Policy WATCH

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Governance and Development

In this issue

Contents

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I Editorial

The Rajiv Gandhi Institute for Contemporary Studies (RGICS) works on five themes:

1. Constitutional Values and Democratic Institutions
2. Governance and Development
3. Growth with Employment
4. Environment, Natural Resources and Sustainability
5. India's Place in the World

We bring out the monthly Policy Watch on each of these themes sequentially and every sixth issue is a Special Issue, where we carry articles from each theme. The previous issue was on the theme Constitutional Values and Democratic Institutions which covered the Bharat Jodo Yatra, arguable a significant attempt to protect and promote Constitutional Values and Democratic Institutions.

One of these values is the relationship of the Union and the states. The constitutional formulation is the Indian Republic is a union of states, and the states have their own legislature, executive and judiciary. The legislative powers, including taxation powers of the states are provided for in the Seventh Schedule of the Constitution and sharing mechanism of the tax revenue accruing to the Union is provided for under article 280 which talks about the Finance Commission mechanism.

This issue is on the theme, Governance and Development. In our view, Governance covers the Executive functions of the State, which involve execution of constitutional, legislative and at times judicial mandates. Thus matters related to law and order, welfare and development, and specific programmes and their financing through tax revenues are all part of governance. However, in the absence of necessary financial resources, governance is seriously constrained. In the last few years this situation has increasingly arisen for the states.

In this issue, we carry only two articles, one by RGICS Senior Research Associate, Arnab Bose, giving a comprehensive overview of the Fiscal Relations under the overall concept of Federalism in India. This is part 3 of the four part review of Federalism in India by Arnab Bose. The second article, written in 2020, is by Issac Thomas, the former Finance Minister of Kerala. He argues that the expectations of GST have not been realised in terms of revenue buoyancy, ease of doing business and positive impact on growth. He suggests a comprehensive overhaul of the GST regime and gives four important suggestions for it.

We hope the readers find the articles interesting and Policy Makers use some of the lessons to design better policies and programs with people's participation.

Vijay Mahajan,
Director, Rajiv Gandhi Institute for Contemporary Studies

2 Federalism in India: Fiscal relations

Arnab Bose

2.1 Introduction

This paper proposes to discuss various issues of inter-governmental fiscal relations in India in the context of federalism. It focuses on three specific areas including the Finance Commissions, the Planning Commission and the Centrally Sponsored Schemes, as well as the Goods and Services Tax. It begins by highlighting the nature of fiscal federalism under the Indian Constitution and the variety of mechanisms available under the Constitution for inter-governmental fiscal transfers. Thereafter, it reviews the working of the Finance Commission as well as the trends of the various FCs. Then, it looks at the fiscal transfers through the erstwhile Planning Commission and the Centrally Sponsored Schemes. It also discusses some of the key constitutional issues that have arisen out of Article 282 and the transfers through the Planning Commission. Thereafter, it discusses the emergence of the Goods and Services Tax and its impact on Fiscal Federalism in India. Finally, it highlights some of the contemporary challenges for fiscal federalism in India.

2.2 Fiscal federalism in the Indian Constitution

The theory of fiscal federalism, as originally developed by Richard Musgrave[1] and Wallace E. Oates,[2] is primarily concerned with the logical division of public sector functions and finances amongst various layers of government. As a sub-field of public finance, it broadly considers the vertical structure of the public sector and the fiscal policy institutions and their interdependence. It explores, in both normative and positive terms, the roles of different levels of government and ways in which they relate to one another through the sharing financial resources through various instruments such as intergovernmental grants.[3]

The foundations of fiscal federalism in India were first laid by the Government of India Act, 1919 which provided for the clear cut separation of revenue heads between the Center and the Provincial governments.[4] The next major step in this direction was the Government of India Act, 1935 wherein, besides the jurisdictional distribution of revenue between Union and States, there was also a provision for revenue sharing and transfer.[5] Since these federal arrangements were effected under the colonial rule there was a strong bias towards the Centre. When independent India adopted its Constitution on 26th January, 1950, the fiscal federal arrangements were largely the logical extensions of the Government of India Act, of 1935.[6]

The Constitution of India provided for the necessary institutional framework, the financial and functional division of responsibilities between the Centre and the states, and a well defined mechanism for intergovernmental transfers particularly from the center to the states and UTs.

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1 *Musgrave, Richard (1959), Theory of Public Finance: A Study in Public Economy. New York: McGraw-Hill*

2 *Oates, Wallace E. (1972), Fiscal Federalism. New York, N.Y.: Harcourt Brace Jovanovich Inc*

3 *Joumard, Isabelle and Per Mathis Kongsrud (2003), Fiscal Relations Across Government Levels, Organisation for Economic Co-operation and Development, Economics Department Working Paper, No. 375.*

4 *M.M Surry, 2008: Centre State Financial Relations in India 1870—2010: Indian Tax Foundation New Delhi.*

5 *Ibid*

6 *Ibid*

The purpose of such a division was to ensure an equitable distribution of financial resources.[7] With regard to India's fiscal arrangement, the Supreme Court of India had made the following observation in the case of Coffee Board v C.T.O: [8]

Realising the limitations on the financial resources of the States and the growing needs of the community in a welfare State, the Constitution has made specific provisions empowering Parliament to set aside a portion of its revenues for the benefit of the States, not in stated proportions but according to their needs. The resources of the Union Government are not meant exclusively for the benefit of the Union activities. The Union and States together form one organic whole for the purposes of utilization of the resources of territories of India as a whole.

In terms of taxation powers under the Indian Constitution there was a clear demarcation between the Union and the States. Under Article 246 there were three Lists, namely, the Union List, the State List and the Concurrent List.[9] The Union government had the sole authority to charge taxes from the union list which included a list of thirteen taxes. The important taxes listed in the Union List or those assigned to the Centre were taxes on income other than agricultural land, duties of custom, duties of excise except those on alcoholic liquor for human consumption, corporation tax, estate duty in respect of property other than agricultural land, terminal taxes on goods and passengers carried by railways, sea or air, taxes other than stamp duty on transactions in stock exchanges and futures markets and taxes on sale and purchase of goods other than newspapers, when such sale takes place in the course of inter-State trade or commerce.[10] The state legislature had authority to impose taxes listed in the State List which included a list of nineteen taxes.[11]

The important taxes listed in the State List were land revenue, taxes on agricultural income, taxes on land and buildings, taxes on mineral rights subject to restrictions imposed by Parliament, duties of excise on alcoholic liquor for human consumption, taxes on sale and purchase of goods other than newspapers, taxes on goods and passengers carried by road, taxes on vehicles, taxation on professions, taxes on luxuries including on entertainments, taxes on entry of goods into a local area and taxes on advertisements other than those published in newspapers and broadcast by radio or television. It should be noted that while a long list of taxes were assigned to the states under the state list, only the tax on the sale and purchase of goods was significant for state revenues.

[7] *Bagchi Amaresh, 'Fifty Years of Fiscal Federalism in India: An Appraisal', Working Paper 2, 2003. National Institute of Public Finance and Policy.*

[8] *AIR 1971 SC 870.*

[9] *Article 246 of the Indian Constitution*

[10] *Entries 82-97 of the Union List*

[11] *Entries 45-63 of the State List.*

[12] *Article 248 of the Indian Constitution*

Therefore, it was tax sharing which constituted a significant portion of the State government's revenue receipts. Further, the residuary powers of taxation were given to the Parliament (i.e., the authority to impose taxes not listed in any of the lists). The parliament could levy a gift tax, a wealth tax or an expenditure tax under this article. There were no tax entries available on the concurrent list. In terms of tax legislation, the concurrent jurisdiction was inaccessible. However, the 101st[12] Amendment Act of 2016 provided an exemption by establishing a unique provision for the goods and services tax.[13] The concurrent competence to make legislation controlling goods and services tax has been given to the parliament and the state legislatures by this amendment.

Articles 268-293, mentioned in Part XII of the Constitution, further specified the financial relations between the Centre and the States.[14] The distribution of taxes was based on the principle of separation, where the following scheme of five categories of taxes was considered:[15]

i) Taxes, which were levied, collected and retained by the Union government.
ii) Taxes, which were levied and collected by the Union government but wholly assigned to the States.
iii) Taxes which were levied and collected by the Union government but the net proceed was shared with the States.
iv) Taxes which were levied by the Union but collected and retained by the States.
v) Taxes which were collected, levied and retained by the States.

In a major restructuring of the above scheme through the 80th amendment of the Constitution in 2000, and the 88th amendment in 2003, there was a change in the way tax revenues were distributed and all the Central taxes were made shareable.

In addition to transfers of resources from Union to the States by means of shared tax, there was also a provision for Grants-in-aid to State governments where the revenue received from tax sharing did not meet the expenditure requirements of the government. There were two types of grants-in-aid to the states: Statutory grants and Discretionary grants.

i) Statutory Grants:

Article 275 empowered the Parliament to offer grants to states which were in need of financial assistance, rather than to all states which were charged to the Consolidated Fund of India (CFI).[16] Aside from this standard provision, the Constitution additionally provided for special funds to promote the welfare of scheduled tribes (STs) in a state or to improve the quality of administration of scheduled territories in a state. Under Article 275 statutory grants are awarded to states on the recommendations of the Finance Commission.

ii) Discretionary Grants:

Article 282 empowered the Union and the states to give grants for any public purpose, even if it fell outside of their own legislative jurisdiction.[17] The Centre was responsible for enforcing this regulation.

The division of taxation powers between the Union and the States, as provided under the Constitution, led to an asymmetry between the tax revenues and the functional responsibilities of the governments.[18] While the Centre was assigned taxes with higher revenue potential, States were assigned with more functional responsibilities. To address this issue of gap in resources assigned to the States and their expenditure responsibilities, the Constitution provided an institutional mechanism for the transfer of resources from the Centre.

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[13] *Article 246A of the Indian Constitution*

[14] *Articles 268-293, The Constitution of India*

[15] *Bagchi Amaresh, 'Fifty Years of Fiscal Federalism in India: An Appraisal', Working Paper 2, 2003. National Institute of Public Finance and Policy*

[16] *Article 275 of the Indian Constitution*

[17] *Article 282 of the Indian Constitution*

[18] *Bagchi Amaresh, 'Fifty Years of Fiscal Federalism in India: An Appraisal', Working Paper 2, 2003. National Institute of Public Finance and Policy.*

Accordingly, there were three main channels that governed fiscal transfers in India.[19] First, the Finance Commission which determined the state's share in Central taxes and grants out of the Consolidated Fund of India. Second, the erstwhile Planning Commission which made recommendations on the magnitude of grants and loans to be provided to the states for financing their expenditure on the targeted interventions for socio-economic development, and third, the Centrally Sponsored Schemes (CSSs) which were designed by various Central government ministries in consultation with the Planning Commission, in which, the Centre's funds were transferred to the states implementing the schemes.[20]

Article 280 of the Indian Constitution provided for the formation of a Finance Commission.[21] The primary objective of the Commission was to address the existing vertical and horizontal imbalances. (Vertical imbalances refer to the mismatch between the revenue-raising capacity and expenditure needs of the Centre and the States and Horizontal imbalances exist on account of the inability of some States to provide comparable services due to inadequate capacity to raise funds.)[22] To address these imbalances, the Finance Commissions had been given a constitutional mandate to decide on[23] (i) the proportion of tax revenue to be shared with the States and (ii) the principles which should govern the grants-in-aid to States. The Commission is appointed every five year by the President of India to assess the States' and Union government's revenue and expenditure projection for the next five years and make recommendations on these issues and on any other matter which the President may ask for of each Finance Commission.

The Planning Commission was not mentioned in the Constitution of India. It was set up as an advisory and specialised institution by a Resolution of the Government in March 1950. The Commission had the responsibility of making an assessment of all the resources of the country, augmenting deficient resources and formulating Plans for the most effective and balanced utilization of resources.[24] While the Finance Commission decided on tax shares and grants, the Planning Commission's responsibility was to facilitate loans and grants for implementing development plans. The most important suggestions made by the Planning Commission were those relating to the magnitude of funds to be given from the Union Budget to different States and Union Territories and the magnitude of funds to be given to Central Government Ministries/Departments for Plan expenditure on the Central Sector Schemes.[25] The Planning Commission made an assessment of the availability of the state's own resources and its capacity to utilize Plan funds before finalizing the size of the State Plan. Once the size of the State Plan was decided, the Planning Commission recommended the Centre to provide assistance to the State for its State Plan.

The Central Ministries provided finance to their State counterparts in the form of grants.[26] Such grants were meant for financing specified projects. These projects may have been wholly financed by such grants or may have required the State governments to share a proportion of cost. The projects that were normally covered under such grants were those that had a considerable amount of interstate spillover, as well as for poverty alleviation program, immunization drives etc.[27]

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[19] *Ibid*

[20] *Ibid*

[21] *Article 280 of the Indian Constitution*

[22] *Bagchi, Amaresh (2001): "Perspectives on Correcting Fiscal Imbalance in the Indian Economy", ICRA Bulletin, Money and Finance, Jan-June 2001*

[23] *Article 280(2) of the Indian Constitution*

[24] *Bagchi Amaresh, 'Fifty Years of Fiscal Federalism in India: An Appraisal', Working Paper 2, 2003. National Institute of Public Finance and Policy*

[25] *Ibid*

[26] *Ibid*

[27] *Ibid*

Finally, articles 292 and 293 defined the borrowing powers of the Union and the State governments, respectively. Article 292 provided the Union government the power to borrow from the security of the Consolidated Fund of India within a limit which was fixed from time-to-time by the Parliament.[28] Similarly, article 293 empowered the States to borrow within the territory of India from the security of the Consolidated Fund of the State.[29] Article 293 further imposed the condition that a State may not raise any loan if any part of the loan extended by the Government of India remained outstanding. In such cases, the permission of the Government of India was required for a State to raise a loan.

2.3 The Finance Commission

India is a country of vast regional diversity and unequal distribution of natural resources, and the capacity of different states to mobilize their own revenue differs substantially. However, in a federal set up principle of equalization demands that citizens living in different geographical regions, with different capacities to raise revenues, should be able to enjoy similar levels of public services, therefore, the revenue needed to provide these services should be devolved to all regions.[30] The inadequacy of Indian states to raise resources with respect to their expenditure responsibilities has been recognized by the Constitution that has laid out the principles of revenue sharing between the Centre and the states.[31] The particulars of the sharing pattern have been vested in a Constitutional body called the Finance Commission.

Source: https://wbpscupsc.com/wp-content/uploads/2020/03/Finance-Commission-of-India.jpg

The Finance Commission is a Constitutional body formulated under Article 280 of the Indian Constitution. It is constituted every five years (or earlier if necessary) by the President of India to review the state of finances of the Union and the States and suggest measures for maintaining a stable fiscal environment. Specifically, the Finance Commission is responsible for addressing fiscal imbalances that arise between a) the Union and state governments (known as vertical imbalance), and b) those that arise across states (known as horizontal imbalance).[32]

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28 *Article 292 of the Indian Constitution*

29 *Article 293 of the Indian Constitution*

30 *Chakraborty, P. 2003. "Unequal Fiscal Capacities across Indian States: How Corrective is the Fiscal Transfer Mechanism?" Paper prepared for the UNU/WIDER Project Conference on Spatial Inequality in Asia, UNU Centre, Tokyo, March 28–29.*

31 *Ibid*

32 *Bagchi, Amaresh (2001): "Perspectives on Correcting Fiscal Imbalance in the Indian Economy", ICRA Bulletin, Money and Finance, Jan-June 2001*

For this purpose, the Finance Commission advises the Union government on the following: [33]

- The distribution of resources between the centre and states from the divisible pool of taxes.
- The principles of distributing grants-in-aid to states, which are additional sums paid to states in need of assistance.
- Any other matter referred to it by the President in the interest of sound finance.

The most important part of the Finance Commission's work is to broadly assess the overall gross tax revenues of the union to determine the share of the states in the net divisible pool (NDP) of taxes.[34] Thus, the taxes and duties levied by the Centre are not meant entirely for the Centre, certain taxes and duties leviable by the Centre are totally assigned to or shared with the States in accordance with their needs. Additionally, the architects of the Constitution also realised that even with a share in the proceeds of divisible taxes, some States might still need additional financial assistance. Accordingly, they made provision for annual grants-in-aid of revenues to such States as may be in need of assistance.[35] Thus, the transfers routed through the Finance Commission pertain to sharing of certain Central taxes, as well as grants-in-aid of revenues of the States.

It is important to note that although the Constitution provides for Central transfers, it neither indicates the share of the States in the divisible taxes nor prescribes any principles for the distribution of States' share among the States themselves. The framers of the Constitution consciously avoided any permanent formulae in view of expected changes in the spheres of taxation and public expenditure.[36] Thus, the precise manner of sharing taxes and the actual determination of grants is left to the deliberations of the Finance Commissions.

The recommendations of Finance Commissions are based on a detailed assessment of the financial position of the Central and State Governments. For this purpose, the finance commissions undertake consultations with various state governments and receive their submissions as well as the submissions of the union government.[37] Discussions are also held with public finance experts and studies are commissioned on specific topics. As the Sixth Finance Commission remarked, "The purpose of Finance Commission, as envisaged in the Constitution, is primarily to facilitate a periodical assessment of the fiscal needs of the States and the formulation on an objective basis of proposals for transfer of resources from the Centre to the States through devolution of taxes and grants-in-aid. But an incidental and by no means insignificant advantage of the appointment of a Finance Commission has generally been to rekindle interest in issues pertaining to financial relations between the Centre and the States and to promote an enlightened national debate on the several facets of our federal fiscal set up." [38]

Under Article 281 of the Constitution, the report of the Finance Commission, together with the Explanatory Memorandum on the action taken on the recommendations of the Commission, is laid on the Table of the House by the Government.[39] Further, the Finance Commission (Miscellaneous Provisions) Act, 1951, has conferred on the Commission all the powers of a Civil Court under the Code of Civil Procedure, 1908.[40] The Commissions have also been empowered to require any person to furnish information on such points or matters as, in the opinion of the Commission, may be useful for, or relevant to, any matter under the consideration of the Commission.

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[33] *Article 280 of the Indian Constitution*

[34] *https://www.oecd-ilibrary.org/sites/940cc5ee-en/index.html?itemId=/content/component/940cc5ee-en*

[35] *Article 275 of the Indian Constitution*

[36] *M.P. Jain , Indian constitutional Law(Wadhwa ,Nagpur .5th edn. ,2004)*

[37] *https://www.oecd-ilibrary.org/sites/940cc5ee-en/index.html?itemId=/content/component/940cc5ee-en*

[38] *Ministry of Finance, Government of India. (1973). Report of the Sixth Finance Commission*

[39] *Article 281 of the Indian Constitution*

[40] *https://www.indiacode.nic.in/bitstream/123456789/1941/1/A1951-33.pdf*

Over the years the role of the FC has expanded significantly, and the resource sharing architecture has undergone several changes, however, the basic mandate for FCs in respect to distribution of taxes and grants-in-aid to states has remained unchanged. This change has been partly the result of a changed political reality in the country and partly due to a growing mismatch between revenue and expenditure needs between different levels of government.[41] Consequently, each FC has exercised varying value judgments in determining the allocation criteria and the size of the vertical revenue transfers.[42]

The most vital aspect of intergovernmental fiscal transfers is the size of the distributive pool of taxes which is available for transfers. As shown in table 1, various FCs progressively enlarged the size of the States' share in income tax collections. It increased from 55 per cent as recommended by the First FC to 85 per cent as recommended by the Ninth FC. The rationale for increasing the size of the States' share in net proceeds of income tax has differed across FCs. For instance, by raising the share of the States in net proceeds of income tax, the Third and Fourth FCs tried to compensate the States for the loss they incurred on account of exclusion of corporation tax in the divisible pool; the divisible pool shrank due to the reclassification in 1959 of income tax paid by companies as corporation tax.[43]

Similarly, for the first time, the Fifth FC included advance tax collections in the divisible pool of income tax and distributed the arrears while retaining the share of the States at 75 per cent.[44] Subsequently, the Sixth FC realised that the arrears were no longer available to States and recommended an increase in the States' share in divisible pool of taxes from 75 per cent to 80 per cent for the award period 1974-79.[45] Considering the States' grievance with regard to the levy of surcharge by the Centre as a normal tax measure, the share of States was again raised by the Seventh FC.[46] The Eighth and Ninth FCs did not recommend any change in States' share in net proceeds of income tax. However, the Tenth FC recommended a downward revision in the share of States in net proceeds of income tax to 77.5 per cent for the award period 1995-2000.[47]

Source: https://life.futuregenerali.in/media/nqfbbwh5/what-are-the-benefits-of-paying-income-tax.jpg

[41] *Chalam, K. S. R. V. S and Rajiv Mishra (1997), "Streamlining norms: a renewed approach for Finance Commission", Economic and Political Weekly, June 21.*

[42] *Ibid*

[43] *Reports of the Third Finance Commission and Fourth Finance Commission*

[44] *Report of the Fifth Finance Commission*

[45] *Report of the Sixth Finance Commission*

[46] *Report of the Seventh Finance Commission*

[47] *Report of the Tenth Finance Commission*

Prior to the 80th Constitutional Amendment, two major Central taxes were mainly shared with the States, viz., and income tax other than corporation tax and Union excise duties. The sharing of income tax was mandatory, but the sharing of Union excise duties with States was discretionary and could be shared if Parliament by law so provided. Following the 80th amendment of the Constitution, it became mandatory for the Centre to share all Central taxes (except taxes under Articles 268 and 269 and earmarked cesses, and surcharges under Article 271) with the States.[48]

Consequent upon the 80th Constitutional Amendment the Eleventh FC recommended a share of 29.5 per cent for States.[49] The Twelfth FC recommended increasing the States' share from 29.5 per cent to 30.5 per cent on the premise that additional transfers can be accommodated by rationalising the Centre's participation in areas that fall directly under the purview of the States.[50] Taking into consideration the factors such as, (i) the higher buoyancy of the Centre's taxes than that of the States during 2000-08, (ii) the States' increasing responsibility with regard to rural and urban infrastructure and (iii) the increase in the Centre's non-tax revenues particularly from royalties and the telecommunications sector,[51] the Thirteenth FC recommended raising the States' share in Central taxes to 32 per cent for the award period 2010-15. The fourteenth FC raised the share of the states to 42 percent which was the biggest ever increase in vertical tax devolution.[52]

Table 1: Recommended Share of States in Major Divisible Taxes

Finance Commissions	Income Tax (%)	Basic Excise Duties (%)	Number of Commodities Covered
First FC (1952-57)	55	40	3
Second FC (1957-62)	60	25	8
Third FC (1962-66)	66.6	20	35
Fourth FC (1966-69)	75	20	All
Fifth FC (1969-74)	75	20	All
Sixth FC (1974-79)	80	20	All
Seventh FC (1979-84)	85	40	All
Eighth FC (1984-89)	85	45	All
Ninth FC (1989-95)	85	45	All
Tenth FC (1995-2000)	77.5	47.5	All
	All Central Taxes		
Eleventh FC (2000-05)	29.5		
Twelfth FC (2005-10)	30.5		
Thirteenth FC (2010-15)	32.0		
Fourteenth FC (2015-20)	42.0		

Source: Reports of the Finance Commission

48 *80th Amendment to the Indian Constitution*

49 *Report of the Eleventh Finance Commission*

50 *Report of the Twelfth Finance Commission*

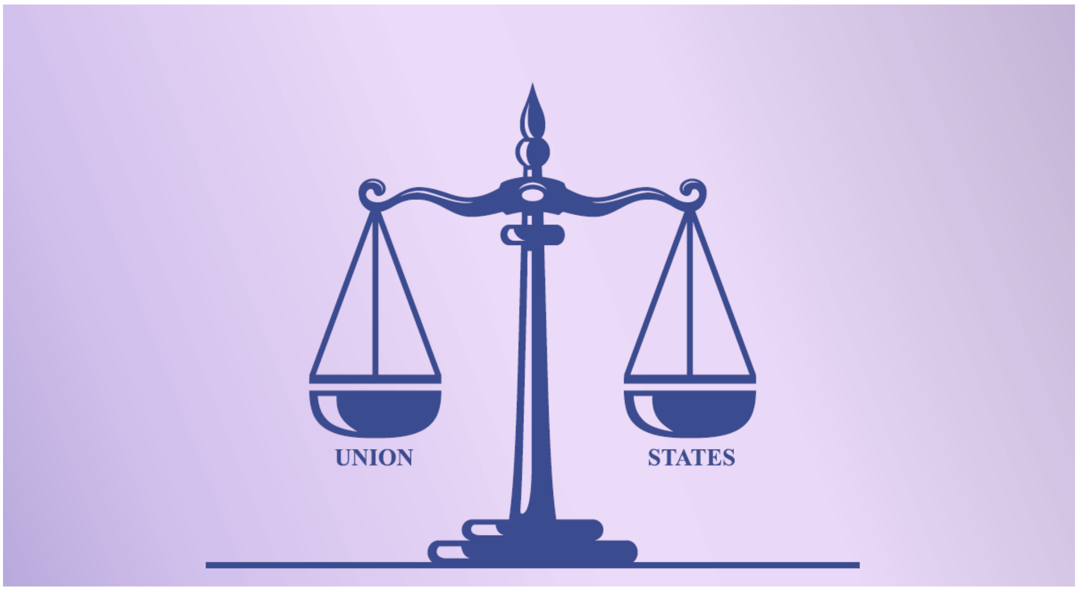
51 *Report of the Thirteenth Finance Commission*

52 *Report of the Fourteenth Finance Commission*

Apart from sharing net income tax, States were also dependent on their share in union excise duties to meet their revenue needs. As shown in the above table, the First FC shared Union excise duties with the States in respect to three commodities (tobacco, matches and vegetable products).[53] Thereafter, successive FCs recommended larger devolutions to the States either by increasing the coverage of shareable items or by increasing the states' share. The number of items included in the list of shareable excise duties was increased from 3 to 8, albeit with a reduced share of 25 per cent, by the Second FC.[54] This was further expanded to 35 commodities by the Third FC, but the share was further reduced to 20 per cent.[55] Consequent upon the demand by the States, the coverage of items for the States' share in union excise duties has been made universal since the Fourth FC.

In terms of the union excise duties the first FC had recommended 40 per cent, but thereafter the subsequent FCs had reduced it to 25 per cent (second FC) and 20 per cent (third to sixth FC). The Seventh FC recommended increasing the share of the States in union excise duties back to 40 per cent, on the grounds that providing sufficient resources to States would reduce their dependence on the Centre.[56]

The Eighth FC further enhanced this share to 45 per cent but the increment of 5 per cent was used to meet the assessed post-devolution revenue deficit of States.[57] The Ninth FC retained this scheme in its first Report submitted for 1989-90, but in its second Report for 1990-91 to 1994-95, it recommended distributing the entire amount of 45 per cent as a consolidated amount without any separate component to be used for reducing States' non-Plan revenue deficits.[58] The Tenth FC recommended a share of 47.5 per cent for States in the net proceeds of Union excise duties while setting apart 7.5 per cent of the Union excise duties for distribution on the basis of assessed deficits.[59] With the 80th Constitutional Amendment, a single pool has been prescribed for all shareable Central taxes (except under Articles 268 and 269) since the Eleventh FC.



Source: https://www.clearias.com/up/15th-Finance-Commission-Recommendations.png

[53] *Report of the First Finance Commission*

[54] *Report of the Second Finance Commission*

[55] *Report of the Third Finance Commission*

[56] *Report of the Seventh Finance Commission*

[57] *Report of the Eighth Finance Commission*

[58] *Report of the Ninth Finance Commission*

[59] *Report of the Tenth Finance Commission*

Apart from vertical tax devolution the FCs also determine the inter-state share of taxes. As regards to this, the basic objective of the FC transfers has been to (i) correct the differentials in revenue capacity and cost disability factors inherent in the economies of the States and (ii) foster fiscal efficiency among the States.[60] The criteria used in the past for these purposes can be grouped under (a) factors reflecting needs, such as population and income measured either as distance from the highest income or as an inverse; (b) cost disability indicators such as area and infrastructure distance; and (c) fiscal efficiency indicators such as tax effort and fiscal discipline.[61] The weightage assigned to each factor has varied across each Finance Commission.

As regards to the weight of different variables in the distribution criteria of net proceeds of income tax, only two factors were taken into account till the Seventh FC.[62] Till the Fifth FC population was a dominant factor with the highest weight of 80 to 90 per cent, while contribution in tax collection was a minor factor. There was no change in the horizontal distribution criteria of net income tax proceeds except that there was some adjustment between the respective weights of population and contribution.

In contrast, the Fifth FC felt that the appointment of a new FC should provide an opportunity for a fresh look at various issues in the light of changed circumstances and available information.[63] The Fifth FC identified several inadequacies with regard to contribution criteria (based on tax collections) recommended by earlier FCs. Therefore, apart from population (with a weight of 90 per cent), the Fifth FC added 'assessment' instead of 'collection' with 10 per cent weight in the distribution scheme of income tax proceeds. This distribution scheme remained unchanged till the Seventh FC.

Keeping in view the memoranda submitted by various States, the Eighth FC noted that the criteria for allocating income tax should be more progressive.[64] It recommended that 90 per cent of States' share in income tax remaining after distributing 10 per cent on the basis of contribution should be allocated based on population (with a weight of 22.5 per cent, i.e., 25.0 per cent of 90 per cent), income-adjusted population (with a weight of 22.5 per cent, i.e., 25.0 per cent of 90 per cent) and the distance of per capita income (with a weight of 45 per cent, i.e., 50.0 per cent of 90 per cent).

The distance of per capita from the highest per capita income was considered as a measure of the relative backwardness of States. Since population was used as a scale factor in determining the 'distance' and 'inverse of per capita', its weight in the overall scheme was much larger than 22.5 per cent. Subsequently, the Ninth FC made a major change by introducing a composite measure of backwardness with a weight of 11.25 per cent.[65] The composite indicator of backwardness comprised two indices, viz., (i) population of Scheduled Castes and Scheduled Tribes and (ii) number of agricultural labourers in different States as revealed by Census 1981.

The Tenth FC adopted a different approach from the previous FCs and stopped using 'contribution' as one of the factors for distribution.[66] It argued that the country as a whole represents a common economic space and market, and economic interdependence among States was growing. Therefore, it was difficult to identify locally generated income in the non-agriculture sector and, hence, there was no need to retain 'contribution' as a criterion. The Tenth FC also discarded the inverse income formula and assigned a larger weight of 60 per cent to distance of per capita income along with population (20 per cent) and some new factors, viz., tax effort (10 per cent), area adjusted (5 per cent) and index of infrastructure (5 per cent). Therefore, there was an explicit emphasis on incentivisation of States for their tax efforts.

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60 *Sen, Tapas K. & Trebesch, Christoph, 2004. "Use of socio-economic criteria for intergovernmental transfers: The case of India," Working Papers 04/10, National Institute of Public Finance and Policy.*

61 *Ibid*

62 *Reports of the First to Sixth Finance Commissions*

63 *Report of the Fifth Finance Commission*

64 *Report of the Eighth Finance Commission*

65 *Report of the Ninth Finance Commission*

66 *Report of the Tenth Finance Commission*

Assessing the prevailing fiscal situation of the States, the Eleventh FC recommended restructuring States' finances through in-built incentives for fiscal discipline and linking them to the principles of devolution.[67] The Eleventh FC introduced a new index of fiscal discipline; tax effort and the index of fiscal discipline were together given a weight of 12.5 per cent. The Twelfth FC evolved a new formula that balanced equity with fiscal efficiency.[68] Equity considerations, however, dominated in the scheme of federal transfers implementing the equalisation principle. Accordingly, it accorded 50 per cent weight to income distance along with 25 per cent weight to population. While 'area' was assigned a weight of 10 per cent, better fiscal management in terms of tax efforts and fiscal discipline was given a higher weight of 15.0 per cent by the Twelfth FC compared with the 12.5 per cent weightage given by the Eleventh FC.

The Thirteenth FC recommended using the concept of 'fiscal capacity distance instead of 'income distance'.[69] Instead of using a single average of GSDP to assess the fiscal distance between States, it recommended estimation of per capita fiscal capacity at reasonably comparable levels of taxation from their respective group averages of non-special category and special category States. The Thirteenth FC accorded the highest weight to fiscal capacity distance (47.5 per cent), followed by population (25 per cent), fiscal discipline (17.5 per cent) and area (10.0 per cent).

Table 2 below shows the various factors and the respective weightage used by the 11th to 14th Finance Commissions. The Fourteenth FC again went back to the previous weightage and accorded the highest weight of 50 per cent to Income Distance followed by 17.5 per cent to population 1971, 15 per cent to area, 10 per cent to population 2011, and 7.5 per cent to forest cover.

- Population is an indicator of the expenditure needs of a state. Over the years, Finance Commissions have used population data of the 1971 Census. The 14th Finance Commission used the 2011 population data, in addition to the 1971 data.
- Area is used as states with larger areas have to incur additional administrative costs to deliver services.
- Income distance is the difference between the per capita income of a state and the average per capita income of all states. States with lower per capita income may be given a higher share to maintain equity among states.
- Forest cover indicates that states with large forest covers bear the cost of not having that area available for other economic activities. Therefore, these states may be given a higher share.

Source: http://www.mpnewsflash.com/fifth-state-finance-commission-formed

[67] *Report of the Eleventh Finance Commission*

[68] *Report of the Twelfth Finance Commission*

[69] *Report of the Thirteenth Finance Commission*

Table 2: Weight of Criteria used by 11th to 14th Finance Commissions

Criteria	11th	12th	13th	14th
Income Distance	62.5	50.0		50.0
Population 1971	10.0	25.0	25.0	17.5
Population 2011				10.0
Index of Infrastructure	7.5			
Fiscal Discipline	7.5	7.5	17.5	
Tax Effort	5.0	7.5		
Fiscal Capacity Discipline			47.5	
Area	7.5	10.0	10.0	15.0
Forest Cover				7.5
Total	100	100	100	100

Source: Reports of the Finance Commission

Besides the shareable Central taxes, another important source of resource transfers to the States from the Centre is grants-in-aid contributions. The guiding principles for grant allocation among States as recommended by the First FC were broadly followed by most of the subsequent FCs. Under Article 275, the First FC recommended that grants should be determined based on (i) the budgetary needs of States, (ii) tax efforts, (iii) economy in expenditure, (iv) equalisation of standard of social services, (v) State-specific obligations and (vi) broad purposes of national importance.[70]

According to Srivastava and Rao (2009), the First FC explicitly stated the best theoretically accepted principles for guiding the determination of fiscal transfers.[71] The Second FC observed that grants-in-aid should be a residuary form of assistance given in the form of general and unconditional grants; it was of the view that grants for broad purposes may be given, provided they were spent exclusively for that purpose.[72]

The Third FC also recommended specific-purpose grants for improvements in communications. Most of the subsequent FCs generally agreed to the principles laid out by the First FC, but they were primarily in favour of unconditional revenue grants. The Seventh FC made some departures from the previous FCs while recommending capital grants to meet capital expenditure as well. This was in recognition of the fact that revenue grants were not adequate for meeting the maintenance expenditure on administrative and residential buildings.[73]

Over the years the FCs had often been criticised for their gap-filling approach for grants-in-aid that led to significant adverse incentives.[74] Singh (2006) argues that the gap-filling approach of grants reduced State government incentives for fiscal discipline while doing little to reduce inter-State inequalities.[75] However, from the Ninth FC there has been a shift to normative approach.[76] Under the normative approach states are assessed in terms of revenues that they ought to raise given their respective capacities. Similarly, expenditures are assessed on the basis of needs consistent with an average or minimum acceptable level of services and are not driven by the past history of expenditures.

[70] *Article 275 of the Indian Constitution*

[71] *Srivastava, D.K. and C. Bhujanga Rao. (2009), "Review of Trends in Fiscal Transfers in India"*

[72] *Ibid*

[73] *Ibid*

2.4 The 15th Finance Commission

The Fifteenth Finance Commission was constituted on 27 November 2017 against the backdrop of the abolition of the Planning Commission and the introduction of the Goods and Services Tax (GST). The Chairman of the Fifteenth Finance Commission was Mr N. K. Singh. The Commission was required to submit two reports. The first report, consisting of recommendations for the financial year 2020-21, was tabled in the Parliament in February 2020. The final report with recommendations for the 2021-26 period was tabled in the Parliament on February 1, 2021.

Some Key Recommendations[77]

i)Share of states in central taxes

- The share of states in the central taxes for the 2021-26 period was recommended to be 41%, the same as that for 2020-21.
- This is less than the 42% share recommended by the 14th Finance Commission for the 2015-20 period.
- The adjustment of 1% was to provide for the newly formed union territories of Jammu and Kashmir, and Ladakh from the resources of the centre.

ii) Criteria for horizontal devolution

Table 3 below shows the criteria used by the Commission to determine each state's share in central taxes, and the weight assigned to each criterion. The criteria for distribution among states for period 2021-26 are same as that for the period 2020-21. However, the reference period for computing income distance and tax efforts are different (2015-18 for 2020-21 and 2016-19 for 2021-26).

Table 3: Criteria for Sharing among States

Criteria	15th FC (2020-21)	15th FC (2021-26)
Income Distance	45.0	45.0
Area	15.0	15.0
Population (2011 census)	15.0	15.0
Demographic Performance	12.5	12.5
Forest and Ecology	10.0	10.0
Tax and Fiscal Efforts	2.5	2.5
Total	100	100

Source: Reports of the 15th Finance Commission

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74 *Article 275 of the Indian Constitution*

75 *Srivastava, D.K. and C. Bhujanga Rao. (2009), "Review of Trends in Fiscal Transfers in India"*

76 *Ibid*

77 *Ibid*

- Income Distance: Income distance is the distance of a state's income from the state with the highest income. A state with a lower per capita income is supposed to have a higher share to maintain equity among states. In this regard the income of a state was computed as the average per capita GSDP during the three years between 2016-17 and 2018-19.
- Demographic Performance: The demographic performance criterion has been used to reward efforts made by states in controlling their population. States with a lower fertility ratio are scored higher on this criterion. The Terms of Reference of the Commission required the use of population data of the 2011 census while making recommendations.
- Forest and Ecology: This criterion has been arrived at by calculating the share of the dense forest area of each state in the total dense forest area of the country.
- Tax and Fiscal Efforts: This criterion has been used to reward states with higher tax collection efficiency. It is measured as the ratio of the average per capita tax revenue of a state and the average per capita state GDP during three years between 2016-17 and 2018-19.
- Population: The population data referred to is of Census 2011

iii) Grants

Over the 2021-26 period, the following grants are to be provided from the centre's resources:

- Revenue deficit grants: 17 states to receive grants worth Rs 2.9 lakh crore to eliminate the revenue deficit.
- Sector-specific grants: Sector-specific grants of Rs 1.3 lakh crore to be given to states for eight sectors. These include (i) health, (ii) school education, (iii) higher education, (iv) implementation of agricultural reforms, (v) maintenance of PMGSY roads, (vi) judiciary, (vii) statistics, and (viii) aspirational districts and blocks. A portion of these grants are to be performance-linked.
- State-specific grants: The Commission recommended state-specific grants of Rs 49,599 crore. These to be given in the areas of (i) social needs, (ii) administrative governance and infrastructure, (iii) water and sanitation, (iv)preservation of cultural and historical monuments, (v) high-cost physical infrastructure, and (vi) tourism. The Commission recommended a high-level committee at the state level to review and monitor the utilisation of state-specific and sector-specific grants.
- Grants to local bodies: The total grants to local bodies to be Rs 4.36 lakh crore (a portion of grants to be performance-linked) including (i) Rs 2.4 lakh crore for rural local bodies, (ii) Rs 1.2 lakh crore for urban local bodies, and (iii) Rs 70,051 crore for health grants through local governments.
    - The grants to local bodies to be made available to all three tiers of Panchayat- village, block, and district.
    - The health grants to be provided for: (i) conversion of rural sub-centres and primary healthcare centres (PHCs) to health and wellness centres (HWCs), (ii) support for diagnostic infrastructure for primary healthcare activities, and (iii) support for urban HWCs, sub-centres, PHCs, and public health units at the block level.
    - Grants to local bodies (other than health grants) to be distributed among states based on population and area, with 90% and 10% weightage, respectively.
    - The Commission has prescribed certain conditions for availing these grants (except health grants). The entry-level criteria include: (i) publishing provisional and audited accounts in the public domain and (ii) fixation of minimum floor rates for property taxes by states and improvement in the collection of property taxes (an additional requirement after 2021-22 for urban bodies).
    - No grants to be released to local bodies of a State after March 2024 if the state does not constitute State Finance Commission and act upon its recommendations by then.

- Disaster risk management: The Commission recommended retaining the existing cost-sharing patterns between the Centre and States for disaster management funds. The cost-sharing pattern between centre and states is (i) 90:10 for north-eastern and Himalayan states, and (ii) 75:25 for all other states. It has further recommended a total corpus of Rs. 1.6 lakh crore for states for disaster management for 2021-26, of which the Union's share is Rs. 1.2 lakh crore

2.5 The Planning Commission and Centrally Sponsored Schemes

The Constitution of India under Article 282 provides that the Union or the States may provide grants for any public purpose, notwithstanding that the purpose is not one with respect to which the Parliament or the legislature of the State, as the case may be, make laws.[78] This miscellaneous financial provision of the constitution has been used for the devolution of funds for socio-economic planning through a non statutory body called the Planning Commission.

The resolution to set up the Planning Commission in India was passed in March, 1950, in an era when centralised planning was perceived to be a means of raising the country's standard of living.[79] A pressing need was felt for a body that could perform a comprehensive appraisal of nationwide resources and formulate a plan for the utilisation of the same.[80] Thus, the Planning Commission had the mandate of coordinating the development plans of the centre and the states, such that they conformed to the national objectives.[81]

The PC was not explicitly mandated to play a role in financing plans and determining inter-governmental fiscal transfers, however, over time, as development planning gained emphasis, the Commission took over the responsibility of determining the size and quantum of the financial assistance given to states to implement the plans prepared by the PC. Another non-statutory body, the National Development Council, was also set up shortly after the Planning Commission, and also played an important role in designing Central welfare programmes.[82]

Image Source

[78] *Article 282 of the Indian Constitution*

[79] *Government of India (1950), "Resolution on setting the Planning Commission"*

[80] *Ibid*

[81] *Prabhat Patnaik, 'From the Planning Commission to the NITI Aayog' (2015) 50(4) Economic and Political Weekly 10*

[82] *Ibid*

The Planning Commission of India was responsible for allocating grants and loans to the States under two non statutory routes: one, via support to State plans called the Central plan assistance and two, via Centrally Sponsored Scheme of the Central Ministries known as specific purpose grants.[83] It transferred resources through itself as well as through different ministries or Departments.

The loans and grants recommended through different ministries/grants were known as discretionary transfers.[84] Since the advent of Five Year plans, the main purpose of the PC was to provide budgetary resources to bridge the gap between the State-generated resources and the approved Plan outlay. It distributed plan transfers to the states through its Normal Central Assistance (NCA) scheme.[85] Each state was allocated a portion of the total plan transfers which was tied to its development plan budget and was negotiable on a bilateral basis. These transfers were in addition to the funds available to the states through the Finance Commission and Union Ministries, which were known as non-plan transfers.[86]

Until 1969 there were no objective criteria to distribute the Plan assistance for State Plan Schemes. The PC used to approve the state Plan Schemes providing scheme-wise pre-determined loans and grants to states. This type of plan assistance provided by the PC was referred to as Schematic Pattern of Assistance.[87] This pattern of assistance carried lot of arbitrariness and failed to achieve the objective of equalization.

Consequent upon the demand by several States in the National Development Council in 1968, the Central Government constituted a committee under the chairmanship of D.R. Gadgil, the then Deputy Chairman of the Planning Commission, to evolve an objective criteria to distribute plan assistance among the states and Union Territories. Consequently, the Gadgil Formula was adopted for the distribution of plan assistance for State Plan Schemes since the Fourth Five Year Plan (1969-70).[88] The same formula was adopted for the Fifth, the Sixth and the Seventh Five Year Plans with minor modifications. A new formula was adopted since the Eighth Five Year Plan (known as the Mukherjee Formula) Table 4 highlights the criteria used in both these formulae.

As shown in the table, the Gadgil Formula was modified by withdrawing the 10% weightage given to the continuing commitments and adding it to the per capita income.[89] This was further revised in October 1990 as 55 per cent for population, 25 per cent for per capita Income, 5 per cent for fiscal management and 15 per cent for special development problems (Mukherjee Formula).[90]

According to the Gadgil Formula the total plan assistance provided to a Non-Special Category State was to be uniform for the loan to grant ratio of 70:30. Such a ratio, in the case of special category states was to be 90:10.[91] Fiscal transfers through the Planning Commission since the adoption of the Gadgil Formula became more equalising compared to the previous periods.[92]

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[83] *Sudarsana Rao, R: Grants-in-Aid and Economic Development in India, Chug Publications, 1986.*

[84] *Ibid*

[85] *Central Plan Assistance (CPA) (also known as plan transfers) constitutes financial assistance provided to support five-year plans by the centre to the states. It comprises Normal Central Assistance (NCA), Additional Central Assistance (ACA) and Special Central Assistance (SCA). NCA is provided as part of state development budgets, ACA is provided for the implementation of externally-aided projects (EAPs) and Centrally-Sponsored Schemes such as Rashtriya Krishi Vikas Yojana etc., and SCA is provided for special projects such as Western Ghats Development Programme, Border Areas Development Programme etc. The Planning Commission is responsible for the allocation of CPA.*

[86] *Rao, MG (2002), "State Finances in India: Issues and Challenges", Economic and Political Weekly, 37(31): 3261-3271*

[87] *Rao, M.Govinda and Tapas K. Sen (1996): "Fiscal Federalism in India- Theory and Practice", Macmillan, Delhi*

[88] *Ibid*

[89] *Planning Commission (2014), 'Databook for Planning Commission'.*

[90] *Ibid*

[91] *Ibid*

[92] *Rao, M.Govinda and Tapas K. Sen (1996): "Fiscal Federalism in India- Theory and Practice", Macmillan, Delhi*

Table 4: Objective Criteria for Determining Distribution of Fiscal federalism Plan Assistance

Criteria	Weightage (%)	
	Gadgil Formula (%)	Mukherjee Formula
Population	60	55
Per Capita Income	10	25
Tax Effort	10	
Continuing Commitments on Major and Medium Integrated Multi Purpose Projects (IMP)	10	
Special Development Problems	10	15
Progress in Fiscal Management		5
	4th, 5th, 6th and 7th Five Year Plan and 1990-91 Annual Plan	8th, 9th, 10th and 11th Five Year Plans

Source: Planning Commission (2014), 'Databook for Planning Commission'

In the six decades of its existence, the Planning Commission delivered eleven five-year plans and it claimed credit in the increased agricultural and industrial production, modernisation of technology (satellite, defence equipment production), liberalisation of the economy (increased reach of the banking sector, among other developments), and improvement in social indicators (increased female education, reduction in caste rigidities).

Besides the central assistance for State Plan Schemes, the central government has been providing loans and grants to Plan schemes known as 'Centrally Sponsored Schemes' and 'Central Sector Schemes'. These schemes are sponsored by the Central Ministries and hence the expenditure on these schemes is a part of the Central Plan for which provision is made in the Central Government Budget.[93] A portion of the CSS are schemes designed by the Union but implemented by the States in accordance with the terms of the Union grant and another are designed and implemented by the Union directly in the States.[94] These Central Sector Schemes pertain to subjects over which the Union has legislative and executive competence.[95]

Over the years the resources transferred through the Planning Commission for State Plan Schemes, for Central Sector Schemes and Centrally Sponsored Schemes increased substantially. For instance, the total Central Planned Assistance (CPA) in 1990-91 was Rs. 27,433 crore and was increased to Rs. 555,322 crore by 2012-13. The ratio of plan expenditure to Gross Domestic Product (GDP) also rose from 4.68% to 5.54% over the same period.[96] Over the years, the Planning Commission became responsible for allocating almost half of the total grants from the centre to the states, and plan expenditure became a significant component of total public expenditure.

[93] *Union of India Expenditure Budget 2020-21: Central Sector Schemes*

[94] *Bibek Debroy 'Restructuring of centrally sponsored schemes cannot be done without consultation with States.' (12 September 2019) Financial Express.*

[95] *Union of India Expenditure Budget 2020-21: Central Sector Schemes*

[96] *Planning Commission (2014), 'Databook for Planning Commission'*

In 2014 the Planning Commission and National Development Council were replaced by the NITI Aayog, another non-statutory body headed by the Prime Minister.[97] Although the NITI Aayog does not frame Five Year Plans, its role overlaps with that of the Planning Commission insofar as it plays a significant role in the design of CSS.[98] In fact, Reddy and Reddy (2019)[99] note that while there is no longer a separate set of normal plan devolutions, a significant number of discretionary transfers between the Union and the States continue.

2.6 Constitutional issues with Article 282, the Planning Commission and the Central Sector Schemes

The use of Article 282 to provide grants to States has generated a lot of debate over the years. In 1965, in his Minute to the Report of the Fourth Finance Commission, Justice P.V. Rajamannar observed that the wording of Article 282 required that any grant to a State by the Union would need to be for a specific public purpose and could not be used for general-purpose grants.[100]

Other criticisms of CSS stemmed from the extra constitutional nature of the Planning Commission. In 1990, H.K. Paranjape argued that while "Article 282 confers on the Union or a State a spending power without conferring legislative power," in practice, the PC took on a central role in development priorities of States, even on matters within state competence.[101] Concerns were also raised that the excessive reliance on ad hoc grants artificially limited the role of the Finance Commission.[102]

In the same year, in an opinion to the Ninth Finance Commission, the jurist N.A. Palkhivala submitted that Article 282 was intended only to be used as a residuary provision, and that the distribution of grants to States should be determined by the Finance Commission under Article 275.[103]

Source: https://vidhilegalpolicy.in/wp-content/uploads/2021/06/imageedit_6_4197386445.png

[97] *Puja Mehra, 'NDC to be scrapped, NITI Aayog council likely to get its powers' (1 January 2016) The Hindu*

[98] *Nirvikar Singh, 'Fiscal Federalism,' in Sujit Choudhry, Madhav Khosla and Pratap Bhanu Mehta (eds) The Oxford Handbook of the Indian Constitution (OUP 2016).*

[99] *Y.V. Reddy and G.V. Reddy, Indian Fiscal Federalism (OUP 2019)*

[100] *Justice P.V. Rajamannar, Minute to the Report of the Fourth Finance Commission*

[101] *H. K. Paranjape, 'Planning Commission as a Constitutional Body.' (1990) Economic and Political Weekly, 25(45)*

[102] *M. Govinda Rao, 'A Review of Indian Fiscal Federalism' in Report of the Commission on Centre-State Relations Supplementary Volume II: Research Studies.*

[103] *Second Report of the Ninth Finance Commission for 1990-1995 (1989)*

There have also been many contrary views with respect to the constitutionality of transfers under Article 282. In 1968, the Administrative Reforms Commission (ARC) noted that the reliance on Article 282 for making grants for CSS "though not unconstitutional, is not neat."[104] In doing so, the ARC noted that the framers of the Constitution had anticipated that large, specific-purpose grants would need to be made for the development of the States.

The ARC's objection was not to the use of CSS as a tool for development, but the extent to which they were used. One of the key recommendations of the report is that CSS be confined to areas of national importance only, and that the states must have discretion to determine the allocation of resources on most development issues within their jurisdiction.[105] Subsequent reports on Union-State relations, such as the Sarkaria Commission Report,[106] and the Puncchi Commission Report[107] have also reasoned that the use of Article 282 for transfers from the Union to the States is not unconstitutional.

Some of these questions pertaining to the use of Article 282 by the Union were settled by the Bhim Singh v. Union of India case in 2010, where the Supreme Court examined the constitutionality of the Members of Parliament Local Area Development Scheme (MPLADS).[108] This scheme provided Members of Parliament (MPs) with grants to use for creating durable assets in their constituencies. It was challenged on the grounds that the wording of Article 282 only provided the power to make grants in exceptional situations for well-defined public purposes, and could not be used for broad grant-making powers. To do so would effectively amount to encroachment into subjects within the competence of States.

The Court disagreed with this and reasoned that it would be improper to place limitations on the interpretation of Article 282, and that it should be given the widest possible construction. It noted, "Article 282 is normally meant for special, temporary or ad hoc schemes. However, the matter of expenditure for a "public purpose," is subject to fulfilment of the constitutional requirements. The power under Article 282 to sanction grant[s] is not restricted."[109] Consequently, the term "public purpose" was to receive a wide interpretation and would extend even to purposes that had not yet been determined, such as in MPLADS. Another issue with respect to MPLADS was the lack of accountability within the scheme. However, the Court rejected the view that the scheme lacked any accountability structure. It noted that there were limits on the scope of work that may be undertaken by MPs and there was a requirement that MPLADS must be implemented through the Panchayati Raj institutions wherever possible. There was also a provision to provide information on the works and the expenditure for them. According to the Court this was an adequate accountability mechanism.[110]

The Bhim Singh case effectively opened the way for CSS to be used for a wide range of development activities, by way of a grant under Article 282. Subsequent decisions have also upheld the view that the Government has wide discretion to determine "public purpose" for which to make grants under this provision, and that the Court would not interfere with this decision.[111] It is important to note, however, that Article 282 only confers a power to "incur expenditure" and not to carry out legislative or executive acts.[112] Thus, while the Union can make grants by CSS, the implementation of these schemes properly falls within the competences of the States.

[104] *Administrative Reforms Commission (ARC), Report of the Study Team on Centre State Relation-ships. (1968).*

[105] *Ibid*

[106] *Report of the Commission on Centre-State Relations (Sarkaria Commission) (1989)*

[107] *Report of the Commission on Centre-State Relations (Puncchi Commission) (2010)*

[108] *Bhim Singh v. Union of India (2010)5 SCC 538.*

[109] *Ibid*

[110] *Ibid*

[111] *Subramaniam Balaji v. State of Tamil Nadu (2013) 9 SCC 659*

[112] *Bhim Singh v. Union of India (2010)5 SCC 538*

Post Bhim Singh there has been attempts to limit the CSS system. In 2011, the Chaturvedi Committee report recommended that the number of CSS in operation be reduced, and 20% of funds for CSS be treated as "flexi funds" to be used at the State's discretion.[113] Likewise, the Fourteenth Finance Commission recognised that States had experienced difficulties in meeting the State contribution to CSS and had recommended that a greater proportion of Union funds be devolved as untied grants.

Consequently, in line with the recommendations of the Fourteenth FC, the Union increased the proportion of transfers to States under the divisible pool of taxes to 42% and reduced the component of CSS.[114] In spite of these limits to the number of schemes in operation, CSS still form an important part of India's development agenda. As of 2020-21, there were a total of 30 CSS in operation.[115] Further, the Ministry of Finance stated in 2018 that the budgetary allocation for CSS has increased by 40% over the period of 2015-16 to 2018-19.[116]

2.7 The Goods and Services Tax and Fiscal Federalism

The Goods and Services Tax (GST') is a uniform indirect tax which is levied on all goods and services produced across the country, as well as all goods and services which are imported from outside the country.[117] It proposes to simplify the previous indirect tax system by encompassing taxes such as the State VAT, Central Excise, Service Tax and a few other indirect taxes into a single broad-based, comprehensive tax which is to be levied on all goods and services (barring a few).[118]

The 101st Amendment to the Constitution led to the introduction of the GST in July 2017, and the replacement of the previous indirect tax law regime with the GST Model.[119] This change was brought about by the addition of Articles 246A, 269A & 279A to the Constitution, along with changes in the Seventh Schedule containing the Union & State Lists, to accommodate the task of subsuming previously charged indirect taxes into a single tax while defining the subject matter and distribution of powers between the Centre and the States.[120]

Article 246A provides for both the Union and States to make laws concurrently with respect to the goods and services tax.[121] It puts inter-state trade exclusively under the jurisdiction of the Union government, while intra-state trade is open to the jurisdiction of both the Union and State government.

Article 269A furthers the same notion expounds that in case of inter-state trade, GST is to be levied and collected by the Union government and thereafter be shared by both the Union and States as per the recommendations of the GST Council.[122] This provision also makes it clear that the proceeds collected in regard to inter-state trade are not credited to the Consolidated Fund of India or the state but their respective share is assigned to both the Centre and State governments.

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[113] *Report of the Committee on Restructuring Centrally Sponsored Schemes (Chaturvedi Committee), (2011).*

[114] *Report of the Fourteenth Finance Commission.*

[115] *Lok Sabha Unstarred Question No. 1872 (07.03.2018).*

[116] *Lok Sabha Unstarred Question No. 2981 (28 December 2018).*

[117] *Sandeepan Banerjee & Mona Banerjee, Rethinking the Prospects and Challenges of Implementing GST in India, 5 International Journal of Commerce, Business and Management, 156, 163, (2016)*

[118] *Ibid*

[119] *https://gstcouncil.gov.in/brief-history-gst*

[120] *https://legislative.gov.in/sites/default/files/Cons.amend%20101-060717.pdf*

[121] *Article 246A of the Indian Constitution*

[122] *Article 269A of the Indian Constitution*

Article 279A deals with the formation of the GST Council which is a body established to deliberate upon all or any issues with respect to the amount of tax to be charged, exemptions to be provided, threshold limits, apportionment of inter-state trade tax or any other matter with regard to the implementation, determination and application of the goods and services tax.[123]

Its composition includes the Union Finance Minister as Chairperson, with the Union Minister of State and other Ministers in-charge of Finance or Taxation of the States acting as members in the council. All decisions have to be taken by a 3/4th majority by the council, wherein the Central government holds 1/3rd of the votes and all other State governments combined together hold 2/3rd of the votes.

While it was envisaged that the GST would bring all goods and services under a single tax rate, however, after much deliberations by the Parliament, it was decided to divide it into four tax slabs: 5%, 12%, 18% and 28% as shown in table 5. The rationale behind the division into slabs was to secure the interests of the weaker sections of society.[124]

Table 5: Tax Rate Slabs within GST

Tax Rate (%)	Category
5	Household necessities such as sugar, spices, tea etc.
12	Items like computers and processed food.
18	Hair oil, soaps, toothpaste, capital goods and industrial intermediaries.
28	Luxury items like cars, AC, refrigerators, cigarettes and aerated drinks.

Source: R. Vasanthagopal, GST in India: A Big Leap in the Indirect Taxation System, 2 International Journal of Trade, Economics, and Finance 2, 9 (April 2011).

In order to ensure stability of the new taxing structure certain items such as petroleum products, alcohol and electricity have not yet been brought within the ambit of GST.[125] Items such as cereals, fruits and vegetables, jute, contraceptives etc., have also been exempted keeping in mind the nature of these products.[126] The tax components of which are charged under GST are:[127]

- CGST – Central GST wherein tax collected is provided to the Centre.
- UTGST – Union Territory GST wherein tax collected is used for administration of the Union Territory.
- SGST – State GST wherein tax collected is provided to the States.
- IGST – Integrated GST wherein tax collected is shared between Centre and State

[123] *Article 279A of the Indian Constitution*

[124] *R. Vasanthagopal, GST in India: A Big Leap in the Indirect Taxation System, 2 International Journal of Trade, Economics, and Finance 2, 9 (April 2011).*

[125] *https://timesofindia.indiatimes.com/business/faqs/gst-faqs/list-of-items-kept-outside-the-purview-of-gst/articleshow/60191839.cms*

[126] *Ibid*

[127] *C. P. Chandrasekhar & Girish Kumar ed.,GST: Fiscal Centralism in a Federal Polity, 32 (Mahatma Gandhi University, 2016)*

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5	Household necessities such as sugar, spices, tea etc.
12	Items like computers and processed food.
18	Hair oil, soaps, toothpaste, capital goods and industrial intermediaries.
28	Luxury items like cars, AC, refrigerators, cigarettes and aerated drinks.

Source: R. Vasanthagopal, GST in India: A Big Leap in the Indirect Taxation System, 2 International Journal of Trade, Economics, and Finance 2, 9 (April 2011).

In order to ensure stability of the new taxing structure certain items such as petroleum products, alcohol and electricity have not yet been brought within the ambit of GST.[125] Items such as cereals, fruits and vegetables, jute, contraceptives etc., have also been exempted keeping in mind the nature of these products.[126] The tax components of which are charged under GST are:[127]

- CGST – Central GST wherein tax collected is provided to the Centre.
- UTGST – Union Territory GST wherein tax collected is used for administration of the Union Territory.
- SGST – State GST wherein tax collected is provided to the States.
- IGST – Integrated GST wherein tax collected is shared between Centre and State

[123] *Article 279A of the Indian Constitution*

[124] *R. Vasanthagopal, GST in India: A Big Leap in the Indirect Taxation System, 2 International Journal of Trade, Economics, and Finance 2, 9 (April 2011).*

[125] *https://timesofindia.indiatimes.com/business/faqs/gst-faqs/list-of-items-kept-outside-the-purview-of-gst/articleshow/60191839.cms*

[126] *Ibid*

[127] *C. P. Chandrasekhar & Girish Kumar ed.,GST: Fiscal Centralism in a Federal Polity, 32 (Mahatma Gandhi University, 2016)*

Source: https://www.squareyards.com/blog/types-of-gst-in-india-gstart

- IGST – Integrated GST wherein tax collected is shared between Centre and State

The GST is based on the application of the destination principle, i.e., the taxes are to be applied in the state where the product is sold and has to be levied on every stage of production, from the distribution chain to the retail level, with the applicable offsets with respect to the taxes levied at the previous levels.[128] Dr. K. Gopakumar has explained the GST as, "a value added Tax on the supply of goods and services in the course of business. The dealer that affects the supply under the GST regime is liable to pay tax only on value addition by off-setting the tax paid for the acquisition of goods or services in previous transaction against the supply. The total tax burden is therefore borne by the ultimate consumer and in that sense the GST is a consumption tax." [129]

The implementation of the GST by the Central government was envisaged as a transformational reform to unify tax administration in India, however, five years since there is a growing mistrust on issues of GST compensation and the decision-making structure of the GST Council. Many critics have argued that it impacts fiscal federalism and curtails state autonomy.[130] This criticism is primarily based on two arguments.

Firstly, under Article 279A(9), any decision taken by the GST Council has to be passed by a majority of not less than 3/4th of the members present and voting. Additionally, under sub-clause (a) & (b) of the same provision, the Union government has been bestowed with 1/3rd of the total votes whereas all other states combined have been given 2/3rd of the total votes. Such a distribution gives the Union government an indirect veto power over any deliberations as no decision can be passed without 3/4th majority, for which the affirmation of the Union government becomes necessary. This clearly undermines state autonomy in deciding their fiscal policy.

[128] *Ibid*

[129] *Ibid*

[130] *Jayanta Roy Chowdhury, Balancing Fiscal Relations 16, Yojna 'A Development Monthly', 31, 32 (2017)*

Secondly, if any issue arises out of the recommendations put forth by the GST Council, the power to establish a mechanism to resolve such disputes has also been vested in the GST Council itself, which is in clear violation of the principles of natural justice. These two issues with respect to the GST Council can directly impact the federal structure of India in general and the fiscal distribution of powers in particular, and can act as obstacles for State governments to put forth their interests in the GST Council.

According to Prabhat Patnaik the implementation of the GST has meant that the states have absolutely no power in deciding what tax rates to impose on what commodities, a right that was given to them under the Constitution.[131] Thus, the freedom of the states to pursue alternative strategies has been severely hindered and the states have become completely dependent on the centre.

Recently, the issue of pending GST compensations has also surfaced where many Opposition-ruled states have accused the Centre of not providing them with their dues that have been seriously undermined their efforts to combat the health crisis and initiate a plan for the post-pandemic economic recovery.[132]

In the context of federalism a recent Supreme Court judgment has an important bearing. The Supreme Court in the Union of India vs Mohit Minerals case in May 2022 observed that, “the ‘recommendations’ of the GST Council are the product of a collaborative dialogue involving the Union and States. They are recommendatory in nature. To regard them as binding would disrupt fiscal federalism, where both the Union and the States are conferred equal power to legislate on GST.”[133]

Thus according to the SC, the GST Council recommendations are not binding on the states and the states can exercise their independent power to legislate on GST under Article 246A of the 101st Constitutional Amendment Act. The GST reform which was largely possible through federal negotiations requires a more consultative and consensus-building framework to deepen fiscal federalism. As five years of GST has been completed, there is a need for a more open and robust consultative approach between the Centre and the states, especially on issues of resource distribution and decision making.

Source: https://vakilsearch.com/blog/what-is-gst-applicability/

[131] https://www.sabrangindia.in/article/gst-anti-constitutional-prabhat-patnaik

[132] https://indianexpress.com/article/india/opposition-says-non-bjp-states-not-getting-gst-dues-nirmala-sitharaman-says-dont-politicise-7821597/

[133] https://indiankanoon.org/doc/98511521/

2.8 Fiscal Federalism: Some Key Issues

i) Implementation of GST

- States have lost their capacity to generate revenue by surrendering their rights in the wake of the Goods and Services Tax (GST) regime.[134]
- Also, the GST compensation (GSTC) will come to an end in March 2026, and it will severely affect the fiscal capacity of states.[135]

ii) Fiscal Capacity of States [136]

- The ability of States to finance current expenditures from their own revenues has declined from 69% in 1955-56 to less than 38% in 2019-20.
- While the expenditure of the States has been shooting up, their revenues have not.

iii) Issues Pertaining to Cess and Surcharge[137]

- The increased share of devolution, mooted by 14th FC, from 32% to 42%, was subverted by raising non-divisible cess and surcharges that go directly to the Union government.
- This non-divisible pool in the Centre's gross tax revenues increased to 15.7% in 2020 from 9.43% in 2012, shrinking the divisible pool of resources for transfers to States.
- The imposition of cess on subjects that fall within the State list is a fiscal subversion of the Seventh Schedule. Examples of such subjects include agriculture, hygiene, health, and education.
- Dilution of Specificity: Specificity is recognised as a core aspect of cess. The Supreme Court in Maru Ram v. Union of India (1981) interpreted the word 'specific' to be "precise, exact, definite and explicit". A simple comparison of the post-independence phase (Salt Cess Act, 1953 or Iron Ore Mines Labour Welfare Cess Act, 1961) with the current phase (Swachh Bharat Cess or Krishi Kalyan Cess) illuminates the loss of specificity in this cess. There has been a tendency to impose cess for financing of national highways, basic education, environment, etc. These essentially constitute broad expenditure heads and not specific heads.

iv) Differential Interest Rate for Borrowings [138]

- States are forced to pay a differential interest; about 10% against 7% by the Union for market borrowings.
- The Union gains at the expense of States by exploiting these interest rate differentials.

v) Diversion of a State's funds to Centrally Sponsored Schemes[139]

- By turning States into mere implementing agencies of the Union's schemes, their autonomy has been curbed.
- There are many centrally sponsored schemes accounting for 90% of the allocation, and States are required to share a part of the cost.
- The states spend about 25% to 40% as matching grants at the expense of their priorities.
- The diversion is thereby depleting resources for its own schemes

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[134] https://www.sabrangindia.in/article/gst-anti-constitutional-prabhat-patnaik42

[135] https://economictimes.indiatimes.com/news/economy/policy/government-notifies-gst-compensation-cess-extension-to-march-2026/articleshow/92449494.cms

[136] https://www.thehindu.com/opinion/lead/the-poor-state-of-indias-fiscal-federalism/article65690849.ece

[137] *Ashrita Prasad, Kotha, Vinti Agarwal , Arghya Sengupta, Rav P Singh. 2018. Cesses and Surcharges: Concept, Practice and Reform (Report to Fifteenth Finance Commission). Vidhi Centre for Legal Policy.*

2.9 Conclusion

Foreseeing the need to address vertical and horizontal fiscal imbalances in India, the constitution-makers made provisions for enabling intergovernmental fiscal transfers through instruments such as shared taxes and grants-in-aid, and an institutional mechanism, the finance commission. Over the years the FCs along with the erstwhile Planning Commission played a distinctive role in inter-governmental fiscal relations in India. This paper has attempted to review the nature of fiscal relations in India through the working of the Finance Commission, Planning Commission and the Centrally Sponsored Schemes.

The paper also highlights some of the fundamental changes are happening ex post the abolition of the Planning Commission, the creation of the National Institution for Transforming India (NITI) Aayog, the constitutional amendment to introduce the Goods and Services Tax (GST), the establishment of the GST Council, and the historically high tax devolution to the states based on the 14th Finance Commission's recommendations and their impact on fiscal federalism in the country.

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3 GST and Federal India

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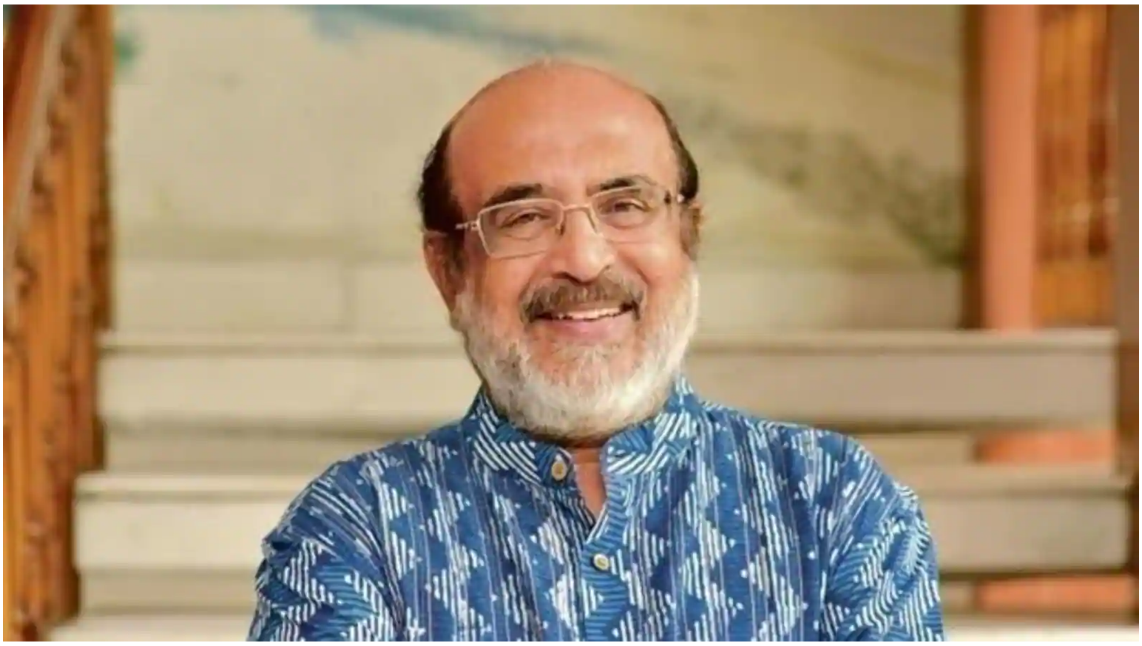

The Goods and Service Tax (GST) Council has been hailed as a model federal institution, where both states and the centre are represented, and consensus is arrived through a detailed deliberative process. Until the 38th GST Council meeting in December 2019, there had not been a single instance of voting, despite strong differences of opinion voiced on many issues. They were settled in a spirit of give and take. That acrimonious meeting on the modification of the existing rate structure of lotteries was indeed a sign of changing times. By the end of the following year, the Council was on the brink of a serious disruption with the centre and states sharply diverging in their stand regarding the payment of GST compensation.

The emergence of GST has been the most important event in the history of centre-state relations since the adoption of the Indian Constitution. According to the Constitution, powers to levy personal income tax, corporation tax, excise (other than on alcohol for human consumption), customs duties and service tax were the domain of the centre. The responsibility for taxes on intra-state purchase and sale of goods lay with the respective states.

The tax on intra-state trade took the form of sales tax, turnover tax, surcharges, luxury tax and various types of entry taxes. Sales tax, which was imposed at the first point of sale, and for some commodities at multiple points of sale, was replaced by value added tax (VAT). Inter-state sales were subject to the levy of central sales tax (CST), a central tax which was, however, levied and collected by the state in which the transaction originated.

The central excise and service tax and commodity taxes of the states, other than those on petrol and alcohol, were merged into GST, to be jointly administered by centre and state. In effect, the states had to surrender a much higher share of their taxation powers, while the centre was still left with many of its buoyant taxes. Even according to the original constitutional arrangement, the states accounted for only 40 per cent of the combined revenues of governments, and this asymmetry worsened with the passage of GST.

Nevertheless, GST has been hailed by some as an exhibition of robustness of Indian federalism, because this major change was brought about by avoiding acrimonious controversies through elaborate negotiations in a spirit of give and take between centre and states, and between states. The first objective of this paper is to broadly outline this process.

We shall then go on to examine the functioning of GST during the last four years to assess whether the high expectations of GST have been realised in terms of revenue buoyancy, ease of doing business and positive impact on growth. The outcomes have been far from expectations. Worse, the give and take attitude that characterised the run-up to the new taxation system has virtually evaporated.

Finally, we conclude that, based on a review of the experience so far, a comprehensive overhaul of the GST regime is required so that federal concerns are addressed, buoyancy of revenue is assured, and the GST Council truly becomes an institution of federal cooperation.

3.1 The emergence of GST: An instance of negotiated federal settlement

There was a growing concern about the complexity of the tax maze of multiple taxes and numerous rates of different taxes in states, together with their cascading effects. Sales tax was levied on commodities that had been subjected to excise duty (and at times additional excise duty). Central sales tax was levied in the case of inter-state sales, besides various types of entry taxes.

The cascading impact imposed a high burden on consumers and eroded the competitiveness of Indian exports. The buoyancy of sales taxes also exhibited a declining trend. The main reason was that the tax system was officer-centered and could easily degenerate into corruption and inefficiency. The response was to move to the multi-point sales tax system so that the leak could be identified at any of the points by following the trail. It made the system even more cumbersome.

The reforms of the 1990s opened an era of deregulation and delicensing, and private capital began to negotiate to bargain for greater advantages from state governments for locating their investment. The states began to offer competitive tax holidays to attract big private investment, a 'fiscal race to the bottom' (Rao and Rao, 2005). Floor rates below which sales tax rates ought not to be reduced were suggested.

3.2 Empowered Committee of Finance Ministers and VAT

It was in this scenario that GST was sought to be replaced by VAT for the intra-state trade of goods. Every point of sale above a threshold limit would be a point of taxation, but only net tax, after allowing for input tax incurred at the point of purchase, was remitted, thereby removing the cascading effect. The uniform rates, model procedures and framework of the new tax system were arrived at through the consensual decisions of the Empowered Committee of State Finance Ministers in which all the states were represented by their finance ministers.

Although there was no constitutional compulsion to fix standardised rates, it was remarkable that the states, after elaborate discussions, came to a consensus. The rates were standardised at 1, 4 and 12.5 per cent, respectively. A few years later, they were raised to 2, 5 and 14.5 per cent, respectively. There was strong criticism that in a country like India, with vast diversity, uniform tax rates would not be a desirable tax reform (Mitra, 2003). It was also alleged that the new rates were not revenue neutral. The West Bengal finance minister Ashim Dasgupta was Chairman of the Empowered Committee and played an important role in evolving the consensus. Value added tax was implemented from 1 April 2005 onwards by most states, though some, viz., Tamil Nadu and Uttar Pradesh, implemented it later.

After teething troubles, VAT revenues proved to be buoyant as the new self-policing system mopped up the slack that existed in the tax system. However, after 2012-2013, there was a decline in the growth rates of tax revenue. A major blow to the VAT system was the adverse judgement of the Supreme Court on the levy of entry tax.

The VAT tax was an intra-state tax and, therefore, without the entry tax there was no possibility of taxing commodities that were brought from outside the states. This was particularly the case for a consumer state like Kerala. There was a substantial reduction in the growth rate of revenues under VAT in many states, from an average of 16-18 per cent from 2005-2006 to 2012-2013, to 8-10 per cent per annum starting 2013-2014. The expenditure burdens of the states, especially in the revenue account, were downwardly inflexible. This prompted the states to look to expand their tax bases.

Source: https://www.legalbites.in/value-added-tax-vat-impact-revenue-generation-india/

3.3 Constitutional Amendment and GST

Taxing the service sector, which comprised about 60 per cent or more of the GDP, to a state's tax base and levying consumption taxes on a destination basis seemed attractive to many states, especially those with a smaller production and manufacturing base. Consumer states such as Kerala with no manufacturing base were severely hit by the abolition of entry tax. A destination tax like GST would bring inter-state purchases for own use also into the state's tax ambit.

However, under GST, a uniform national tax rate would prevail, and states would have to surrender their right to determine rates. But this was a right that was already surrendered to the Empowered Committee who oversaw the implementation of VAT. What was de facto lost was only going to be lost de jure.

The implication of GST for the states' autonomy in taxation was an issue that was elaborately discussed in the Empowered Committee. A major decision was the rejection of the suggestion that a single tax be collected by a single authority, and then apportioned between the centre and the states.

The Indian GST was to be jointly administered by the centre and the states, with the centre collecting Central GST (CGST), and the states collecting State GST (SGST). In every invoice, both CGST and SGST had to be separately shown, and the taxes so collected paid separately into the accounts of the centre and the states. The GST on inter-state trade (IGST) was to be separately collected.

In this scheme of things, SGST did not directly impact inter-state trade. Therefore, the basic architecture of GST and its input credit chain is not affected by giving states the option to choose a particular SGST within a narrow band. Even though VAT had introduced uniform tax rates throughout India, in practice there existed minor variations between states. It was the general understanding that this flexibility would be carried into GST.

Another key issue was the rate of apportionment of GST rates between the centre and states. Many states had adopted a consistent position during the discussions in the Empowered Committee that the apportionment of rates of GST between the centre and the states should be 60:40. The basis of this argument was that the proportion of state taxes subsumed was 44 per cent as against 28 per cent in the case of the centre. The centre still has other buoyant sources of tax revenue as well.

A third set of issues relating to GST and the rights of states concerned tax administration. What would be the relative role of the state and central tax departments in the administration of the new tax? The threshold limit for central excise was Rs. 1.5 crore and, therefore, the discussions in the Empowered Committee almost took it for granted that the smaller suppliers with a turnover of less than Rs. 1.5 crore would be within the primary domain of state administrations, while the centre and the states would share the larger suppliers equally. The data crucial to the implementation of the new tax would be managed by a public limited company whose shares were held equally by the states and the centre.

There was near consensus in the Empowered Committee on the foregoing issues until the middle of 2010. Then, initially, a few Bharatiya Janata Party (BJP) state governments, led by Madhya Pradesh, began to dissent, protesting that GST infringed on the states' interests.

Even though the BJP had included GST in its election manifesto, very soon all the BJP states, including Gujarat, joined hands to block any further action on GST implementation. Since then, the discussions in the Empowered Committee came to be limited to VAT issues, and discussions on GST dragged on.

However, the BJP reversed its position after it came to power at the centre in 2014. Paradoxically, agreement on all the issues that had been raised in the Empowered Committee, and around which a broad consensus had emerged, was given short shrift and the Constitution (122nd Amendment) Bill was introduced in the 16th Lok Sabha, in December 2014, for the introduction of GST, and was passed by the Lok Sabha in May 2015.

The Bill, with certain amendments, was finally passed in the Rajya Sabha and thereafter by the Lok Sabha in August 2016. Further, the Bill was ratified by the required number of states and received the assent of the president of India on 8 September 2016. It was enacted as the 101st Constitution Amendment Act, 2016.

The GST Council was also notified on 12 September 2016. It was to give final shape to the new tax system within the framework legislated by Parliament. Once the constitutional amendments had become a reality, there was little room left for manoeuvrability and bargaining.

Nevertheless, the spirit of the Empowered Committee continued to prevail. Even though there were serious differences of opinion on many issues-the division of administrative powers between the centre and the states, standard rates, compensation mechanism, rate split between centre and state-consensus decisions were always arrived at through extensive discussions. More than two dozen Council meetings, most of them extending more than a day, took place before GST was formally ushered in from 7 July 2017.

3.4 GST: The unrealised expectations

Even four years after the implementation of GST, the IT backbone for its full execution was not in place. Tax buoyancy has been far below expectations and with COVID-19 the shortfalls have ballooned. Compensation payments were delayed and in arrears. And, now, as the compensation guarantee period is ending, most states are at the precipice of a sudden fall in revenue and an inevitable fiscal crisis. There is a want of dialogue on these issues-the GST Council failed to meet for more than six months at a stretch in 2020-2021, and when it finally met, some of the veterans of the Council openly complained of the undemocratic manner in which business was transacted. The discussions have degenerated to party alignments. A former union finance minister, who had always been supportive of the GST, even feared that a time would come to script an elegy for Indian GST. What went wrong?

3.4.1 Revenue Buoyancy

The Achilles heel of the new system has been its failure to increase revenue buoyancy. As a result, the vertical fiscal imbalances between the centre and the states have worsened. There are many factors that have contributed to the decline in revenues, the most important being the ad hoc downward revision of GST rates in 2019.

The GST Council had spent many meetings carefully drawing up Revenue Neutral Rates (RNR) for taxing goods and services subsumed under GST to prevent a fall in revenues. A rate structure of 0, 0.25, 3, 5, 12, 18 and 28 per cent was adopted. However, even before the new rates could stabilise, politically motivated tinkering with the rate structure started.

With an eye to the impending elections in one of the GST Council meetings, the 28 per cent bracket was virtually eliminated by moving the majority of taxable goods and services to 18 per cent rates, and many goods in the 18 per cent bracket to 12 per cent. The standard rate under the GST regime is 18 per cent. This implies that the standard rate for the states has now fallen to 9 per cent. It may be remembered that the standard VAT rate was 14.5 per cent. This is, in principle and in practice, not revenue neutral for the states.

3.4.2 Issues of Tax Administration

The major disappointment was the functioning of GSTN and the lacklustre performance of the IT backbone. For a whole year, tax collection was based on a summary statement submitted by taxpayers (GSTR 3B) from which it is not possible to verify the veracity of input credit claims, which is generally believed to be excessive. There was much delay in finalising the final format of tax returns. Not only has this led to substantial leakage of revenue but also the piling up of export refunds.

Source: https://akm-img-a-in.tosshub.com/businesstoday/images/story/202003/gst_7_2_660_030320010824.jpg

An important issue that needs mention is the new burden of compliance on small traders (Isaac, et al., 2019). The basic exemption limit under the previous central excise tax was up to ₹1.5 crore. With GST, the centre will be able to tax retail sales above the exemption limit of ₹20 lakh. Dealers with a turnover up to ₹1.5 crore can now opt for the composition scheme (earlier the limit was ₹75 lakh), but they cannot get input tax credit for purchases from registered dealers. This would restrict their purchase choices and could also compel small traders, who fall within the limits of composition levy, to opt for the regular procedure and the rigours associated with it. Even though this is a hardship for smaller dealers, it is a substantial expansion of the tax base for the union.

3.4.3 The Compensation Controversy

The uneasy relations in the GST Council reached its nadir with the controversy over GST compensation payment. The introduction of GST meant a substantial loss of taxation powers of the states. To sweeten this loss, the centre guaranteed a minimum annual increase of 14 per cent in GST revenue. In case there was a shortfall in revenue for any state, that state would be compensated through collections made from a special compensation cess imposed on selected commodities. This was enshrined in the constitutional amendment. A special Act was also passed by Parliament in this regard.

The issue was discussed at length in the Empowered Committee, the GST Council, and even Parliament. The ticklish question was how compensation payment would be made in case there was too severe a shortfall in revenue and there was no money in the Compensation Cess Fund. To quote an instance, this was how the union finance minister responded:

The Secretary stated that Section 8(1) of the draft Compensation Law provided that cess could be collected for a period of five years, or such period as may be prescribed on the recommendation of the Council. He stated that this implied that the Central Government could raise resources by other means for compensation and this could be then recouped by continuation of cess beyond five years. He stated that the other decisions including the possibility of market borrowing for payment of compensation was part of the Minutes of the s" Meeting of the Council (held on 3rd and 4th January 2017) and need not be incorporated in the Law. The Council agreed to this suggestion.

However, the union government announced in the budget speech of 2020-2021 that hereafter 'the transfers to the fund would be limited only to collection by way of GST compensation cess'. This was a negation of the repeated assurances that were given to the states in the Empowered Committee, the GST Council and Parliament.

The understanding was that if there was a shortfall in the collection of GST Cess Fund, it would be made good by way of central government borrowing, to be recouped by extending the compensation cess beyond the stipulated five years. It took nine months of acrimonious wrangling to get the centre to agree to borrow at least part of the fund requirement.

Even before COVID-19, it was clear that, given the lacklustre performance of the economy and maladministration of GST, revenue growth would be far below the 14 per cent envisaged in the compensation law. The Chairman of the Finance Commission even suggested in the 37th GST Council that the states should revisit the compensation formula which, of course, no state was willing to do. With the outbreak of COVID-19, the anxieties of the states grew manifold. The total shortfall in GST revenue from legally protected revenue, in 2020-2021, was expected to be ₹3 lakh crore. The only solution was to borrow to meet the shortfall and repay it by extending the cess collection.

There were two key issues: Who should borrow? How much to borrow? In the 41st GST Council meeting, a discussion went on for over eight hours. Fifteen states suggested that the centre should borrow, and that full compensation ought to be paid. But at the end of the meeting, without any reference to the discussions thus far, the central government placed two options before the states to choose from.

Option I introduced a new concept of dividing the revenue losses on account of implementation of GST and due to the pandemic. The compensation 'due to the pandemic' would be deferred to post-2022.

Events like recessions, pandemics, demonetisation, etc., were never considerations when the compensation formula was devised. The Compensation Law clearly defines how compensation is to be calculated and it has no reference at all to any force majeure conditions. In the second option, the entire shortfall was to be borrowed by the states and the interest burden was to be paid from their consolidated fund. No state even wanted to consider this option.

The centre also argued that the Attorney General for India had stated that the central government was not legally bound to compensate the states from the Consolidated Fund of India. Given the history of the discussions and the consensus reached by the states and the centre regarding compensation, bringing up these types of arguments to coerce the states to accept one of the two options was the lowest point in centre-state fiscal relations.

In the 42nd GST Council, it was announced that 21 states had already opted for Option 1. Nine states rejected both options.

There are three cardinal principles on which dissenting states have objected: (i) there can be no bifurcation of revenue shortfall for compensation purposes, as due to the pandemic or due to the implementation of GST. The entire shortfall needs to be compensated; (ii) the centre ought to borrow, given its better capacity and ability to gain better terms, and administrative ease of borrowing; and (iii) compensation cannot be linked to normal borrowing or the additional borrowing limits allowed to the states. Both options infringed upon these principles and were unacceptable to the dissenting states.

It was clear from the Attorney General's opinion that a decision of the Council was necessary to extend the cess collection and also for the deferment of compensation payment beyond five years. The Council decided to extend the cess collection, but no such decision was made with respect to the deferment of compensation payment.

The demand for a formal decision in the Council was not heeded in the name of consensus. If such a decision was made, it would have been binding on the states which did not accept either option. These states would have continued to agitate the issue through the grievance redressal mechanism or other means. Instead of adopting such a democratic procedure, the meeting was concluded without any decision, ostensibly for lack of consensus. An announcement was then made at the press conference that choosing neither of the options would mean no compensation.

It would appear that better sense prevailed, and the centre expressed its willingness to borrow through a special window and provide back-to-back loans to states in lieu of compensation. The dissenting states have all welcomed the move-at least, the demand that the central government should borrow was met. However, the whole controversy has been a severe setback for the cooperative federal traditions that have been laid down since the time of the Empowered Committee.

Source: https://etimg.etb2bimg.com/photo/78105216.cms

3.5 Time to revisit GST

The review of GST from the perspective of federalism assumes importance, particularly in the context of growing fiscal imbalance in the Indian federal structure. The trend has accelerated in recent years with the Fiscal Responsibility and Budget Management Act, and a tendency on the part of the centre to unilaterally set terms of reference loaded against the states (Isaac, et al., 2019).

Indian GST has been designed through a consultative process between the centre and the states, and jointly administered by them. In this sense, it has the potential to be an ideal federal tax. However, this brief review of the experience thus far underlines the importance of revisiting GST. The constitutional amendment has only created the broad framework for the introduction of GST in the country. Within that constitutional framework it is still an open question whether we can have a GST which is more responsive to the concerns of the states and the people.

To achieve this, four key reforms are necessary. First, on state flexibility to tailor SGST rates, GST can be viewed as an extension of the VAT principle on the national scale, with most of the other indirect taxes of the states and service and excise tax of the centre subsumed in it. Even though VAT had introduced uniform tax rates throughout India, in practice there existed minor variations between states. It was the general understanding that this flexibility would be carried into GST.

In the GST law adopted by Parliament, the only flexibility that was permitted was the right of the states to impose a special cess for a definite period in extraordinary circumstances, such as a natural calamity, and even that with the approval of the Council. As has been clarified, the states need to be given the right to modify SGST within the narrow band to introduce some level of federal flexibility into the GST.

Second, the share of the centre and the states in the GST that is levied, the equal apportionment of GST rates (on a 50:50 basis) between the centre and the states is unjustified, given the revenue shortfalls for the states. Now, from most of the commodities which were taxed at 14.5 per cent under the VAT regime, the states receive only 9 per cent, which is 50 per cent of 18 per cent GST, that too on a base which is devoid of CST and union excise duty.

The centre still has many other buoyant direct taxes and customs duties, which is not the case for the states. So, the states have been permanently handicapped by the reduction of the standard rate. This logic for the apportionment of GST rates in a 60:40 ratio between the states and the centre had been recognised by the Government of India Committee on Revenue Neutral Rates. This must be implemented.

Third, the clamour for merging the present multi-rate GST into a single-rate one if attended to would result in further deterioration of GST revenue collections. As we have seen, even with the present structure, there is a substantial rate fall for most commodities. If there is movement to a single rate, GST would lose even the semblance of progressivity in an otherwise regressive indirect tax.

Tax rates on consumer durables and urban consumer products are the ones which have seen the sharpest decline. It is these same products which would further gain if the demand for a maximum ceiling rate of 18 per cent is accepted. The problem of multiplicity of rates is exaggerated. One only needs to think of the rate structure that existed before the GST to realise the extent to which the tax structure has been simplified.

Given the high levels of income inequality and mass poverty in the country, it is preposterous to suggest a common rate of tax for grain flour and luxury vehicles. The ideal of equity ought to be considered at least as important as ease of doing business. Excessive simplification is anathema to fairness.

Fourth, the institution of the GST Council needs to be revisited. The Empowered Committee of Finance Ministers existed even under the VAT regime. But there is a crucial difference with the GST regime: the uniformity of tax rates, which was suggested and implemented based on recommendations of the non-statutory Empowered Committee of State Finance Ministers, would now be decided by a constitutional body: The GST Council of Union and State Finance Ministers, constituted under Article 279A of the Constitution.

They are forced to abide by the decisions of the GST Council where no decisions can be made without the concurrence of the central government, not even if all the states take a united position. All the decisions of the Council require a three-fourths majority and the central government holds one-third of the votes. Recent events underline the importance of re-evaluating the institutional framework and practices of the GST Council.

With these four reforms, the GST may be able to live up to its original promise of being an ideal federal tax. Without them, it may reduce the Indian union to one that pays lip service to federalism and sharing between the centre and the states, but defies it when it comes to the issue where sharing matters most- government revenue.

3.6 References

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