COOPERATIVE FEDERALISM IN INDIA

THE GOODS AND SERVICES TAX COUNCIL: DIALECTICS AND DESIGN

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ABSTRACT

This paper explores the origins of the GST Council, examines its impacts on federalism in India, and considers the road ahead for the institution. It also addresses key arguments that have been put forth about the design and functioning of the Council. The GST Council, despite its shortccomings, has the potential to evolve as the centrepiece of a new federal architecture in India. It has changed the institutional architecture of fiscal federalism in India and can potentially change the dynamics of Centre-state relations. However, India's evolving political economy threatens to derail the federal compact that underlay its formation.

INTRODUCTION

The Goods and Services Tax (GST) regime introduced in 2016 is justifiably considered to be India's most significant indirect tax reform since independence, with wide-reaching implications for fiscal, financial, and monetary aspects of the Indian economy.[1] Yet the formation and consequences of the functioning of the Goods and Services Tax Council (GST Council) on the political economy of policy-making, the institutional framework of federalism, and the tax administrative structure have not received adequate attention.

By changing the indirect tax regime from one based on the principle of separation to one based on a model of concurrency of indirect taxation powers, the Union government effectively shared its tax sovereignty with the State governments. The States, in turn, circumscribed their legislative powers by pooling their tax authority with the Union. Consequently, the GST Council as an institution was vested with de facto powers of the sovereign and de jure authority of the sub-sovereigns. This makes the GST Council a uniquely powerful institution that decides on all issues related to indirect taxation in the form of the GST and its administration, including tax rates, bands, base, exemptions, and associated laws and principles.[2]

In the concurrent dual GST model, Parliament and State legislatures have the power to levy and collect the Central Goods and Services Tax (CGST) and State Goods and Services Tax (SGST) on all transactions, but the GST Council decides the tax rates. This makes the institutional position and operative mandate of the GST Council so overarching that it borders on violating the legislative supremacy of both the Parliament and State legislatures. In fact, to prevent a Constitutional crisis (resulting from the fact that the GST Council, a creation of the Parliament and State legislatures, has the potential to appropriate powers of the two, both representative institutions in the realm of indirect taxation), the GST Council's decisions were made recommendatory rather than final and binding.[3]

However, unlike the Finance Commission—a Constitutional body that is required to make recommendations to the to the President of India—the GST Council is required to recommend to the "Union and the states," both of which make up the Council.[4] The difference is not just semantic and procedural but substantive and significant. For one, both the Union and the States comprise the GST Council and are collectively a party to the decisions or recommendations made by the Council, ab initio. Individually, they cannot go against it, especially after their own elected representatives in their State legislatures have vested the GST Council with such powers.[5]

1 The GST bill was accorded assent by the President on 8 September 2016, following which the GST Council was notified. The four enabling Acts – (the Central GST (CGST) Act, the Union Territory GST (UTGST) Act, the Integrated GST (IGST) Act and the GST (Compensation to States) Act) – were enacted on 12 April 2017. Between April and July, all states enacted their respective state goods and services tax (SGST) laws. Thus, a comprehensive concurrent dual GST was introduced in India from 1 July 2017.

2 Article 279 A: The Council shall make recommendations to the Union and the States on:
(a) the taxes, cesses and surcharges levied by the Union, the States and the local bodies which may be subsumed in the goods and services tax;
(b) the goods and services that may be subjected to, or exempted from the goods and services tax;
(c) model Goods and Services Tax Laws, principles of levy, apportionment of Goods and Services Tax levied on supplies in the course of inter-State trade or commerce under article 269A and the principles that govern the place of supply;
(d) the threshold limit of turnover below which goods and services may be exempted from goods and services tax;
(e) the rates including floor rates with bands of goods and services tax;
(f) any special rate or rates for a specified period, to raise additional resources during any natural calamity or disaster
(g) special provision with respect to the States of Arunachal Pradesh, Assam, Jammu and Kashmir, Manipur, Meghalaya, Mizoram, Nagaland, Sikkim, Tripura, Himachal Pradesh, and Uttarakhand [Such States are referred as Special Category States]; and
(h) any other matter relating to the goods and services tax, as the Council may decide.

3 A recent Supreme Court judgment in a commercial tax matter, *Union of India vs. Mohit Minerals*, opined that the decisions of the GST council are not "binding and hence states are not obliged to follow it" triggered a nationwide debate on fiscal federalism.

4 Article 279A uses the word 'recommendation' at four different places and doubts have been raised over the binding nature of such recommendations on members states.

5 To set up the GST Council, the Constitutional (122nd Amendment) Bill not only passed by the Parliament but also by all the state legislatures and UTs with legislature. Only thereafter did the President gave assent to The Constitution (One Hundred and First Amendment) Act, 2016 on 8th of September 2016 leading to the notification of the bringing into existence the Constitutional body to decide issues relating to GST.

Legalistically, too, the context in which the word "recommendation" occurs and the intent of the legislature suggests that it is is binding for all members—the Union and the States. [6] Indeed, if the GST Council were intended to make mere recommendations, there is no need to provide, as has been done, a dispute-settlement body to enforce the compliance of Council recommendation[7] or, for that matter, to provide the Union and the State collectively a veto against one another.

This paper explores the origins of the GST Council, examines its impacts on federalism in India, and considers the road ahead for the institution. It also addresses key arguments that have been put forth about the design and functioning of the Council. The first section looks at the introduction of the GST regime through the lens of India's evolving political economy. The second section outlines exactly what makes the GST Council such a unique institution. The third section explores how the GST Council has sought to recalibrate horizontal imbalances between the States. The fourth section responds to charges that the GST regime has undermined States' fiscal authority, finding that States have benefitted more from their increased participation in tax policy-making. The final section considers how the GST Council can evolve to be the centrepiece of India's new federal architecture.

POLITICAL ECONOMY OF FORMATION

The formation of the GST Council, a first-of-its-kind federal institution, is monumental given the Indian Constitution's weak basis for federalism. Even though the Constitution earmarks jurisdictional areas for States and entitles them to revenue shares, it stops short of empowering sub-national governments with federal rights.[8] Because federal rights only apply in a situation of no exit of States from the Union, India's approach to federalism can be described as vertical rather than horizontal.[9] This aligns with "default verticality," a foundational feature of the Constitution, which has defined the practice of federalism, especially fiscal federalism, in India.[10] The bane of Indian federalism is that it exists not only at the behest, but also at the pleasure, of the Union.[11] [12]

The GST has been widely described as a "grand bargain"[13] between the Union and the States. Underlying the creation and Constitutional status of the GST Council was the realignment of the relationship between politics and business, not so much at the national level as at the regional level, that has defined India's new political economy.

The advent and rise of regional political parties and the consequent era of coalition politics during the mid-1980s resulted in the federalization of the Union government, even as the Constitution and the

6 On several occasions, the Supreme Court has held that "Provisions of a legislation have to be interpreted liberally and with a view to furthering the object of the legislation and not with a view to defeat the same in a strict and constricted manner". *See Chakradhar Rao vs State Of Andhra Pradesh & Ors. Etc.* on 29 March 1990)

7 Also, the voting mechanism which doesn't provide for an individual veto, the recommendations of the Council are by default binding both on the Centre and the State Governments.

8 The word federal doesn't even find a place in the Constitution of India. It is interesting to note that the only important feature of the Government of India Act 1935 Act that wasn't adopted was defining India as a "federation of states" which was, in a significant and serious departure, replaced by the "Union of States" in the Constitution.

9 The definition of "Central government" as defined under Section 3(8)(b) of the General Clauses Act, 1897 is ultra vires to the Constitution.

10 Default verticality means that the existence and application of horizontal constitutional rights is deemed to be an exception, that stands in need of special justification. See Gaurav Bhatia, *Horizontal Rights: An Institutional Approach* (London: Hart, 2023).

11 In the Constitution, the word "may" as against "shall" is the norm on most of the provisions relating to centre-state relations.

12 The most recent, and glaring example of this is the downgrading of Jammu and Kashmir state to a Union Territory and reading down Article 370. In the process, the asymmetric federation was also homogenised.

13 Vijay Kelkar, "Seminar on GST Revolution: Challenges and Opportunities, Pune International Centre," June 20, 2017. See also Dipayan Datta Chaudhuri and Deepak Sethia, "The Grand Federal Bargain for Goods and Services Tax (GST) in India," IIM Indore Working Paper WP/02/2022-23/ECO, May 2022.

institutional structure continued to be unionist. National parties, like the Indian National Congress and Bharatiya Janata Party (BJP), came to rely on regional parties to form the Union government. This reconfiguration of Indian politics imparted a consensual as well as conflictual federal dynamic to policy-making without a change in the institutional framework, despite some feeble attempts like the creation of the Inter-State Council. The sharp rise in States' share of Union taxes, from 10 percent in the 1950s to 29 percent in 1990s to 42 percent in 2015, is a manifestation of the new federal dynamic.

The consensual political push toward federalization was set back by two unrelated, though not mutually exclusive, developments: economic liberalization in 1991 and political decentralization in 1993-94, with the Seventy-Third and Seventy-Fourth Amendments to the Constitution giving statutory status to the third tier of governance. Both had a bearing on governance at the sub-national level, as the Union squeezed the States from the top and the panchayats and urban local bodies undercut them from below—the former threatening to disempower and the latter to emaciate the State governments. This generated conflictual pressures with the federal system.

After liberalization, regional businesses had the opportunity to grow their size and scale. They started looking for ways to align national economic policy with their own interests and investments. This was facilitated in no small way by the rising dominance of regional political parties, which had during this period gained clout disproportionate to their political footprint and strength.

The conflictual pressures came to head on the issue of redesigning the indirect tax regime to ensure trade and allocative efficiency, which was an important component of the change in 1991 from a closed controlled economy to an open regulated one.

In 1993, the Tax Reform Committee lead by Raja Chelliah recommended a national value-added tax (VAT) for India. Faced with resistance from the States, especially politically important ones, the Union Finance Minister first set up a Standing Committee of State Finance Ministers in 1999 to deliberate on the design of the VAT across States. This committee, without any mission or mandate, did not placate the States; it was converted into an Empowered Committee of State Finance Ministers a year later. Interestingly, this Empowered Committee, set up contrary to established practice, comprised only a handful of politically powerful and economically strong States. It was only in 2004 that the Union reconstituted the Empowered Committee to include all sub-national governments—including States and Union Territories.

The relative success of the Empowered Committee in moving from a disparate sales tax regime to a harmonized VAT system across the country underscored the importance of an institutional forum for coordination, discussion, and decision-making on Union-State issues. This need was not new; it had, in fact, been felt very early on, soon after Independence. It took these economic reforms for the Union government to understand that coordination with the States was a critical element in conceptualizing further reform in India. While it did not quite put States at the centre, it was a big break from the past.

The States, for their part, found the Empowered Committee useful as a forum. To reduce the committee's dependence on the Union, which had constituted it, the States sought to establish its independent identity by registering it as a society. They sought and received contributions from the State governments and were provided with accommodations by the Government of Delhi. Even the Thirteenth Finance Commission gave them a grant to meet their expenditures, instilling the

Empowered Committee with more legitimacy as a forum for federal dialogue. After the roll-out of the VAT, the Empowered Committee continued its meetings and sought to exercise oversight on operational and policy issues relating to the harmonization of the VAT across States.

As a forum, the Empowered Committee was useful for articulating and representing the needs and requirements of not only State government but also of regional businesses interests. Regional businesses across the country, which had benefitted from the dismantling of the license-quota-control raj as a part of economic liberalization, sought to influence indirect tax policy through the regional political parties that were in power at the State level or in coalition in the Union government.

The Empowered Committee not only established itself as a forum of relevance but also sowed the seeds for an institution that could coordinate changes in the tax regime across the two levels of government.[14] Two years after the introduction of the VAT, in 2007, the Kelkar Task Force on Indirect Taxes and the Union Finance Minister formally announced their intent to move to a GST regime. The Empowered Committee of State Finance Ministers was given the mandate to come up with a roadmap and structure for the GST. [15]

In 2017, the Empowered Committee was effectively converted into the GST Council, with the Union joining and assuming leadership of the Council. Interestingly, some States saw this as a capture by the Union of a well-established States-led forum and tried to preserve the Empowered Committee as a body. In fact, a few meetings of the Empowered Committee were held even after the GST Council was constituted. They failed to gain traction, however, as many States—especially those ruled by the BJP—did not want to compromise the authority of the Union-led GST Council.

Notwithstanding the alleged capture and change in leadership, the Empowered Committee's DNA was built into the GST Council. This resulted in the GST Council's ability to function largely above political party lines and ideologies. At least until 2019, in the deliberations of the Council, ideologies were, if not obliterated, certainly blurred. Political party lines would invariably get nuanced in accordance with governance compulsions and State-level needs. This meant that the States' overall tone in the Council was sub-nationally oriented even on contentious issue like the imposition of GST on textiles, bullion, tourism, or lottery. On many occasions, it was clear that within the same party, be it the Communist Party of India or the BJP, the views of the State-level leadership and representation of their concerns were articulated differently from those at the national level.

Despite the fact that the GST Council was designed as a policy-making body, its mindset, particularly given its composition, was inherently political. Given the wide-ranging experience of its members across the political spectrum, GST Council deliberations added a realpolitik sensibility and political sensitivity to the economic rationality of the GST regime. Many decisions of the Council that have been widely seen as distortionary in design or compromise solutions were driven by political rationality to preserve economic stability and protect business interests, especially at the regional level. As such, the GST Council's final decision on the tax-rate band for commodities was the outcome of different competing regional interests, rather than tax ideologies and instrumentalities. In the process, the GST Council served as a powerful platform for emerging regional capital to have a say in national indirect tax policy-making.

14 By 2004, all sub-national governments – states and UTs – gradually moved to a harmonized VAT.

15 Based on discussions within and between it and the Union Government, the EC released its First Discussion Paper on the GST in November, 2009 spelling out the features of the proposed GST and has formed the basis for discussion between the Centre and the States.

The GST Council's deliberations regarding the introduction and implementation of the GST regime were driven by two considerations: first, all decisions must be based on consensus; second, its measures must be gradual and nondisruptive. In its formative phase—the first thirty-odd meetings—hundreds of decisions, ranging from legislative to operational, were all taken by consensus. The effort was to build consensus by seeking a “sense of the house.” The GST Council also established a mechanism, borrowed from Parliament, of creating a Group of Ministers to build consensus on many contentious issues. Often, these groups were chaired by the one of the State finance ministers. This unwritten principle of decision by consensus has become the DNA of the institution. It is no wonder then that, despite some acrimonious meetings, highly contentious decisions, and deep divisions in the Council, nothing has been put to a vote so far.

The choice of rate/band structure and the multiplicity of rates threatened to distort the design of the GST. Yet the GST Council chose a path of deliberate gradualism in their policy-making. The Council sought to be nondisruptive by opting to funnel goods and services into bands that already existed in the VAT regime. Hence, they decided on five rate bands, instead of the ideal three.

The theoretical one-rate GST had no takers in the GST Council, be it the Union or the States. Conceptually though, the GST Council conceived of one main rate: 12.5 to 14.5 percent, which was derived from the revenue neutral rate. Below that was the merit good rate of 5 percent; above it was the intermediate rate of 18 percent. The 0 percent rate for essential goods and the rate of 28 percent for so-called “sin goods” were outliers. The stated intent of the GST Council was to transition most commodities from the 18 percent rate to 14.5 percent and then to collapse the two rates into one, preferable at 12.5 or 14.5 percent. This was planned to be done after the stabilization of revenues from the GST.

In responding to political compulsions, the approach of the Union in the GST Council was, at least in the initial stages, to seek State governments’ acquiescence not through hierarchical control but by offering concessions under the garb of cooperative federalism. This has ensured that regional constituencies and local interests of various political parties are protected. The 0 percent rate GST on items used in religious rituals and the rate cuts that threatened to distort the design of the GST in the Council's twenty-third meeting in 2017 are examples of this inimical but pragmatic political approach.

TURF WARS AND SERVICE BATTLES

Administrative jostling for power, more than political friction, has been evident in the GST Council. The root cause of this is the Union Revenue Secretary's designation as the Council's ex-officio secretary while the Chairman of the Central Board of Excise and Customs (CBEC), the operative head of indirect taxes, was reduced to being an invitee. The Indian Revenue Service (IRS), which had dominated the tax administration until then, saw this move as an encroachment on their turf by the Indian Administrative Service (IAS). This set in motion a power struggle between officers from the IRS and the IAS for control over the Council secretariat.

Not content with usurping the design and administration of the GST Council—which logically should have been the domain of the IRS rather than the IAS—the IAS cadre also controlled the GST Network, the not-for-profit private company tasked with creating the information technology infrastructure of the GST regime. Both the Chairman and Chief Executive Officer's posts were held by former IAS officers, as well as many board seats. Of the thirteen board members, there was only one representative from the CBEC.

The IRS officers' association opposed making the Union Revenue Secretary head of the GST Council. They believed that the Chairman of the CBEC ought to be the Council's ex-officio secretary. They also opposed the composition of the GST Network, demanding that the IRS' large cadre be allowed to man the network. The ensuing power struggle even spilled over into the direct taxes domain, as te income tax officers rebelled against the Union Revenue Secretary. This turf battle between the two Central services, however, did not engage the GST Council. Rather, the fierce struggle fought inside the Council was between the Union tax bureaucracy and the States' tax bureaucracies.

After the IRS officials lost their battle against the IAS, they started to find ways to expand their domain by cutting into the territory of the State commercial tax departments. This move was, not surprisingly, backed by the GST Council secretariat. A variety of reasons were advanced in support of the IRS effectively taking over GST administration in the States, chief among them that the nature of tax administration under the GST regmine would undergo a major change from tax assessment to audit and from recovery to ruling. The States, proponents argued, lack the capacity to administer the GST regime; thus, until these competencies were created, the Union officials would help the States.

The GST Council, with an overwhelming majority of members from the States, fiercely resisted ceding the oversight of commercial taxes, which normally sit under State finance ministers, on grounds of domain knowledge, linguistic ease, and ethnic comfort during the transition to a totally different tax regime. In fact, more discussion was devoted to who would monitor and manage the tax than to how it should be administered. Eventually, the Union and States reached a compromise that would allow the State governments and tax administrations to exercise oversight over units below Rs 15 million annual turnover. This compromise code contained obvious loopholes that could—and likely do—result in tax evasion.[16]

These inter-service and intra-government bureaucratic battles were symptomatic of a deeper issue that bothered the Union bureaucracy. The formation of the GST Council marked a decisive break from the deep-seated colonial construct of Union-State relations in India. The form that Indian federalism took was colonial in moorings and design and, hence, not suited for a democratic republic. The fiscal federal architecture of post-Independence India was not just inspired by but draws heavily from a piece of colonial-era legislation that was enacted with the sole purpose of strengthening the domination of the Centre in its relations with the provincial governments. That system was operationalized by a colonial-trained power elite and well-entrenched administrative class with an ingrained centralized culture. To create and empower a Constitutionally positioned institution like the GST Council, in which the States play an equal role, marked a loss of governance control for the Union bureaucracy.

A SUI GENERIS INSTITUTION

As India's first genuinely federal and fully empowered institution, the GST Council is more than administrative break from the past. It is a bold experiment in pooling Union and State sovereignty that has changed the concept and contours of federalism in India.

16 For instance, with the threshold of Rs 20 lakhs fixed for exempting goods and services from GST, many assesses can, and do, break up their operations into an informally connected web of small units. Here also, there were variations; smaller states, especially the Northeastern states, sought and got a different threshold for exemption. Initially, the exemption threshold was put at Rs 20 lakhs, revised to Rs 40 lakhs in 2019. At the first stage itself, the smaller states, the erstwhile special categories states argued and got lower limits on the grounds of small scale of businesses.

All the other institutions that have worked across the two levels of government—including the Finance Commission, the Planning Commission, the National Development Council, and the Inter-State Council—have functioned as extended arms of the Union government. Their efforts have largely been to direct intergovernmental cooperation and align sub-national policies with national policies. States have had no real role in their formation, composition, or decisions.[17]

The GST Council changed that paradigm. Within the GST Council, intergovernmental cooperation is not only negotiated but, on many occasions, made contingent. Unlike central plan assistance—which was calculated, decided, and distributed by the Planning Commission—the GST Council recommends levy of the GST, its components (CGST and SGST), the tax bases, and tax rates, which are determined jointly by the Union and State governments and shared on a mutually agreed formula.

Compared to other institutions, what makes the Council remarkably federal is its composition and process of decision-making. [18] Even though the Council is a policy-making body, its composition more resembles a representative institution. Its members are all elected representatives from across the country; one from every State and Union Territory and two from the Union government. However, while other representative institutions have a majoritarian bias, the Council's distinct non-majoritarian construct stands out as unique. All representative institutions in India—whether it be Parliament or a State legislature—affords the majority the right and the power to make decisions that affect an entire society. Not so in the GST Council.

Each State has one vote in the Council, irrespective of population. For example, the State of Manipur, with a population of 2.7 million, sits on an equal footing with Maharashtra, which has a population of 120 million. Uttar Pradesh's population of 240 million are given the same voice and vote as Pondicherry's population of 1.3 million. As such, the GST Council can act as an important institution for minority views. This is a particular strength of the Council in the context of economic policy matters, which have typically been biased towards the more developed States on the basis of their numerical strength and representation in law-making bodies. This makes the Council an institutional mechanism for formulating taxation policy based on diversity through vertical and horizontal intergovernmental interactions, collaboration, bargaining, and conflict resolution

In addition to deciding changes to the indirect tax rate, the GST Council has also demonstrated an alternative way of formulating laws. On many occasions, the Council has converted itself into a drafting committee. The Council has discussed draft laws section by section—even line by line—making changes in real time while taking inputs from all members. It has essentially redrafted the proposed formulation of laws on the fly. Even in Parliament, this has never been done. Indeed, one struggles think of any place in the world where such participatory law-making has occurred. This style and method needs to be showcased and replicated elsewhere in the country. In fulfilling its mandate of drafting model laws, the GST Council can be considered the constituent assembly of indirect taxation in India.

Seen from a wider perspective, it could be argued that the creation of the GST Council is a step back for democratization. It holds virtually all the powers to decide indirect taxation. Taxes that before would have been discussed publicly in Union and State legislatures are now decided by an essentially unelected

17 Even the five advisory Zonal Councils of the states, grouped as geographical clusters to foster inter-state cooperation among them which were set up vide Part-III of the States Reorganization Act, 1956, has the union home minister as the common chairman of all the five zonal Councils.

18 The members of the include the Union Finance Minister, the Union Minister of State for Finance, and the Finance Ministers of all State Governments. The Finance Minister of India and the Minister of State for Finance act as representatives of the Central Government while Finance Ministers of each State Government act as representatives of their respective States.

council whose functioning is not open to the public at large. In a sense, the GST Council has effectively divorced taxation—arguably the most important power of the state—from democratic politics. While it is true that the Council itself is unelected, it comprises only elected representatives. In addition, the minutes and deliberations of the Council are recorded in detail and are available in the public domain.

RECALIBRATING HORIZONAL IMBALANCE

While the implications of subsuming all major indirect taxes under one generic tax have been widely discussed, another aspect of the GST has not attacted adequate attention from either academics or policy-makers. The political economy of the move from an origin-based tax regime to a destination-based one[19] —and from a production-based indirect tax system to a consumption-based one[20] —has had wide-reaching and under-studied impacts on the federal dynamics of India.

Under the GST regime, goods and services are taxed for consumption and not production. That tax is collected in the State where the goods or services are consumed, rather than the State where they are produced. This changes both the vertical and the horizontal dynamics of Indian federalism. Additionally, the Integrated Goods and Services Tax (IGST) charged during the inter-State supply of goods or services is transferred to the consuming State as its destination. This move from the principle of origin to the principle of destination has potentially reconfigured the inter-state balance of power amongst States.[21] In the pre-GST regime, the Central Sales Tax, being an origin-based tax, effectively exported the tax burden from rich manufacturing states to consuming states, which contributed to horizontal fiscal imbalances. By putting in place the destination principle for cross-border trading, the system ensures that poorer, consuming States benefit at the cost of more affluent and industrialized States.

Even as the GST regime addressed some horizontal imbalances by introducing a progressive element to devolution by apportioning the proceeds of the IGST between the Union and the destination States, the high- and middle-income States bargained hard to secure a rather generous compensation package. The open-ended design of the compensation package effectively makes it an insurance policy against low tax collections of States, which may or may not be due to the transition to the GST. Furthermore, the expected revenue loss for industrialized States, because of the shift from a production-linked tax to a consumption-based tax, was alleviated by extra revenue from the SGST on services, as the industrialized States have a higher share of services in the State gross domestic product (SGDP) than the consuming States. Thus, the less industrialized states got a larger share of revenue from the IGST, while States with more manufacturing capacity benefitted from the buoyant sources of revenue, even as the potential downside was protected by the compensation packages.

All these concessions and trade-offs made by the GST Council were the result of the States' bargaining power, which has often been underestimated in fiscal federal discussions. The State governments' negotiating strategies in the GST Council were uncannily informed by their experiences with the Finance Commission. Through mandatory sharing of proceeds from only income tax and permissive sharing of Union excise duty under Article 272—amounting to around 10 percent of the total revenues of the Union in the First Finance Commission—the States have managed to increase their statutory share to 41 percent

19 Origin based tax is levied at the production of goods or services and not when they are consumed.

20 A consumption/destination-based tax is based on the consumption of goods or services. It is a tax we pay for using goods or services. It is levied at the time of consumption of goods or services. It is like an indirect tax paid at the time of consumption.

21 Prior to the GST reforms, the principle that was followed was all revenue accruing from tax on inter-state sales of goods was collected and retained by the states which supply the goods.

of the total tax revenues of the Union, as recommended by the Fourteenth Finance Commission. This is more than a four-fold increase in the States' share of Union tax revenues.

Indeed, the States' insistence that the Compensation Act mandatorily provide for compensation to the States rather than a permissive provision drew heavily upon a distinction originally made in the Constitution, which stated that the Union "shall" share income tax even as it "may" share excise duties. In the GST Council, the Union had proposed that compensation under the Act "may be" payable to any State during the transition period. It was finally negotiated to stipulate in Section 7 of the Compensation Act that "The compensation under this Act shall be payable to any State during the transition period." [22]

When the States pushed the Union to fund this compensation through the levy of cesses—non-shareable additional taxes collected to fund specific programs or finance general expenditures of the Union government—it was tantamount to getting the Union to share a part of their proceeds from cesses, which have historically been used to deny States their rightful share in indirect taxes.[23] Notwithstanding the discordant behaviour vis-à-vis sub-national governments, the Union eventually took recourse to additional borrowings and passed it on to the States as a back-to-back loan in lieu of GST compensation cess releases. Quite significantly, the GST Council decided to extend the levy of the compensation cess beyond June 2022.

The first big win for sub-national governments was to ensure a concurrent dual GST model rather than the unified GST model that the Union originally considered. Beyond that, States retained a measure of their fiscal autonomy through their successful demand to keep petroleum (including crude oil, natural gas, aviation fuel, diesel, and petrol), alcohol, electricity, and real estate outside the purview of the GST regime. Taxes on these items make up more than one-third of State governments' revenues. States have also made sure that they continue to exercise their discretion to levy wholesale market taxes and vehicle registration fees outside the GST and to raise the entertainment tax over and above the SGST.[24] This effectively means a pre-GST taxation system continues to apply to these items.

On this and other key issues of the GST's design, not a single State was in favour of subsuming petroleum, electricity, and real estate within the GST—no matter what political party they were led by or in coalition with. All these concessions were secured even though many regional parties represented in the GST Council were in coalition with the BJP-led national government. Indeed, the BJP and its regional allies held fifteen States out of the twenty-six members of the first GST Council. This indicates that even BJP-ruled States continued to be oriented sub-nationally on key contentious issues.

FROM FISCAL AUTONOMY TO FINANCIAL AUTHORITY

Much has been made of the States' loss of fiscal autonomy because of the move to the GST regime. Indeed, much of the discussions in the meetings of the GST Council were about how after the Constitutional amendment, the States had lost the "bargaining power and had been reduced to the level of a municipality" [25] and seeking cross-empowerement of administrative powers to redress

22 Minutes of the 5th, 6th and 7th GST Council Meeting held on 2-3 December 2016, 11th December, 2016 and 22nd/23rd December 2016 respectively.
23 Article 270 stipulated mandatory sharing of the net proceeds of income tax levied and collected by the Union with the States, while Article 272 provided for sharing of Union excise duties, if Parliament by law so provided. This position changed with the 80th amendment of the Constitution in 2000.
24 For instance, Tamil Nadu, Maharashtra, Gujarat and Rajasthan are levying additional taxes on theatres at varying rates over and above the GST rate of 28%. Maharashtra has also increased the registration tax on private vehicles by 2%. Extra sales taxes that the states apply over and above the SGST are administered separately from the GST.
25 Para 9, Minutes of the Meeting of the 5th GST Council Meeting held on 2-3rd December, 2016.

the balance. From a federalist perspective, by far the biggest criticism of the GST Council is that the decision-making process and voting formula are heavily skewed in favour of the Union, resulting in an erosion of sub-national fiscal autonomy.

This notion of fiscal autonomy of States, independent of the introduction of the GST regime, is extremely ambiguous. States in the Indian Union have a history of curtailed powers, sanctified by the Constitution itself. Indeed, as mentioned earlier, there are hardly any enforceable federal rights in the Constitution of India.

Prior to the GST regime, even while the administration of the VAT regime—including enforcement and collection—varied between states, it was only in terms of rules and implementation guidelines. VAT rates were uniform within a band structure. States were obligated to adhere to the rate/band structure of 0 percent, 1 percent, 4 to 5 percent, and a general VAT of 12.5 to 14.5 percent, leaving them with little autonomy to make changes in the rate or base of taxation. This clearly shows that the fiscal autonomy of the States had been compromised prior to the introduction of the GST by the harmonization of rates in the VAT regime.

If anything, the GST Council has restored the balance in two ways. First, States now have a say in deciding the GST rates even as they continue to levy and collect the SGST component. Second, the GST has reined in the large, more developed States—who in the pre-GST tax regime exported their taxes to other States and indulged in unfair tax competition[26] —to help smaller and poorer States.

Those who argue that the GST has eroded States' fiscal autonomy point to the way voting works in the GST Council. As stipulated in Clause 9 of Article 279A, a three-fourths majority (75 percent) of the weighted votes of the members present and voting is necessary for any proposal to be passed.[27] The Union government's vote is worth a third of the total votes cast (33 percent). All the State governments collectively make up the remaining two thirds (66 percent). Thus, it is argued that under no condition can the States even collectively get a proposal passed if it is opposed by the Union. The Union government, in other words, effectively has veto power.

While technically correct, this veto is a not an affirmative veto in the sense that if all states, with a total weightage of two-thirds, oppose a measure then the Centre's veto becomes inoperative. Rather, it is a vestigial veto when contextualized in the real democratic situation. If the Union didn't hold effective veto power in the GST Council, it could, by virtue of having a majority in the Parliament where tax sovereignty resides, stop any proposal even after it is recommended by the GST Council. In effect, the veto power does not add a new arrow to the Union's quiver.

Equally relevant is the fact that if all States oppose a proposal in the GST Council, their cumulative weighed vote of two-thirds affords them a collective veto over the Union. As such, any proposal made by the Union cannot go through if all the States oppose it. This is precisely what makes the one-State, one vote principle—irrespective of population or geographic size—so critical. If, like all other institutions, decisions

26 Going beyond taxation, a case in point is the borrowing powers of the sub-national governments. Up until the recent relaxation, post the liberalization, the borrowing powers of states were non-existent as the Constitution prevented them from borrowing if they were indebted to the Union. Clause (3) and (4) of Article 293 stipulate that State Governments need to obtain the consent of the Centre for raising fresh loans in case they are indebted to the latter, and such consent may be granted, subject to certain conditions. And the plan financing scheme was such that it was not possible for a state not to be indebted to the Union. The Planning Commission decided not only the central assistance to the state plan but also the size of the state plan as also the sectoral allocation of the plan by linking it to institutional loans, centrally sponsored schemes, and the central plan.

27 The total weighed vote of the Union is 10 votes

were driven by the majority, even two or three States (for example, Uttar Pradesh, Maharashtra, and Bihar, or Rajasthan, Madhya Pradesh, and Gujarat) could collude with the Union to push forward its agenda. Instead, the one-State, one-vote model prevents larger States from dominating the GST Council.

Thus, the Union cannot on its own impose its will on all the States. It will need the support of at least twenty States, which jointly control 42 percent of the vote share. Nor can the States collectively impose their will on the Union, because the Union can effectively veto any proposal the States put forward. In effect, the Union and the States exercise a veto over each other. Therefore, no substantive change can be made to the GST base, rate band, or revenue-sharing arrangement without the consent of both sides. This was devised to incentivize consensus-building by making policy gridlock the only other option.

In theory, the Union may have an effective veto. In reality, however, it will not be possible for the Union to repeatedly stall demands made by the States. Practically speaking, States have the option to boycott meetings of the Council. If sixteen or more States refuse to attend a meeting, even the Union is unable to put forth any proposals or reach a decision through the Council. Hence, instead of exercising its veto power, the Union would be forced to negotiate and collaborate with the State governments to arrive at a mutually agreeable solution.

Any loss of fiscal autonomy, therefore, has been more than compensated by the increase in financial authority of the States. Simply by virtue of being members of the GST Council, the States have acquired a greater role in shaping indirect tax policies and their outcomes.

At a broader level, the Union government's acceptance of the Fourteenth Finance Commission's recommendation that the States' share of central taxes be increased—by 100 basis points from 32 to 42 percent, the single largest hike in history—was not unlinked to the impending implementation of the GST regime and the deliberations of the GST Council. Prior to this, in the Empowered Committee, the consequences that giving up tax powers might have on budgetary inflexibility had been repeatedly articulated as a major concern for sub-national governments. The so-called free plan—unencumbered by earmarked borrowings or conditional and linked grants—had in many States been almost reduced to a bare minimum, and State budgets had become completely predetermined.

Recognizing this as a genuine operational issue, the Fourteenth Finance Commission recommended increasing revenue shares and statutory grants and reducing the underwriting of expenditures by the Union. Even as the total transfers were kept at the existing level of around 62 percent, the increase in the divisible pool—by the inclusion of the CGST and the Union's share of the IGST—and the compositional change resulted in greater flexibility for States in their budgetary management. In a way, it redressed the Constitutional congenital imbalance between the responsibilities of the States and their revenue-raising powers. The idea that the fiscal federal system should eventually move to a revenue federation with complete expenditure autonomy and authority to the States underpins the very existence of the GST Council.

All these changes were complementary to the shift in taxation powers under the proposed GST regime, and they cushioned the rebalancing of powers. The trade-off between reduced taxation powers and greater discretion in expenditure freedom was a political no-brainer for most States; it is easy to blame the Union for taxation hikes and take the credit for higher expenditure allocation. Thus, the perceived loss of fiscal autonomy was negated by a real increase in expenditure discretion.

More than the erosion of a non-functional fiscal autonomy, sub-national governments have actually gained in terms of real empowerment and influence through involvement and participation taxation policy-making. As has been observed correctly by political scientist Chanchal Kumar Sharma, "a reduction in self-rule has been more than offset by increasing shared rule."[28]

It has been argued that the so-called grand federal bargain was lopsided, with States losing control over 65 percent of their revenue from taxes subsumed under GST while the Union yielded only 30 percent. Yet the GST Council—of which twenty-one out of thirty-one member States and Union Territories at the time belonged to the national ruling party—determined that the ratio would be fifty-fifty. What this argument fails to recognized is that 42 percent of proceeds from the CGST are shared with the States. As such, while States gave up two-thirds of their revenue, they are getting 63 percent of the total collection of indirect taxes. Moreover, the tax revenue collected from the IGST is distributed between the Union and the States where the product is consumed. Again, the Union's share of the IGST becomes part of the divisible pool.

Although the States may have less fiscal autonomy under the GST regime, the increase in their share of Union taxes has enhanced revenue adequacy and financial flexibility at the sub-national level. Furthermore, by establishing the GST Council as a Constitutional body that makes collective decisions on GST issues, the principle of negotiated cooperation has been operationalized.

THE GST COUNCIL AND THE FINANCE COMMISSION

The GST Council plays a crucial role in taxes devolved to the States by the Finance Commission. The size of the revenue kitty that the Finance Commissions devolves is now being determined by the GST Council. Any decision on the rate bands, for instance, will have huge implications on the vertical distribution of revenues between the States and the Union to be decided by the Finance Commission. In its endeavour to build on the emerging federal compact of cooperative federalism, the GST Council needs to ensure that the Finance Commission is in sync with the changed institutional landscape and new realities of of Indian federalism.

A serious effort must now be made to review the existing scheme of fiscal transfers, considering the GST Council's impact on the federal landscape. To start with, the existing criteria for devolution have evolved in, and for, a production-based tax system. Now that a a consumption-based tax regime has been introduced, all the horizontal distribution criteria must be reformulated. The structural change from production to consumption will make a significant difference to inter-state distribution as well as the need, nature, and distribution of equalizing grants.

Revenue deficit grants, too, must be reexamined. The so-called gap-filling approach must be redesigned since the GST Council has provided a minimum guaranteed revenue of 14 percent to every State in the form of compensation to all States. The result of not doing so is that total grants—statutory and non-statutory alike—account for almost 55 percent of total transfers, a stark increase from less than 50 percent in recent years. The share of tax devolution in aggregate transfers has dropped to 45 percent, making the system more discretionary.

28 Chanchal Kumar Sharma, "Concessionary Federalism in a Dominant Party System? Indirect Tax Reforms and Subnational Acquiescence in India," *Territory, Politics, Governance* 10, no. 1 (2022): 32-50.

At another level, institutional representation in the form of Finance Commission membership has not be re-jigged in light of the new structure. It was well conceived for a member of the erstwhile Planning Commission to be an ex-officio member of the Finance Commission. This was done to ensure coordination between plan expenditures handled by the Planning Commission and non-plan expenditures managed by the Finance Commission. Now, however, not only has the plan and non-plan distinction been replaced by revenue and capital expenditure (capex) budget, but the NITI Aayog—the Planning Commission's successor agency—has no mandate to decide on the capex budget of the States. As such, for more meaningful institutional coordination, a member of the Finance Commission ought to be from the GST Council rather than the NITI Aayog.

To prevent a constitutional impasse, if not a crisis, it is only proper that GST Council should be represented in the Finance Commission. Those who decide the size of the divisible pool and those who distribute the divisible pool should know each other's minds. It is imperative that the Council and the Commission be on the same page.

CONCLUSIONS: UNDER-LEVERAGED MORE THAN UNDERMINED

In its five years of existence, the institution of the GST Council has been under-leveraged by the States more than it has been undermined by the Union. The biggest failure so far has been its unrealized potential as a forum for States to coordinate intergovernmental action and proactively build a sub-national consensus on an indirect taxation. Indeed, the States have not even been able to make the GST Council a platform for sharing knowledge on best practices across States. Through the GST Council, the States should contribute to building a national indirect tax policy based on their diversity of sub-national experiences.

Instead, State governments, having been given a voice and vote, have been reactive rather than proactive in their interventions. The States' own victimhood mentality in fiscal federal policy-making has prevented them from collectively taking the lead. The tax responses to the COVID-19 pandemic provide a good example. Despite endless statements and discussion about how the Union government was being insensitive for not reducing the GST on vaccines—including the COVID-19 vaccine—not a single State took the initiative to exempt vaccines from the SGST, which they administer and levy.

However, the GST Council does face the threat of being undermined by the Union. Since the GST Council took over the role of deciding indirect tax rates and base, the Union bureaucracy has moved stealthily to increase the number and magnitude of cesses. Between 2011-12 and 2021-21 (budget estimates), cesses and surcharges have seen a five-fold increase.[29] At the end of the current fiscal year, budget documents suggest that almost 20 percent of the net tax collections will be from cesses; up from 6 percent not so long ago. This is a more than a three-fold increase in the share of cesses in tax revenue. (This includes the cess for funding the compensation to States for their loss of revenue under the GST; even if this part is excluded, however, the share of cesses in net tax revenues will still go up to nearly 15 percent.)

With the Union taking in almost Rs 3 trillion through cesses, it axiomatically means that the States have been deprived of their share of this amount. Even if the GST compensation cess was to be excluded, the States still lost at least Rs 2 trillion during 2018–19 on account of surcharges and cesses.[30] This fiscal year, it

29 Fifteenth Finance Commission, *Finance Commission in COVID Times: Report for 2021-2026*, Volume 1 (New Delhi: Government of India, 2020): 67.
30 See Union Government budget documents for 2018-29 and 2019-20.

will be even more. Effectively, the non-shareable part of taxes has been raised more than shareable taxes, be it cess or surcharges. Whether it is creating a separate fund for defence or any other sector or taking recourse to cess for raising revenue, both moves would shrink the divisible pool—first by earmarking and second by preempting revenues from flowing into the divisible pool.

This is exactly how the erstwhile Gadgil pool was emaciated and rendered ineffective before it was eventually abandoned. The Gadgil pool was the pool of money to be distributed amongst the States based on a set of well-considered criteria.[31] Over time, central assistance to state plans was cannibalized by centrally sponsored schemes, which were neither uniform nor criteria-based. However, unlike the Gadgil pool, which was not statutory, the divisible pool (especially after the formation of the GST Council) has a Constitutional basis. Thus, efforts to shrink it go against the Constitution.

THE ROAD AHEAD

Such transgressive behaviour by the Union, while not entirely unexpected, will, unlike in the past, result in a serious political contestation between the forces of centralization and federalism within the GST Council. While efforts to re-centralize control over the economy and public resources will have an impact on the Council's functioning, it is unlikely that the fundamental reordering of federal fiscal relations will be reversed. The GST Council has the numerical and legislative strength to protect sub-national interests in the fiscal arena.

The GST Council, despite its institutional design infirmities and the way it has functioned over the last six years, has the potential to evolve as the centrepiece of a new federal architecture in India. It must be seen as an institution for federal rights as well as the jurisdictional rights of State governments.

Even as these larger battles are being fought, the Council's business must continue. With the GST having stabilized, the GST Council must address two key stakeholders: consumers and small businesses. This is important for the GST regime to gain acceptability in the public sphere. For small businesses, it is imperative to put in place a modified composition scheme that will make the GST regime attractive. Currently, small businesses are in a bind; the GST neither allows input tax credit (ITC) to composition dealers nor GST invoices enabling the buyer to take the same. Registered dealers are reluctant to make purchases from these composition dealers because they do not get ITC. This has destabilized the supply chain and caused business distress.

In regards to the consumer, there is one important systemic issue that the GST Council needs to deliberate upon: the relevance of a maximum retail price (MRP) system—an anachronism from control raj days[32] —in a GST regime. The MRP system was relevant in the pre-liberalization economy that operated with producer taxation. The producers would work out the costs and margins of the distribution chain and allocate them within the MRP. With the change to a consumption tax, however, the final payment of tax occurs at the last stage. Here, it becomes an anomaly to have an MRP. It over-determines the system besides contributing to inflation.[33]

31 The central government would allocate central assistance to state plans in its budget as a large part of the budgetary assistance to the plan. As a part of the plan financing scheme, the Planning Commission would finance its own five-year plan and distribute the remaining among the states and determine the size of state plans. The inter se distribution was based on the Gadgil formula.

32 Small traders with turnover of less than Rs 1.5 crore can avail of the Composition Scheme under GST to avoid tedious GST formalities and pay GST at a fixed rate of turnover.

33 In Malaysia, rising inflation attributed to introduction of the GST regime led the government to scrap it three years after its rollout.

Under the GST regime, the consumer has not yet benefited as they ought to; small businesses have found it difficult to cope with the new system, while big businesses are getting used to it. The tax bureaucracy is struggling to come to terms with the loss of control and authority, while fiscal managers are beginning to see the pot of revenue at the end of the rainbow. In transactional terms, the business-to-consumer segment is running well but the business-to-business sector continues to have operational and structural hiccups.

Some sectoral issues that have surfaced—chief among them being tourism, exporters, and handicrafts—which need to be resolved. For tourism, it is imperative that the tax refunds system is put in place as soon as possible. The effective tax burden on exports as well as handicrafts has become high compared to the previous tax regime. The issue of embedded taxes for exports will have to be resolved through a proper mechanism and not in an ad hoc manner.

For the GST Council to remain relevant, it must assume the leadership role in evolving a new fiscal federal compact. This has become imperative in view of a host of contemporary developments. From being a federal institution, GST Council must now grow as an institution of federalism.

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