

Federalism and the Goods and Services Tax*

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After a recent meeting of the Empowered Committee of Finance Ministers, Arun Jaitley announced that barring Tamilnadu all other state governments had favoured the introduction of the Goods and Services Tax (GST). What he meant by that remark was not clear. But if he meant that all other state governments had approved the proposal for a uniform Central Goods and Services Tax (CGST) and a uniform State Goods and Services Tax (SGST) to replace, respectively, the current array of central and state indirect taxes, then this is a most unfortunate development, for the GST proposal constitutes a blow against the federal nature of the Indian polity.

This aspect oddly has scarcely been discussed, all attention being focused on whether the states will be better or worse off in terms of revenue, compared to their present situation. And here the Centre has promised to make good any revenue loss for a period of three years. The real point however is not revenue loss compared to the present situation, but the constitutional powers of the state governments. It is these powers that the proposed GST is threatening to abrogate.

The essence of a federal polity is that different political parties can hold power in different states and at the Centre, and they should be able to pursue their different programmes in keeping with their divergent ideologies. For doing so, however they should have the freedom to pursue their preferred fiscal policies: while some may provide incentives to corporate capital to invest in the state, others may raise their tax rates to garner larger revenue for undertaking more welfare expenditure; while some may enforce complete prohibition, thereby losing revenue for the sake of pursuing what they believe to be a laudable objective, others may use this very source for raising revenue for what they consider worthwhile programmes.

No doubt the revenue sources available to state governments are limited; they are dominated by the sales tax which fetches close to 80 percent of the revenues for most states. But in the matter of sales tax rates, the states did have a degree of freedom. The Value Added Tax tried to reduce that freedom, but it did not tie the states down to one uniform rate for all goods and all states. This is what the Goods and Services Tax proposes to do.

Once it is introduced, the state governments will have no freedom to decide on the rates at which they choose to tax commodities. (If they wish to raise some rate, they would have to approach the GST council where theirs will be only one voice among many, and hence likely to be quite inconsequential). With a uniform GST, and Fiscal Responsibility legislation restricting the size of their fiscal deficits, the freedom of state governments to pursue divergent economic trajectories will be greatly curtailed for the following simple reason.

The base level of resources available to a state government will be more or less pre-determined and non-augmentable. And as the tax rates will be given, the only option before them for obtaining larger revenue would be to expand the tax base; and for doing so, in a situation where loss of freedom to raise tax rates has reduced the scope for augmenting public investment, they would perforce invite private corporate capital

to set up plants in their states to expand the level of activity. The “Gujarat Model” of inviting corporate investment and using the available resources for doing so, while foregoing welfare expenditure, would have got generalized, not because it embodies superior wisdom in any way, but because the coercion of a uniform GST would have ruled out any other trajectory.

The point I am making about GST being a blow against federalism and hence against the position of the Left which has always stood for greater devolution of resources and powers, and hence freedom with regard to the economic trajectory to follow, to the states, has nothing to do with whether Left-ruled states, or states where the Left is prominent, are going to be gainers or losers from a shift to the GST. Even if they are gainers, the shift to a GST, being contrary to the Left position, must be opposed by it.

But then, what about the benefits which the country as a whole, and hence by implication the states too, are supposed to derive from such a shift? Much of the claimed benefits however are sheer hype. In fact, Arun Jaitley’s assertion that a shift to the GST will add 2 percent to the growth-rate of the Gross Domestic Product, is so intellectually infirm, being based on all sorts of assumptions which are never made fully explicit and which would not stand a moment’s scrutiny (such as for instance the complete absence of any problem of aggregate demand), that one is surprised at the Finance Minister’s making it.

There are however two arguments of some substance which have been advanced: first, that the GST will simplify and rationalize the indirect tax system, which, no matter what its other consequences, is worthy in itself; and second, that it would prevent competition among states to lower tax rates as a means of attracting private investment, which makes all of them collectively worse off.

Now, the second of these arguments does not require a uniform tax rate for all states and all commodities: a common floor tax rate, with states being allowed to charge whatever rate they wish to in excess of it, is quite adequate for preventing unhealthy competition among them. But as regards the first argument, the real question is: should we sacrifice a basic feature of our federalism for some unspecified benefits that may arise from the “simplification and rationalization” of our system of indirect taxation?

There is much talk about the GST unifying the “national market”; but the example of the United States is instructive here. The U.S. does not have a uniform value-added tax like the GST. Different states in the U.S. tax commodities by value, not value added, at different rates, which, moreover, vary across commodities within each state. There is a plethora of taxes on commodities, and not just one single tax, within each state. And even the exemption limits for the value of business turnover, below which indirect taxation is not levied, are not uniform across the states.

The world’s largest capitalist economy has thus got along all these years without having a “unified national market” according to the criteria advanced by the votaries of the GST; and it proposes to do so in the future as well. The question naturally arises: if the U.S. can get along without apparently a “unified national market”, why are we so hell-bent on it, to the point of sacrificing our federalism?

In fact, the reason why the U.S. continues to have such a plethora of taxes and tax-rates across states is precisely because it values its federalism. A symptom of this is the composition of its senate where each state has an equal number of senators, namely two. Large states like New York or California are on the same footing, in terms of senate representation, as tiny ones like Delaware or Rhode Island; no state therefore can complain about its voice not being heard. And it is this fierce commitment to federalism that overrides pettifogging economic arguments advanced by corporate spokespersons even in that land where corporate-financial interests exercise unquestioned hegemony.

Such commitment to federalism alas is not visible in India. The Centre uses all kinds of blandishments to make the state governments fall in line; and the state governments are so exclusively concerned with whatever resources they can lay their hands on, that they have little time to ponder over principles, especially the foundational principles of the Indian State, among which federalism occupies a prominent place.

But precisely because federalism constitutes a part of the “basic structure” of our Constitutional arrangement, in the sense defined by the Supreme Court in the wake of the Emergency of 1975, one can argue that even if all the state governments as well as the central government, at any given time, agree on some measure to abridge it, they are not empowered to do so by the Supreme Court’s ruling. The introduction of the GST as currently visualized amounts to an interference with the “basic structure” of our Constitution. The fact that it may have the support of all the state governments, including even Tamilnadu whom Jaitley may succeed in appeasing, is not germane to the issue. A set of existing governments, even if they decide to forego their own freedom to pursue economic trajectories of their choice, cannot make that decision for all future governments, which in effect is what is being proposed.

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