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The Road to the Good and Services Tax – Growing Importance of India's States

The introduction of the Goods and Services Tax in India effective 1 July 2017 is significant, not only as a major reform, but also as an illustration of the growing importance of India's states in the country's economic management. As India graduates from first generation to second generation reforms, the involvement of states is becoming increasingly important in moving the agenda forward. The role of states is increasing, also because they get to spend a larger share of the total public expenditure and are on the frontlines in implementing governance reforms. How states use their growing importance will determine how India performs on growth and welfare on the way forward.

Duvvuri Subbarao[1]

The introduction of the Goods and Services Tax (GST) effective 1 July 2017 is being hailed as the most significant economic reform in India since the whirlwind reforms of 1991. It is significant also for another important reason – as an illustration of the growing importance of India's states in the country's economic management.

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GST – A Testimonial to India's Cooperative Federalism

There have, of course, been tax reforms in the past, most notably the transition from single point taxation to value added tax (VAT) both by the central government (henceforth 'centre') and states. However, that transition happened largely in silos with only little interface across tax jurisdictions. The GST, on the other hand, involving as it did a comprehensive integration of the indirect tax system straddling the centre and states, is a unique experiment in fiscal federalism. The negotiations brought to the fore clash of interests not just between the centre and states but also between producer and consumer states, large and small states, and coastal and inland states. Compounding the complexity was the uncertainty about the costs and benefits of the GST with the result that negotiating positions were taken based on heuristics rather than empirical evidence and compromises were reached based on assurances rather than hard estimates.

The GST has been criticised for being less than optimal - too many rates, too many exemptions, too much of bureaucracy and too much of compromise, all of which would potentially limit its transformational potential. There is no denying that. However, even this admittedly suboptimal formulation is a remarkable achievement in a federal structure where states jealously guard their financial autonomy, and fiercely compete with one another for investment. As someone said, India's priority should be to sign a 'free trade agreement' with itself, implying how the country is forfeiting the advantages of a large common market because of a complicated, cascading and frustrating tax structure. That the centre and states entered into a grand bargain by pooling their autonomy is a tribute to the maturity and resilience of India's federalism. It is also an illustration of the growing clout of states in India's economic management.[2]

Evolution of India's Economic Federalism

It was not always like this. In the early years after the Constitution came into force in 1950, India started off more as a 'unitary state with a federal structure' rather than as a federation of

[2] Some analysts have argued that the compromises that have had to be made in negotiating the GST, in fact, reflect not only cooperative federalism but also strains of contesting federalism which need to be acknowledged and address.

states. The centre dominated in the political, economic and administrative spaces, and states, even those led by dominant political leaders, acquiesced in the central leadership. That arrangement was perhaps necessary after 200 years of colonial rule to build the 'idea of India'. It helped that the Congress party which governed at the centre was also in power in many states during this early period.

The reaction to the central dominance came in the early 1980s when strong regional leaders started agitating against 'the hegemony of the centre'. Indeed, several of them built their political careers on an 'anti-centre' platform – criticising the centre for assaulting the sovereignty of states and of playing patronage politics with its affirmative action policies. The centre yielded to the states, but largely in the political space. Much of the economic policy control stayed with the centre which decided not just public investment but even private investment through its industrial licensing policies, leaving states on the margins of the economic policy even much after the economic reforms took off in 1991.

That started changing gradually in the 2000s when the reform agenda shifted from first generation reforms, largely within the domain of the centre, to second generation reforms where the active cooperation, if not explicit consent, of states was necessary to move forward.

The prominent role played by states in the negotiations leading to the finalisation of the GST is a part of the dynamic of the growing importance of states in managing the economy. Even though it was the centre which first proposed the GST, and quite rightly so, the process thereafter was led by a committee of state finance ministers. And after the Constitution amendment approving the GST was passed by the centre and states in 2014, the process management was taken over by the GST Council where states together command two-thirds of the voting power leaving the centre with only one third.

Shifting Economic Centre of Gravity

Analytically, there are three trends driving this shift in the economic centre of gravity from the centre to states.

Evolution of the Reform Agenda

The first, as already indicated, is the change in the character of the reform agenda. The centre could push through the first generation reforms implemented in the 1990s, even without informing, much less consulting, states because they were all centred on product markets which were entirely within the centre's domain. In contrast, the second generation reforms, centred on factor markets like land, labour, taxation and infrastructure building, need the active involvement of states. The experience with several reform initiatives over the last 10 years illustrates these changing dynamics.

An example is the reform of land acquisition. Since the 'acquisition of property' is in the concurrent list of the Constitution, both the centre and states can legislate on the subject with the central law taking precedence if there is a conflict. The reform of land acquisition has been politically contentious because of the tension between two objectives - the need for industrial projects to get the required land at a viable price and in good time, and the obligation to pay the farmers a fair compensation that reflects not just the current market price, but also its prospective value post industrialisation.

The United Progressive Alliance (UPA) government replaced the colonial era Land Acquisition Act of 1894 with a new law, "The Right to Fair Compensation and Transparency in Land Acquisition, Rehabilitation and Resettlement Act, 2013", which came into force from 1 January 2014. In the lead up to enacting this new law, several states took combative positions depending on where they stood on the balance between the interests of the farmers and of industrial investors and the new law reflected a compromise between all these interests.

Deeming the new law passed by the outgoing UPA government to be too heavily biased in favour of the farmers, the current Narendra Modi government decided to amend it in order to "meet the twin objectives of farmer welfare, along with expeditiously meeting the strategic

and developmental needs of the country". Even as the Lok Sabha (lower house of parliament) passed the bill with some amendments, the legislation is bogged down in the Rajya Sabha (upper house of parliament). Frustrated with the process, the centre asked states to go forward with their own reforms in this regard.

The story is somewhat similar with labour reforms where the initiative has also shifted to states. Labour laws reform, everyone agrees, is critical for India to generate a manufacturing revolution that it desperately needs in order to provide jobs to the hundreds of millions of under- and unemployed. Labour is also in the concurrent list of the Constitution. Keenly aware that labour reforms too will confront contentious agitation from a variety of interest groups, the centre has asked individual states to go forward with their own reforms even as it is reported to be working on consolidating all the various labour laws currently scattered across several acts.

Foreign direct investment (FDI) is another area that demonstrates the increasing role of states in determining the content and pace of reforms. The UPA government's initiative to allow 100 per cent FDI in single brand retail ran into headwinds with some states protesting that it would destroy neighbourhood retail shops which provide huge employment in the informal sector. The centre gave in, allowing states to decide whether they will allow 100 percent FDI in single brand retail in their respective states, and this even though FDI is in the central list of the Constitution where states have no say.

Fiscal Federalism

The second factor driving India's economic centre of gravity towards states is the changing dynamics of its fiscal federalism. As of now, the centre collects about 60 percent of the combined revenue (centre and states) but gets to spend only about 40 per cent of the combined expenditure. The states' fiscal weights mirror this asymmetry – together they collect 40 per cent of the combined revenue but spend as much as 60 per cent of the combined expenditure. This is a reflection of how successive Finance Commissions, which determine the share of its taxes and grants that the centre must pass on to states, have weighed in favour of states.

More important than the aggregates is the greater autonomy that states now enjoy in determining expenditures. Earlier, some of the central transfers, especially plan transfers, were tied to specific so-called ‘centrally-sponsored schemes’ to signal national priorities. States consistently baulked at this arrangement arguing that they should have the discretion to determine how to spend these funds since they are better judges of local needs and priorities. With the centre accepting the landmark recommendation of the Fourteenth Finance Commission that all central transfers should be untied, states now get not only a larger quantum of central transfers, but also decide how to spend that larger quantum. And how they use this discretion determines not only their own performance on growth and welfare but also India’s collective performance.

Another dimension of the growing importance of states in macroeconomic management stems from their market borrowing. In the excessive focus on the fiscal stance of the centre, there is a tendency to overlook the fact that fiscal profligacy at the state level can have equally egregious macroeconomic consequences. The cause for concern is that state fiscal deficits have widened by almost one percentage point of gross domestic product over the past five years. As a consequence, market borrowing by states has more than doubled in just four years; in 2013-14, it constituted 34 percent of the centre’s borrowing; by 2016-17, that share had jumped to 84 percent of that of the centre, and is likely to have exceeded that of the centre in 2017-18.

The market does not know the colour of the fiscal deficit as it were. The surge in state borrowing can crowd out private investment, impede monetary transmission and spill-over into the external sector just like the centre’s market borrowing could do. No doubt profligate states will in time pay the price for their excesses, but the bigger anxiety is that their profligacy will impair macroeconomic stability at the national level.

Ease of Doing Business

The third major trend shifting the economic centre of gravity towards states is their role in creating a conducive investment climate in the country. There is a big effort by the centre to improve India’s position in the World Bank’s ranking of countries by way of ease of doing business. Much of the responsibility for making this effort successful rests, not in fact with New Delhi, but with India’s 29 states. It is because of the vexatious processes, delays and

corruption at the field level that entrepreneurs are frustrated. “Maximum governance, minimum government” is what states should aim for much more than the centre.

Democracy – India’s Safeguard

As India graduates from first generation to second generation reforms, the involvement of the country’s states in both cooperative and competitive federalism frameworks is becoming critical to moving the agenda forward. How states use their growing clout will determine India’s performance on growth and welfare. The big safeguard in India, as always, is its vigorous democracy. A promising trend has been the growing tendency of voters to prefer politicians and political parties who promise not handouts but those who promise and deliver on sustainable growth and welfare. It is ultimately for the voters to ensure that states use their growing economic importance in economic management to the collective advantage of the nation.

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