WORKING PAPER 222/2022

INTERGOVERNMENTAL FISCAL RELATIONS IN INDIA: TIME FOR THE NEXT GENERATION OF REFORMS

D.K. Srivastava

MSE
Mentoring Excellence

CENTRE FOR PUBLIC FINANCE
MADRAS SCHOOL OF ECONOMICS
Gandhi Mandapam Road
Chennai 600 025
India

July 2022

Intergovernmental Fiscal Relations in India: Time for the Next Generation of Reforms

D.K. Srivastava
Executive Council Member, Madras School of Economics
and
Chief Policy Advisor, EY India and formerly Director, Madras School of Economics
dkscloud@gmail.com

CENTRE FOR PUBLIC FINANCE
MADRAS SCHOOL OF ECONOMICS
Gandhi Mandapam Road
Chennai 600 025
India

July 2022

WORKING PAPER 222/2022

CENTRE FOR PUBLIC FINANCE
MADRAS SCHOOL OF ECONOMICS
Gandhi Mandapam Road
Chennai 600 025
India

July 2022

Price : Rs. 35

Phone: 2230 0304/2230 0307/2235 2157
Fax: 2235 4847/2235 2155
Email : info@mse.ac.in
Website: www.mse.ac.in

Preface

Madras School of Economics (MSE) established the Centre for Public Finance (CPF), which started functioning from April 1, 2021. This Centre is financed by the Government of Tamil Nadu. Its activities are guided by an Advisory Council (headed by me). The Centre focuses on both theoretical and empirical issues of public finance covering the following areas: deficit financing and public debt, monetary and fiscal interactions, tax policy and reforms, public expenditure management, public investment appraisal and cost benefit analysis, public enterprises reform, intergovernmental transfers, local finances and environmental issues.

Apart from general research activities, the Centre is committed (i) to review the Tamil Nadu Economy and State Finances every year, (ii) to conduct an Annual Conference on topics related to public finance and policy and (iii) to conduct Training Programs on public finance. It will also undertake specific studies on public finance funded by Government of Tamil Nadu and other National and International agencies.

During the academic year 2021-22, the Centre organized "Virtual Meeting on Improving the Presentation of Tamil Nadu Budget Document" on April 29, 2021 and conducted 5-day Training Programs on Public Finance for 15 batches covering a total of 270 Group A and Group B officials of Government of Tamil Nadu through online mode (from August 31, 2021 to December 31, 2021). It has also initiated about 10 research studies.

The study "Intergovernmental Fiscal Relations in India: Time for the Next Generation of Reforms" by Dr. D.K. Srivastava is the Second working paper of the Centre for Public Finance. The working paper after tracing the evolution of intergovernmental fiscal relations in India over the last seven decades suggests a set of reforms which cover raising India's tax GDP ratio, comprehensive GST reforms, mechanisms and formulae used in determining intergovernmental transfers, and Fiscal Responsibility Legislations.

C. Rangarajan
Chairman, MSE

Intergovernmental Fiscal Relations in India: Time for the Next Generation of Reforms

D.K. Srivastava

Abstract

The system of intergovernmental fiscal relations in India has steadily evolved over the last seven decades under the guidance provided by Finance Commissions. Various dimensions of the fiscal landscape in India have been subjected to periodic reforms. In spite of these, India's tax-GDP ratio has effectively stagnated over the last thirty years. Recent GST reforms have also qualitatively and quantitatively affected the relative position of resources for the central and state governments. Debt and fiscal deficit stabilization which has been subjected to Fiscal Responsibility Legislations also requires a relook due to certain inbuilt inconsistencies which have been highlighted in the paper and in view of the current global challenges. This paper suggests that it is time for undertaking the next generation of reforms that would guide intergovernmental fiscal relations in India in the emerging future. The suggested reforms cover issues pertaining to uplifting India's tax-GDP ratio, comprehensive GST reforms, mechanisms and formulae used in determining intergovernmental transfers, and Fiscal Responsibility Legislations.

Keywords: *Intergovernmental relations, fiscal reforms, tax-GDP ratio, debt sustainability, GST reforms, finance commission*

JEL Codes: *E61, E62, H21, H25, H63, H77*

Acknowledgement

I would like to thank Dr. C. Rangarajan for his valuable inputs on the earlier versions of this paper. His ideas led to improving some important conceptual and empirical underpinnings of this paper. I would also like to thank my colleagues, Muralikrishna Bharadwaj, Tarrung Kapur and Ragini Trehan, for their valuable suggestions and continued support in the completion of this paper.

I would also like to thank Dr. K.R. Shanmugam, Director, Madras School of Economics (MSE), for reviewing earlier versions of this paper and for finally publishing this paper as a working paper of the Centre for Public Finance, MSE.

D.K. Srivastava

INTRODUCTION[1]

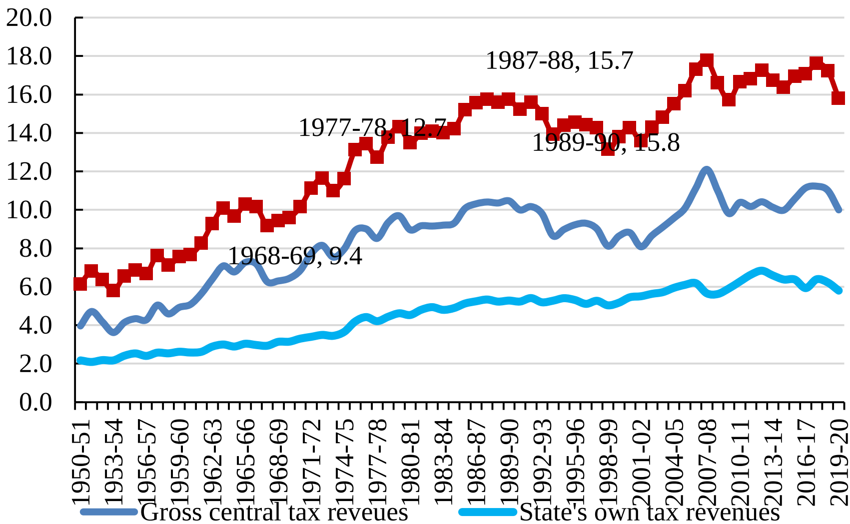
During the last decade, important and somewhat disturbing trends have emerged in the ongoing evolution of intergovernmental fiscal relations in India. With the Fifteenth Finance Commission (15th FC) having provided its recommendations and the Indian economy recovering from Covid-19's massive economic shock, this may be an opportune time to take stock of the developments affecting intergovernmental fiscal relations which appear to have moved in favour of growing centralization and away from safeguarding the autonomy of states and local governments. There are many reasons for this, but we may particularly note some of the major ones. These pertain to (1) falling aggregate tax-GDP ratio, (2) revenue underperformance of the GST, (3) erosion of revenue autonomy of state governments in the presence of the GST Council, (4) increasing reliance on the non-sharable cesses and surcharges by the central government and (5) effective rejection of some of the welfare-oriented grants recommended by the 15th FC by postponing a clear-cut decision in the Action Taken Report (ATR) under the clause of *"under consideration".* In the context of fiscal consolidation, states' debt-GDP target was reduced unduly and theoretically inconsistently to 20 percent while increasing that for the Centre from 30 percent to 40 percent in the 2018 amendment of the Centre's FRBM. There is thus a need to re-examine these trends and consider measures by which these can be rectified. Data analysis in this paper is up to 2019-20, the pre-Covid year for which actuals are available.

[1] This paper is a revised version of an earlier presentation at the University of Calicut. This presentation was in the form of the Foundation Day Lecture which was organized by the University in honour of Professor M.A. Oommen's lifetime contribution to the field of fiscal decentralization and more broadly, fiscal federalism.

INDIA'S STAGNATING TAX-GDP RATIO

Managing public finances in any country especially a federal country becomes extremely challenging when the aggregate tax-GDP ratio shows a tendency to stagnate at an unduly low level. India's tax-GDP ratio considering centre and states together, has languished in the range of 16 percent to 18 percent since the late eighties. It reached a peak of 17.8 percent in 2007-08. It was at 17.6 percent in 2017-18 after which it steadily fell to 15.8 percent in 2019-20. Both centre's gross taxes and states' own taxes are responsible for this downward trend. The Centre is relatively more responsible because of the eroded revenue growth in the case of Corporate Income Tax (CIT) while in the case of GST, both centre and states are responsible for the fallen growth and buoyancy of revenues.

Chart 1: Tax-GDP Ratio: Combined, Centre and States (percent)



Source (basic data): MoSPI, RBI, IPFS, Union Budgets (various issues).

Under pressure from the falling tax revenues relative to GDP, both central and state governments have relied increasingly on non-GST indirect taxes. Thus, the central government has exploited its jurisdiction on petroleum taxes through the continuation of the union excise duties on selected petroleum products. Not only has the central government been increasing the rates of the central excise duties on these products but it has also increased the non-sharable component of these taxes. The share of non-sharable cesses and surcharges in total central taxes on petrol and diesel was 95.7 percent and 94.3 percent respectively as of 20 October 2021. States have also heavily relied on their VAT on petroleum products as well as on taxation of alcoholic beverages.

It is useful to place India's tax-GDP ratio in the perspective of a select group of benchmark countries including some of the emerging market economies. These are summarized in Table 1. Even in a country like Brazil, the tax GDP ratio is in the range of 29.4 percent to 33.2 percent. In advanced countries, of course, it is much higher. Amongst these advanced countries, it is the lowest for USA ranging between 23.5 percent to 28.3 percent. Even these low rates are much higher than those for India.

Table 1: Tax-GDP Ratio of Selected Countries (percent)

Countries	2000	2010	2015	2017	2018	2019
France	43.4	42.1	45.3	46.1	45.9	45.4
Italy	40.5	41.7	43.0	41.9	41.9	42.4
Germany	36.4	35.5	37.3	37.8	38.5	38.8
Canada	34.7	31.0	32.8	33.1	33.2	33.5
Brazil	29.4	33.2	32.0	32.3	33.2	33.1
UK	32.8	32.1	32.4	32.8	32.9	33.0
Japan	25.8	26.5	30.7	31.4	32.0	--
Australia	30.5	25.3	27.9	28.5	28.7	--
USA	28.3	23.5	26.2	26.7	24.4	24.5
India*	14.3	16.7	16.9	17.6	17.2	15.8

Source (basic data): OECD (https://data.oecd.org/tax/tax-revenue.htm), IPFS-Government of India and Union and States' Budget documents;
Note: *For India, data is with reference to fiscal year

GST: LOSS OF REVENUES AND REVENUE AUTONOMY FOR STATES

GST was implemented with effect from 1 July 2017, replacing selected subsets of the erstwhile central and state taxes. Major central taxes which were merged in the GST included (1) Union Excise Duties except those pertaining to specified petroleum products, (2) service tax, (3) Additional Duties of Excise, (4) Excise duty on Medicinal and Toiletries Preparation, (5) Special Additional Duties of Customs (CVD), (6) Additional Duties of Customs (SAD) and (7) selected Surcharges and Cesses. Major state taxes which were merged in the GST included (1) State VAT, (2) Entry Tax, (3) Entertainment Tax (Other than those levied by local bodies), (4) Hotel and Luxury Tax, (5) Central Sales Tax except on petroleum products, (6) Advertisement Tax, (7) Taxes on lottery, betting and gambling and (8) State Surcharges.

In respect of these merged taxes, the revenue autonomy that is, the autonomy of the entities levying the taxes to change their rates, classification schemes, deductions, exemptions etc., was effectively vested in the GST Council. This of course applied both to the central and state governments. However, the provisions pertaining to the GST Council and the dynamics of its working has largely implied that it is extremely difficult for any individual state to change any tax rate or other GST related provisions by itself. The weighting scheme and the voting pattern is such that the central government can almost always get its decisions implemented while no individual state can do so. As per Article 279(A) of the Constitution pertaining to the GST Council, the weight attached to the vote of the central government is 1/3 and that to the state governments/UTs is 2/3. Since the number of states and UTs that are members of the GST Council add to 31, individual state/UT accounts for 0.0215 that is 2.15 percent as compared to the centre's weight of 33.33 percent. These numbers are based on the assumption that all members of the GST Council are present and voting.

Further, it is provided that:

"Every decision of the Goods and Services Tax Council shall be taken at a meeting, by a majority of not less than three-fourths of the weighted votes of the members present and voting, in accordance with the following principles, namely:—

(a) the vote of the Central Government shall have a weightage of one-third of the total votes cast, and

(b) the votes of all the State Governments taken together shall have a weightage of two-thirds of the total votes cast, in that meeting."

Thus, even if all states join together, they will only have an aggregate vote of 66.66 percent. As such, states individually or together, cannot carry forward any GST reform on their own. Thus, effectively, centre has a veto power. On the other hand, if the states were to form a group in order to hold a centre's move, they will require a minimum of 12 votes. If we examine these provisions from the viewpoint of the centre, they will require the support of 19.4 states/UTs with legislature that is at least 20 states/UTs with legislature *(This is so because 1/3 + 20*2/3*1/31=0.33+0.43=0.76, thus crossing the 75 percent benchmark)*. This may prove to be an uphill task as long as there are 12 states/UTs forming governments by opposition parties provided they form a group. These provisions, therefore, make any reform to GST as compared to the original set of provisions, extremely difficult. This is why the GST Council keeps going by the rule of unanimity. But unanimity leads to agreement on lowest common denominators. Such agreement is usually arrived at when rates are lowered rather than increased or rationalized. Further, incremental changes may go through relatively more smoothly whereas major reforms which India's GST actually requires is very difficult to be carried forward. This explains why most GST rate revisions have been on the downward side as summarized in Table 8 in the section on Suggested next generation of reforms. That has become one of the major reasons as to why there has been a continuing erosion of revenue growth and buoyancy.

However, the recent Supreme Court ruling recognizes the primacy of Parliament and state legislatures in matters relating to GST including tax rate determination, clarifying that the central and state governments are not bound to accept the GST Council recommendations. In a recent landmark judgment dated 19 May 2022[2], originally with respect to a case relating to the levy of IGST on ocean freight, the Supreme Court ruled that the GST Council's recommendations are not binding on the Union government and states but would have a persuasive value. According to the ruling, considering the Council's recommendations as binding would disrupt fiscal federalism. As per Article 246(A)[3] of the Constitution, both the center and the states have simultaneous power to legislate on GST. In this context, the Supreme Court[4] noted that *"the recommendation of the GST Council made under Article 279(A)[5] is non-qualified. That is, there is no explanation on the value of such a recommendation. Yet the notion that the recommendations of the GST Council transform into legislation in and of themselves under Article 246(A) would be farfetched. If the GST Council was intended to be a decision-making authority whose recommendations transform to legislation, such a qualification would have been included in Articles 246A or 279A. Neither does Article 279A begin with a non-obstante clause nor does Article 246A provide that the legislative power is 'subject to' Article 279A."*

Apart from the loss of revenue autonomy, the states have also lost revenues. The growth of GST revenues and its buoyancy with respect to GDP at current prices indicates a massive erosion as compared

[2] Union of India & Anr. Vs M/s Mohit Minerals Pvt. Ltd.

[3] 246A. (1) Notwithstanding anything contained in articles 246 and 254, Parliament, and, subject to clause (2), the Legislature of every State, have power to make laws with respect to goods and services tax imposed by the Union or by such State.

[4] Noted while examining the nature of the recommendations of the GST Council as under the constitutional architecture of the GST.

[5] Constitutional Article on composition, voting mechanism and functions of the GST Council

to the pre-GST performance of the taxes merged in GST. As shown in Table 2, the growth of taxes merged in GST during 2014-15 to 2016-17 was 12.46 percent. This fell to 6.21 percent during 2017-18 to 2021-22. Correspondingly, the buoyancy of GST vis-à-vis. that of the merged taxes fell from 1.13 to 0.50 during this period (excluding 2020-21). These are comparisons based on GST performance excluding the GST compensation cess. Similar trends are seen even if we include the compensation cess as shown in Table 3.

Table 2: Assessing GST's Performance (Excluding GST Compensation Cess)

Year	Subsumed taxes/GST collections excluding GST Compensation cess	GST revenues		
		Growth	Buoyancy	Notes
2011-12	5,09,076			Pre-GST
2012-13	6,33,921	24.5	1.8	
2013-14	6,96,299	9.8	0.8	
2014-15	7,50,110	7.7	0.7	
2015-16	8,57,228	14.3	1.4	
2016-17	9,88,997	15.4	1.3	
2017-18	9,24,252	-6.5	-0.6	Part GST
2018-19	9,76,939	5.7	0.5	
2019-20	10,02,244	2.6	0.4	
2020-21	9,77,824	-2.4	--	Covid year
2021-22	12,88,296	31.8	1.6	
Average over FY18-FY22		**6.21**	**0.50***	
Average over FY15-FY17		**12.46**	**1.13**	
FY18-FY20 minus FY15-FY17		**-6.25**	**-0.37**	

Source: Respective state budgets, Union Budgets, CGA, RBI (State Finances: A study of state budgets

* Excludes the buoyancy for the COVID year of FY21 because of negative nominal growth and tax revenues

Notes: 1. State revenues include revenues of all states and Union Territories with legislature. For 2019-20 and 2020-21, SGST revenues for Jammu and Kashmir are estimated and included within the total SGST revenues.

2. Until 2018-19 SGST revenues have been sourced from RBI (State Finances: A study of state budgets). For 2019-20 onwards respective state budget data has been used.
3. For the centre's 2020-21 revenues, data has been sourced from the CGA

Table 3: Assessing GST's Performance (Including GST Compensation Cess)

Year	Subsumed taxes/GST collections including GST compensation cess	GDP growth	GST revenues		
			Growth in revenues	Buoyancy	Notes
2011-12	5,09,076				Pre-GST
2012-13	6,33,921	13.8	24.5	1.77	
2013-14	6,96,299	13.0	9.8	0.76	
2014-15	7,50,110	11.0	7.7	0.70	
2015-16	8,57,228	10.5	14.3	1.37	
2016-17	9,88,997	11.8	15.4	1.31	
2017-18	9,86,864	11.0	-0.2	-0.02	Part GST
2018-19	10,72,020	10.5	8.6	0.82	
2019-20	10,97,797	6.2	2.4	0.39	
2020-21	10,63,016	-1.4	-3.2	--	Covid year
2021-22	13,92,879	19.5	31.0	1.59	
Average over FY18-FY22			**7.74**	**0.69***	
Average over FY15-FY17			**12.46**	**1.13**	
FY18-FY20 *minus* FY15-FY17			**-4.72**	**-0.11**	

Source: Respective state budgets, Union Budgets, CGA, RBI (State Finances: A study of state budgets)

***** Excludes the buoyancy for the COVID year of FY21 because of negative nominal growth and tax revenues

Notes: 1. State revenues include revenues of all states and Union Territories with legislature. For 2019-20 and 2020-21, SGST revenues for Jammu and Kashmir are estimated and included within the total SGST revenues.

2. Until 2018-19 SGST revenues have been sourced from RBI (State Finances: A study of state budgets). For 2019-20 onwards respective state budget data has been used.

3. For the centre's 2020-21 revenues, data has been sourced from the CGA
4. GST compensation cess revenues by the centre have been included in the total revenues. However, borrowings by the centre in lieu of shortfall in GST compensation cess has been excluded.

Difficulties with the Compensation Mechanism

The compensation mechanism was designed to make up for some of the anticipated revenue loss to the so-called net producing states for a limited period. There have been many issues in the design and working of the compensation cess mechanism. The decision to finance it through an elaborate scheme of cesses defeated the very first objective of making the transition to GST which was to discontinue the erstwhile multiple cesses mainly on central taxes. The compensation cess mechanism worked by replacing one set of cesses by another and a larger one, which was also distortionary in some cases. One important example is the erstwhile Clean Energy Cess/Coal Cess which has been merged in the GST Compensation Cess. This defeated the very purpose of compensating the states that suffered the environmental hazards due to coal mining by the revenues of the Clean Energy Cess. Instead, now these revenues are to be shared amongst all the states that would be entitled for receiving the compensation according to the agreed formula. Thus, a targeted cess was replaced by a generalized revenue sharing device.

A second difficulty in the implementation of the cess pertained to its inadequate revenues. Thus, the agreed compensation at the rate of 14 percent growth on the 2015-16 base of the merged taxes could not be financed by the proceeds of the compensation cess. As per the 15th FC estimates, the total requirement for compensation would be INR7.10 lakh crore at the end of June 2022. At that point of time, they estimated the balance in the compensation fund at INR2.25 lakh crore. Therefore, they recommended the extension of the compensation cess up to 2025-26 in order to raise the balance amount of INR4.85 lakh crore. In order to finance these unpaid amounts, the GST Council will have to continue with the cess but not necessarily the compensation mechanism. Already, the GST Council has decided to extend the compensation cess up to March

2026[6] for financing the unpaid amounts for 2020-21 and 2021-22 including repayment and servicing of loans raised by the central government to pay due compensation as an interim measure.

If the compensation provisions are discontinued, a good number of states would suffer a major revenue shock. Some of the major losers in spite of the compensation mechanism have been Tamil Nadu, Kerala, Andhra Pradesh (Table 4).

Table 4: Perspective on State-Wise Gainers and Losers Under GST

State	Average share (percent) in SGST + state's share in IGST (2017-18 to 2019-20)	Share (percent) in taxes merged into GST (2015-16)	Excess of GST share (percent) over share in merged taxes
1	*2*	*3*	*4 = 2-3*
TN	7.63	11.43	**-3.8**
KL	4.02	5.62	**-1.6**
AP	4	5.11	**-1.1**
TS	4.5	5.18	**-0.68**
UK	0.9	1.14	**-0.25**
KA	8.12	8.34	**-0.22**
HP	0.68	0.89	**-0.21**
PY	0.13	0.32	**-0.19**
DL	3.81	3.97	**-0.17**
GJ	6.73	6.88	**-0.15**
GA	0.49	0.55	**-0.06**
PB	2.56	2.62	**-0.06**
JK	1.03	1.08	**-0.05**
HR	3.55	3.58	**-0.04**

Source (basic data): RBI (State Finances: A Study of Budgets 2020) for SGST revenues covering 2017-18 and 2018-19 and taxes merged into GST and respective state budget documents for data on SGST revenues for 2019-20.

[6] A notification for the extension of the levy of the GST compensation cess was issued by CBIC on 24 June 2022 (https://taxinformation.cbic.gov.in/view-pdf/1009408/ENG/Notifications).

The provision of the compensation mechanism itself became a reason for GST's underperformance. Having been guaranteed a minimum growth over a reasonably healthy baseline number, states had little incentive to optimize their tax effort in regard to SGST collections. Furthermore, collectively, they favoured frequent downward revisions of the GST rates. As highlighted in Table 8, many of the rate revisions involved placing goods in lower tax rate slabs. State governments readily agreed to it because downward rate revisions did not imply any revenue loss to their guaranteed amounts.

Even the central government had a weak incentive to keep the GST rates close to the originally calculated revenue-neutral rates. This is so because the GST compensation amount was being raised through a separate compensation cess mechanism. It was not to come out of their own budget as was the case in the pre-GST era provision for compensating the states for agreeing to a central sales tax rate at less than 4 percent. That mechanism did not work properly since at that time, the compensation amount had to come out of Centre's own resources.

The levy of numerous individual cesses that are included in the compensation cess mechanism has distorted the GST structure and has significantly reduced its expected efficiency benefits. In order to properly reform the GST system, the compensation cess mechanism will have to be discontinued as soon as possible. If the GST Council however decides to extend the cess for a limited period, say two years, it should also revise the base magnitude from 2015-16 levels to a more recent number. It should also lower the guaranteed growth number from the earlier 14 percent. This guaranteed growth may be fixed keeping in mind the actual growth of GST revenues since its introduction.

The GST Council, had in September 2021, set up a group of state ministers, headed by the Karnataka Chief Minister, to review the performance of GST revenues and suggest ways to augment it by rationalizing tax rates and considering merger of different tax slabs. This group submitted an interim report during the 47th GST Council meeting held on 28-29 June 2022. This meeting also discussed the recommendations of three other ministerial panels constituted in the following fields: a) movement of gold and precious stones, b) system reforms, and c) casinos, horse racing and online gaming. Based on the inputs provided by these panels, the Council recommended rate revisions to 42 items as shown in Table 9.

Completing the GST Reforms

Major goods that could not be included in the present GST include petroleum products, alcoholic liquor, real estate, electricity and agriculture. These items are of significant revenue importance both for the central and state governments. The continuation of taxation of these products outside of GST provides a limited degree of residual revenue autonomy both to the central and state governments. Given the lackluster performance of GST, neither the central government nor the state governments are in favour of including these under GST. Further reform of GST has become difficult because of its poor revenue performance. GST reforms appear to have entered into a gridlock which none of the participating governments are willing to break out of. In the section on suggested next generation of fiscal reforms, we have argued that there is only one way in which the GST reforms can be completed while ensuring revenue adequacy as well as revenue autonomy for the participating governments. This way is to integrate environmental and demerit taxes with the GST by including a non-rebatable cess in the GST scheme of taxation and giving a degree of autonomy for the participating governments to fix the rate of the cess.

VERTICAL DIMENSION: EFFECTIVE UNDOING OF THE 42 (41) PERCENT SHARE OF THE STATES

The 14th FC had recommended an increase in states' share in the sharable pool of central taxes from 32 percent to 42 percent. This increase was meant partly to make up for the discontinuation of plan grants. Partly however, the objective was to give greater emphasis to untied and unconditional transfers with a view to increasing the autonomy of the states. The 15th FC reduced it to 41 percent to account for the reduced number of states[7]. In practice however, central government adopted measures by which this move has almost been fully neutralized. The central government succeeded in this effort by progressively increasing the share of cesses and surcharges associated with the central taxes which have remained non-sharable (Table 5).

Table 5: Recommended and Effective Share of States in Sharable Central Revenues (percent): FC12 to FC15 (2)

Commission	Recommended share in divisible pool (percent)	Effective share in gross central taxes (percent)	Shortfall in effective share relative to recommended (percent points)	Share of cesses and surcharges# in centre's gross tax revenues (percent)
FC 12	30.5	25.9	-4.6	
FC 13	32.0	27.9	-4.1	9.6
FC 14	42.0	34.9	-7.1	12.8
FC 15 (1)	41.0	28.9	-12.1	23.8
FC 15 (2)	41.0	30.0*	-11.0*	20.5*

Source: Union Budget Documents, Reports of 12th-15th FCs.
Note: *pertains to data for one year namely, FY22 (BE); #excludes GST compensation cess.

Secondly, the central government increased the share of state's contribution in the centrally sponsored schemes (Table 6). Thirdly, the central government showed reluctance in accepting any Finance Commission recommended grants which were in addition to the revenue gap grants, the local body grants and the natural calamity related grants. The latest example of this pertains to the centre not accepting the

[7] With the enactment of the Jammu and Kashmir Reorganisation Act, 2019, the former state of Jammu and Kashmir has been reorganized as the new Union Territory of Jammu and Kashmir and the new Union Territory of Ladakh with effect from 31st October 2019. With this, there are 28 states and 3 UTs with legislature.

sector-specific and state specific grants as recommended by the 15th FC (Table 7).

Table 6: Funding pattern of the Centrally Sponsored Schemes: Before And After 2015

From 2015-16, the sharing pattern for expenditure on CSS between the Centre and States was changed from an average of 67:33 to an average of 60:40 for all Core schemes.

Source: Report on 'Development Expenditure in the States Post Fourteenth Finance Commission Award: An Assessment of the Centrally Sponsored Schemes', ICRIER, November 2018;
https://fincomindia.nic.in/writereaddata/html_en_files/fincom15/StudyReports/Development percent20Expenditure percent20in percent20the percent20States percent20post percent20FFC percent20award_An percent20assessment percent20of percent20the percent20Centrally percent20Sponsored percent20schemes.pdf

One implication for this erosion of the share of states from the recommended share of 42 percent/41 percent to an effective share in the range of 30 percent to 35 percent pertains to the devolution formula and the broad issue of targeting of transfers (Table 5). In the devolution formula, only broad indicators and dated data are used thereby compromising the quality of targeting. Greater share of grants in the overall transfers permits better targeting pertaining to sectors or segments of population. Given that sharing of central taxes will continue to cover a relatively larger portion of the Finance Commission transfers, there is a need to redesign the tax devolution formulae so as to increase the targeting content of this instrument of transfers to better reflect cost and need disabilities. This point is further considered in the section on suggested next generation of fiscal reforms.

Table 7: Relevant sections from the ATR of FC 15

<u>Grants to States for Specific Sectors</u>

18.The Commission has recommended providing grants to State Governments in eight different sectors, namely health, school education, higher education, agriculture, maintenance of PMGSY roads, aspirational districts and blocks, judiciary and statistics. The Commission has recommended providing grants to these sectors amounting to INR 1,29,987 crore during the five-year period of the award period.

19.The details of the sectoral grants for health to be provided through State Governments are contained in paras 9.52 to 9.67 of Chapter 9 of Volume-I of the Final Report. The details of these sectoral grants are contained in paras 10.31 to 10.92 of Chapter 10 of Volume-I of the Final Report.

Government will give due consideration to sectors identified by the Commission while formulating and implementing existing and new Centrally Sponsored and Central Sector Schemes.

<u>State Specific Grants</u>

20.The Commission has recommended State Specific Grants amounting to INR 49,599 crore over the award period of the Commission. These recommendations are contained in paras 10.117 to 10.125 including Table 10.11 and Annexes 10.9 and 10.10 in Chapter 10 of Volume-I of the Final Report.

Keeping in view the untied resources with the State Governments and the fiscal commitments of the Central Government, due consideration will be given to the above recommendation.

Source: Explanatory memorandum for 2021-26, Finance Commission, Government of India

HORIZONTAL DIMENSION: DESIGN OF FISCAL TRANSFERS

Historically, a relatively higher weight has been given to tax devolution as compared to grants as the principal channel of transfer. This is also preferred by the state governments since they consider funds received through this channel as unconditional and therefore autonomous for their allocative decisions. Share in central taxes rather than actual magnitudes also has the advantage of a built-in buoyancy. If central taxes perform better, there is an automatic upward adjustment when the transfer is routed through shares rather than fixed magnitudes as in the case of grants.

Determination of inter-state share of tax devolution in India has so far been based on broad criteria which do not permit refined targeting of funds amongst states. On the other hand, grants can be more finely targeted but recent developments in the context of intergovernmental fiscal relations imply that greater emphasis will have to be given to tax devolution formulae. Some of these developments may be noted below:

1. **80th amendment (2000, made effective from 1996):** 'Alternative Scheme of Devolution' as recommended by the Tenth FC accepted through this amendment. This scheme provided for sharing of proceeds of all central taxes except for cesses and surcharges and Article 268 and 269 taxes.
2. **92nd amendment (2003, effective from 1 April 2004):** enabled levy of service tax by the government and listed it under the Union List as Item 92C
3. **Fourteenth Finance Commission (2015-16)** increased the vertical share of states from 32 percent to 42 percent in one step.
4. **Discontinuation of plan grants (2016, effective from 2017-18)**
5. **101st amendment (2016):** Article 246A was added to the Constitution that allowed the Parliament and the state legislatures to

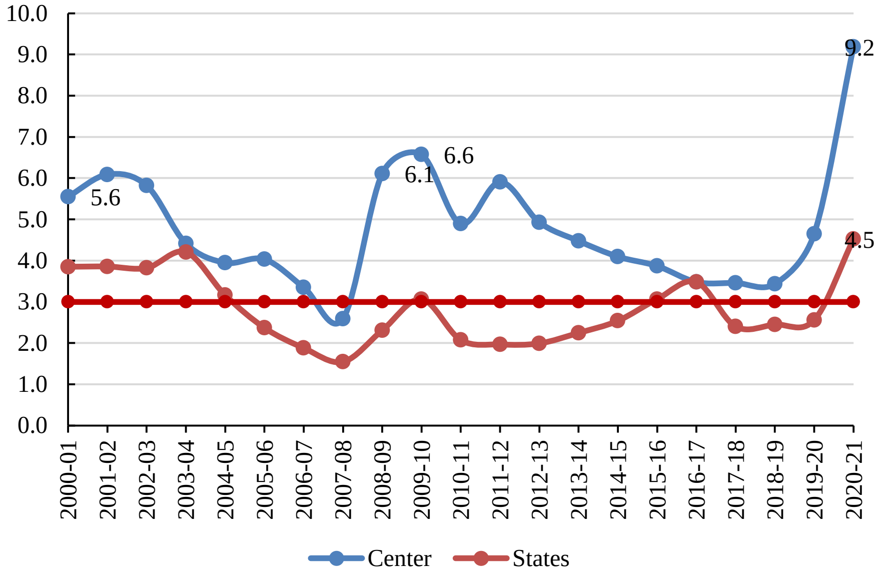
have concurrent powers to tax transactions of supply of goods and services. Parliament was conferred exclusive power to make laws with respect to goods and services tax where supply of goods and/or of services, or both take place in the course of inter-state trade or commerce.

We need therefore, to devise the 'next generation of devolution formulae' which can accommodate methods by which finer targeting of fiscal transfers to the states can be done so as to incorporate not only equity and efficiency considerations but also considerations reflecting cost and need disabilities. This subject is also considered briefly in the section of suggested next generation of fiscal reforms.

SLIPPAGE IN FISCAL CONSOLIDATION

In meeting their respective FRBM targets, states have proved to be far more successful compared to the central government. In fact, the central government was able to achieve the fiscal deficit target of 3 percent of GDP only once in 2007-08. Many state governments have contained their respective fiscal deficits relative to GSDP within the stipulated limits. States as an aggregate have met the 3 percent fiscal deficit target in many years during the last decade and a half (Chart 2).

Chart 2: Fiscal Deficit (+) Relative to GDP: Centre and States



Source: IPFS, Union Budget (various issues) and RBI.
Note: states' fiscal deficit for 2020-21 is as per the RE from RBI.

The 2018 amendment of Centre's FRBM although meant to correct many of the inadequacies of the erstwhile Act, itself suffered from a number of deficiencies and inadequacies. The key difficulties of this amendment can be summarized as below:

1. **Elimination of revenue deficit target:** Maintaining balance or surplus on revenue account is critical since it is linked to government sector dissavings[8]. For realizing India's potential growth, it is critical to maximize the overall savings rate, of which government's savings rate, pertaining to the savings of the administrative departments, is a critical component. The revenue deficit target was one of the primary objectives of centre's 2003 FRBMA. This target has been given up altogether in the latest amendment.

[8] For details see paragraph 4.13 of the Report of the Twelfth Finance Commission

2. **Inconsistent targets for debt and deficit for centre and states:** Maintaining a fiscal deficit target of 3 percent of GDP for both centre and states is inconsistent with targeting debt-GDP ratio at 40 percent for centre and 20 percent for states. Simulations indicate that they should both be equal if the fiscal deficit targets are equal. Charts 3 and 4 show that they would converge to an equal level if fiscal deficit to GDP ratios are equal and the nominal growth rate is common. In this example, the starting levels of the debt-GDP ratio relate to 2019-20 and the assumed nominal annual GDP growth rate is 12 percent. The fiscal deficit is assumed at 3 percent of GDP each for the centre and the states as specified in FRBM 2018. It is notable that states debt-GDP ratio increases to 28 percent by 2057-58 while the Centre's debt-GDP ratio reaches this level by 2077-78 because of its much higher level in 2020-21.

Chart 3: Centre's Debt-GDP Ratio

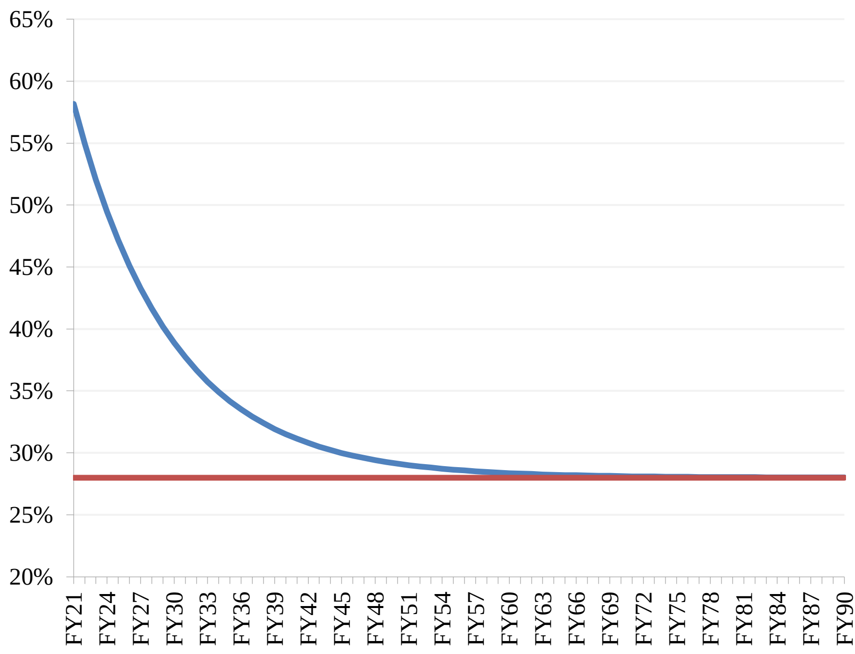
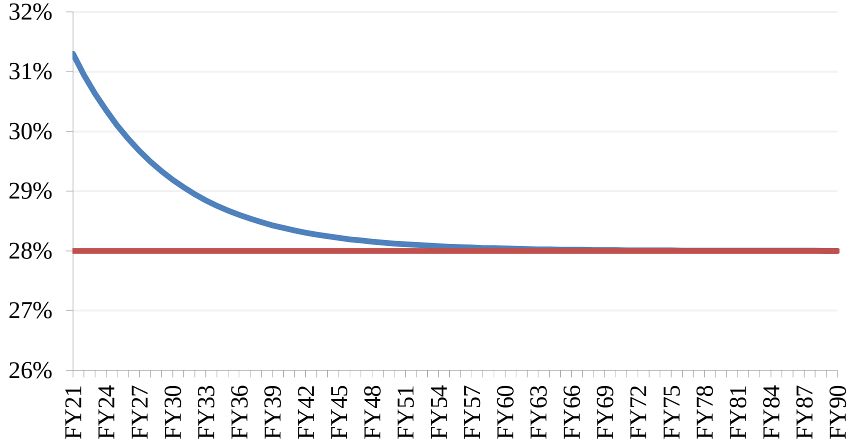


Chart 4: States Debt-GDP Ratio



Source: RBI, MOSPI, and author's estimates

Note: (1) Initial debt-GDP ratio is considered for 2020-21 at 58.2 percent for the centre and at 31.3 percent for the states.

(2) Centre's outstanding debt excludes accumulated inter-governmental net on-lending.

3. Inadequate Countercyclical Clauses

Centre's 2018 FRBMA has a provision for countercyclical measures. It provides for five conditions in which a departure from the operational fiscal deficit target of 3 percent of GDP can be made. These conditions relate to: (a) national security, (b) act of war, (c) national calamity, (d) collapse of agriculture severely affecting farm output and incomes and (e) structural reforms in the economy with unanticipated fiscal implications. The Act provides that if, as a result of one or more of the above conditions, there is a "…*decline in real output growth of a quarter by at least 3 percent points below its average of the previous four quarters…*", then fiscal deficit limit may be increased but this increase "*shall not exceed one half percent of the gross domestic product in a year*". The Covid-19 pandemic may be classified as a national calamity under clause (c) above. However, the real GDP growth had started declining in the pre-pandemic quarters. In fact, it declined progressively, quarter after quarter, from a peak of 8.9

percent in the fourth quarter of 2017-18 to 3.0 percent in the fourth quarter of 2019-20. Yet this rule of a departure of 0.5 percent points of GDP could not be invoked. Its conditions proved to be too impractical to capture the evolving situation. When it was invoked in 2019-20, the cited reason was '*structural reforms*' and the magnitude of actual departure became much larger than 0.5 percent points of GDP[9]. Further, in a pandemic kind of situation also, the magnitude of permitted departure proved to be too inadequate.

Covid-19 has thrown out of gear, all the projections not only of the NK Singh FRBM Review Committee, but also that of the 15th FC in regard to the path of debt and deficit of the central and state governments. But this has also created the occasion to review India's Fiscal Responsibility Frameworks so as to better serve the purpose of such frameworks which is to support growth while maintaining fiscal sustainability. We consider some of the relevant revisions in this regard in the section on suggested next generation of fiscal reforms. In fact, the 15th FC has itself recommended the setting up of a High-Powered Inter-governmental Group to review and recast the Centre's FRBMA.

SUGGESTED NEXT GENERATION OF REFORMS

Corresponding to the issues plaguing the working of India's public finances especially in the perspective of intergovernmental fiscal relations, it is worthwhile spending some time on considering suitable remedial measures. The issues that we have considered are all interlinked. As such, the remedial measures would also be interlinked.

The first issue pertains to the falling tax-GDP ratio. It is this feature that has led to the heavy reliance on petroleum taxation and the uncontrolled rise of retail prices of petroleum products. It is also one of the reasons why centre has relied more and more on non-sharable cesses and

[9] Centre's fiscal deficit was budgeted at 3.5 percent of GDP for 2019-20. The actual fiscal deficit relative to GDP was at 4.6 percent.

surcharges. Even in the pre-Covid years, the CIT reforms had led to a massive fall in central tax revenues in 2019-20. Soon after, we were hit by Covid-19. It is only now that we may be able to ascertain whether the downward revenue impact of CIT rate reduction will outweigh any upward increase in the CIT tax base. We may have a better idea in a year or two. If the rate reduction impact proves to be stronger than the base increase impact of the CIT reforms, there would eventually be a need to increase the CIT rates again even if we do not take these back to the old levels.

The main issue however pertains to GST's revenue underperformance. The artificial attempt to seek unanimity in the GST Council decisions has led over time, to all participants agreeing to the lowest common denominators. As such, in the long list of GST rate revisions, the overwhelming portion pertains to the lowering of the GST rates. As the rates are lowered, the revenue performance also gets compromised if the base increasing effect is overtaken by the revenue reducing impact of the rate reduction. In Table 8, we highlight that in 46 GST Council meetings held up to 31 December 2021, 577 rate revisions were undertaken and a very large number of these rate revisions involved lowering the tax rate from a higher to a lower level. The instances where rates were lowered amount to 559 out of the 577 changes.

Table 8: List of GST Rate Revisions: First to 45th GST Council Meetings

Change in GST rate(s)	First to Twelfth revision till Tenth revision 39th GST council meeting on 14 March 2020	Thirteenth revision 42nd GST council meeting held on 5 October 2020	Fourteenth revision 43rd GST council meeting held on 28 May 2021	Fifteenth revision 44th GST council meeting held on 27 June 2021	Sixteenth revision 45th GST council meeting held on 17 September 2021	Seventeenth revision, 18 Nov 2021 and 46th GST council meeting held on 31 December 2021	Total
28 % to 18 %, 12 %, 5 %, 0 %, Nil	277	0	0	1	0	0	278
18 % to 12 %, 5 %, 0 %, Nil	119	0	1	3	1	0	124
12 % to 5 %, 0 %, Nil	69	0	1	11	10	0	91
8 % to 1 %	1	0	0	0	0	0	1
5 % to 0 %, Nil	24	0	0	2	0	0	26
Applicable rate to 3 %	2	0	0	0	0	0	2
3 % to 0.25 %, 0 %, Nil	5	0	0	0	0	0	5
Exemption	6	1	20*	0	0	0	7
15 %[1] to 1 %, 3 %	2	0	0	0	0	0	2
Total items with lower GST rates	**505**	**1**	**22**	**18#**	**13^**	**0**	**559**
Total items with higher GST rates	**10**	**0**	**0**	**0**	**7**	**1**	**18**
Total items affected	**515**	**1**	**22**	**18**	**20**	**1**	**577**

Source: GSTN

Notes: * These 20 items were exempted from IGST on imports even if imported on payment basis. Earlier on 03 May 2021, these had been exempted if imported on free of cost basis for free distribution

Includes a category of items whose GST rates are reduced to 5 % from upon the recommendation of MoHFW and Dep of Pharma

^includes a) retro fitment kits for vehicles used by the disabled whose rate was reduced to 5 % from more the applicable rate as per PIB PR dated 17 Sep 2021 and b) IGST exemption on goods supplied at Indo-Bangladesh Border haats

1- Rate of GST compensation cess

In its 47th meeting, the GST council, for the first time, initiated a concerted effort to increase the GST rates on a list of selected goods and services based on the recommendations of the Group of Ministers on GST Rate Rationalization. The rate revisions included a) rate increases on 21 goods/services (excluding withdrawal of exemptions), b) withdrawal of complete exemption on 15 goods/services and c) reduction in rates of 6 goods/services. Most of the upward rate revisions were undertaken with the objective of correcting the still continuing inverted duty structures. These rate revisions along with compliance improving measures are expected to have an annual revenue impact of over INR 15,000 crores after netting out INR 2000-3000 crore due to downward rate revisions and refunds. The new rates are to be applicable from 18 July 2022. The GoM has been asked to submit a more comprehensive scheme of rate rationalization after deliberating on the matter in the next three months.

Table 9: Number of Goods and Services with Changes to GST Rate in the 47th GST Council Meeting

Decrease in rate		Increase in rate		Complete exemptions to be withdrawn	
Rate	**Number of items**	**Rate**	**Number of items**	**Rate**	**Number of items**
12% to 5%	2	5% to 12%	7	0% to 18%	2
18% to 5%	1	5% to 18%	3	0% to 12%	3
18% to 12%	1	5% to applicable rate	1	0% to 5%	2
5% to Nil	1	12% to 18%	9	0% to applicable rate	8
Various applicable rates to Nil	1	0.25% to 1.5%	1	**Total**	**15**
Total	**6**	**Total**	**21**	**Overall total**	**42**

Source: PIB release dated 30 June 2022.

India's GST requires to be reformed and brought closer to the original intent and design. These reforms will remain incomplete as long as important economic activities remain outside of GST. We had noted the important exclusions as pertaining to petroleum products and alcoholic beverages. The proportion of tax revenues from petroleum products and alcoholic beverages to GST revenues excluding compensation cess amounted to 77.9 percent in 2020-21 and 66.5 percent in 2021-22 (Table 10). Real estate, electricity and agricultural products also remain outside the purview of GST.

Table 10: Taxes on Petroleum Products and Alcoholic Beverages Relative to GST Revenues (Taxes Merged in GST in the pre-GST Years)

Year	Including GST compensation cess	Excluding GST compensation cess
(1)	*(2)*	*(3)*
2011-12	49.1	Same as in Column *(2)*
2012-13	45.3	
2013-14	43.5	
2014-15	45.5	
2015-16	50.9	
2016-17	53.1	
2017-18	56.3	60.1
2018-19	54.3	59.6
2019-20	54.7	59.9
2020-21	71.6	77.9
2021-22	61.5	66.5

Source: Respective state budgets, Union Budgets, CGA, RBI (State Finances: A study of state budgets)

Given the revenue importance of these exclusions, neither the central nor the state governments are likely to vote in favour of including these products in GST due to the need for maintaining a degree of revenue autonomy. The only way in which GST can be reformed and made fully or near-fully comprehensive is to ensure that all participating governments have adequate revenue autonomy. For this purpose, one clear way out and perhaps the only way out, is to incorporate the idea of integrating environmental taxes in GST through the mechanism of a non-rebatable cess on polluting and demerit inputs and outputs. We had earlier conducted relevant studies and also presented our findings to the 13th Finance Commission and the Commission on Centre-State Relations (Puncchi Commission). In their respective reports, they had emphatically endorsed this idea.

Para 5.28 of the FC 13 Report - 2010

"The taxation of petroleum products and natural gas would be rationalised by including them in the tax base. HSD, MS, and ATF could be charged GST and an additional levy by both the Central and State Governments. No input credit would be available against either CGST or SGST on the additional levy. A similar treatment would be provided to alcohol and tobacco. Such an arrangement would ensure protection of existing revenues while taking care of environmental concerns."

Para 9.5.02 of the Report of the Commission on Centre-State Relations (Volume III) - 2010

"In view of the dire need to arrest environmental degradation it is necessary to integrate environmental considerations within the framework of GST. Environmental taxes act as an indirect mechanism to control pollution and are likely to induce appropriate environmental decisions. We therefore recommend that polluting inputs and outputs may be subjected to a special non-rebatable levy by both the Centre and the States. In addition, petroleum products alcoholic beverages and tobacco products may also be subjected to a non-rebatable levy"

This reform can not only serve the purpose of restoring revenue buoyancy but also protecting revenue autonomy. This is so because the GST core rate may be fixed at a suitable level, but it is the non-rebatable cess which can be calibrated with upward and downward adjustments. Both centre and states may be given a flexibility in determining the applicable rate of cess in their respective jurisdictions. This would ensure revenue autonomy.

It is up to the GST Council to work on the future of both, the GST and the GST compensation cess. Since the number of losing states in spite of the compensation is quite large, there is demand for the continuation of the compensation mechanism beyond June 2022. The central government may be opposed to continuation of the compensation mechanism except for financing the arrears for which the compensation cess has already been extended up to 31 March 2026. However, if the compensation cess mechanism is continued, critical issues relate to (a) determination of the rate of growth in revenues that is to be applied on the base year revenues and b) determination of the base year and c) the duration of continuation of the compensation. The Council may choose to redetermine the base in 2021-22 since 14 percent proved to be quite unrealistic. In addition, the Council may also choose to apply a growth rate which is lower than 14 percent after June 2022. Whatever may be the final choice, the outcome of any extension of the compensation mechanism would involve continuation of the long list of compensation cesses, which the Council may even choose to increase. As long as this continues, the GST reform would remain incomplete and distorted. Already, the GST Council has decided to extend the compensation cess up to March 2026 only for repayment and servicing of loans raised by the central government to pay due compensation to states as an interim measure.

In the context of redesigning fiscal transfers, we now have to contemplate on developing a new generation of tax devolution formulae which would permit better degree of targeting of resources to achieve goals of equity and efficiency etc. Debates about using dated population data, floors and ceilings in the case of area criterion, the relevance of incentive-based revenue sharing have so far led to a scheme of devolution based on a very narrow set of information. It is time to develop a framework incorporating a larger information set as also the development of weighting schemes which are far more scientific and rational. Instead of thinking of individual criterion, it would be better to think of groups of criteria and then carry out a two-stage aggregation through suitable weighting schemes. In terms of the framework, the following groups of criteria may be considered as a starting point.

(1) Population based group of revenue sharing criteria

(a) Latest available census-based total population

(b) Using deprived segments of population in the criterion

- Scheduled tribes
- Scheduled castes
- Population of aspirational districts
- Relative size of young and old population
- Differential weighting for net migration (floating vs. resident population)

(c) Methods of relative weighting and aggregation within the population-group criteria

(2) *Area based group of revenue sharing criteria*

(a) Actual area

(b) Graded area approach: floors and ceilings

(c) Cost and need constrained area segments

- Forests
- Coastal areas
- Hilly areas
- International boundaries
- Share of glaciers and climate-challenged areas

(3) *Fiscal capacity group of revenue sharing criteria*

(a) Actual per capita GSDP

(b) Censored per-capita GSDP

(c) Linear and convex formulae

(d) Broader indicators of fiscal capacity as compared to per capita GSDP

- Per-capita consumption expenditure, incorporation of remittances
- Measures of intra-state disparity

(4) *Incentive based group of revenue sharing criteria*

(a) Index of fiscal discipline
(b) Index of tax effort
(c) Index of expenditure efficiency
(d) Index of infrastructure
(e) Index of prioritization of climate financing

The criteria suggested above can all be measured through either census-based available data or data derived from other reliable sources. Individual criteria within each group can be given different weights to reflect their priorities and then the group indices can be again given differentiated weights so as to determine the share of individual states. Such a procedure would enable capturing cost and need disabilities as well as differences in fiscal capacity in a more refined way than the present set of broad-based criteria wherein it is difficult to finetune the allocation of sharable central taxes.

States like Kerala and Uttarakhand are currently bearing the brunt of ignoring environmental considerations in policy regimes for long. The cost of postponing climate change related initiatives is only going to increase progressively. Some states are bound to suffer more than the others. It is the responsibility of those who manage intergovernmental fiscal relations such as the Finance Commission and the GST Council to bring upfront, considerations of climate budgeting and financing and adjusting our taxation and expenditure regimes to cater to the climate-related needs.

In the context of the vertical share, it would be ideal to make adjustments so as to convince both the central and the state governments. The central government may be protected by fixing the upper limit of state's share in the sharable pool of central taxes in the Constitution itself. The state governments may be protected by fixing also within the Constitution, the duration and the limit of revenues to be raised from the central cesses and surcharges as a proportion of centre's gross tax revenue. The centre may still choose to levy cesses and surcharges as needed, but if the revenues from these exceed the constitutionally determined limit, this excess should be shared with the states.

In the context of fiscal consolidation as suggested by the 15th FC, a High-Powered Intergovernmental Group may be constituted shortly to consider this matter. In a recent contribution[10], we have suggested amendments to centre's FRBM. The main suggestions of our proposed changes are summarized below:

(1) The new FRBMA should bring back revenue account balance as a key target for both central and state governments.
(2) There is a case to consider the need for introducing asymmetric targets for fiscal deficit and correspondingly for debt relative to GDP for the central government vis-à-vis. the state governments. Centre's fiscal deficit and debt may be kept at somewhat higher levels in the current circumstances of the Indian economy given the macro stabilizing role that the centre undertakes and the need to build infrastructure in the next five years or so. We may consider a combination of 40 percent of debt-GDP ratio and 4 percent of fiscal deficit to GDP ratio for the centre and 30 percent of debt-GDP ratio and 3 percent of fiscal deficit-GDP ratio for the states considered together. These are stable combinations at a nominal GDP growth rate of 11 percent. Together, the debt-GDP ratio target can be increased to 70 percent. It may be noted that for the last 30 years, the combined debt-GDP ratio of the central and state governments in India has remained close to 70 percent with some patches where inter-year variations were relatively larger.

[10] Srivastava, D.K., Bharadwaj, M., Kapur, T., & Trehan, R. (2021). Covid's Economic Impact: Should India Recast its Fiscal and Monetary Policy Frameworks?: Journal of International Economics and Finance. 1(1), 53-71.

(3) State governments should be given a specific macro stabilization role particularly for agricultural cycles which may be handled by establishing an *Agricultural Cycle Stabilization Fund (ACSF).*

(4) Non-agricultural cycles should be handled by a rule-based flexibility of 1 percent point of GDP in centre's fiscal deficit wherein there should be a mechanism for ensuring that departures of fiscal deficit from its average target are followed symmetrically in cyclical upturns and downturns so that the debt-GDP ratio remains stable and sustainable.

(5) The effective interest rate shows a noticeable downward trend, falling from a peak of 8.8 percent in 2001-02 to 7.1 percent in 2019-20. This indicates that in India also, as in many other countries, the nominal interest rate at which governments borrow has been falling over time. The product of the combined debt-GDP ratio and the effective interest rate gives the interest payments as a percentage of GDP (IP/GDP). Considering the current FRBM combined debt target of 60 percent of GDP, the corresponding IP/GDP ratio is 4.2 percent if the effective interest rate is 7.0 percent. With an expected fall in the effective interest rate to nearly 6 percent, the combined debt-GDP target can be uplifted to 70.0 percent while maintaining the IP/GDP ratio at 4.2 percent. At the current juncture, because of global crude price trends and comparatively high inflation levels, interest rates have come under pressure again. In India also, government borrowing cost may temporarily increase. However, we expect that once the global situation affecting crude prices normalizes, there would soon be a reversion towards the long-term trend of a falling effective nominal interest rate.

(6) For dealing with wars, emergencies and pandemic-kind situations, greater flexibility can be allowed depending on the prevailing economic situation. This should be monitored by an independent *Fiscal and Monetary Policy Coordination Committee* which may also guide policy coordination.

CONCLUDING OBSERVATIONS

India has seen a spate of fiscal reforms in recent years with significant implications in the working of intergovernmental fiscal relations. Some of these pertained only to the central government such as the reforms of the CIT but even this affected the flow of funds to the subnational governments. We have discussed in this paper, the revenue and other implications of some of the major events such as GST, changes in the vertical share of states in centre's gross taxes and slippage in fiscal consolidation. One summary outcome of these events some of which may have also adversely affected GDP growth has been the stagnation and erosion in recent years, of India's tax-GDP ratio, which has languished in the range of 16-18 percent since the late eighties. This stagnation has made the task of achieving fiscal consolidation difficult and challenging. In the meanwhile, a number of developments in the context of fiscal transfers has implied that there is a need to relook at both the vertical and horizontal dimensions of fiscal transfers. The vertical dimension is important because the central government has over time, attempted to dilute the impact of the 42 percent/41 percent share of states in centre's gross tax revenues by increasing the share of cesses and surcharges which are not sharable. The objective of fiscal consolidation has been achieved so far more in breach than in satisfaction. In fact, the combined debt-GDP ratio of the central and state governments in India has exceeded 90 percent in the aftermath of Covid[11]. The 2018 amendment to the FRBM had many characteristics whose utility and validity are doubtful.

Accordingly, there is a need to rethink the vertical and horizontal dimensions of fiscal transfers within the overall theme of role of fiscal

---

[11] D. K. Srivastava, Muralikrishna Bharadwaj, Tarrung Kapur, and Ragini Trehan (2021), 'Sustainability of Government debt in India: post-Covid prospects', published in Journal of Advanced Studies in Finance, Volume XII, Summer, 1(23): 51 - 62. DOI: 10.14505/jasf.v12.1(23).05

policy in supporting growth. In our framework of suggested next generation of fiscal reforms, the following may be highlighted:

(1) For augmenting the tax-GDP ratio, apart from completing the GST reforms, there may be a need to review the revenue impact of the CIT rate revisions undertaken in 2019 with a view to ensuring that eventually the corporate tax base responds in a manner that eventually leads to an augmentation of CIT revenues relative to GDP.

(2) With respect to GST, rates should be re-rationalised going back to a simple rate structure of 2 rates and a non-rebatable cess on demerit and polluting goods. This will permit inclusion of taxation of petroleum products, alcoholic liquor and electricity within the framework of GST. This would also improve revenue buoyancy and provide the needed revenue autonomy both to central and state governments. It is imperative that environmental taxes are integrated into GST. In order to improve the quality of analysis of GST performance, there should be a more open and prompter sharing of GST database and related information. In the context of the discussion on whether the compensation cess arrangement should be continued beyond June 2022, in our assessment, with a view to considering the case of the states that may continue to suffer net losses even after undertaking rate rationalization, there is a case for a temporary extension of the compensation cess arrangement for a period of say, two years after adjusting the assured growth of 14% so that this is more in line with the current GST revenue growth. According to available information, 16 states suggested continuation of the compensation cess arrangement in the 47th GST Council meeting.

(3) States like Kerala and Uttarakhand are currently bearing the brunt of ignoring environmental considerations in policy regimes for long. The cost of postponing climate change related initiatives is only going to increase progressively. Some states are bound to suffer more than

the others. It is the responsibility of those who manage intergovernmental fiscal relations such as the Finance Commission and the GST Council to bring upfront, considerations of climate budgeting and financing and adjusting our taxation and expenditure regimes to cater to the climate-related needs.

(4) With respect to fiscal transfers from the centre to states, there is now a need to develop a new generation of tax devolution formulae which would permit better degree of targeting of resources to achieve goals of equity and efficiency. This framework should incorporate a much larger information set and aim to develop weighting schemes which are far more scientific and rational. Instead of thinking of individual criterion, it would be better to think of groups of criteria and then carry out a two-stage aggregation through suitable weighting schemes.

(5) In the context of the vertical share, it would be ideal to make adjustments so as to convince both the central and the state governments. The central government may be protected by fixing the upper limit of state's share in the sharable pool of central taxes in the Constitution itself. The state governments may be protected by fixing also within the Constitution, the duration and the limit of revenues to be raised from the central cesses and surcharges as a proportion of centre's gross tax revenue. The centre may still choose to levy cesses and surcharges as needed, but if the revenues from these exceed the constitutionally determined limit, this excess should be shared with the states.

(6) In regard to fiscal consolidation, it is important to undertake the following reforms:

(a) The new FRBMA should bring back revenue account balance as a key target for both central and state governments.

(b) There is a case to consider the need for introducing asymmetric targets for fiscal deficit and correspondingly for debt relative to GDP for the central government vis-à-vis. the state governments. Centre's fiscal deficit and debt may be kept at somewhat higher levels in the current circumstances of the Indian economy given the macro stabilizing role that the centre undertakes and the need to build infrastructure in the next five years or so. We may consider a combination of 40 percent of debt-GDP ratio and 4 percent of fiscal deficit to GDP ratio for the centre and 30 percent of debt-GDP ratio and 3 percent of fiscal deficit-GDP ratio for the states considered together. These are stable combinations at a nominal growth rate of 11 percent. Together, the debt-GDP ratio target can be increased to 70 percent.

(c) State governments should be given a specific macro stabilization role particularly for agricultural cycles which may be handled by establishing an *Agricultural Cycle Stabilization Fund (ACSF).*

(d) Non-agricultural cycles should be handled by a rule-based flexibility of 1 percent point of GDP in centre's fiscal deficit wherein there should be a mechanism for ensuring that departures of fiscal deficit from its average target are followed symmetrically in cyclical upturns and downturns so that the debt-GDP ratio remains stable and sustainable.

(e) The effective interest rate shows a noticeable downward trend, falling from a peak of 8.8 percent in 2001-02 to 7.1 percent in 2019-20. This indicates that in India also, as in many other countries, the nominal interest rate at which governments borrow has been falling over time. The product of the combined debt-GDP ratio and the effective interest rate gives the interest payments as a percentage of GDP (IP/GDP). Considering the current FRBM combined debt target of 60 percent of GDP, the corresponding IP/GDP ratio is 4.2 percent if the effective interest rate is 7.0 percent. With an expected fall in the effective interest rate to nearly 6 percent, the combined debt-GDP target can be uplifted to 70.0 percent while maintaining the IP/GDP ratio at 4.2

percent. At the current juncture, because of global crude price trends and comparatively high inflation levels, interest rates have come under pressure again including in India. However, we expect that there would soon be a reversion towards the long-term trend of a falling effective nominal interest rate.

(f) For dealing with wars, emergencies and pandemic-kind situations, greater flexibility can be allowed depending on the prevailing economic situation. This should be monitored by an independent *Fiscal and Monetary Policy Coordination Committee* which may also guide policy coordination.

REFERENCES

Srivastava, D. K., and K.S. Kavi Kumar (2012), "Integrating Eco-taxes in the Goods and Services Tax Regime in India", Madras School of Economics.

Srivastava, D. K., and Kumar, K. K. (Eds.) (2014), Environment and fiscal reforms in India. SAGE Publications India.

Report of the Thirteenth and Fifteenth Finance Commissions; https://fincomindia.nic.in/ShowContentOne.aspx?id=9andSection=1

Report of the Commission on Centre-State Relations (Volume III on Centre-State Financial Relations and Planning; http://interstatecouncil.nic.in/wp-content/uploads/2015/06/volume3.pdf

Srivastava, D. K. (2021), Fiscal consolidation and FRBM in the COVID-19 context: Fifteenth finance commission and beyond. Economic and Political Weekly, 48-55.

Designing and Implementing Equalization Transfers in India (2019), presented at the EY-MSE Roundtable on 'Fiscal Federalism in India: Contemporary Perspectives' held on 22-23 February.

Rangarajan, C., and D.K. Srivastava (2011), Federalism and Fiscal Transfers in India, OUP Catalogue.

Rangarajan, C., and D.K. Srivastava (2008), Reforming India's Fiscal Transfer System: Resolving Vertical and Horizontal Imbalances, Economic and Political Weekly: 47-60.

Srivastava, D.K. and Pawan K. Aggarwal (1995), Revenue Sharing in Developing Countries: Role of Population in Criteria-Based Transfers, National Institute of Public Finance and Policy.

Srivastava, D.K. (2006), Equalizing Health and Education: Approach of the Twelfth Finance Commission, Working Paper 8, Madras School of Economics.

Srivastava, D.K., M. Bharadwaj, T. Kapur and R.Trehan (2021), Covid's Economic Impact: Should India Recast its Fiscal and Monetary Policy Frameworks?", Journal of International Economics and Finance 1(1), 53-71.

RBI Occasional Papers (2019), Fiscal Rules and Cyclicality of Fiscal Policy: Evidence from Indian States. 40 (2):2019; https://www.rbi.org.in/Scripts/bs_viewcontent.aspx?Id=3841#AP1

FRBM Review Committee Report (2017), Responsible Growth: A Debt and Fiscal Framework for 21st Century India, January https://dea.gov.in/sites/default/files/Volume percent201 percent20FRBM percent20Review percent20Committee percent20Report.pdf

Fiscal Rules and Cyclicality of Fiscal Policy (2019), "Evidence from Indian States", RBI Occasional Papers 40(2), 2019; https://www.rbi.org.in/Scripts/bs_viewcontent.aspx?Id=3841#AP1

Oommen, M. A. (2021), Local Governments in the Fiscal Space of Indian Federalism: Towards More Rational Arrangements; Occasional Papers, Centre for Development Studies[12].

[12] Available at http://14.139.171.199:8080/xmlui/handle/123456789/495

Oommen, M. A. (2013), The Third Tier and The Fourteenth Finance Commission, Economic and Political Weekly, 15-18.

Oommen, M. A. (2020), Fiscal Decentralisation to Local Governments in India, United Kingdom: Cambridge Scholars Publishing.

MSE Monographs

- * Monograph 34/2015
  Farm Production Diversity, Household Dietary Diversity and Women's BMI: A Study of Rural Indian Farm Households
  Brinda Viswanathan
- * Monograph 35/2016
  Valuation of Coastal and Marine Ecosystem Services in India: Macro Assessment
  K. S. Kavi Kumar, Lavanya Ravikanth Anneboina, Ramachandra Bhatta, P. Naren, Megha Nath, Abhijit Sharan, Pranab Mukhopadhyay, Santadas Ghosh, Vanessa da Costa and Sulochana Pednekar
- * Monograph 36/2017
  Underlying Drivers of India's Potential Growth
  C.Rangarajan and D.K. Srivastava
- * Monograph 37/2018
  India: The Need for Good Macro Policies *(4th Dr. Raja J. Chelliah Memorial Lecture)*
  Ashok K. Lahiri
- * Monograph 38/2018
  Finances of Tamil Nadu Government
  K R Shanmugam
- * Monograph 39/2018
  Growth Dynamics of Tamil Nadu Economy
  K R Shanmugam
- * Monograph 40/2018
  Goods and Services Tax: Revenue Implications and RNR for Tamil Nadu
  D.K. Srivastava, K.R. Shanmugam
- * Monograph 41/2018
  Medium Term Macro Econometric Model of the Indian Economy
  D.K. Srivastava, K.R. Shanmugam
- * Monograph 42/2018
  A Macro-Econometric Model of the Indian Economy Based on Quarterly Data
  D.K. Srivastava
- * Monograph 43/2019
  The Evolving GST
  Indira Rajaraman

MSE Working Papers
Recent Issues

* Working Paper 213/2022
  Potential Inequities in Covid -19 vaccinations
  Brijesh C Purohit
* Working Paper 214/2022
  Predicting Power of Ticker Search Volume in Indian Stock Market
  Ishani Chaudhuri and Parthajit Kayal
* Working Paper 215/2022
  How Much Does Volatility Influence Stock Market Returns? – Empirical Evidence from India
  Malvika Saraf and Parthajit Kayal
* Working Paper 216/2022
  Multiple Dimensions of Cyclicality in Investing
  Thillaikkoothan Palanichamy and Parthajit Kayal
* Working Paper 217/2022
  Socio-Economic Factors and Conflicts in North-Eastern Region of India
  Nabeel Asharaf and Brinda Viswanathan
* Working Paper 218/2022
  Political Concentration, Religious Diversity and Human Development: Evidence from Indian
  Shrabani Mukherjee and Vivek Sharadadevi Jadhav
* Working Paper 219/2022
  Outcome of FPTP in Diversified Society: Evidence on Disproportionality from Loksabha Constituencies
  Vivek Jadhav
* Working Paper 220/2022
  Medium-term Projections of Vehicle Ownership, Energy Demand and Vehicular Emissions in India
  B. Ajay Krishna
* Working Paper 221/2022
  Evolving Issues and Future Directions in GST Reform in India
  M. Govinda Rao

---

* Working papers are downloadable from MSE website http://www.mse.ac.in
$ Restricted circulation