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Concessionary federalism in a dominant party system? Indirect tax reforms and subnational acquiescence in India

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ABSTRACT
What accounts for subnational assent to policies that seek to reduce their fiscal autonomy and increase fiscal centralization? Since subnational actors with access to veto capabilities can block such reforms, the key to this theoretical puzzle lies in the identification of those conditions that create weak veto possibilities. This article seeks to solve this puzzle by analysing the case of India which has amended the constitution to introduce a 'dual GST' system. The combined logic of a market economy paradigm – within which the realization of a common economic market was an important policy goal – and the logic of a 'dominant party equilibrium' – which reduced the number and impact of veto players – created the right conditions for intergovernmental coordination. However, even under these conditions, the coordination dilemma, which had plagued the indirect tax reform process since 1991, could not have been resolved without making compromises as midpoints of competing claims. Thus, even under a dominant party system, the institutional condition of federalism cannot be ignored entirely. Overall, India's transition to a goods and services tax (GST) regime is a classic case of the centre and the states pooling sovereignty over the taxes assigned to them. This has strengthened the 'shared rule' dimension of Indian fiscal federalism.

KEYWORDS
India; goods and services tax (GST); federalism; indirect tax reforms; party system

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INTRODUCTION

Designing and implementing goods and services tax (GST) reforms in countries with federal constitutional structures is extremely challenging (Due, 1990; Tait, 1988). While the best practice is to implement a general consumption tax assessed on a broad base at a low uniform rate (Musgrave, 1987), this format does not suit federal countries because complete tax harmonization violates the federal principle. Therefore, Richard Musgrave recommends levying retail sales taxes instead of GST in federal countries. In practice, however, several federal countries have imposed national value-added tax (VAT) or GST,[1] the Australian and German systems being the best models. Both of these federations levy national GST, the bases and rates of which are determined jointly by the central and local governments and use a formula to share the GST

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or VAT revenue – all of it in the Australian system and almost half of the VAT revenue in the German system. Although the Australian and German systems are useful models for other federal countries, entrusting the federal government with the administration and collection of VAT may be unacceptable to subnational governments (SNGs) in federal countries where regional identities and provincial loyalties are strong. In such cases, a system of decentralized VAT harmonized with federal GST is generally endorsed. Notably, such a system of destination-based subnational VAT alongside a federal GST does not exist in any federal country except Canada. The success of this system in Canada may be attributed to three factors: (1) the fact that Canadian provinces do not depend on sales taxation, as they have access to direct taxes; (2) the power invested in the Canadian federal parliament to enact the federal GST under the Canadian Constitution; and (3) the high standard of Canada's tax administration (Bird et al., 2006).

However, there are no easy answers or best practices when it comes to implementing GST in federal countries where (1) the power to impose a GST lies outside the legal competence of the federal parliament and (2) SNGs depend largely on indirect taxes and do not have access to other broad-based taxes (e.g., personal income taxes and payroll taxes). The key obstacle to GST reform in these countries is the need to alter the distribution of powers between the centre and individual states by amending the constitution. However, it is generally recognized in the literature on federalism that changing a constitution, especially to reallocate powers among levels of government, is extraordinarily difficult (Scharpf, 1988).

These difficulties are exacerbated in developing country federations (Bird & Gendron, 2007; Gillis et al., 1990), which – in addition to facing issues posed by intergovernmental political dynamics and federal constitutional structures – are beset by the problems of low per capita income, income inequalities, regional disparities, fiscal imbalances, poor accounting practices and weak tax administration. Brazil, for instance, since the promulgation of its 1988 Constitution, has faced immense hurdles in attempting to reform its consumption tax system – origin-based state VAT – due to its complex and inefficient tax administration and a lack of coordination between the federal, state and local governments (Pulice et al., 2019). Pakistan is another example of a federal country where the weaknesses in the legal framework and tax administration, combined with issues about the revenue assignment and equalization scheme, have led to the failure of the GST (Ahmad, 2011). In Malaysia, it was the fierce public opposition in light of rising inflation and the GST's regressive effects on income distribution that led the government to scrap the GST in 2018, barely three years after its rollout (Narayanan, 2018).

Given the well-documented challenges associated with the introduction of a GST in developing country federations, where SNGs depend largely on indirect taxes, the successful introduction of a dual GST model in India from 1 July 2017 following an amendment to the constitutional division of powers warrants a detailed examination. India is now the only developing country federation with a dual GST system, which – unlike the Canadian system – grants states with no discretion regarding the SGST (the subnational component of GST) and has no system to equalize SGST revenues. India's case may provide lessons for other federal economies and offer valuable insights that contribute to the emerging literature on fiscal centralization and the state abdication of taxes in federal systems (Diaz-Cayeros, 2006; Gordin, 2020).

The puzzle and the argument

To conduct an in-depth analysis of this case, we pose the following question: What conditions or which logic – political or economic – made the subnational states approve the tax reforms, notwithstanding the clear prospect of a reduction in their fiscal autonomy after the implementation of the GST? If we assume that the assent of all veto players is the key to policy change (Tsebelis, 2000), the question boils down to how that can be accomplished. To address this question, we must examine why subnational veto players oppose policy changes. Even if there is a strong economic rationale for reforms aimed at increasing centralization, SNGs may oppose such reforms by

taking either a principled or unprincipled position. SNGs can take a principled position by invoking a purely subnational perspective on federalism, such as the loss of an important tax base or the diminution of their constitutionally recognized authority. National governments can mitigate these concerns by promising packages of concessions, which may include a guarantee to compensate states for revenue losses and a compensatory increase in the shared-rule provisions (by increasing states' share in central taxes and by establishing mechanisms of intergovernmental coordination and dispute settlement). Another concession could be to dilute some of the contentious clauses of the proposed bills without violating the essence and integrity of the reforms.

However, concession-based bargaining approaches to extract SNGs' agreement to give up their fiscal autonomy (unless SNGs themselves prefer tax-sharing over tax autonomy, as in Australia and Argentina) are likely to fail in two situations: when regional parties participate in coalition governments formed at the national level and when the partisan alignment of most of the states differs from the national ruling party – a situation made possible when state and national elections have different electoral cycles. In the former case, national parties depend on state parties to form and maintain a national governing coalition. Thus, the formateur's ability to extract compliance or impose cooperation is hindered. In the latter case, subnational veto players tend to take adversarial positions on reforms for partisan reasons, a phenomenon known as partisan federalism (Sharma et al., 2020). Overall, when national ruling parties are weak, retaining fiscal authority creates greater payoffs for SNGs than swapping their autonomy for concessions. Conversely, the presence of the same party at the two levels alters the payoff in a way that self-interested agents have incentives to cooperate. Therefore, concessions alone are insufficient for extracting subnational assent to surrender their fiscal autonomy. This article argues that the nature of the party system is the last piece of the puzzle. The complete picture emerges when we place all the pieces together and observe the interactions among the economic, federal and party systems (Figure 1).

A dominant party, by virtue of its control over most states, can circumvent barriers to change and even mobilize support for a constitutional amendment to alter the division of powers. In this scenario, subnational incumbents are induced to embrace the national perspective and ultimately cease to be subnationally oriented (Diaz-Cayeros, 2006; Levi, 1989). In other words, when co-partisan subnational incumbents support the national government's fiscal centralization, the

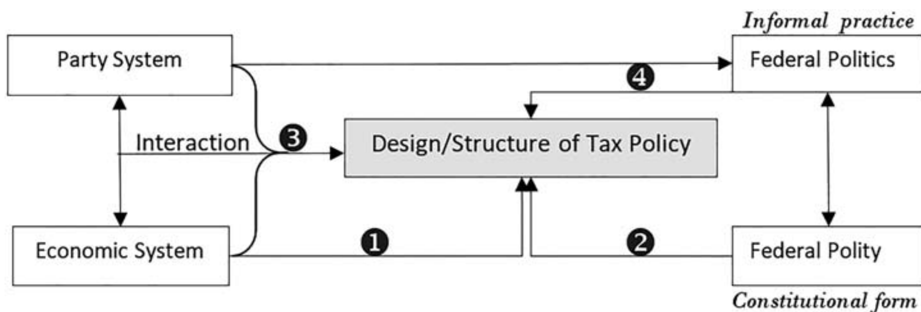

Figure 1. Political and economic interactions in India's indirect tax policy reform. Note: (1) A transition from a command to a market economy involves an overhaul of the tax system. (2) Fiscal constitutions may be designed around the principle of tax separation or concurrent taxation. (3) While a dominant party may or may not undertake reforms to reconfigure intergovernmental fiscal relations, a coalition government remains restricted in its ability to bring about constitutional change. (4) Power asymmetries reflected in the party system determine the nature of federal politics in practice which in turn shapes the specific elements of tax policy.

phenomenon of partisan federalism works in favour of the national party. Thus, the most critical condition for solving the coordination dilemma – the SNGs' acceptance of limits on their fiscal authority – is met. The dilemma here is that any government powerful enough to extract states' acquiescence is also powerful enough to enact reforms without offering any concessions or to renege on its commitment later on. In other words, the explanation relying exclusively on party hegemony or dominance leaves open the question of incentives that induce the hegemon to adhere to the previously made commitments in a political context defined by weak veto possibilities.

Note that in a federal context, the dominant party is restrained by the path-dependent effects of the procedural and political safeguards inherent in federal constitutional structures and the role of courts in safeguarding federalism. Furthermore, opposition-ruled states, even if they are outnumbered by affiliated states, can still present an obstacle to reforms. More importantly, outright encroachment upon states' jurisdictions can threaten the dominance of the national ruling party in state elections. In essence, a federal organization itself solves the dilemma by creating legally independent and constitutionally protected spheres of political authority (Elazar, 1987). Thus, the necessary step of offering concession packages cannot be brushed aside.

This case study of indirect tax reforms in India outlines the unique process through which India resolved the coordination dilemma associated with the introduction of GST. Three important factors which can produce subnational acquiescence, that is – a convinced executive at the national level; a broad consensus on the rationale of reforms, and the executive's willingness to offer concessions had prevailed throughout the coalition era in Indian politics (*DNA India*, 2013; Mint, 2013), yet the reforms lingered. We argue that it was primarily because of the opposition parties' reluctance to compromise in the intensely partisan and adversarial political landscape that characterized the coalition era (*Business Standard India*, 2016). Opposition parties – who ruled more than half of the states, were confident in their ability to block the centre's bid to pass the contentious GST bill – had no incentive to concede.

It is remarkable that the SNGs, which were reluctant to part with their tax authority under coalition governments, became amenable to engaging in the reciprocity of concessions under a dominant-party system. Thereafter, the issue was no longer autonomy versus concessions, but rather how magnanimous the concession package needed to be. Indeed, the ruling party offered generous packages. The promise of cash compensation assuaged the immediate concerns related to lost revenue, whereas the higher devolution of untied grants promised to increase the states' financial flexibility, thereby compensating for the loss of financial autonomy resulting from the implementation of the GST. The implementation process was further facilitated by adopting a concurrent dual GST model because it was preferable to states when compared to the unified GST model. Furthermore, a measure of subnational fiscal autonomy was retained by accepting the states' demand to keep petroleum products beyond the scope of the GST. Finally, the establishment of the GST Council (GSTC) ensured that the decline of self-rule was offset by increased participation in the shared rule system. The concessions offered by the central government reciprocated the concessions received from the states so that the states' losses, in terms of fiscal autonomy, were at least partially offset by utility gain, in terms of financial adequacy and flexibility.

The Indian case shows that commitment problems do occur. For instance, the central government failed to release compensation funds after the implementation of GST. Interestingly, however, when the government attempted to renege on its commitment, the effective use of legal threat[2] by the opposition ruled SNGs induced the central government to change its stance (see the subsection Resolution of the GST compensation impasse). This fits into the theoretical expectation, derived from the literature on auto-limitation, that governments take into account court's preferences and exercise 'self-restraint' to avoid defeat at the court (Stone, 1992). It also lends support to the

argument that courts should be systematically included in the veto player analysis of political systems (Brouard & Hönnige, 2017).

CONCEPTUALIZING CONCESSIONARY FEDERALISM IN A DOMINANT-PARTY FEDERAL SYSTEM

Following the approach of Spiller and Tommasi (2007), we assume that public policies represent the outcomes of the political transactions that political actors undertake within a specific political and economic operating environment. A change in the operating environment creates opportunities to change the constitutional allocation of powers. Yet, constitutional change can be difficult to achieve if – in line with the normative theory of federalism (Riker, 1964) – the 'federal bargain' regarding the distribution of powers is rigidly fixed. Therefore, the literature on federalism recognizes the importance of flexible constitutions in terms of making federalism work. However, the reallocation of powers and the modification of the rules of intergovernmental relations must involve the participation of SNGs (Benz, 2016). These principles and precepts are reflected in the evolution of indirect tax reforms in India, which has been characterized by political exchange in a changing operating environment within the broader context of a flexible constitution offering sufficient rigidity to protect the division of powers.[3]

In the present article, we attempt to reveal the mechanisms by which India's coordination dilemma was resolved and the substance of the tax reforms determined. To this end, we adapt assertions from the literature that perceive the constraints on government to be a type of coordination game[4] (de Figueiredo & Weingast, 2005; Filippov et al., 2004). This body of literature illustrates how, under a dominant-party system, the transgressive behaviour of the centre will face little resistance, while any subnational challenge is likely to fail. In doing so, we also rely on the concept of dominant-party equilibrium[5] (Diaz-Cayeros et al., 2015) and benefit from insights concerning both institutional theory (North, 1991) and the veto players[6] theory (Tsebelis, 2000).

Within a federal system, the national government must determine the minimum level of concessions to be offered to the SNGs in return for the abdication of taxes. The national government, as the first mover in this context, sets the concessions at a level considered rational from its perspective as well as acceptable from the perspective of the SNGs. In this way, the coordination game begins.[7] If the non-affiliated states are large enough in number to collectively block any constitutional amendments designed to limit subnational fiscal powers, the federal concessions will be rejected, which means that the federal bargain will be unsuccessful. This is the likely outcome when a coalition government rules at the centre and different parties govern different states. However, if a single party controls the national legislature and the majority of states, the coordination dilemma is resolved because any challenge mounted by opposition-ruled states is likely to fail. In such a scenario, an interactive sequence of offers regarding concessions will begin, which will continue until an agreement is eventually reached whereby the states surrender their tax authority in exchange for the concessions offered by the central government. This situation of reciprocal offers of concessions in an effort to reach a joint agreement between the centre and the states is what we refer to as *concessionary federalism*. In understanding the role of concessions in relation to federal bargains, we take inspiration from the negotiation literature (Bartos, 1974; Filzmoser & Vetschera, 2008), which holds that concessions represent an essential ingredient of any negotiation process and, further, that the concessions offered by one party should reciprocate the concessions received from the other party.

Thus, *concessionary federalism* may be understood as an exculpatory theory of federalism whereby the concessions offered by the central government reciprocate the concessions received from the SNGs in such a way that any loss of utility suffered by the latter in one dimension is at least partially offset by a gain in some other dimension(s). The reciprocity of concessions

represents an important aspect of concessionary federalism because trade-offs occur between national and SNGs' utilities in a federal system.

To assess the outcomes of this reciprocity of concessions, we employ the concepts of self-rule and shared rule (Elazar, 1987; Hooghe et al., 2016; Sharma & Swenden, 2018; Watts, 2008). In the context of fiscal federalism, self-rule implies tax separation and independent fiscal policymaking, whereas shared rule implies the joint occupation of the revenue bases, tax revenue sharing, and interdependent fiscal policymaking (Sharma, 2012). Since the SNGs' abdication of their tax authority threatens to make them subject to the power and abuse of the national government (Diaz-Cayeros, 2006), a concessionary federal approach implies that a reduction in self-rule will be offset by increasing shared rule. When self-rule is replaced by a shared rule, federalism moves from a dual (two levels of government legislate in separate spheres) to a cooperative direction (both levels legislate in the same sphere). In light of this, the recent indirect tax reforms can be seen to have moved Indian fiscal federalism closer to the idea of shared rule or cooperative federalism.

Concessionary federalism signifies a distinct form of cooperation. It incorporates a strong element of 'negotiation' but the outcome depends on the relative bargaining powers of the negotiating parties. The first mover often starts with an extreme demand and then continuously makes concessions to work towards a joint agreement depending on (1) trade-offs between its own and the second mover's utilities (2) the extent to which the second mover's non-cooperative move can result in lower utility for the first mover. In terms of what it is not, it is important to recognize that concessionary federalism differs from *contract federalism* (Spahn, 2006), which implies *quid pro quo* transactions that take place between *equal partners* or autonomous bodies with no hierarchical links. Any partner or body that is dissatisfied with the contract can exit at any time. Concessionary federalism also differs from *reciprocal federalism* (Zuker, 1995), where one level introduces voluntary initiatives that promote development at the other level, thereby creating a win–win environment characterized by mutual gains. Finally, concessionary federalism differs from *compensatory federalism* (Martha, 2010), which implies that governments at one level are able to compensate for any weaknesses at another level in order to prevent policy failure. While all these formulations exhibit a normative intent and assume non-hierarchical interactions, concessionary federalism is grounded in the empirical reality of the case under investigation. It can be applied to capture the experiences of federal systems characterized by a dominant party and hierarchical relationships, such as Mexico and South Africa. In these cases, although concessions are offered in many different forms, yet the national government ultimately gains more utility than it loses. The present article shows, inter alia, that while the concessionary federalism seen in India has led to the so-called 'pooling of sovereignty', the pooling remains unequal due to SNGs being obliged to cede more authority than the centre.

The concept of concessionary federalism can also be applied to the federal systems where SNGs – intent on extracting financial resources from the national government – voluntarily delegate their tax authority in exchange for the promise of insuring them against economic shocks. Although, SNGs generally perceive their tax authority as one of the primordial features of their institutional empowerment, yet this does not have to be a default position. When SNGs have political influence at the national level, they can use it to either safeguard their autonomy or abdicate autonomy in exchange for financial assistance. For instance, when the Australian Commonwealth offered to allow the states to levy income tax in 1934, they rejected the offer. The states' response was captured by Robert Garran: 'Please keep the cow and do the milking for us' (Garran, 1958). A similar pattern of fiscal behaviour is recognizable in Argentine fiscal federalism. In this sense, concessionary federalism subsumes the notion of *delegative federalism* (Gordin, 2020), which captures only one side of the story.

Finally, to piece together the events leading up to the implementation of the GST, we examine the role of critical junctures – which are defined as crises followed by ideational changes

(Hogan & Doyle, 2007) – and change agents who possess the capacity to both communicate convincingly and contest the existing policies to bring about change (Schmidt, 2010). We also look for manifestations of path-dependent legacies (Mahoney, 2001) and examine the extent to which the paradigm shift was preceded by more incremental or gradual change processes (Mahoney & Thelen, 2010).

THREE PROPOSITIONS

Scholars have long recognized that 'economic policy operates at the intersection of economics and politics' (Kelkar & Shah, 2019; Winer, 2011). Thus, we argue that the resolution of the coordination dilemma related to fiscal federal reforms is a function of the interaction between economic and political variables. The political variable of interest in the context of a federal polity is the party system (Riker, 1975), whereas the economic variable is the economic paradigm of the day (Ray, 1992; Singh & Srinivasan, 2006).

We make two sets of propositions about the political and economic interactions in tax policy reform:

- When a dominant party system intersects with a centrally planned economic system, the central government will pursue 'independent' policymaking and design the tax system to reflect the objectives of planned development. When a dominant party system intersects with a market economy, the national goal of establishing a common market and fostering domestic economic integration will be pursued. Under a dominant party equilibrium, intergovernmental partisan harmony, achieved by the congruent party affiliation of national and subnational incumbents, will ensure that subnational policies reflect national priorities. Thus, the national executive will have the upper hand in centre–state negotiations. In other words, intergovernmental cooperation will be largely 'imposed', although it may incorporate an element of 'negotiation.'
- Under a fragmented party system, the central government will be prevented by partisan and institutional veto players from pursuing 'independent' policy goals, except those that suit the interests of the veto players and not without their engagement. The centre–state cooperation in a coalition party system will display signs of a genuine negotiation between equal partners (negotiated cooperation) or even contingent cooperation[8] if the SNGs are too strong and can outmanoeuvre the national government.

The implementation of GST in India is a paradigm shift in the indirect taxation regime. Paradigmatic shifts in policies are often attributed to critical junctures (Hogan & Doyle, 2007) or change agents (Schmidt, 2010). Institutional theories also emphasize the role of path dependence (Mahoney, 2001) and gradual institutional change (Mahoney & Thelen, 2010). Therefore:

- The origins of the paradigmatic shift in India's indirect tax policy may be traceable to factors such as critical junctures, path-dependent legacies, and the role of party leadership as an agent of change.

RESEARCH DESIGN

To elucidate the causal mechanisms by which a paradigm shift occurred in India's indirect tax regime, we use an in-depth within-case study method where causation has been tested via the process tracing approach in a cross-temporally comparative manner. We compare three phases

in the history of India's indirect tax reforms: 1947–89 – a dominant/hegemonic ruling party seeking to impose a centrally planned economic model; 1990–2013 – coalition governments operating in the context of a free-market economy; and post-2014 – a dominant ruling party seeking to operationalize the market economy. We examine evidence and evaluate causal claims using deductive logic.

POLITICAL AND ECONOMIC INTERACTIONS IN INDIA'S INDIRECT TAX POLICY REFORM

The nature, direction and extent of fiscal reforms at a given point in time are determined not just by their economic rationality but also by their political viability. To preserve and promote political stability, governments generally combine fiscal instruments in ways that achieve the most desirable (economically as well as politically) combination of tax structures, systems of dividing taxation and spending authority, revenue sharing, and intergovernmental transfers. Thus, we can expect the evolution of the indirect tax system in India during different periods to mirror the interaction between the prevailing economic paradigm, party system, and federal politics during those periods.

A dominant party system intersects with a centrally planned economic system, 1947–89

The Constitution of India, known for its centralizing tendencies, creates incentives for the establishment of a centralized fiscal regime. It enables the national government to use its higher revenue-raising powers to influence the spending priorities of SNGs. Until the late 1980s, these tendencies were reinforced by a centralizing economic system combined with a centralizing party system. The ruling party's dominance and its extensive control over public resources, which was legitimized by widespread agreement on the desirability of a command economy, enhanced the ability of the ruling Congress Party to make unilateral fiscal policy changes. Being a dominant party, Congress could extract SNGs' acquiescence – by exercising its hierarchical control (imposed cooperation) in the name of cooperative federalism – on the issues that affected the SNGs' finances (Sharma & Swenden, 2018).

A perusal of the developments in indirect tax policies shows that the national government attempted to increase its control over indirect taxes under the jurisdiction of the state government during the period 1952–89 (Rao & Rao, 2005). The Constitution (Sixth Amendment) Act, 1956, placed taxes on the sale or purchase of goods other than newspapers on the Union List and enabled Parliament to formulate principles for determining when the sale or purchase of goods could occur in the course of inter-state trade or commerce. This resulted in the enactment of the Central Sales Tax (CST) Act, 1956, which was intended to trace and create an information base for inter-state transactions. In 1957, the Congress Party's chief ministers, at a single sitting of the National Development Council and without any consultation with the state legislatures, allowed the centre to take over sales taxes on textiles, sugar, and tobacco in exchange for additional excise duties. In 1961, pursuant to the recommendations of the Railway Convention Committee, the tax on railway passenger fares, which was levied and collected by the Government of India, but the proceeds of which were assigned to the states was merged with basic fares. Throughout the Nehru era, the Congress Party enjoyed hegemonic status and sweeping election victories, so it was easy for it to impose national priorities on states and yet still receive their cooperation. In this situation of imposed cooperation, the only reciprocal compensation that the central government offered subnational incumbents was an assurance of a secured career through the party, similar to the case of Mexico. During the Nehru era, the Congress Party, like Mexico's PRI, created a regional compromise, where regional branches of the party were allowed

to maintain relative autonomy and national elites exercised centralized control over the economy and public resources.

The VAT/GST reforms were not on the cards in the period dominated by the Congress Party because neither export promotion nor greater economic integration with the global economy were the goals. Rather, the tax policy since independence had two goals: (1) raising resources for the import-substituting industrialization strategy and (2) achieving redistribution of income to establish a 'socialistic pattern of society' (Bagchi & Nayak, 1994). Although the Indirect Taxes Enquiry Committee in 1977 recommended simplification of consumption taxes, no major rationalization exercise was carried out until the mid-1980s, when the ruling Congress Party attempted to introduce the principle of VAT in Union excise duties. The so-called MODVAT (modified VAT) came into effect on 1 March 1986. However, long-term fiscal reforms were not envisaged.

Interactions between coalition governments and India's federal market economy, 1990s–2000s

In 1991, India's economic policy paradigm shifted from a command economy to a free-market economy. This paradigm shift was precipitated by an exceptionally severe balance of payments crisis, which was largely perceived to have been a product of India's state interventionist and inward-looking model of economic development. As the crisis was followed by an ideational change in favour of liberalization, privatization, and globalization, it fulfilled the diagnostic criteria for a 'critical juncture' set out by Hogan and Doyle (2007). The paradigm shift in economic policymaking sparked a vivid discussion about removing barriers to factor and product mobility via indirect tax reforms. To this end, the government established a committee under the economist Raja Chelliah which recommended a 'national VAT' for India (Chelliah, 1993). However, the government could not go beyond a series of incomplete attempts at fixing the structural flaws of India's tax regime.

What kept the biggest indirect tax reform from becoming a reality in India for a quarter of a century after the adoption of the structural adjustment programme in 1991, while significant reforms in other dimensions of fiscal federalism moved forward?

One important factor was the breakdown of the dominant party equilibrium and its replacement with a more fragmented party system in the 1990s (Sharma & Swenden, 2020). This increased the number of veto players by increasing the number of (1) opposition party Members of Parliament (MPs) in the national legislature, (2) states ruled by opposition parties and (3) regional parties sharing power at the national level. As political opposition became difficult to manage, the interactions between institutional but partisan veto players became more conflictual. For instance, the GST bill, introduced by the Congress-led United Progressive Alliance (UPA) in 2011, was opposed by the non-affiliated states and blocked by the opposition parties in the upper house.

Thus, India witnessed a halting process of change during this period of intensely competitive politics, which was aptly described as 'creating a strong consensus for weak reforms' (Ahluwalia, 2002, p. 87). Although there was a broad base of consensus on the need for indirect tax reforms, the only way forward was to negotiate and compromise with the veto players who had a decisive say in constitutional amendments.

The analysis that follows demonstrates that during the coalition era, when the balance of power shifted in favour of the regional parties, the SNGs acquired a greater role in shaping public policies and their outcomes. Political cooperation during this period was a combination of contingent cooperation from the provincial side and the negotiated variety from the national side of the federalism scale. The power asymmetries are reflected in the cooperative bargaining on the VAT reforms that occurred during this period.

The design of VAT/GST was a major source of disagreement between the centre and states because the proposed new tax regime would subsume the sales tax, the only major revenue source for SNGs in India (Bagchi, 2005; Mukhopadhyay, 2003). The Chief Ministers' Conference held in November 1999 considered all competing models recommended by experts, following which the central government (1) extended MODVAT to all goods and rechristened it central VAT (CENVAT) in April 2000 and (2) set up the Empowered Committee of State Finance Ministers (EC) on 17 July 2000 to design and implement state VATs in India. In 2002, the Kelkar Task Force on Indirect Taxes (named after Vijay Kelkar, then adviser to the Finance Ministry) recommended a 'grand bargain' between the centre and the states to impose concurrent dual GST at all points in the supply chain, right up to the final consumer (Kelkar et al., 2003). However, this could not be achieved due to the constitutional division of taxation power between the centre and the states. The constitutional amendment needed to overcome the constitutional constraints required a reasonable consensus across political parties and state governments, which could not be forged due to (1) the antagonistic politics of the coalition era and (2) the absence of an effective institutional mechanism for collaborative decision making.

Thus, a state-level VAT system was implemented in the country on 1 April 2005. Although the CENVAT and the state VATs laid the foundation for more comprehensive tax reforms in the future, they did not remove the irritants that were discouraging new investment and keeping the Indian market fragmented. These included the continuation of the origin-based central sales tax (CST) on inter-state sales; restricted input credit on inter-state transfers and wider exemptions under CENVAT, service tax and state VAT, all of which contributed to a cascade effect (tax on tax) (Das-Gupta, 2005); and poor infrastructure for tax administration, which increased the costs of compliance (Acharya, 2005). Thus, the VAT system, despite being a considerable improvement on the archaic, irrational and complex system that had existed previously, remained largely inefficient and complex.

It is noteworthy that even such an imperfect model of VAT could only be implemented after a decade of preparation and a great deal of consultation with states. The practice of fiscal federalism in the era of de facto decentralization of political and economic powers generated a federal dynamic that prevented a move towards the levy of a comprehensive GST. However, the incremental and gradual change from a single-point state sales tax system to a state VAT system during the coalition era was a significant step forward, which prepared the ground for more radical reforms in the future. Furthermore, the path-dependent effect of the one decade's groundwork undertaken by the Empowered Committee – which included the finance ministers of all states as its members – ensured that generous concessions were offered to states.

One-party dominance meets the market economy – a fortuitous encounter that facilitated tax reforms in post-2014 India

The GST bill was accorded assent by the President on 8 September 2016, following which the GSTC 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.

What motivated the SNGs to abandon adversarial politics over GST reforms leading to the implementation of the broad-based indirect tax reform in 2016? More specifically, what prompted the states to ratify the GST constitutional amendment bill which sought to curb their fiscal autonomy?

We argue that the key lies in the interaction between India's prevailing economic paradigm – within which the realization of a common economic market was an important policy goal – and the rise of the 'dominant party equilibrium', which reduced the number and impact of veto

players (opposition chief ministers and parliamentarians). Although the critical juncture, in terms of economic policymaking, occurred in 1991, yet in a political context characterized by the rise of regional parties as active actors in national politics the change that ensued was gradual at best and opportunistic at worst (Ahluwalia, 2002). While there had been a policy consensus since 1991 on the need to reform India's overly complex and inefficient indirect tax system – the comprehensive reforms had been scuttled by the adversarial politics of veto players during the era of coalition politics. While the gradual switch from a sales tax system to a state VAT system by 2008 had prepared the ground for further reforms, a quantum leap was required to switch to a dual GST system. Such a quantum jump was made possible by a critical juncture in Indian politics in 2014 when a landslide victory of the BJP in the general elections brought the era of coalition politics to an end.

The rise to the political dominance of the BJP and the presence of strong leadership at the centre marked a turning point in India's federal governance. This historical circumstance presented a unique opportunity for radical reforms because it reduced the impact of veto players. When a single party controls the national government and most of the states, intergovernmental coordination is achieved via a combination of two strategies: (1) undertaking 'intra-party' interaction with affiliated states and (2) establishing a 'punishment' regime against opposition-ruled states. In this system, challenging the central government becomes difficult. Such self-enforcing centralized federalism functioned for the duration of the Congress Party's dominance in India and is functioning again now under the BJP's dominance.

Under the influence of a domineering centre, the federal bargain has been somewhat asymmetric, with states losing more sovereignty and space than the centre. While both centre and states gave up their indirect tax sovereignties, states lost control over more than two-thirds of their revenue. In terms of fiscal space subsumed under GST, the centre yielded only 30%, while the states yielded 47% of their fiscal space (Reddy & Reddy, 2019). To address this asymmetrical impact of GST, a GST task force recommended that the GST tax base be apportioned between the centre and the states in the ratio of 42:58 (Rao, 2010). However, the GSTC, which at the time of the passing of this resolution had 21 out of 31 member states and union territories belonging to the national ruling party, determined that this ratio would be 50:50. However, this did not mean that the coordination dilemma that had plagued the indirect tax reform process since 1991 could be resolved without paying heed to the subnational interests. The Indian GST model bears the influence of India's federal governance in general and two decades of coalition politics in particular in a variety of ways. This is the focus of the next section.

WHEN THE FEDERALISM IMPERATIVE PREVAILS: CONCESSIONARY FEDERALISM IN A DOMINANT PARTY SYSTEM

In this section we demonstrate that although the dominant party equilibrium makes it difficult for the partisan veto players to pose an outright challenge to the central government, yet the existing federal structure, political processes and judicial safeguards activate a *federalism imperative* which necessitate compromises as midpoints of competing claims.

Offsetting the centralizing implications of the GST regime for fiscal federalism by establishing an intergovernmental GST council (GSTC)

As the implementation of GST required states to give up their right to determine tax rates on the sale and purchase of goods within their jurisdiction, the goal could not have been achieved without intergovernmental coordination. Thus, the compulsion to persuade and collaborate with the states to roll out a GST led to the establishment of the GSTC[9] – a new institutional mechanism for intergovernmental fiscal collaboration, bargaining and conflict resolution. The GSTC has emerged as a unique constitutional body through which the centre and the states pool the

legislative sovereignty of Parliament and the state legislatures to make decisions related to the GST in India. Intense centre–state consultations in GSTC meetings led to the implementation of the concurrent dual GST and a multilayered rate structure as a grand bargain between the centre and the states. The GSTC requires a three-fourths majority (75%) of the weighted votes of the members *present and voting* to adopt a proposal. The central government's vote is worth a third of the total votes cast (33%), while the votes of the state governments put together (each state is entitled to one vote) account for the rest (66%). This means that the centre cannot impose its will on all states single-handedly unless it has the support of at least 20 states (out of 31, including three 'half states', i.e., union territories with legislatures), which jointly have a weightage of 42%. However, the states collectively cannot impose their will on the centre because the centre can veto any proposal the states put forward. Thus, no change can be made to the GST base, GST rate or GST revenue-sharing arrangement without the consent of both sides.

Adjusting the GST design to bear the imprint of SNGs' preferences

Generally, a single, unified national GST is considered an ideal model for the establishment of a common market in a country. However, India has adopted a 'Concurrent Dual GST' model with a differentiated rate structure and numerous exemptions (Sharma & Swenden, 2018). Despite limitations associated with the dual administration of GST and economic distortions caused by a multiple tax rate structure and a long list of exemptions, this model was preferable to states compared to the 'unified' GST under which tax rates, base, and administration are completely harmonized and fiscal autonomy is severely compromised (Reddy & Reddy, 2019). In the concurrent dual GST system, Parliament and state legislatures have the power to levy and collect the CGST and SGST, respectively, on a common base of economic activity (Article 246A). CGST and SGST are levied on all transactions within a state at all stages from manufacturing to final consumption, with credit for taxes paid at previous stages available as a set-off. However, the rates at which the CGST and SGST are to be levied will be jointly decided by the centre and states in the GSTC. As far as the tax on interstate supply of goods and services (IGST) is concerned, the Parliament of India has the exclusive power to make laws. However, the tax proceeds from IGST are shared between the centre and the states, in accordance with the rules framed by the GSTC (Article 269A of the Indian Constitution). CGST and SGST are remitted to the central and state governments, respectively, in the ratio of 50:50. Since the 50% share of the central government becomes a part of the divisible pool of Union taxes (42% of which is shared with the states), the latter gets a share in the CGST as well. The tax revenue collected on inter-state transactions (IGST) is distributed between the centre and the states where the product is consumed. Again, the centre's share of the IGST becomes a part of the divisible pool (Art 270 of the Indian Constitution).

Preserving a measure of the states' fiscal autonomy

The centre accepted the states' demand to keep petroleum products (crude oil, natural gas, aviation fuel, diesel and petrol), alcohol, electricity and real estate outside the purview of GST. Taxes on these items contribute more than 35% of state governments' revenues and thus gives satisfaction to states that they have some fiscal autonomy left. Furthermore, states have also been allowed 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. 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. They are like excise taxes in that they do not lead to input tax credits for those who pay them. Although this means that the pre-GST taxation system (central excise and state VATs) continues for these items, leaving ample scope for the cascading (tax on

tax) phenomenon, yet it preserves some fiscal autonomy of the states and was considered necessary to persuade states to accept the GST regime.

Offering a generous compensation package to allay SNGs' fears of a revenue shortfall

Compensation had remained one of the most contentious issues, leading to centre–state disagreement on the implementation of the GST. The state governments had made their support for the GST conditional upon compensation against any possible loss of revenue after GST rollout. The centre, while acting 'in the spirit of compromise', established a compensation fund guaranteeing full compensation for five years from July 2017 to June 2022 for any shortfall between the revenues projected to have accrued in the pre-GST regime – assuming an annual incremental growth rate of 14% for all states over the base year 2015–16 – and the actual GST revenue realized in a particular year. This guarantee acted as a major incentive that assuaged even the opposition ruled states.

Resolution of the GST compensation impasse

The centre–state dispute over GST compensation and its resolution is another illustration of the ruling party diluting its stance even in a political context with 'weak' veto possibilities. In this episode, briefly summarized below, the central government changed its posture, not because of a change of heart, but because some of the dissenting SNGs threatened to move the apex court – the guardian of Indian federalism – as a strategy. The possibility of coming under judicial scrutiny and the likelihood of defeat at the court led even the dominant party to exercise 'self-restraint'.

After 2019, the BJP was re-elected with a greater majority and strengthened its dominance in the party system. In this scenario, the ruling party sought to address the post-GST implementation issues on its own terms (*The Financial Express*, 2020b). In the 41st meeting of the GST council on 27 August 2020, the centre used the pandemic-induced slowdown as an excuse to rule out paying compensation to states, suggesting them to borrow instead. The opposition-ruled states demanded that the centre undertake all the borrowings to compensate states for the revenue shortfall. This demand was in the interest of all the states. However, surprisingly, all the BJP-ruled states decided to support the centre's proposal, despite the realization that it will throw their finances into disarray. With 21 states agreeing to borrow to meet the shortfall in compensation, the central government hardened its stance against the opposition-ruled states. As the logic of the dominant party equilibrium unfolded, the central government not only flayed the disgruntled SNGs for their uncooperative attitude but also threatened to postpone the payment of their compensation dues for a further two years, until June 2022 (*The Financial Express*, 2020a).

However, as some of the opposition-ruled states decided to approach the Supreme Court against what they called a 'discriminatory and illegal action of centre regarding GST Compensation' (*The Hindu*, 2020), the centre sweetened the proposal by offering to borrow the estimated shortfall arising out of GST implementation (pegged at Rs1.1 trillion) – excluding the estimated shortfall on account of the coronavirus induced lockdown – and pass it on to the states as a back-to-back loan in lieu of GST compensation cess releases. Per the proposal, the compensation fund, financed through a cess on luxury and demerit goods, will be used to repay the principal amount and interest. As this process would necessitate the raising of funds after the transition period of five years is over in June 2022, the GSTC decided to extend the levy of compensation cess beyond June 2022, for such period as may be required to meet the revenue gap. In addition to borrowing Rs1.1 trillion on behalf of states, the central government also raised the borrowing limit of the states under the Fiscal Responsibility and Budget Management (FRBM) Act by an additional 0.5% of gross state domestic product (GSDP) to help them cover the GST revenue

shortfall on account of other causes such as COVID management and lockdown effects. This proposal struck a middle ground between the centre's stance that states borrow the estimated shortfall of Rs2.35 trillion in 2020–21 and the opposition states' demand that the entire amount be borrowed by the centre and passed on to states. This change of stance by the central government helped bring the dissenting state governments on board.

THE RESIDUAL EFFECTS OF THE CONCESSIONARY APPROACH

As the new indirect tax regime has been designed along the lines of shared responsibility, it has brought about a fundamental change in the principles, frameworks and institutions guiding intergovernmental fiscal interactions. Broadly speaking, the following shifts represent the residual effect of the concessionary approach.

From separate to shared jurisdiction

The most significant concession, given the states' demand, was that the Indian GST model was allowed to deviate from the GST purist ideal – a single unified GST levied on a comprehensive base at a single rate (Poddar & Ahmad, 2009). With the introduction of a concurrent dual GST model, India has made a transition from 'separate jurisdictions' (Wheare, 1963) to 'shared jurisdiction' (Elazar, 1987) in the policy domain of indirect taxation. The framing fathers of the constitution had embraced the principle of the separation of tax powers, which means the exclusive assignment of tax categories either to the centre or to the states. This has now changed. With the 101st Amendment Act, 2016, which led to a comprehensive overhaul of India's indirect tax regime, India embraced the principle of concurrence. Moving from the exclusive assignment of tax handles to the joint assignment of consumption taxes has strengthened the *shared rule* dimension of fiscal federalism. Although it came at the cost of surrendering subnational autonomy to determine the sales tax base and rates, the new paradigm is a classic case of the centre and the states *pooling sovereignty* over the taxes assigned to them. This fundamental reordering of federal fiscal relations has happened with the consent of the states, for the common cause of eliminating tax disharmony and promoting export orientation.

From fiscal autonomy to financial flexibility

Implementation of the GST regime to make India a unified market, required India's states to surrender their taxing powers. To extract this concession from states, it was necessary, given India's federal context, that the alternative source of subnational finance, that is, untied grants, be increased. Therefore, the new direction assumed by the Indian fiscal federal system seeks to supplement subnational funds primarily via revenue sharing and grants rather than by granting independent revenue-raising authority to the states. The new system seeks to balance the loss of subnational fiscal autonomy by a gain in financial flexibility and empowerment (higher share of unconditional transfers, enhancing each state's discretion to spend based on its priorities). To this end, the central government accepted the recommendation of the Finance Commission to enhance the states' share in the net proceeds of the central tax receipts (the divisible pool), from 32% to 42%. In addition to a significant 10% increase in the states' share, the size of the divisible pool itself has been expanded by the inclusion of the CGST and the centre's share of IGST in the divisible pool. The enhanced revenue adequacy at the subnational level has sought (1) to expand fiscal space for states to spend on development and fulfil substantial social spending obligations, (2) to ensure debt sustainability for states and (3) to reduce the mismatch between subnational responsibilities and the revenues they have with which to fulfil them.

Towards negotiated cooperation in the field of indirect taxation

As discussed in detail in the previous section, because of the greater need for and significance of continuous intergovernmental interactions in the dual GST regime, an institutional mechanism, the GSTC, has been enshrined in the constitution to facilitate intergovernmental collaboration. The GSTC and its innovative voting structure have contributed a lot towards achieving the state governments' support for the GST reform. Before the GST rollout, the central government resolved several intractable issues by accommodating the states' concerns raised during intergovernmental GSTC meetings (Mint, 2017). However, since 2019, as the BJP won a second term in office with a greater majority than the first term and has retained control over the majority of Indian states, its appetite for negotiated cooperation has been minimal. The reason for this lies in the co-option of the affiliated SNGs by the national ruling party to the extent that they have ceased to be subnationally oriented. Thus, the twin objectives of protecting the states' authority and promoting subnational interests in India's centralized federal system have been left to states ruled by opposition parties. However, since they control only 10 of the 31 states and union territories (as of 30 April 2021), the options, apart from falling into line, are limited. Thus, the capacity of the GSTC to protect states' interests in financial matters depends to a large extent on how important actors (national and subnational incumbents) engage in the politics of collective action. If the partisan logic of collective action looms large, which is likely when a single party dominates at the centre and governs most of the states, the capacity of the council to uphold 'negotiated cooperation' and achieve convergence beyond politics will be compromised.

CONCLUSIONS

This systematic study of indirect tax reforms in India has revealed that policy shifts have taken place within the structural context of constitutional rules, to the economic policy paradigm and to political dynamics. Our analysis has exposed the underlying federal dynamic that first prevented and then facilitated a paradigm shift in the indirect taxation regime, that is, a move towards levying a comprehensive GST. Although the states under the GST regime have less fiscal autonomy, the increase in the states' share of union taxes has enhanced revenue adequacy and financial flexibility at the subnational level. Furthermore, by establishing a constitutional body, the GSTC, to make collective decisions on GST issues, the principle of negotiated cooperation has been operationalized. Insights from the India case contribute to advancing our general understanding of the broader puzzle regarding the resolution of the coordination dilemma faced by national and subnational political incumbents in a federal system, particularly when a radical change in the distribution of power is envisaged.

First, critical junctures play a role, although the causal logic can be complex. The critical juncture, in terms of economic policymaking, occurred in 1991. It generated a broad consensus on the need to achieve the policy goal of establishing a common market. This rendered the reform of India's inefficient indirect tax system essential. However, due to the cost and complexity of constitutional changes to India's federal market economy, the reforms were marked by gradualism. This shows that even when policy reforms are drastically needed, components of the reforms aimed at the reallocation of powers among levels of government remain politically contentious. India's fragmented party system between 1991 and 2014 led the centre and the states to embrace incremental change while preserving the stability of the constitutional distribution of tax powers between levels of government. Modification of the status quo by the 2017 GST Constitutional Amendment Act materialized only after a critical juncture in Indian politics brought the era of coalition politics to an end and a stable 'dominant party equilibrium' began to operate.

Second, and following from the above, is the insight concerning the ability of the defenders of the status quo and change agents to frustrate or facilitate change. When reallocation requires

ratification by SNGs and the preferences of the subnational incumbents are determined by party politics, the difficulty or ease with which a constitution can be amended depends on whether the operating environment is characterized by strong or weak veto possibilities. For instance, the high level of fractionalized multi-partism from the 1990s until 2014 created a political context with strong veto possibilities. The increase in the number of veto players shaped the relationship between national and regional governments in a way that precluded the possibility of wider constitutional reforms, which would have made possible a concurrent dual GST. However, with the dawn of single-party dominance after 2014, it became feasible to forge political compromises for constitutional settlements. Thus, when national and subnational incumbents are co-partisans, the most difficult constitutional change – one that aims at a reallocation of powers – becomes easy to accomplish.

Third, although a dominant party equilibrium in a federal system presents a unique opportunity to alter the division of power by amending the constitution, a dominant party cannot ignore the federal constitutional structures it operates within. Under a political context characterized by weak veto possibilities, the institutional condition of federalism and the role of courts as guardians of the constitutional conscience provide valuable safeguards. The possibility of coming under judicial scrutiny and the likelihood of defeat can induce the dominant party to make compromises the midpoints of competing claims.

Fourth, and relatedly, the coordination dilemma cannot be effectively resolved without making the reallocation of constitutional powers less intimidating to subnational levels. This is where concessionary federalism kicks in. Thus, this article notes the various concessions offered by the union government to bring SNGs on board. The practice of concessionary federalism by a dominant ruling party shows that even when party congruence paves the way for 'imposed cooperation', the institutional condition of federalism lurks in the background. Thus, the need for an explicit bargaining federal process (negotiated cooperation) cannot be entirely ignored.

Finally, the way in which India resolved the coordination dilemma associated with the introduction of GST may provide lessons for other federal economies. In particular, subnational engagement in designing policy reforms early on, and a particular combination of a high level of unconditional and predictable federal grants and the provision of an institutional mechanism for intergovernmental interactions, collaboration, bargaining, and conflict resolution, can be conducive to reforms that impinge upon subnational autonomy. The overall direction of change has been from fiscal autonomy to (1) financial empowerment via devolution of independent revenues and (2) centre–state financial coordination and collaboration. In other words, when a reduction in self-rule is offset by increasing shared rule, the change becomes more acceptable to SNGs.

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NOTES

1. Federal countries that levy centrally controlled VAT include Argentina, Australia, Austria, Germany, Mexico, Russia and Switzerland.
2. The constitutionalization of fiscal federalism in India and the resultant role of the Supreme Court in policing it (Swenden & Saxena, 2021) increases the scope of negotiated cooperation in this domain. However, as the

constitutional position of the states is comparatively weaker in other policy fields, the form of cooperation in tacit or imposed at best.

3. The Supreme Court has ruled that federalism is a 'basic and unamendable feature' of Indian Constitution (*Kesavananda Bharati versus State of Kerala* [1983] 4 SCC 225; AIR 1973 SC 1461).

4. In a simple coordination game, any transgression attempted by the central government can be repelled only if both the affiliated states and the opposition-ruled states challenge the central government. If only the opposition group (which is outnumbered by the affiliated states under a dominant party system) challenges, the challenge fails. If both groups acquiesce, then the attempted transgression succeeds.

5. A dominant party equilibrium is formed when a single party has the majority in the national parliament, and the same party rules most of the subnational states.

6. Tsebelis (2000) defines veto players as individual or collective actors whose agreement is required for a change of the status quo.

7. See note 4.

8. In using these terms, we draw on international theories of cooperation among nations, which make a distinction between tacit, imposed, negotiated and contingent cooperation (Young, 1989).

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