BALANCING POWER: HOW GST PROMOTES FISCAL FEDERALISM IN INDIA

Shlok Bhogila, National Law University, Odisha

Shreya Pandey, National Law University, Odisha

Introduction

Federalism is a political philosophy that combines the governing structures of a central or federal government and the governments of different states into one streamlined C hierarchical arrangement for better governance of a nation. **Montesquieu's "The Spirit of Laws"** is a foundational text that explores the complexities of governance and provides insights into the concept of federalism.

In a federal structure, power is divided between the central government and regional governments. Each level of government has its own jurisdiction, both geographically and in terms of specific policy areas. **Fiscal federalism** specifically refers to the financial relationship between these two levels of government in a federal structure.

The term "Fiscal Federalism" was coined by economist Richard Musgrave. This addresses the critical issues such as distribution of income, resource allocation, reducing financial disparities, and promoting economic stability. These challenges are particularly relevant in the current global economic scenario and fiscal federalism offers a potential solution. In the Indian context, there are certain constitutional provisions that support a federal structure, the prime indicator being the Seventh Schedule of the Indian constitution that assigns specific tax bases to the state and centre in the State and Union lists. Recent years have witnessed increased collaborations between the state and central governments on certain matters of national importance.

Introduction of GST or the Goods and Services Tax through the 122nd amendment bill back in 2014 is one of the most significant tax reforms made in the last decade in the taxation structure of the entire nation. The primary objective behind the introduction of GST was the extremely cluttered and outdated system of taxation which was followed earlier.. The newly elected NDA government saw it as an opportunity to set a precedent and also take the first few steps towards a more formal economical structure in India.

The integration of various central and state taxes was the biggest highlight of GST along with features such as the introduction of destination-based tax replacing the previously used origin-based taxation system, reduction of the tax burden on consumers, and due to the transparency in the taxation system of GST, it became easier to administer. The GST council sits every few months to decide the tax rates for various items and services and the decided rate is divided by two to get the respective rates for CGST and SGST. IGST on the other hand is levied on Inter State transactions and is collected by the central government, which is later on distributed among states on the basis of the

destination of consumption. However, the distribution of IGST among states, based on the principle of destination-based taxation, was opposed by the southern states in early 2024, stressing over the losses the manufacturing states are suffering due to implementation of the taxation system. The protest is headed by the Chief Minister of Karnataka, the southeastern state renowned for its manufacturing industries and a tech hub of the country, often referred to as the Silicon Valley of India. The primary concern of the protesting states is the distribution of central tax revenue. These states allege that the central government has been releasing a disproportionate amount of tax revenue to states governed by the ruling party, often located in the northern region of India. This perceived bias has led to discontent among southern states, particularly those with significant manufacturing and export-oriented industries. Imagine a big potluck dinner where each person brings a dish to share. The host decides to distribute desserts based on the number of people at each table. However, some tables with larger numbers of guests but fewer main courses and good quality dishes receive more desserts, while tables with smaller groups of people but excellent quality dishes might receive fewer desserts. This is somehow fair to make sure the entire table is fed well.

GST Structure and Distribution of Taxes

The Goods and Services Tax (GST) is a unified indirect tax system implemented in India on July 1, 2017. It replaced a complex web of multiple central and state taxes, streamlining the tax structure.

Under GST, three divisions were created for better administration,

1. Central Goods and Services Tax or the CGST,

2. State Goods and Services Tax or the SGST,

3. and the Integrated Goods and Services Tax or the IGST.

Both CGST and SGST are levied on the same transaction, with the revenue collected from CGST going to the central pool and the revenue from SGST going to the state pool. The revenue from both taxes is shared equally between the central and state governments.

All sales within a state are taxed both by the centre as well as the states over a common base and at the same rate, which together add up to the full GST rate. The taxes levied are called the State GST (SGST) and the Central GST (CGST), respectively.

All sales from one state to another are taxed by the centre at the full GST rate applicable. The relevant tax levied is called the Inter-State GST (IGST).[1]

For sales across state lines, any input taxes on purchases can be deducted (i.e. an input tax credit is available) from taxes collected on sales regardless of the source of the purchases.

India employs a multi rate GST structure, with rates ranging from 0%, 5%, 12%, 18%, going up to 28% based on the nature of goods and services. To ensure equitable revenue distribution, the central government distributes a portion of IGST revenue to states based on their consumption pattern of goods and services. This helps in addressing any imbalance arising from inter-state transactions. Retrospectively, for the first five years of GST implementation (up to June 2022), states were guaranteed compensation for any revenue shortfall due to the introduction of GST compared to the pre-GST regime. This compensation was funded by a cess levied on certain high-value goods.. It is important to note that certain items, such as alcoholic beverages for human consumption, diesel, petroleum and electricity are exempt from GST. These items are typically under the purview of the state's responsibilities and are hence taxed under the state-specific Value Added Tax or VAT laws. .

The theory of fiscal federalism is embodied in the constitution of India in different provisions, the most important of them being Part XI (Relations between the Union and the States) and

[1] The World Bank, India Development Update: India's Growth Story, at 1, World Bank Group (Mar. 2018), http://documents.worldbank.org/curated/en/814101517840592525/pdf/India-development-update-Indias-growth-story.pdf.

Part XII (Finance, Property, Contracts, and Suits), which contain Article 246, read along with the seventh schedule, and Article 280.

Article 246 under part XI mentions the distribution of powers between Parliament and State Legislatures, detailing the Union List, State List, and Concurrent List of subjects, which are further enumerated in the Seventh Schedule.

1. **Union List:** The Union List or List I covers areas such as defence, foreign affairs, banking, interstate trade etc

2. **State List:** The State List or List II, gives states the authority to deal with police, public health and sanitation and excise duty on alcohol regulation

3. **Concurrent List:** List III, i.e. the "concurrent list" refers to subjects on which both the Union and the State governments have the authority to make decisions and enact laws. This list includes criminal law, education, welfare of labourers, etc.

Under Part XII, articles 265-267 deal with the distribution of revenues between the Union and states, including the sharing of taxes and grants-in-aid. However, in case of a conflict in relation to a legislature under List III, the union's legislation shall prevail.

Article 280 provides for a Finance Commission, which has the crucial function of recommending how the financial resources should be shared between the Union and the States with regard to fair distribution and addressal of fiscal imbalances. As a matter of fact, the fourteenth finance commission has opined that 42% of the union tax needs to be transferred to states.

Protests by Southern States

Following the announcement of the 2024 interim budget on February 1st, the congress led Karnataka government raised concerns regarding the reduced allocation of revenue to the state.

Karnataka launched a protest the following day eventually joining hands with Telangana, Tamil Nadu and Kerala, in opposition to alleged fiscal injustice perpetrated by the Union government. These southern states contested the Union government's policies regarding tax revenue and state grants. The southern states, particularly the ones mentioned above, have expressed concerns that the central government's policies often disadvantage them in terms of revenue sharing and resource allocation. They argue that the formula used to distribute central resources does not adequately reflect their needs or contributions. Notably, Bengaluru, the capital of Karnataka has the second highest tax contribution in the country. In the last four years the state saw its share of tax funds transferred back from the federal government has fallen to 3.64% of total national taxes collected, down from 4.71%[2] as stated by the State's Chief Minister, Siddaramaiah. He claimed that the north Indian states failed to adequately address population increase, and that as a result, the southern states that have overcome this issue, must now contribute to the development of these other states. The protesters staged a sit-in at Jantar Mantar, holding posters that read "Our Tax, Our Right", and "Our Tax Money, Give it to us".[3]

Kerala has filed a suit against the Union of India in the Supreme Court under Article 131 of the Constitution, requesting the court to direct the Union to remove the restrictions on the amount of funds the state is allowed to borrow. Kerala advocates for increased borrowing autonomy, but the Union government stresses the need of debt supervision to maintain macroeconomic stability. Some argue that borrowing freely allows the state to oversee its own budgets, promoting self-reliance by enabling states to finance local developments and needs without relying solely on the funds allotted by the centre. It also gives states the power to compete to draw firms and investments by having the power to borrow money, which could result in creative growth plans. However, unrestricted borrowing powers can threaten states' long-term financial stability by accumulating unmanageable debt. Political factors may lead to misallocation of funds, taking precedence over sound economic judgement when making borrowing decisions. For example, Punjab's debt-to-GSDP ratio surged to 53.3% in 2021-22, largely due to borrowing for appealing schemes.

The case has sparked debates about the balance of power between the central and state governments under the Indian Constitution, specifically regarding the Union's authority to enforce national policies that affect state functions. Currently, states with larger populations receive more revenue for growth, regardless of their taxation contribution. In contrast, states with higher production but smaller populations receive less funding compared to their

[2] Devdiscourse, India's Southern States Protest Against Federal Funds Distribution by Modi Govt, Devdiscourse (Dec. 31, 2024), https://www.devdiscourse.com/article/politics/2801748-indias-southern-states-protest-against-federal-fund s-distribution-by-modi-govt.

[3] Devdiscourse, India's Southern States Protest Against Federal Funds Distribution by Modi Govt, Devdiscourse (Dec. 31, 2024), https://www.devdiscourse.com/article/politics/2801748-indias-southern-states-protest-against-federal-fund s-distribution-by-modi-govt.

contribution. Implementation of the budgetary policies largely depends on the extent of federalism incorporated into the democratic political system.

India is often characterized as quasi federal in nature, which means it combines the features of both federalism and unitarism. In a federal system, power is typically divided equally between central and regional governments, whereas in a unitary system, power is concentrated at the central level. India's system incorporates elements of both. The union and state lists clearly demarcate the decision-making power between the state and centre. However, in cases where the state and the centre have conflicting opinions, the centre prevails. Similarly, another power arises with fiscal distribution i.e. The central government controls significant financial resources and has the power to redistribute funds to states through various grants and allocations, influencing state finances. Fiscal federalism refers to the framework governing the allocation of financial responsibilities and resources between central and state authorities within federal systems. It encompasses. the allocation of financial powers, revenue collection and distribution, and the division of spending responsibilities.

Is Fiscal Federalism Truly Necessary?

The usual point of contention that arises after a thorough study of the facts above is the validity and viability of fiscal federalism in contemporary times. Fiscal federalism can be highly advantageous, offering an effective framework for managing and organizing responsibilities.

However, its success largely rests on its implementation and the unique context of the country.

One key benefit of this system is the fiscal efficiency and balance it promotes. Local governments, being closer to their constituents, have a better understanding of their needs and concerns, enhancing accountability and responsiveness. Furthermore, successful initiatives in one region can inspire and guide others, fostering innovation and the sharing of best practices. Fiscal federalism can include mechanisms for redistributing resources from wealthier regions to poorer ones, promoting a more balanced overall development. However, disparities in funds and resources among states pose a challenge for several reasons. Differences in fiscal capacity among regions can lead to disparities in the quality of public services with the wealthier regions providing the better services compared to poorer ones. The allocation of funds based on population size has sparked protests from southern states, which argue against sacrificing their resources for the development of other states that have not effectively managed their population growth. For instance, in the 2024-2025 revenue allocation, Uttar Pradesh received the highest amount of funds i.e. 2,23,737.23 crore, despite being only the 6th highest tax contributing state with its contribution of 96,421 crore from October 2023 to January 2024.[4]Whereas, Karnataka being the second highest tax contributor received only 45,480.83 crore. This situation fuels anger, frustration, and disputes over fiscal responsibilities and resource allocation. Nonetheless, fiscal federalism is vital for maintaining stability and achieving inclusive growth. It has the potential to enhance efficiency, accountability, and regional development. However, more productive states may perceive an imbalance, feeling penalized for contributing more in taxes than they receive in benefits, which they see as a deterrent to maintaining or improving their productivity. On the other hand, redistribution serves as a tool to boost economic development in less productive regions, striving to create a more equitable and balanced economy overall.

However, the success of fiscal federalism depends on the design of fiscal arrangements, mechanisms for equalisation, and the capacity of regional governments. Well-designed fiscal federalism can foster innovation and balanced development, but careful management is needed to address the challenges and ensure that it serves the broader goals of equity and effective governance.

Recommendation

To address the challenges and disparities in fiscal federalism, the following recommendations can be considered:

1. **Transparency and detailed report:** Providing detailed reports with explanations of financial resources distribution and decision-making processes can foster transparency and accountability. This must include documentation of data-driven and decision-making processes.

2. **Transparency in the meetings of the GST council:** it is important to ensure that the GST Council regularly reviews and updates its policies and distribution mechanisms to address evolving needs and imbalances and encourage more extensive input from all states, including

[4] Gov't of India, Receipt Budget 2024-25: Annex 4 - Non-Tax Revenue Collections, at 1, Ministry of Finance, https://www.indiabudget.gov.in/doc/rec/annex4.pdf.

those with grievances, during policy formulation and decision-making processes.

3. Specific grants: Introducing targeted grants or financial support for states with specific development needs, such as infrastructure, education, or health, can address disparities in development and service provision or introducing performance-based incentives that reward states for achieving specific developmental goals or efficiently utilising resources.

Conclusion

Fiscal federalism in India strives to balance central and state interests, but it has faced challenges, notably from states which have incumbent governments from the opposition parties. Their protests highlight issues with the current resource allocation, which sometimes favours population size over economic productivity. Ensuring equitable development and responsive policies is crucial yet difficult to achieve for a harmonious federal relations and balanced growth. Taxation has historically been a contentious issue, with greater tax independence being a long-standing demand since the imperial Raj era. The struggle of autonomy continues to this day. The public at large is directly affected and influenced by this subject matter, and is frequently in conversation for not being in favour of one section of the society while favouring others. Taxes form the foundation of governance and growth, requiring careful deliberation and reform to cater to all sections of society. It is vital to reform allocation methods and increase transparency to cater to all the states and sections of society. Addressing these issues will not only ensure more balanced regional development but also reinforce national unity, making fiscal federalism a cornerstone of India's democratic and economic stability.