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A ‘TWO-THIRD, ONE-THIRD’ PROBLEM OF INDIAN FEDERALISM

Relevant for: Indian Polity | Topic: Issues and Challenges Pertaining to the Federal Structure, Dispute Redressal Mechanisms, and the Centre-State Relations

States get too little tax money for the spending they do and it’ll be a relief if they get their full GST compensation

A tsunami of commentary was unleashed by three words uttered by finance minister Nirmala Sitharaman after the last meeting of the Goods and Services Tax (GST) Council. The amount of ink spilt on her “act of God" comment could fill many doctoral theses, and be the envy of divinity schools. It was a marathon meeting and those words were perhaps just a throwaway remark. Who would have guessed their power? They were evocative and conjured up the notion of force majeure in commercial contracts, which lets parties abandon their commitments. But this was the sovereign trying to renege on a written promise made to its sub-sovereigns: i.e., the states. It was an unconditional promise. Going back on it would have signalled betrayal, a huge crack in the foundation of trust, the very basis for cooperative federalism. There are good reasons why the Centre would have to honour its promise to the states, as it reportedly avowed on Monday, of filling the gap to ensure a 14% growth in GST revenues. The Centre is eminently more capable than the states to raise the requisite funds, having access to the central bank, foreign dollar investors, the instrument of cess, and de facto monetization of debt. States do not have any of these, and could not be left in the lurch. It does not matter that the 14% promise was too generous in hindsight. It did, after all, help secure a historic consensus.

The pandemic, the lockdown and the consequent deep recession are opportune moments, if not a useful alibi, to work upon a complete redesign of the GST. This will not need parliamentary action and can be accomplished by the GST Council. GST is a destination-based consumption tax. If consumption is two-thirds of gross domestic product (GDP), we should ensure that the tax coverage is as comprehensive as possible. The current coverage is barely one-third, since it excludes electricity, petrol, diesel and real estate, as also agriculture. And despite such an incomplete coverage, the weighted average tax burden of GST is only 11.6%, as per Reserve Bank of India calculations. If the standard rate is brought down from 18% to 12%, as originally proposed by the Kelkar Committee, it would still be higher than the currently realized rate of 11.6%. To elucidate, if the standard rate of 12% is applied to half of GDP, then total collection will be 12 trillion, which would exceed current collections. There should be only a few items in the merit rate of 5%, and “sin" goods rate of, say, 24%. This also leaves room for additional excise on petroleum products at the state level. Further, a 12% rate would increase compliance, reduce the need for arbitrary classification and discretion, and result in lower litigation. It would also act as a strong fiscal dose, which is the need of the hour.

It is utterly myopic to get hung up on a notional “revenue neutral rate" (RNR), as a reference peg. The GST is a long-term and structural reform. The underlying consumption and production patterns will change, sometimes drastically. The digital economy is growing by leaps and bounds. We can’t be bogged down by an elusive and ill-defined RNR, which may work as a reference point only in the short-run.

The world over, standard GST rates began much lower than India’s 18%. For instance, Australia rolled out GST, coincidentally also on 1 July, 20 years ago. Its rate has been a constant 10% since then. In these two decades, its underlying consumption pattern has changed. The share of consumption that is subject to GST has declined from 61% to 55%. That’s because of a rise in healthcare spending, which is exempt due to its demographics of an ageing society. E-commerce and digital transactions too can erode the tax base of GST. The challenge in Australia is to meet the increasing expenditure obligations at the state level, with a declining revenue share from GST in its federal system. Currently, only 44% of its state-level expenditures are covered by GST. The states feel that their autonomy is getting constrained. Sound familiar? The choice of reforms in GST is to either widen the net and remove exemptions or increase the standard rate to 12%. This needs a national consensus. Both India and Australia as federal democracies have a mismatch between revenue and expenditure at the state or local government level. There is an inbuilt imbalance, more so in India's case. It can be called India's "two-third, one-third" problem, where two-thirds of revenue accrues to the Centre, but two-thirds of all expenditure obligations are on state and local governments. Rapid urbanization is putting more pressure on local governments. The need to align the tax base and government responsibilities is acute. Hence, India's revised GST system should earmark revenues directly for the third tier. The formula could be that 10% be equally shared between the Centre and states, and 2% kept for the third tier. As more citizens pay this consumption tax, of which some portion they know helps run their local government, there would develop a nexus between the demand for and supply of good governance.

India's cooperative federalism will be tested in 2026, when the current framework of delimitation ends. Parliamentary constituencies, unchanged since 1971, would have to be realigned to reflect population changes. Either that, or the number of representatives will have to be increased. Interstate sharing of river waters is another thorny issue. In this light, maybe there is a God-given opportunity in these covid times to radically reform GST and make it states- and taxpayer-friendly.

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