



CONCESSIONARY FEDERALISM AS A TACTICAL CHOICE TO FACILITATE CONSTITUTIONAL CHANGE—A LESSON FROM INDIA’S INDIRECT TAX REFORMS

Chanchal Kumar Sharma



Prof. Dr. Chanchal Kumar Sharma is a Professor of Political Science at Central University of Haryana and Associate at the GIGA Institute of Asian Studies, Germany, since 2017. He critically engages with themes lying at the intersection of politics and economy in federal systems. His research has been funded by grants from the GIGA (Hamburg), Leverhulme International Network Grant (UK), Edinburgh Global, Hanns-Seidel-Stiftung (HSS) and ICSSR (India).

Abstract

One of the key questions of research on federalism is to understand the conditions or causal mechanisms under which constitutional change—that reallocates powers between the centre and the states— becomes feasible in federal systems. However, the literature on federalism offers limited

guidance on how to persuade subnational states to adopt amendments which seek to diminish their constitutionally assigned powers—especially their tax authority, which is a primordial feature of their institutional empowerment—*without violating democratic decorum and federal principles*. The case of indirect tax reforms in India assumes significance in this context. It adds important insights to the debate on how best to understand the circumstances under which the proposals to amend the constitutional division of powers enter the political agenda and the conditions under which they fail or are finally adopted.

Introduction

The successful introduction of a ‘Concurrent Dual GST’^[1] model in India from 1st July 2017 following an amendment to the constitutional division of powers makes it a case of tax reforms having no parallel. India is now the only developing country federation with a concurrent 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 equalise SGST revenues^[2].

After 1991, the paradigm shift in economic policymaking, precipitated by an exceptionally severe balance of payments crisis, had generated a broad consensus on the need to reform India’s inefficient and complex indirect tax system. The Indirect Tax Reform Committee, 1991, recommended reforms to remove barriers to factor and product mobility and foster domestic economic integration. Given that the implementation of GST required states to give up their right to determine tax rates on the sales and purchases of goods within their jurisdiction, the indirect tax reform process got off to a slow start and remained embroiled, for more than two decades, in the centre-state coordination dilemma about concerns related to the loss of revenue and fiscal autonomy.

Despite a broad consensus on the rationale of reforms, and the centre’s willingness to offer concessions, the reforms lingered throughout the coalition era in Indian politics. Interestingly, while the coalition governments failed to motivate the Subnational Governments (SNGs) to reach an agreement on contentious issues related to these tax reforms, a negotiated solution to the coordination dilemma could be constructed when a ‘dominant party equilibrium’ began to operate after 2014.

What prompted the states to accept limits on their fiscal authority and what induced the dominant ruling party to adhere to the previously made commitments?

The Principle and the Politics of Concessionary Federalism: How Does it Work?

Within a federal system, constitutional change is often required to reallocate competences (Behnke and Benz 2009). A constitutional reallocation of power may aim at peripheralization, federalization or centralization. Here we are concerned with the specific case of changing federalism’s boundaries—to diminish the subnational governments’ tax powers—through formal amendment(s), with the approval of the subnational governments (SNGs). In this situation, the national government, as a first mover, determines the minimum level of concessions— rational from its perspective and acceptable to the SNGs— in return for the SNGs’ abdication of tax powers. In this way, the coordination game begins. 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. Thus, a concessionary approach to intergovernmental interactions (or 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).

Under what conditions is the concessionary approach likely to be (in)effective?

The concession-based bargaining approaches to extract SNGs' agreement are likely to fail in the context of a weak national government (for instance, minority/coalition governments) because when national ruling parties are weak, retaining fiscal authority creates greater payoffs for SNGs than swapping their autonomy for concessions. When a coalition government rules at the centre and different parties govern different states, the non-affiliated states are large enough in number to collectively block any constitutional amendments designed to limit subnational fiscal powers. Therefore, the federal concessions will be rejected, which means that the federal bargain will be unsuccessful. 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 constitutional powers 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 has been referred to as concessionary federalism.

Concessionary Federalism and India's Transition to the GST Regime

As the federal political institutions or the structures of voluntary cooperation are weak in India, the centre-state interactions on specific policy issues produce either conflict or cooperation, depending on in/congruent partisan affiliation (Sharma and Swenden 2018), weak/strong constitutional position of states in those specific policy fields and low/high national priority accorded to those issues (Swenden, Saxena, and Sharma 2021).

Despite the indirect tax reforms being a high priority issue, the coordination dilemma associated with it could not be resolved for more than two decades after adoption of the structural adjustment programme in 1991, because of the combined effect of the states' constitutional authority to charge and levy tax on sale or purchase of goods and the contentious politics of the coalition era. It is important to highlight that the opposition parties—who ruled more than half of the states and had the ability to block the centre's bid to pass the contentious GST bill—had no incentive to swap their fiscal autonomy for concessions which the national ruling coalition was willing to offer. Thus the 'concessionary approach' did not work during the coalition era. However, with the BJP's rise to federal power in 2014 and a streak of victories in state assembly elections (Schakel, Sharma, and Swenden 2019), the number and impact of veto players, such as the opposition chief ministers and parliamentarians, reduced considerably. Consequently, a new political structure of voluntary cooperation, based on partisan ties, began to operate between the two levels. Interestingly, 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. In this situation of the dominant party equilibrium, the affiliated state governments (21 at the time of the passage of the GST bill) ceased to

be subnationally oriented and approved the constitutional amendment to impose limits on their fiscal authority in exchange for a package of concessions, leaving no choice for the non-affiliated states but to follow suit.

Here it can be argued that since a single party dominance paves the way for a hierarchical control over the SNGs, 'imposed' cooperation can replace the need for an explicit bargaining process. After all, why would a national government powerful enough to extract states' acquiescence agree to concessions demanded by the SNGs? In other words, the explanation relying exclusively on the party dominance leaves open the question of incentives that induce the dominant party to adhere to the previously made commitments. The solution to this puzzle lies in the constitutionally established federal structure which creates legally independent and constitutionally protected spheres of political authority (Elazar 1987). Thus, a dominant party in a federal system is often restrained by the path-dependent effects of the procedural and political safeguards inherent in a federal organisation itself. Therefore, the dominant party is obliged to make a tactical choice, an efficient frontier that seeks to address the trade-off between national and subnational utilities in a federal system. It engages in a reciprocity of concessions—whereby a loss of utility suffered by the SNGs in one dimension is at least partially offset by a gain in some other dimension(s).

Therefore, I argue that the transition to a GST regime became a reality only when the dominant national ruling party, otherwise capable of imposing cooperation via hierarchical control, adopted the negotiating path under the influence of India's federal governance in general and the path dependent legacies of the two decades of coalition politics in particular. The union government embraced a concessionary approach by

(a) agreeing to the GST design most preferable to the SNGs— that is, a "Concurrent Dual GST" rather than a single, unified national GST model

(b) increasing vertical devolution of the states' share in the divisible pool of Union taxes

(c) agreeing to a generous compensation package promising a growth rate of 14% in GST revenue for the first five years of GST's implementation

(d) accepting the states' demand to keep some of the revenue yielding products (such as petroleum products alcohol, electricity, and real estate) out of the purview of the GST and finally

(e) enshrining in the constitution, a new institutional mechanism (the GST Council) 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.

Finally, the Indian experience shows that commitment problems do occur. For instance, the central government attempted to renege on its commitment to compensate states for revenue losses due to the transition to the GST regime. Interestingly, all affiliated (BJP ruled) states supported the centre's proposal. Emboldened by the support of the affiliated states, the central government flayed the disgruntled SNGs for their uncooperative attitude and threatened to postpone the payment of their compensation dues for a further two years until June 2022. At this moment, the dissenting (opposition ruled) states threatened to move the apex court against the centre's decision. Such an effective use of legal threat by the opposition ruled SNGs induced the central government to change its stance. This not only highlights the role of the judiciary in enforcing the constitution's limit on federal power but also confirms the insight from the literature on auto limitation (Stone 1992), that governments take into account court's preferences and exercise 'self-restraint' to avoid defeat at the court.

Conclusion

In this short contribution I have highlighted the logic that made the subnational states approve the tax reforms, notwithstanding the clear prospect of a reduction in their fiscal autonomy after implementing the GST. It has highlighted the role of critical junctures; the role of the post 2014 political environment characterised by weak veto possibilities in removing barriers to change; the role of federal constitutional structures in compelling the dominant national ruling party into making concessions and the role of judicial safeguards in protecting the states from federal overreach, pre-emption and coercion. Most importantly, it has highlighted the salutary effect of the concessionary approach to dispute prevention—which is the only way to undertake reforms that impinge upon subnational authority. The concept of concessionary federalism can be applied to capture the experiences of federal systems characterized by a dominant party and hierarchical relationships, such as Mexico and South Africa. It can also be applied to the federal systems such as Argentina and Australia, 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.

[1] Goods and Services Tax (GST) is a destination-based (i.e., consumption-based rather than a production-linked tax), comprehensive (i.e., applies to all purchases of goods and services with minimal or negligible exemptions), multi-stage (i.e., levied on the net value added at each stage of transaction in the production and distribution chain), credit-invoice tax (i.e. allows producers to claim credit for tax paid on purchases of inputs). Generally, a single (unified) tax levied by the national government is considered ideal from a viewpoint of economic efficiency. However, this 'ideal' model is not politically convenient for large federal countries like India, where subnational fiscal autonomy is a sensitive issue. Therefore, India has adopted a concurrent dual model in which the centre and the states levy their own GST on intra-state supplies of goods and services. In addition, the centre has exclusive power to levy and collect integrated GST (IGST) on all inter-state supplies of goods and services. IGST is then shared between the centre and the destination (consuming) state.

[2] The Central government levies Central GST (CGST) and states levy State GST (SGST) on goods and services. The rates at which the CGST and SGST are to be levied are jointly decided by the Centre and States in the GST Council— a unique institution for intergovernmental coordination. Although there is no system to equalize SGST revenues which benefit rich states (the advanced states benefit because of higher receipts from SGST on goods and services), yet the equalization effect is indirectly achieved by the fact that (a) the less industrialized states get a larger share of revenue from IGST and (b) The tax revenue collected by the Centre on intra-state supplies and inter-state transactions becomes a part of the divisible pool of central taxes which is devolved to states following a principle of equalization.

Sharma, CK. 2022. 'Concessionary Federalism as a Tactical Choice to Facilitate Constitutional Change—A Lesson from India's Indirect Tax Reforms ', *50 Shades of Federalism*. Available at: <http://50shadesoffederalism.com/case-studies/concessionary-federalism-as-a-tactical-choice-to-facilitate-constitutional-change-a-lesson-from-indias-indirect-tax-reforms/>

References

Behnke, Nathalie, and Arthur Benz. 2009. "The Politics of Constitutional Change between Reform and Evolution." *Publius: The Journal of Federalism* 39(2): 213–40.

Elazar, Daniel J. 1987. *Exploring Federalism*. Tuscaloosa, Alabama: University of Alabama Press.

Schakel, Arjan H., Chanchal Kumar Sharma, and Wilfried Swenden. 2019. "India after the 2014 General Elections: BJP Dominance and the Crisis of the Third Party System." *Regional & Federal Studies* 29(3): 329–54.

Sharma, Chanchal Kumar. 2021. "Concessionary Federalism in a Dominant Party System? Indirect Tax Reforms and Subnational Acquiescence in India." *Territory, Politics, Governance*. 1–19.

———. 2021. "The Political Economy of India's Transition to Goods and Services Tax." *GIGA Working Papers* (325), German Institute for Global and Area Studies, Hamburg.

Sharma, Chanchal Kumar, and Wilfried Swenden. 2018. "Modi-Fying Indian Federalism?: Centre-State Relations under Modi's Tenure as Prime Minister." *Indian Politics and Policy* 1(1): 51–81.

Stone, Alec. 1992. *The Birth of Judicial Politics in France: The Constitutional Council in Comparative Perspective*. Oxford University Press.

Swenden, Wilfried, Rekha Saxena, and Chanchal Kumar Sharma. 2021. "Understanding Multilevel Dynamics in India: Constituent Power and Multilevel Governance." *Territory, Politics, Governance* 0(0): 1–11.

Further Reading

Benz, A. (2016). *Constitutional policy in multilevel government: The art of keeping the balance*. Oxford University Press.

Filippov, M., Ordeshook, P. C., & Shvetsova, O. (2004). *Designing federalism: A theory of self-sustainable federal institutions*. Cambridge University Press.

Reddy, Y. V., & Reddy, G. R. (2019). *Indian fiscal federalism*. Oxford University Press

Sharma, C. K. (2012). Beyond gaps and imbalances: Re-structuring the debate on intergovernmental fiscal relations. *Public Administration*, 90(1), 99–128.

Tsebelis, G. (2000). Veto players and institutional analysis. *Governance*, 13(4), 441–474.

"india-flag-independence-day" by [bm nnetwork](#) is marked with [CC BY 2.0](#).

