GOODS AND SERVICES TAX AND FEDERALISM

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Introduction

The Indian state being federal in nature, through its Constitution lays down distinct responsibilities to be performed by the Centre and the State, according to the division of powers, for which they need to raise resources. For this purpose the Constitution empowers both the Centre and the State to levy and collect taxes through their respective legislations as enshrined in the seventh schedule to the Constitution of India. Revenue generation through the taxation of goods and services is a prominent source of financing the governmental operations. The existing system of taxation of goods and services suffers from various problems mainly the multiplicity of Centre and state taxes on goods leading to cascading effect of taxes. Moreover there is a blurring of the distinction between goods and services which makes the separate taxation of goods and services untenable. Thus there is a need for a comprehensive taxation regime which is proposed under the title of the Goods and Services Tax (GST). GST is India's most ambitious tax reform initiative that is targeted at bringing simplicity, transparency and efficiency to the system of indirect taxation in the country and is being considered imperative in the emerging economic environment. [1]

In operational terms a well established and functioning federalism is a dire necessity for effective governance of the country. A fundamental requirement for effective governance is the establishment of a relationship of trust between all principal stakeholders in India's federal set-up: the central government, states, regions and even villages and Panchayats. This involves inter alia that all stakeholders be clear about their responsibilities and rights and that financial flows between these stakeholders are predictable and easily understood.

[1] Jaya Pandey, Fiscal Federalism In India an Insight Into The Concept And Structure Of Sales Taxation, Available at: http://www.legalserviceindia.com/articles/fiscal.htm, Last visited 21/12/18.

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Fiscal federalism, however, represents the polar case where federal fiscal arrangements are decided purely on economic principles. The existence or otherwise of a federal constitution is not a consideration, and the principles of fiscal federalism apply to both unitary and federal countries. What is relevant is the degree of decentralization and not whether a country is unitary or federal. Under fiscal federalism, everything - boundaries, tax and expenditure assignments, intergovernmental and inter-jurisdictional interactions and intergovernmental transfer systems is determined purely on economic considerations. While such an analysis is clearly removed from reality, it certainly shows economic solutions to federal fiscal problems in a multi-jurisdictional community and helps us to set benchmark or ideal economic solutions to the problems of federal finance.

The fiscal policy can be effective only when the policies of different levels of government are coordinated. Similarly, satisfactory resolution of tax and expenditure overlapping and conflicts between different levels of government and jurisdictions within each of the levels can be achieved only when there is a certain degree of coordinated behavior among these governmental units. The competitive federalism, to be successful should have, (i) clearly enforceable property rights or the assignment of functions and sources of finance; (ii) adherence to the set rules by each of the governmental units and effective mechanisms to foster interactions based on mutual trust and understanding; and (iii) an independent and a just mechanism to conduct and monitor intergovernmental relationships. The mechanism should ensure that no governmental unit is able to exploit free ride and dominate other units so as to ensure competitive equality and cost benefit among governmental units.

FISCAL FEDERALISM

Federalism in its simplest and most basic form means the setting up of government at multiple tiers and primarily at two tiers in most federal states. Thus it envisages an idea of decentralization of government. Compared to a unitary form of government where the government is at a single level and where there is centralization of power, in a federal state there is a clear demarcation of powers between the federal national unit and the sub-national state units. The federal character of public finance in India has its origin as far as the seventies of the last century. Although at that time the country had a unitary form of government, some division of functions and financial powers between the Center and the state was found administratively desirable. Ever since then the arrangements have been revised and improved

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from time to time. Fiscal federalism entails the division of responsibilities in respect of taxation and public expenditure among the different layers of the government, namely the Center, the states and the local bodies.[2] Fiscal federalism helps governmental organization to realize cost efficiency by economies of scale in providing public services, which correspond most closely to the preference of the people. From the point of view of economy, it creates a unified common market, which promotes greater economic activity. In the Indian context the establishment of a federal structure was first proposed in the Government of India Act, 1919 and was later given shape by the Government of India Act, 1935. Division of powers between the federation and the units where they are given ordinate and equal status within their respective fields is known as co-ordinate federalism. The next where the units and the federation do not compete for power but co-operate through various instrumentalities to promote the common purpose is known as "co-operative federalism." [3]The Seventh Schedule (Article 246) delineates 'the subject matter of laws made by the Parliament and by the Legislatures of the states' and indicates the Union List (List I), states List (List II) and the Concurrent List (List III). List I invests the union with all functions of national importance such as defence, external affairs, communications, constitution, organization of the Supreme Court and the High Courts, elections etc, List II invests the states with a number of important functions touching on the life and welfare of the people such as public order, police, local government, public health, agriculture, land etc. List III is a concurrent List, which includes administration of justice, economic and social planning, trade and commerce, etc.

Fiscal federalism to be described most fundamentally would mean applying the federal principles in fiscal relations between the federation and units. The concept of fiscal federalism which is a concept of public economics is centered on the designing of a framework which details out the fiscal powers and responsibilities of the central unit vis-à-vis those which need to be decentralized to the sub-national units. It is generally believed that the Central Government must provide national public goods that render services to the entire population of the country. A challenge before most federal states including India is to ensure that the financial relations between the Centre and the state units should not result is a fiscal imbalance.

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[2] Available at: http://shodhganga.inflibnet.ac.in/bitstream/10603/6308/12/12_chapter%203.pdf, Last visited 24/12/18.

[3] Raghbendra Jha, Indirect Tax Reform and Fiscal Federalism in India, Australian National University, ASARC Working Paper 2013,
Available at: https://acde.crawford.anu.edu.au/sites/default/files/publication/acde_crawford_anu_edu_au/2016-10/wp2013_09.pdf, Last visited 26/12/18

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Fiscal imbalances in India result due to the mismatching of revenue and expenditure of the State units. Due to a strong unitary control the Centre is able to command greater share in the public funds and hence it leads to a vertical fiscal imbalance Usually the states lack funds in proportion to the responsibilities entrusted to them to discharge the same. Thus the states have to rely heavily upon the Centre for aids, grants and revenue sharing.

These lists include the powers of taxation also. The Union List includes among others, taxes on income other than agricultural income, excise duties, customs and corporation tax. The State list includes land revenue, excise on Alcoholic liquors, tax on agricultural incomes, estate duty, taxes on sale or purchase of goods, taxes on vehicles, on professions, on luxuries, on entertainment, on stamp duties, etc. the concurrent list does not include any important taxes.[4]

Accordingly there are both mandatory and enabling provisions in the Constitution for facilitating a wide-ranging transfer of resources, arranged in a systematic manner, through -

1) Levy of duties by the Center but collected and retained by the States.
2) Taxes and duties levied and collected by the Center but assigned in whole to the states
3) Mandatory sharing of the proceeds of income tax
4) Permissible participation in the proceeds of the Union excise duties
5) Statutory grants –in-aid of the revenues of states
6) Grants for any public purpose and
7) Grants of loans for any public purpose

The Indian Constitution has, under Article 246[5] and Seventh Schedule, distributed powers and allotted subjects to the Union and the states with a threefold classification of subjects: (i) List

[4] Motilal Mahamallik, Pareshwar Sahu and Sushant Mahapatra, The Paradox of Fiscal Imbalances in India, Department of Economic Sciences (DSE), University of Bologna, Available at: http://amsacta.unibo.it/4088/1/WP969.pdf, Last visited 27/12/18

[5] Article 246 in The Constitution Of India 1949**:** Subject matter of laws made by Parliament and by the Legislatures of States (1) Notwithstanding anything in clauses (2) and (3), Parliament has exclusive power to make laws with respect to any of the matters enumerated in List I in the Seventh Schedule (in this Constitution referred to as the Union List)

(2) Notwithstanding anything in clause (3), Parliament, and, subject to clause (1), the Legislature of any State also, have power to make laws with respect to any of the matters enumerated in List III in the Seventh Schedule (in this Constitution referred to as the Concurrent List)

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I invests the Union with all functions of national importance such as defence, external affairs, communications, constitution, organization of the Supreme Court and the High courts, elections etc. (ii) List II invests the states with a number of important functions touching on the life and welfare of the people such as public order, police, local government, public health, agriculture, water land etc. (iii) List III is the Concurrent list, which includes administration of justice (excluding Supreme Court and High Courts), economic and social planning, trade and commerce, etc. It is of interest to note that higher education; forests and population control were all added to this list in 1977 during the emergency when it was felt that the states were not doing justice to these subjects of national importance. The residuary functions, that is, those not included in either lists I or II, vest with the Union. The Union and State lists include the powers of taxation as well. The enumeration of taxation powers placed in the Union List includes: tax on income other than agricultural income, excise duties, customs and corporate tax. Recently service tax had been included in view of diminishing importance of customs. The State List contains land revenue, excise on alcoholic liquor, tax on agricultural income, estate duty, tax on sale or purchase of goods, tax on vehicles, tax on professions, luxuries, entertainment, stamp duties etc. However, due to political reasons, none of the states had imposed tax on agriculture income.

HARMONISATION OF TAX SYSTEM IN INDIA

Tax harmonization is generally understood as a process of adjusting tax systems of different jurisdictions in the pursuit of a common policy objective. Tax harmonization involves the removal of tax distortions affecting commodity and factor movements in order to bring about a more efficient allocation of resources within an integrated market. Tax harmonization may serve alternative goals, such as equity or stabilization. It also can be subsumed, along with public expenditure harmonization, under the broader concept of fiscal harmonization. Narrowly defined, tax harmonization guided by this policy goal implies — under simplifying assumptions about other policy instruments and economic structure — convergence toward a more uniform effective tax burden on commodities or on factors of production.[6] Convergence may be attained through the alignment of one or several elements that enter the determination

(4) Parliament has power to make laws with respect to any matter for any part of the territory of India not included (in a State) notwithstanding that such matter is a matter enumerated in the State List

[6] Prof. Gheorghe MATEI, University of Craiova, Reasons For Tax Harmonization In The EU, Available at: http://www.financejournal.ro/fisiere/revista/328623098013-09.pdf, Last visited 28/11/18

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of effective tax rates: the statutory tax rate and tax base, and enforcement practices. Perhaps the most widely accepted argument for harmonization involves convergence in the definition of product value or income for tax purposes. Such tax base harmonization would contribute to transparency for economic decision-making and, thus, to improved efficiency in resource allocation. In particular, a common income tax base for multinational companies operating in different jurisdictions would be instrumental not only in enhancing efficiency, but also in preventing overlaps or gaps in tax claims by different countries.

Tax harmonization is an important part of the fiscal integration process. Fiscal integration is the process by which a group of countries agree on taking measures that lead to a higher level of fiscal convergence, the ultimate goal being the formation of a fiscal union. Tax harmonization doesn't automatically lead to the formation of a fiscal union, the second part involving much larger scale project that includes fiscal transfers, a fully harmonized legislation and maybe some supervising institutions, beside a long-run agreement. We can easily say that tax harmonization is the process by which a heterogeneous group of countries, federal states or even local governments agree on setting a minimum and maximum level of their tax rates, including also a higher degree of harmonization of tax legislation, in order to attract foreign investors and to encourage local development and investments.[7]

Overlapping taxes can rob the tax system of simplicity and transparency, alter relative prices in unintended ways, make tax crediting on exports difficult, cause inter-state tax competition and tax exportation to result in inequitable resource flows.[8] It was also pointed out that tax overlapping can occur due to overlapping assignment of tax powers itself, but more often, the problem arises because of the very nature of economic interactions. Interdependence in tax bases and concurrent pursuit of distributional functions by different levels of governments and by different units within each of the levels assumes enormous significance in all federations attempting to achieve efficient and equitable allocation of resources. It is notable that at present, indirect taxes constitute about 84 per cent of total tax revenue and domestic trade taxes constitute over 60 per cent. At the State level, the share of indirect taxes is over 90 per cent and

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[7] Available at: http://www.oecd.org/ctp/tax-policy/39866155.pdf

[8] Available at: http://www.udyogsoftware.com/implications-of-gst-on-inter-state-transactions-of-goods-services/, Last visited 28/11/18.

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the contribution of sales tax alone is more than 55 per cent of the States' tax revenue. Therefore, overlapping in commodity tax system surely is a major problem in the Indian federation.[9]

The major deficiencies in the prevailing commodity tax systems may be briefly stated here:-

1) Vertical overlap of commodity tax systems: The levy of union excise duties by the Centre, sales taxes by the States and octroi by local bodies has made the tax system non-transparent and rendered the pursuit of the objectives of tax policy by any level of government difficult. In such a tax system, the incidence of taxes on different commodities remains unknown and repeated taxation of the same commodities by different levels of government creates broader wedges between producer and consumer prices. This is particularly true as the Centre levies the tax at the manufacturing stage and the States levy the sales tax predominantly at the first point of sale - on the excise duty paid value.[10]
2) Cascading of commodity taxes: Although giving tax credit to inputs in respect of most of the industries and extension of tax credit to capital goods has resulted in the union excise duties acquiring the character of a manufacturing value added tax, sales taxes levied by the States are of cascading type; they are levied not merely on final consumer good but also on inputs and capital goods. Along with excise duties levied on manufactures, sales tax payable at the first point of sale and the taxes on inputs and capital goods can cause a very high degree of cascading.[11]
3) Multiplicity of tax rates: To begin with, multiplicity of objectives in sales tax policy has led to minute differentiation in the structure of tax rates. In addition, the acute tax competition between different States has caused further rate differentiation and contrary to what is observed in many countries, this has resulted in divergence in the tax rates among different States.

FISCAL IMBALANCES IN INDIAN FEDERALISM:-

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[9] Statistical Year Book of India, Chapter 6, Direct and Indirect Taxes, Available at: http://mospi.nic.in/sites/default/files/Statistical_year_book_india_chapters/Taxes.pdf, Last visited 26/10/17

[10] M. Govina Rao and Tapas K. Sen, National Institute of Public Finance and Policy, Fiscal Federalism in India: theory and Practice, Available at: http://www.nipfp.org.in/media/medialibrary/2014/10/FISCAL_FEDERALISM_IN_INDIA_THEORY_AND_PRACTICE.pdf, Last visited 28/12/18

[11] Available at: http://www.economicsdiscussion.net/taxes/defects/8-major-defects-in-the-tax-structure-of-india/12917, Last visited 29/12/18

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Fiscal imbalance refers to the mismatch between own revenue raising capacity and expenditure needs at different governmental units. In an abstract sense, this implies the gap between revenue and expenditure when both revenue sources and functions are allocated between various units of the government optimally. However, empirical estimates of fiscal imbalances are difficult to derive on the basis of such definitions, for, estimates of revenue capacity or expenditure needs in an absolute sense will depend heavily on the relevant value judgments made and in practice, it is difficult to find an allocation of revenue sources and responsibilities which is strictly optimal in any sense. [12]

Thus, the fiscal imbalance among the states would arise because of inadequate revenue resources in comparison to their respective expenditure commitments. Such non-correspondence between the revenue resources and expenditure requirements among the states in a federation is known as fiscal imbalance.

In the concept of fiscal federalism, two types of fiscal imbalances are measured:

Vertical Fiscal Imbalance:

Non-correspondence between revenue and expenditure commitments of the central governments vis-a-vis the non-correspondence between revenue and expenditure commitments of the federating units put together is known as Vertical Fiscal Imbalance. It is natural that the federal governments of any country have vertical fiscal imbalance irrespective of their development status.[13]

The vertical imbalance has been examined using own revenue receipt, total receipts, revenue expenditures and total expenditures of states as per cent of their corresponding combination of centre and states. These variables indicate the share of own revenue capacity, total capacity, basic requirements and total requirements of states in their total of both centre and states respectively. Elsewhere the vertical imbalance has also been estimated by using different components of receipts and expenditures of the centre as well as states. The analysis shows persistence disparities in different components of revenue and expenditure of centre and states.

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[12] M. Govina Rao and Tapas K. Sen, National Institute of Public Finance and Policy, Fiscal Federalism in India: theory and Practice, Available at: http://www.nipfp.org.in/media/medialibrary/2014/10/FISCAL_FEDERALISM_IN_INDIA_THEORY_AND_PRACTICE.pdf, Last visited 14/01/19

[13] Shreya Jain, The Goods and Services Tax (GST) Regime Through The Lens of Fiscal Federalism in India, ILI Law Review Summer Issue 2016, Available at: http://ili.ac.in/pdf/paper14.pdf, Last visited 16/01/19

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Inequalities exist in (1) own capacity, measured in terms of own revenue, (2) total capacity measured in terms of total receipts , and (3) both revenue as well as total expenditure responsibility of state and centre.

Horizontal Fiscal Imbalance:

Non-correspondence between revenue and expenditure commitments across state governments in a federation is known as Horizontal Fiscal Imbalance. This type of fiscal imbalances arises due to the differences in the endowment of natural resources, given the uniform revenue powers and expenditure responsibilities. Thus, horizontal fiscal imbalance also exists in federations across the countries irrespective of their state of development.

Horizontal fiscal imbalance has been captured through two inter-related but different sets of indicators, (1) components of receipts and expenditure, and (2) deficit indicators. In the first set, the ratio of own revenue to revenue expenditure, own receipts to total expenditure, and revenue expenditure to total expenditure of states have been used to understand the inequality in own revenue capacity (ORC) to meet the basic needs, own total capacity to meet the overall requirements, and the proportion of basic needs in total requirements respectively. Similarly, the second set depicts inequality in deficits faced by states to meet different levels of requirement. Elsewhere fiscal imbalance was also measured using components of receipts, and expenditures. Three important observations on the imbalance are (1) persistent inequality, (2) growing inequality across states, and (3) further deepening up of inequality in the post liberalization period.

CONCLUSION-

The GST regime which aims to stitch together a common market by dismantling fiscal barriers and is eyed as a move to boost investor confidence in the country is certainly not without hurdles and challenges. Around 160 countries in the world have implemented the GST, the latest addition to the list being India, where the implementation of GST became effective from July 2017. However the taxation system of India which is a two tiered federal structure (excluding a third tier of rural and urban local bodies) imposes serious challenges to the overhauling of the existing system to integrate the same into a single regime. A dual GST has thus been proposed, keeping with the constitutional requirements of fiscal federalism. It has been argued that GST rates which have been proposed as high as 24-27% will create

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apprehension in the minds of paying consumers and may lead to greater tax evasion instead. Also the GST appears to be treating unequal states equally by ignoring that the level of manufacturing activities in states vary greatly and the proposed framework may not be suitable, keeping in view the heterogeneity and vastness of India. Administration and complexity issues have been at the centre of most debates opposing the same. Thus, uncertainty still prevails over the suggested reforms as well as regarding the exact nature of how the fiscal relations between the Centre and state would be changed and redesigned.

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