission's current disbursement mechanism.

4. DATA ANALYSIS AND FINDINGS

4.1 ANALYSIS OF HORIZONTAL AND VERTICAL DEVOLUTION

In this part, the government distribution after the introduction of horizontal devolution of taxes and how the criteria given by the finance commission (under the devolution) have affected the share of the states in the net tax proceeds (creating an imbalance). The study also focuses on an anomaly where lower HDI states have been allotted lower funds and *vice-versa*. Furthermore, the better devolution of taxation strategy will be assessed and suggested.

4.1.1 Vertical Devolution vs. Horizontal Devolution

The criteria finalized by the 14th Finance Commission for horizontal devolution of taxes in their latest report assigns a Criteria Weight, which determines the share of each state in the transfer of taxes. Table 1 lists these criteria.

Table 1: Criteria Weight

Criteria Weight (%)	Share (%)
Area	15
Population(2011)	10
Forest Cover	7.5
Fiscal Capacity/Income distance	50
Population(1971)	17.5
Total	**100**

Source: Vol1-Chap10.pmd (indiabudget.gov.in) (accessed in July, 2023)

Table 2 below represents the percentage share of each state in the net proceeds of taxes as recommended by the 14th Finance Commission, the share is decided based on the methodology criteria mentioned in Table 1.

As suggested by the 14th Finance Commission of India-The percentage share of taxes for states (out of the total tax collection in 2020-21), stood at 42% of the total net GST collection. The net GST collection FY 2020-21 stood at Rs.845401 crore, out of which 42% went to states.

Net GST to states = Net GST collected X 42%

*Net GST collection = Gross GST collection - Refunds

The 42% share differs according to the recommendations of the finance commission. So, the Net GST to states will be Rs. 355068 crores, which is then distributed according to the HDI (2018) (also devised by the finance commission).

Data analysed from Table 2 shows that states, such as Uttar Pradesh, Bihar, Odisha, Jharkhand, have lower HDI and receive a lower share of the GST. Whereas, states with

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higher HDI, such as, Goa, Sikkim, Uttarakhand, Himachal Pradesh and other hilly area states receive higher share of GST, which should not be the case while keeping in mind effectiveness and efficiency of GST disbursements. This clearly indicates that the current devolution of taxes Weight Criterion is not working effectively and consistently.

Table 2: Percentage share of states in net proceeds of taxes (FY 2020-21)

States	Share(%)	Share of states (in cr)	HDI (2018)	Population (2011 census)	Per capita disbursement (in Rs)
Uttar Pradesh	17.931	63667.2431	0.596	33448035	10615.51
Bihar	10.016	35563.6109	0.576	104099452	3410.85
Madhya Pradesh	7.886	28000.6625	0.606	72626809	4888.94
West Bengal	7.519	26697.5629	0.641	20380315	17422.11
Maharashtra	6.135	21783.4218	0.696	112374333	3159.69
Rajasthan	5.979	21229.5157	0.629	12711146	27933.59
Odisha	4.629	16436.0977	0.606	41974218	8459.19
Tamil Nadu	4.189	14873.7985	0.708	18524982	19166.98
Andhra Pradesh	4	14596.8455	0.65	56361702	6299.81
Karnataka	3.646	12945.7793	0.682	61095297	5811.71
Chattisgarh	3.418	12136.2242	0.613	25545198	13899.60
Gujarat	3.398	12065.2106	0.672	60439692	5874.75
Jharkhand	3.313	11763.4028	0.599	32988134	10763.51
Assam	3.131	11117.1791	0.614	31205576	11378.35
Telangana	2.133	7573.60044	0.669	N/A	N/A
Kerala	1.943	6898.97124	0.779	33406061	10628.85
Punjab	1.788	6348.61584	0.723	27743338	12798.32
Arunachal Pradesh	1.76	6249.1968	0.66	1383727	256602.64
Uttarakhand	1.104	3919.95072	0.684	2056975	172616.59
Haryana	1.082	3841.83576	0.708	25351462	14005.82
Himachal Pradesh	0.799	2836.99332	0.725	6864602	51724.48
Meghalaya	0.765	2716.2702	0.656	2966889	119676.87
Manipur	0.718	2549.38824	0.696	2855794	124332.50
Tripura	0.709	2517.43212	0.658	855556	415014.33
Nagaland	0.573	2034.53964	0.679	41974218	8459.19
Mizoram	0.506	1796.64408	0.705	1978502	179463.05
Sikkim	0.388	1377.66384	0.716	129006	2752337.10
Goa	0.386	1370.56248	0.761	1458545	243439.87

Source: :: Finance Commission, India :: (fincomindia.nic.in) (accessed in July, 2023)

4.2 ANALYSIS OF GST AND FISCAL MANAGEMENT

This section explains THE FISCAL RESPONSIBILITY AND BUDGET MANAGEMENT (FRBM) ACT of 2003, and the role of GST in countering the budget deficit. Adopted by Parliament in the 54th year of the Indian Republic, FRBM Act, establishes the central government's obligation to maintain intergenerational justice in fiscal management and long-term macroeconomic stability by removing fiscal obstacles to the efficient implementation of monetary policy and prudential debt management in line with fiscal sustainability, increasing openness in the Central Government's fiscal operations, and implementing fiscal policy in a way that is compatible with fiscal sustainability (Government of India, Ministry of Finance, Department of Economic Affairs, 2003). This Act aims to pay off the 'General Government Debt' (Centre and State Government) by the revenue generated through proper implementation of fiscal policy, mainly taxation.

The two main ways that the government raises money to pay for its expenses are through taxes and borrowing. While the government's net tax revenue made up 44.37% of its total receipts in 2021–2022, borrowing came in at a close second with 43.26%. (GOI, 2022)

Given that GST has become the government's second largest revenue source, surpassing income tax, it is evident that the collected GST funds are intended to be utilised for debt repayment and developmental initiatives. (Ministry of Finance Budget Division, 2023)

In each fiscal year, the Central Government is required to present the statements of fiscal policy to both Houses of Parliament, alongside the annual financial statement. This obligation mandates the inclusion of:

1) ***Fiscal policy statements to be laid before parliament:***

The budget estimates for Fiscal Deficit FY 2021-22 stood at 3.5% of the Total GDP. When it came to enacting countercyclical policies while balancing the budget, the government concentrated on maintaining the standard of expenditure. (Government of India, 2022)

Over the previous years, it is predicted that the Gross Tax Revenue would increase by 12.3%

in 2021–2022 and by 12.6% in 2022–2023 The reduction in company tax has caused a slowdown in the rise of direct taxes in 2019–20. During the years 2021–2022 and 2022–2023, there is an expectation of a relatively lower growth rate in indirect taxes, at 10.7% and 11.1% respectively, while direct taxes are projected to rise by 13.6% and 13.8%. (Government of India, 2022)

A certain range for budget deficit is sometimes preferred as it indicates the revenue collection through taxation and grants received through other countries is fully utilised. Keeping in mind the budget deficit is controlled and does not go out of hand.

2) Fiscal Policy Strategy Statement:

The document highlights the government's strategic aims for the current fiscal year in relation to taxation, spending, lending and investments, administered pricing, borrowings, and guarantees. The statement provides justification for any significant divergence in important fiscal metrics and explains how the present fiscal policies are in compliance with good fiscal management principles (Government of India, Ministry of Finance, Department of Economic Affairs, 2003).

3) Macro-economic Framework Statement:

In the first quarter of 2020–21, a recovery in GDP growth is expected, despite the temporary moderation in Gross Domestic Product (GDP) growth in 2019–20. Although the Indian economy's fundamentals remain sound, the real GDP growth slowed to 5.0 percent in 2019–20 from 6.8 percent in 2018–19 due to global headwinds and domestic financial sector challenges (Government of India, 2019).

This prospect talks about the Macroeconomic Factors of the economy (basically the industries), including the Agriculture Sector, Manufacturing Industries, External Sectors, the Price Level in the economy, the Monetary Policy recommendations by the RBI (Reserve Bank of India), Banking and Non-Banking Sectors, Non-Banking Financial sectors, Capital Markets, Central Government Finances.

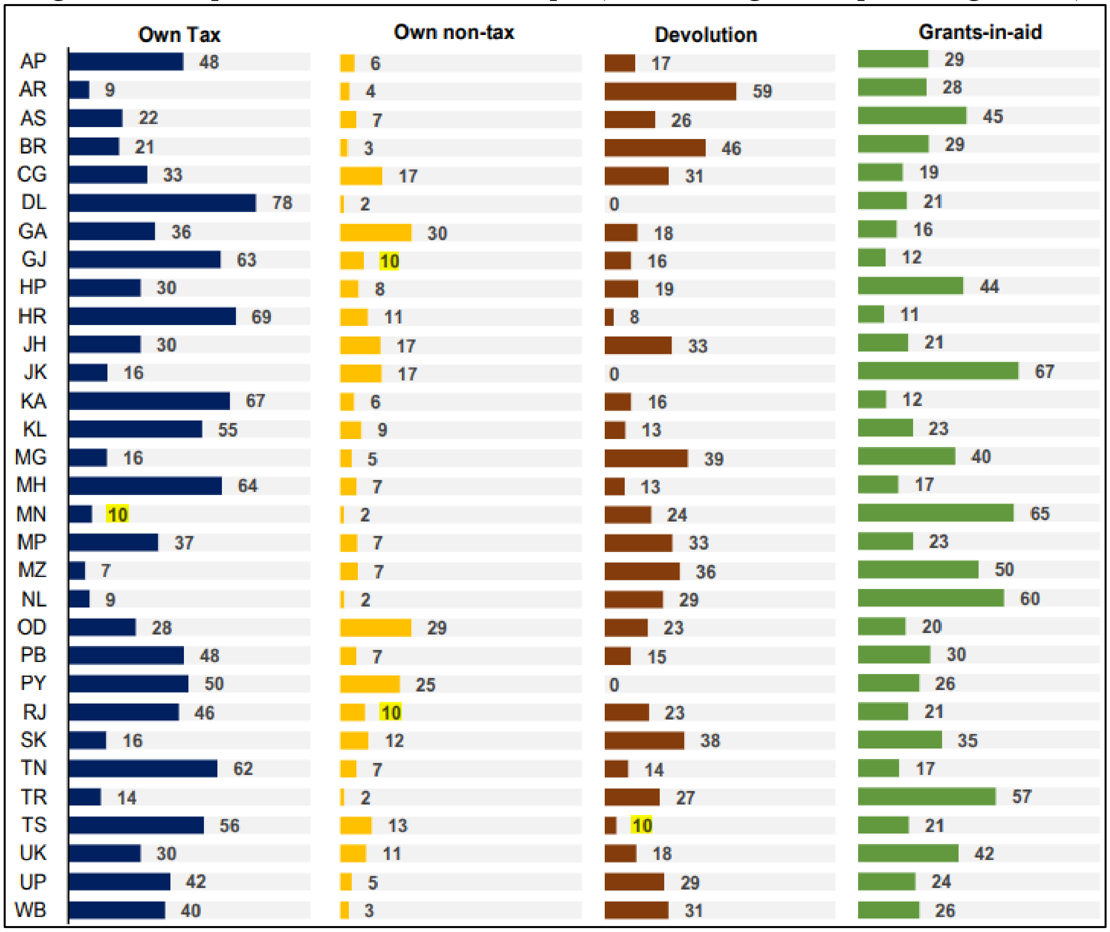
4.3 EXPENDITURE PATTERN OF SUB-NATIONAL GOVERNMENT

A state's revenue can be divided into two categories: (i) own revenue, and (ii) transfers from the centre. Own revenue is money that the state government generates on its own from tax, and non-tax-paying sources. According to the Constitution, each state will receive a portion of the taxes levied by the Federal Government. The distribution of this share among the states is based on criteria set by the Finance Commission. Additionally, the federal government gives state governments several kinds of grants. These include: (i) Specific Grants in accordance with the Finance Commission's recommendations, such as grants for disaster management, revenue deficit grants, and grants to local authorities; (ii) Grants for centrally sponsored programmes; and (iii) Funds for GST compensation. Based on the recommendation of the Finance Commission the government changes the composition of revenue receipts of the states. The states that depend on central transfers for funding the most are Bihar, the northeast, and the hill states. Arunachal Pradesh and Bihar receive a disproportionately higher proportion of central funds in the form of central tax devolution The share of grants is higher for other north-eastern states and hill states (Jammu and Kashmir, Himachal Pradesh, and Uttrakhand).

States collectively project that their own non-tax revenue will account for around 1.3% of their GSDP in 2022–2023. The amount of non-tax revenue generated varies greatly between states. State estimates for non-tax revenue have been much higher in states like Odisha, Chhattisgarh, and Jharkhand, primarily because of mining royalties. In the case of Odisha, it is anticipated that non-tax revenue will surpass its own tax revenue in 2021–2022.

States like Bihar, Jharkhand, and Uttar Pradesh are falling behind on important human development metrics relating to health and education, according to the 15th Finance Commission. It also noted that their per capita spending in these sectors continues to be below average and that more money must be invested there for these spending levels to converge on these parameters.

Figure 1: Composition of Revenue Receipts (2021-22, figures in percentage terms)



Source: PRS India, State of State Finances

5. Conclusion and Policy Recommendation

Finance Commission being the sole body handling all the Federal Fiscal decisions must include stakeholders from states and must give them equal weightage. The Finance Commission comes up with their own parameters to transfer funds. Including HDI as one of the factors can be useful and might end up having more efficacies. As we saw in our analysis, many states which have lower HDI end up receiving lower fund transfers. States must look to increase their non-tax revenue through various ways as recently observed most states depend upon the grants given by the centre to meet their deficits instead of trying to be financially independent for public services, commenting on how to increase non-tax revenue would be a separate topic for a broader research. We also suggest structural changes in the way the GST council functions, one of them being implementing a consensus method to reach a decision instead of the presently skewed way of voting.

6. Direction for Future Research

The Finance commission still uses outdated census data of 2011 for assigning weightage Criteria which must be revised. Future research will only be useful once we have a new census and HDI of States (2018) data, given the current situation scholars can look into advising the finance commission to incorporate better parameters to disburse the funds and research upon ways states can enhance the capacity of sub-national tax administration authorities to effectively administer and collect GST. This includes investing in training, infrastructure, and technology to improve compliance and reduce tax evasion.

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