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# GST- Changing Centre State Financial Relations in India.

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**Abstract:**

Over the last 65 years many changes have been incorporated in the Indian federation through different constitutional amendments, changes in criteria for devolution of resources etc. to fulfill the objectives of fiscal federalism viz; reducing fiscal imbalances and ensuring provision of equal level of public services like education, health etc across all states at similar rate of taxes. Similar is the case of Indian federalism where there is a mismatch of resources and expenditure responsibilities at different layers of government. Though inter-governmental transfers take place to reduce fiscal imbalances and provide average level of public services across the sub-national governments, there exist fiscal imbalances and regional disparities across the states even after 70 years of independence.

**Key words:** independence, financial powers, finance commission

***"Taxes are the Sinews of the State."*** **– Marcus Tullius Cicero**

## Introduction

The Financial Relationship between the centre and the state is provided in the constitution. The constitution gives a detailed scheme of distribution of financial resources between Union and States. Like other powers, financial powers are also distributed between the two sets of government. The constitution grants the Union Parliament exclusive power to levy taxes on several items. The State Legislatures enjoy similar power with regard to several other specified items. In general, the Union Parliament levies taxes on items mentioned in the union list while the State Legislatures levy taxes on items mentioned in the state list. The residuary power of taxation belongs to the centre. It means that the subjects which have not been included either in the union or in the state list may be taxed only by the union government.

Part XII (Articles 264-291) of the constitution deals with finance, property, contracts and suits. Articles 268-272 deal with distribution of taxes and revenues between the union and the states. In addition to this, under Article 275, grants-in-aid shall be made in each year by the union to such states as parliament may determine to be in need of assistance. Articles 270,[1] 273,[2] 275[3] and 280 provide for the constitution of a finance commission for the tenure of five

[1] Article 270 in the Constitution of India deals with Taxes levied and collected by the Union and distributed between the Union and the States.

[2] Article 273 in the Constitution of India deals with Grants in lieu of export duty on jute and jute products.

[3] Article 275 in the Constitution of India deals with Grants from the Union to certain States.

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years to recommend to the president certain measures relating to the distribution of financial resources between the Union and the States. The constitution of the commission has to be read with the Finance Commission Act of 1951,4 which has supplemented the provisions of the Constitution. Under Article 271,5 parliament may at any time increase any of the duties or taxes referred to in Article 2696 and Article 270 by a surcharge for purposes of the union and the whole proceeds of any such surcharge shall form part of the Consolidated Fund of India. Article 2927 confers unlimited powers to the Union to borrow from the Consolidated Fund; however restrictions have been imposed on borrowings by the States in the same under Article 2938.

Over the last 65 years many changes have been incorporated in the Indian federation through different constitutional amendments, changes in criteria for devolution of resources etc. to fulfill the objectives of fiscal federalism viz; reducing fiscal imbalances and ensuring provision of equal level of public services like education, health etc across all states at similar rate of taxes. Similar is the case of Indian federalism where there is a mismatch of resources and expenditure responsibilities at different layers of government. Though inter-governmental transfers take place to reduce fiscal imbalances and provide average level of public services across the sub-national governments, there exist fiscal imbalances and regional disparities across the states even after 70 years of independence. The transfers from centre to states take place through three channels, viz; Union Finance Commission, Planning Commission (Niti Ayog)9 and Central Ministries, of which the transfers from Finance Commission are predominant. Gross devolution and transfers comprises of states' share in central taxes, grants-in-aid and gross loans from centre.

## GST - Centre State Fiscal Relations

Goods and Services Tax (GST) is an indirect tax which was introduced in India on 1 July 2017 and was applicable throughout India which replaced multiple cascading taxes levied by the central and state governments.

Prior to GST, fiscal powers between the Centre and the States are clearly demarcated in the Constitution10 with

[4] The Finance Commission Act, 1951 was enacted on 16.05.1951 under Article 280 of Indian Constitution to initiate financial relationship between the Central Government and State Government on revenues distributions that are earned through various sources.

[5] Article 271 in the Indian Constitution deals with Surcharge on certain duties and taxes for purposes of the Union-Notwithstanding anything in articles 269 and 270.

[6] Article 269 in the Indian Constitution deals with Taxes levied and collected by the union but assigned to the States.

[7] Article 292 of the Indian Constitution states that the Government of India can borrow amounts specified by the Parliament from time to time.

[8] Article 293 of Constitution of India deals with borrowing by States.

[9] The National Institution for Transforming India, also called NITI Aayog, was formed via a resolution of the Union Cabinet on January 1, 2015.

[10] Articles 268 to 293 in the Constitution of India deals with financial relations between Centre and States.

almost no overlap between the respective domains. The Centre has the powers to levy tax on the manufacture of goods (except alcoholic liquor for human consumption, opium, narcotics etc.) while the States have the powers to levy tax on sale of goods. In case of inter-states sales, the Centre has the powers to levy a tax (the Central Sales Tax) but, the tax is collected and retained entirely by the originating States. As for services, it is the Centre alone that is empowered to levy Service Tax. Since the States are not empowered to levy any tax on the sale or purchase of goods in the course of their importation into or exportations from India, the Centre levies and collects this tax in addition to the Basic Customs Duty. Introduction of GST required amendments in the Constitution so as to empower the Centre and the States concurrently to levy and collect GST.

Accordingly, By Constitution (One Hundred and Twenty-Second Amendment) Bill, 2014 the GST Bill was introduced in the Lok Sabha by Finance Minister Arun Jaitley on 19 December 2014, and passed by the House on 6 May 2015. In the Rajya Sabha the bill was referred to a Select Committee11 on 14 May 2015, and the Committee submitted its report on 22 July 2015. The bill was passed by the Rajya Sabha on 3 August 2016, and the amended bill was passed by the Lok Sabha on 8 August 2016. Finally the CGST, IGST, UTGST and GST compensation law12 were passed in Loksabha on 29 March 2017, and introduced a national Goods and Service tax (GST) in India from 1 July 2017. GST will be a giant leap from the colonial legacy tax system to one more suited to the needs of a dynamic and vibrant economy that India is today. It defines a new vision of federalism where the tangles between the Union and state governments in exercise of their taxation powers give way to collective and harmonious tango.

## GST - One Nation. One Tax.

GST is a value added tax (VAT) and subsumed most of the indirect taxes existed at the level of state and federal governments, reducing the red-tape, plugging leakages and paving the way for a transparent indirect tax regime. This will be a comprehensive tax for almost all goods and services. Some of the goods like crude oil, natural gas, turbine fuel, high speed diesel, and alcohol for human consumption are not included in the list due to import dependence, environmental and social reasons. Central Taxes to be subsumed under the Goods and Services Tax are Central Excise Duty, other Excise Duties, Service Tax, Customs Duties (countervailing taxes), and Surcharges. Apart from this some state taxes which subsumed under GST are VAT / Sales tax, Entertainment tax, Luxury tax, Taxes on lottery, betting & gambling, State Cesses and Surcharges in so far as they relate to supply of goods and services and Entry tax. GST is a valued added tax on goods and services that is paid by the final consumer while the retailer will be taking credit of the tax he has paid while buying goods for

[11] The Select Committee is comprised of 21 members and is headed by Bhupender Yadav, M.P., Lok Sabha.

[12] A Bill to provide for compensation to the States for loss of revenue arising on account of implementation of the goods and services tax for a period of five years as per Section 18 of The Constitution (One Hundred and First Amendment) Act, 2016.

retailing. It created the uniform tax rates all over the nation against the multiple taxes. Through this "One Nation, One Tax" can be achieved. This helps in free movement of goods across the country with diffused state boundaries, which will encourage the easy doing of the business by merging all taxes.

## GST - Cooperative Federalism

With GST, India has moved towards a major economic reform. It is considered as the most important financial changes that have been brought in the country since that of 1991 economy reforms. The adoption of GST is an iconic example for the Cooperative Federalism in the true sense. It represents a national consensus; an outcome of a grand bargain struck together by 29 States and Seven Union Territories with the Central Government. The Prime Minister Mr. Modi has hailed in the House of Parliament, that the "GST is the historical example for the Cooperative Federalism. Together we will take India to new heights."13

The task of designing GST is assigned to the GST Council.14 The current difficulties in holding GST Council meetings and reaching agreement on the architecture of the GST regime are indications of the challenges ahead in realising a vision of cooperative federalism. These challenges have become much greater, following demonetisation. Not only have many states complained about the expected hit to their revenues caused by it (Kerala's finance minister recently estimated the state's revenues would decline by 40 per cent), but the political fallout of demonetisation has made Centre-state relations a much testier issue.

## GST – Challenges Ahead.

GST Council is a collective forum of state and central government. Any change to tax rates will have to be within a narrow band prescribed by the GST Council. Any changes to the tax rate will need to be agreed to with three-fourth majority at the GST Council. While states together have weightage of two-third in any decision and Centre will retain the balance one-third. This is akin to giving the Centre veto power, which is biggest apprehension of the states. The council will be deciding on all important aspects of the tax, including the base, rates, allocation of tax base among the states, administrative architecture and compliance procedures This effectively means that states together will not be able to act on their own or take any decision, consent of the Centre will be necessary.

Aligned with India s federal structure, the GST is a dual structure, under which taxes will be levied and collected by the Union Government (Central GST) as also the respective State governments (State GST). This dual GST model would be implemented and governed by the CGST Act, IGST Act, and the SGST Acts of each State as also common rules determining valuation, place of supply, place of origin, and so on. This would imply that the Centre and the States would have

[13] GST Bill, Parliamentary Debate – Lok Sabha.

[14] As per Article 279A of the amended Constitution, the GST Council will be a joint forum of the Centre and the States. In this Council, the Union Finance Minister will be the Chairperson, The Union Minister of State, In Charge of Revenue or Finance as Member and the Minister in-charge of Finance or taxation or any other Minister nominated by each State as members.

concurrent jurisdiction on the entire value chain. Under the GST, the Central Government and the State governments would be required to work closely in a coordinated manner, as the IGST collected by the Central Government to be apportioned to the respective States and Central government has to mandatorily compensate the State government. In other words, now onwards, the centre and states are enjoined in three-legged race-one which they can win only if they coordinate their actions. In short, their future destines depend on how they cooperate with each other.

GST is a destination based taxation system, by which the IGST revenue on interstate sales (SGST portion) will accrue to the state which consumes the goods - destination based tax ('DBT'). Whereas in the existing scenario where CST is charged at 2% (when form C is produced) or local vat rate (if C form not produced) is charged, it will accrue to the state which supplies the goods. Hence CST is origin based taxation as it accrues to the state which supplies it. Now, when this Origin Based Taxation is replaced by a DBT, then the manufacturing states is going to lose its portion of revenue from interstate sales and the consuming states are going to earn higher. Thus, state Governments fear loss of revenue and expects compensation from the centre. Manufacturing states (Tamil Nadu, Gujarat etc.) loses and consuming states will gain due to this change. States with high and strong manufacturing base will be the biggest contenders for compensation Tamil Nadu government will lose Rs 3,500 Crores annually due to abolition of CST and wants compensation from the Centre.15 Maharashtra government is set to lose Rs 14,000 Crores that it collects as Octroi16. So, GST will bring a shift here. The Center will compensate for the revenue loss to states for the 1st 5 yrs post-GST implementation. But after 5yrs period, if states face any revenue loss, the same might not be compensated which is a point of concern which in long run may impact state's economy and ease of doing business especially in the manufacturing states.

The manner of taxation on products such as alcohol and petroleum under the GST mechanism has been a point of disagreement between the Union and the states because of the amount of revenue generated by the states in taxing these products. The Bill has sought to address this issue and keep the states happy by keeping the taxation of alcohol and petroleum outside the purview of GST altogether. This essentially means that the states will continue to tax the sale of alcohol and petroleum under its existing state excise and sale tax laws. Additionally, to address the long standing (but slightly unjustified) concerns of revenue loss to the states, the Bill insisted an additional tax not exceeding 1 per cent on the supply of goods in the course of inter-state trade or commerce to be levied and collected by the Union Government for a period of at least two years, but assigned to the states from where the supply of goods originates.

15 https://timesofindia.indiatimes.com/business/india-business/Manufacturers-will-gain-from-GST-but-Tamil-Nadu-differs/articleshow/47622135.cms

16 https://www.quora.com/How-will-gst-reduce-the-revenue-for-manufacturing-states

However, since this 1 per cent additional tax is intended to be collected in addition to the IGST under Article 269A, it appears that this 1 per cent additional tax falls outside the purview of the GST framework altogether; else, it could have been specifically incorporated into Article 269A itself.

Tax incentives granted by state governments to companies making investments in the respective states. Some tax benefits are generally granted by states as subsidies based on the quantum of taxes paid (i.e. VAT and CST) by companies to the State Government on their manufacturing activities and that too, over a specified time period. Of course, such incentives are subject to a maximum ceiling limit based on total capital investments made by these companies. Since the amount of incentives are based on the amount of indirect taxes paid to the State Government, it is important to analyse how these incentives would get impacted under the GST scenario.

### Sharing of un-utilised money

The Constitution (101st) Amendment Act, 2016 requires the centre to compensate states for any revenue loss due to implementation of GST for a five-year period. To compensate states, an additional cess on certain goods and services will be levied under GST. However, at the end of the five-year period, the unutilised funds received by levying the cess will be shared equally between by centre and states; the share of states will be apportioned in the ratio of their SGST collections in the last year of transition. This tax is collected from consumers by the central government and the question is how to apportion it among the Centre and each state. In case of direct taxes (and other central taxes such as customs duty), the formula is based on the recommendations of the Finance Commission. Such formula is used for dividing the funds collected through CGST and the centre's share of IGST too. The apportionment of excess funds collected through the compensation cess differs from such formula.

### Effects on States Autonomy

Goods and Services Tax, is India's biggest tax reform since 1991 economic reforms. It will convert India into a unified market by replacing all indirect taxes with one tax is likely to affect the federal structure of India. One of the biggest concern has been about the autonomy of states which is likely to be affected.

- Financial autonomy of states would be affected as states would no longer have the independence to introduce/modify taxes as per their wishes. Concurrency of GST council would be required.
- The advantageous position enjoyed by certain producing states like (Gujarat, Maharashtra and Tamil Nadu) would be eroded and thus the elbow room enjoyed by them earlier in framing state specific policies/schemes would be compromised.
- The revenue loss would be compensated for 5 years only. If states fail to adapt even after 5 year then once again it would have to depend on Center for Financial aid/Grants/Special category status etc. Will Lead to weakening of unit.
- Only those states that are well prepared will be able to absorb advantages arising out of GST. Thus, regional disparity might increase as there is no mechanism that would

help in trickling down form stronger to weaker state.

- Since it is an indirect tax reform. Hence, poor and people in unorganised sector likely to be affected the most. States would no longer be able to keep them out of the ambit based on BPL/SECC criteria.
- Uniforming the indirect taxes, will significantly impact the manufacturing states like Gujarat, Maharashtra, TN etc which will impact spending on state specific and state sponsored social schemes on health, education, skill development, TPDS etc finally impacting the target segment of population.
- GST council to enjoy the supreme power. Smaller states will have lesser say. Also no precedence available for any such platform would make things difficult.
- Many political parties would no longer be able to frame policies after coming to power based on their political ideology (e.g., Left has tilt towards socialism and against privatisation)
- Since, in GST council the Government of India would have a 33% weightage. Hence, it would ultimately enjoy a veto power. Thus, chances of Union centralization.

Thus, the GST is expected to strengthen Cooperative Federalism and weaken Competitive Federalism. Now states won't have any power to give tax holidays for attracting investment in their states. In this context, States need to capitalize through structural reforms in labour laws, land issues, etc., to be able to provide the incentives for investors and business.

## Conclusion

GST at the state level will be a major improvement in its tax base for future revenue generation. The service sector has always been on the rise and is growing at much faster pace than the manufacturing sector. As per the 2017 data on GDP the service sector contributes around 54 % while industrial sector contributes about 29% to the GDP of India[17]. Without GST the major tax base will be absent in the revenue stream of state governments. Further the tax compliance will improve in the GST regime due to computerization of tax payers at national level, common registration at national level and also due to linkage of the registration with the income tax records. GST will be the collective gains for industry, trade, agriculture, common consumer as well as the federal and state governments. GST will be more progressive due to exemption of food articles, inclusion of informal sector and higher taxes on luxury goods. This also will improve the adequacy and stability of the state resources due to broader tax base. Similarly, the states combined voting power is 2/3rd Vs 1/3rd voting power with the Central Government and each decision taken by the GST council must be passed by minimum 3/4th majority. So, states have the larger combined voting power. So, their autonomy is not as such threatened, but consensus would prevail. Center with 33% voting power will have a veto on all decisions made by GST Council. But States will no longer be making sole decision on indirect taxes related matters but the same will be

[17] http://statisticstimes.com/economy/sectorwise-gdp-contribution-of-india.php

decided by the GST Council represented by the States and Union Territories.

Though overall GST is a welcome move that will ultimately benefit the consumers and improve the ease of doing business in India by simplifying the indirect tax structure and removing the cascading effect at various stages, it will have adversarial impacts also in short and long run for the manufacturing states in particular and a robust safeguard mechanism for such states is required for both short and long term.

"It has potential for great success. It has potential also to be of great difficulty...this is going to be the biggest challenge in Centre- State relations."18

[18] As said by *Y V Reddy,* former Governor of The Reserve Bank of India in Hakeem Abdul Hameed memorial lecture organized by Hamdard University, New Delhi on 3rd December, 2016.