Subtheme

Assignment Systems in Federations

Work Session 4: How Effective are Different Forms of Harmonizing VAT and Other Taxes?

Work Session 16: Does Fiscal Responsibility Legislation Undermine Federalism?

Vishwa Nath Alok

1. Harmonizing Value Added Tax and Other Taxes?

Harmonization of VAT and other taxes has been attempted in a large number of federations by subsuming sales tax and other commodity taxes into this. It has involved a grand bargain between the federal and state governments. A number of issues had to be dealt in view of the heterogeneity of states in terms of its income, economic character, population, size, geographical location, etc. Consensual sharing of taxation jurisdiction of states with the federal government without affecting fiscal autonomy had been the key challenge. With the belief that retail sales tax is best suited at the regional level and the VAT is best administered at the federal level, efforts have been made to harmonize it during the transition from sales tax to VAT. On the basis of experiences across federations, some key issues were addressed.

Each country attempted fiscal harmonization in its own fashion and evolved its own model. Broadly, this can be categorized into four:

1. *Federal VAT with Tax Sharing.* The VAT is collected at the federal level and shared with the subnational governments on the basis of a formula. The merits of the model include unification of tax rates across the country and the coverage of all transactions from manufacturing to retail by one level of government. On the flipside subnational governments surrender taxing powers and fiscal decentralization is affected adversely.
2. *Autonomous State VAT.* The federal government vacates the field of commodity taxation for states except some sumptuary items and VAT is exclusively collected and retained by the states. While this system enhances fiscal responsibility on the part of states, it has implications in intergovernmental fiscal transfer mechanism as revenue equalization role of the federal government gets affected.
3. *Dual VAT.* whereby both levels of governments collect the VAT independently on a separate economic base as per the powers defined in the constitution. In this case both tiers retain autonomy in fixing tax rates, exemptions and administrative procedures. However, arrangements for harmonization of state VAT need to be strengthened time to time.
4. *Nationally regulated State VAT.* National government determines rates, exemptions, and procedures of VAT, and states collect and retain the tax. This model ensures automatic harmonization. However, redistributive role of federal finance gets affected and subnational governments lose autonomy to vary rates.

As mentioned by the chairperson and other experts, India has recently adopted a system of dual VAT, at both the Union and state level. Adoption of state level VAT is a result of repeated and candid discussions amongst the states. Harmonization of VAT rates across states for integration was crucial as multiple tax rates were barriers to free movement of goods. While the need for tax harmonization was well recognized, its process and procedures threw up intense debate in terms of putting in place regulatory instruments and mechanisms to ensure uniformity and compatibility. In India, though sales tax has been replaced with VAT, other commodity taxes and levies imposed by the state governments and local governments still affect fiscal harmonization. It is viewed that a common or a central information exchange system might bring in transparency in tax administration. Current consultations for a final negotiation with the states for a point of convergence between the central VAT, service tax and state VAT, to lead to a Goods and Service Tax (GST), could be an important step forward, along with the phasing out of central sales tax (tax on inter-state movement of goods) in the next three years. Currently, the system of taxation of inter-state trade based on the origin principle is being reformed. Alternatives, so far discussed, include (a) zero-rating of inter-state sales, (b) clearing house mechanism, and (c) destination based pre-paid VAT. It is viewed that while subnational jurisdictions could feel loss of fiscal autonomy, they would gain from a common market that would provide hassle free tax administration for individuals and corporate sector to plan and engage in productive economic activity leading to creation of wealth and employment opportunities.

The case of Brazil was also presented. Federal, state and municipal governments in Brazil administer a variety of commodity taxes, i.e. (a) IPI *(Imposto sobre Productos Industrializados)*, a federal VAT on manufacturing, (b) ICMS *(Imposto sobre operacoes Relativas a Circulacao de Mercadorias e Servicos),* a state VAT on consumption covering almost all economic activities related to agriculture, manufacturing and services, and (c) ISS *(Imposto Sobre Servicos),* a tax on the gross receipts of municipalities, based on a variety of industrial, commercial, and professional services that is not included in the ICMS. The state VAT is levied on sales within and outside the state. However, the rate differs on intra-state and inter-state sales subject to floors and ceilings determined by the federal government. Even for inter-state sales, the rate of tax varies according to destination. However, the importing state gives rebate for the tax. The National Public Finance Council (*Conselho de Politica fazendaria*—CONFAZ) comprising representative of all states with 27 councillors plays a crucial role in harmonizing the inter-state tax. The council determines exemptions and rate of ICMS through periodic meetings. Brazilian VAT at two levels poses some technical and administrative problems in its application in different states, in addition to a federal VAT. Various attempts have been made to integrate the IPI and ICMS systems (vertical) with the inter-state transactions (horizontal). But, a hassle free harmonized VAT system in Brazil is yet to be developed and implemented.

The Argentine case was also discussed. The central government collects most of the taxes in Argentina. These taxes are shared with the states through a "co-participacion" (tax-sharing) system. The gross receipts tax is the most important in own source revenues of the provinces. In order to change the gross receipt tax to a retail sales tax, many provinces abolished or reduced the tax on agriculture and some items on manufacturing. All options including central VAT, state VAT, dual VAT and retail sales tax are being examined in Argentina. Inter-state variations in fiscal capacity create challenges in the design of a new system.

The case of EU suggests that EU levies VAT at the state level. The tax system has been based on destination principles through VAT information exchange systems ensuring zero-rating for the transactions between the registered dealers only. The VAT has been harmonized through abolition of fiscal frontiers and zero rating of inter-state transactions. The EU Parliament issues directives from time to time to impose uniformity in structure, organization and procedures of VAT in the European Union.

The debate on how effective different forms of harmonizing VAT and other taxes have been is inconclusive. It reiterated that different contexts require different solutions. Many dimensions including population, size, location, economic pattern, quality of tax administration, the degree of trust, and the existing tax structure of a country play an important role in tax harmonization and determining its effectiveness.

2. Fiscal Responsibility Legislation

Since the beginning of the last decade of the twentieth century, several governments have been intensely exploring the mechanism to shift from discretion based fiscal policy to a rule based fiscal responsibility framework. An increasing number of countries, including federations, introduced fiscal responsibility legislation (FRL). FRL includes elements like numerical fiscal targets, fiscal transparency standards, escape clause in case of exigencies, fiscal policy rules, and enforcement mechanism. The examples of such countries are Argentina, Australia, Brazil, Chile, Columbia, Ecuador, Estonia, India, Indonesia, Mexico, New Zealand, Peru, Russia, South Africa, the United Kingdom, and Venezuela. However, the fiscal targets set under the Treaty of Maastricht in 1992 facilitated the adoption of the Euro.

The adoption of fiscal policy rules emanated from the tendency of the populist governments towards fiscal profligacy to enhance their election prospects. The tendencies became unsustainable over the medium term and jeopardized public service delivery and the safety of the financial system in view of the fact that the banks were the major holders of the public debt. The creditworthiness of the states or the governments themselves were affected when there were huge accumulations of debts, as states' ability to service those debts decreased in the market. Finally, the overall macro economic stability of the central bank was affected.

FRL, if well designed and rightly implemented, is considered as a commitment device. It commits federal, regional and local governments through cooperative framework to follow a certain fiscal discipline and ensure that deficits are within tolerant levels so that the tendency of an individual government to run excessive deficits is minimized. Country examples suggest that it has been more voluntary rather than coercive. So, some states have adopted this legislation whereas others have not. Thus, for a group of the federal and subnational governments it is mutually reinforcing, as every government is part of the bargaining solution framework. To an extent, it protects the common interest that although not every government is part of the framework, there is commitment to bringing down the level of fiscal deficit and reducing borrowing. It is considered the state of fiscal behaviour of both the federal and subnational governments. However, within a common framework, there is a tendency in both governments—the federal and subnational—to take advantage and violate some of these frameworks.

Therefore, it is essential for every government to abide by the same framework.

3. Discussions and Conclusions

Against this backdrop, the Chairman of the session presented the Indian case, among others, in his speech. The Indian Constitution recognizes federalism in its legal, political, administrative and financial aspects. The two tier federal system of the Union and the state governments was extended a decade and a half ago to cover local governments at the district, sub-district, city, town and village levels. Like many other federations, a complex system of financial relations between different levels of government attempt to address existing vertical and horizontal imbalances. The Union Government of India enjoys a greater share of the overall tax revenues while the states bear greater responsibilities for expenditure to meet many basic needs of the people, such as education, health services, water supply, electricity, transport infrastructure and many others. Successive finance commissions guide a system of devolution of tax revenues from the Union to the states. The institution of planning commission and ministries provide development assistance and funds to states for implementing many 'Centrally Sponsored Development Programmes'. The finances of both the Union and the state governments in India were under great stress during the nineties due to a number of reasons including inadequate mobilization of taxes and fast expanding revenue expenditure. The combined fiscal deficit of the Union and the states at one time went up to about 11 per cent of the Gross Domestic Product (GDP). The combined internal debt of the Union and state governments was very high at about 80 per cent of the GDP. The interest payments consumed a substantial part of the tax and non-tax revenues of the Government with revenue deficits becoming very common, which forced the governments to borrow increasingly to meet their revenue expenditure. Consequently, the Government was unable to commit adequate resources to pursue its development goals.

It was in this context that FRL was adopted as one of the first steps in that direction. This was first passed in 2002 by the state of Karnataka followed by Punjab even before the Union Government passed the Fiscal Responsibility and Budget Management Act in 2003. The Act required the Union to eliminate its revenue deficit before 2008. It also imposed restrictions on borrowing from the Central Bank, i.e. the Reserve Bank of India. The Centre is also required to present to Parliament every year a Medium Term Fiscal Policy Statement and a Macroeconomic Framework Statement along with the budget. Further, quarterly reviews of receipts and expenditure are also to be presented by the Finance Minister. Other states, namely, Kerala and Tamil Nadu, also passed it in 2003 and Uttar Pradesh in 2004. The enactment has helped the state in bringing about the required fiscal correction and restricts its fiscal deficit to less than 3 per cent since 2004-5. The Act requires the state to present to the Legislature a rolling Medium Term Fiscal Plan every year and a review of its fiscal situation once in six months. As a consequence of adopting these measures, the state of Karnataka has been able to restrict its revenue expenditure and exercise prudence in its overall financial management. After the adoption of the FRL by the Union, the Twelfth Finance Commission stipulated a scheme of consolidation and partial waiver of the state's debts to the Union Government. The states were required to adopt fiscal responsibility measures to become eligible for this debt restructuring and waiver. Consequently, remaining states have also passed the FRL. However, it is believed that the passage of an Act is no guarantee of its implementation, but most of the states that have bound themselves to fiscal targets have so far achieved them.

Indian experts were of the view that the Fiscal Responsibility Legislation adopted by the Union and the state governments in India has greatly helped in strengthening the federal structure instead of weakening it in any manner. It was emphasized that states which manage their finances prudently can sustain their political autonomy much more effectively than those which have to repeatedly seek the assistance of the Union Government to overcome their financial difficulties. FRL acts as a check against unbridled populism on the part of governments, which indulge in financial profligacy in the hope of improving their electoral prospects. The risk of such populism is very high in cases where elections result in a fractured mandate leading to unstable coalition governments. "The balanced development of all parts of a large country like India also requires financial discipline being observed by the states, so that the profligate financial policies of some states do not result in serious distortions in the efforts needed for the development of different regions", the chairman said, with support from other experts.

An Austrian case was also presented. The salient features of the presentation are as follows: The federal assembly of Austria comprises a federal government, nine states and 2357 municipalities. Austria joined the European Union in 1995 with a fiscal responsibility framework. Under the Austrian Internal Stability Pact, fiscal policy rules were framed, federal fiscal deficit was restricted, and state surplus was made mandatory with balanced municipal budgets. Procedures such as accrual based accounting and frequent government reporting were adopted. There is an independent monitoring and financial sanction that is possible. A high level committee comprising Federal Minister of Finance, nine state finance ministers, and political representatives of rural and urban municipalities coordinate the budgets. It was viewed that in Austria, FRL, although it did not guarantee fiscal discipline, was a formal expression of the political will towards sustainable public finances and could be reconciled with federalism. It is a good instrument to harmonize fiscal behaviour; this point was stressed during the case presentation of Spain.

The case of Brazil was also presented and discussed at length. The genesis of the FRL in Brazil can be traced in three subnational debt crises that happened in 1989, 1993, and 1997. Each time there was an agreement, the agreement specified some ways of limiting the future subnational debt. It reinforced the perception that the federal government would rescue states and bail the subnational debts. However, most debts were rescheduled and not waived. The provinces continued to borrow and the debts kept growing. There was no penalty on the subnational government for having defaulted. So, the federal government was left with all the debts of subnational government. In the 1997, under the new strategy, the states were liable to pay more by way of debt servicing to the centre on the existing debt. There would be deduction in the fiscal transfers from the federal government to the provinces in favour of debt service. Privatization was prescribed to all the state enterprises including all state owned banks. This was considered imperative, as state owned banks were financing provincial debt in Brazil. Therefore, it was an effort as part of the privatization regime to force the states to divest their holdings in state-owned banks. The passage of FRL of 2000 was the culmination.

The Brazilian FRL of 2000 was considered to be a coercive law. It was one law for all level of governments, federal, state, and municipality. It had prescribed the eligibility criteria to borrow and the legal penalties for any default. It had all the in built intermediate targets, caps on the spending, deficits, and debt targets were specified. It prohibited debt refinance operations between governments.

To conclude, the experience in countries at the subnational level with fiscal responsibility legislation so far, while mixed, is fairly positive. Passage of an act is no guarantee of its implementation, but most of the subnational governments, which have bound themselves to fiscal targets, have by and large achieved them. However, in a federal set up considerable care is needed in the design and enforcement of numerical fiscal policy rules. While uniform fiscal policy and procedural rules are possible in a top down approach, these are difficult where considerable fiscal decentralization exists.