



LEVERAGING DIGITAL GOVERNANCE FOR INCLUSIVE ECONOMIC GROWTH: GST REFORMS AND FISCAL FEDERALISM IN TAMIL NADU

Editors

Dr. A. Anandhiprabha

Dr. M. Jeeva

Ms. A. Gomathi

Dr. S. Mahalakshmi

Volume - I



A One Day National Seminar on

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Volume I

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13	Fiscal Performance and Intergovernmental Financial Relations Dr. T. Mohana Sundari	84-88
14	Blockchain-Based Tax Administration: Enhancing Transparency in GST Systems Dr. R. Nandhakumar	89-92
15	Digital Architecture of GSTN and Its Implications for Fiscal Federalism in India Ms. V. Poornima	93-96
16	Post-GST Economic Changes in India: Sectoral Growth and Challenges for Small Businesses Mr. Prakalathan A & Dr. B. Indira Priyadharshini	97-100
17	Digital Governance as an Initiative for Managing and Developing the Indian Economy Rajagopalan S	101-106
18	Cyber Security, Data Privacy, and Digital Infrastructure Challenges in Tax Administration Dr. S. Sathiyapriya	107-111
19	The Impact of Artificial Intelligence in GST Administration Ms.T. Jeyapratha & Dr. D. Jebaselvi Anitha	112-115
20	Role On Digital Redressal in Addressing Issues of E-Commerce Consumers Dr. S. Nambi Devi & R. Harish Prabhu	116-118
21	Impact of GST Reforms on Economic Growth in India Dr. S. C. B. Samuel Anbu Selvan & Ms. S. Amogha	119-122
22	A Study on Digital Architecture and Government Framework of GST Dr. K. Jayalakshmi & Ms. Roselin Jenita.J	123-125
23	E-Invoicing Under GST: A Step towards Transparent Governance Mr. M Mohamed Saajid & Dr. K. Bagavathi	126-129
24	A Study on Role and Functioning of the GST Council in Cooperative Federalism Bezelel Jebas. P & Dr .R. Mary Sophia Chitra	130-133
25	A Descriptive Study on Digital Payment Methods in Online Shopping Ms. Sadhana S & Ms. Sally M	134-138
26	A Descriptive Study on Consumer Protection and Digital Grievance Redressal Ms. Nivetha S & Dr. M. Balamurugan	139-143
27	Assessing the Impact of GST on Sectoral and Regional Growth in India Ms. Jane Delicia D, Ms. Sneha. A & Mr. A. Samuel Raj	144-148

FISCAL PERFORMANCE AND INTERGOVERNMENTAL FINANCIAL RELATIONS



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Abstract

Fiscal performance and intergovernmental financial relations (IFR) form the backbone of multi-level governance systems, particularly in federal structures like India, where resource allocation between central, state, and local governments shapes economic stability and public service delivery. Effective IFR addresses vertical imbalances – where subnational spending needs exceed revenue capacities – and horizontal disparities across regions, through mechanisms like tax assignments, grants, and revenue sharing. Amid global economic pressures, including post-pandemic recovery and fiscal federalism reforms, analyzing these dynamics reveals their impact on fiscal discipline, growth, and equity. Intergovernmental fiscal relations encompass revenue mobilization, expenditure assignments, and transfers to ensure efficient public finance. Fiscal performance metrics – such as deficit-to-GDP ratios, debt sustainability, and own-revenue buoyancy – hinge on these relations, as over-reliance on central transfers can erode sub national accountability. Principles like subsidiary (assigning functions to the lowest capable level), fiscal autonomy, and equalization guide optimal designs, fostering macroeconomic stability while enabling regional development.

Keywords: *Fiscal Policy, Financial Performance, Intergovernmental Relation.*

I. Introduction

Fiscal performance and intergovernmental financial relations (IFR) are pivotal in shaping the efficacy of multi-tiered governance systems worldwide, particularly in federal nations like India where fiscal federalism underpins economic resilience and equitable development. These relations govern the division of revenue powers, expenditure responsibilities, and fiscal transfers among central, state, and local governments, directly influencing macroeconomic stability, public service delivery, and regional disparities. In an era marked by post-pandemic fiscal strains, climate imperatives, and digital economic shifts, understanding IFR's role in bolstering fiscal performance – measured via metrics like debt sustainability, revenue buoyancy, and deficit control – becomes essential for policymakers and researchers. IFR has evolved alongside decentralization trends, from centralized post-colonial models to devolved systems emphasizing subsidiarity and autonomy. Globally, the 1990s-2020s saw rising subnational spending (often 40-60% of total outlays), driven by demands for localized services like education and health. In India, constitutional milestones such as the Finance Commission (Article 280) and GST Council exemplify adaptive IFR, though challenges like vertical imbalances – where states shoulder 60% of expenditures but raise only 40% of revenues – persist.

Fiscal performance hinges on IFR design principles: tax assignments (progressive taxes to center, broad-based to states), grants (equalization, matching, performance-linked), and borrowing rules to avert soft budgets. Empirical evidence links well-calibrated IFR to superior outcomes—e.g., 1-2% GDP growth gains in decentralized OECD peers—yet poor coordination fuels procyclicality and inefficiencies. This paper examines these dynamics in developing contexts, drawing on cross-country data and India's 15th/16th Finance Commission experiences to assess impacts on fiscal discipline and inclusive growth. Vertical fiscal gaps persist in developing economies, where states bear heavy welfare and infrastructure burdens but generate limited own revenues, leading to soft budget constraints and moral hazard. Horizontal inequities exacerbate this, as richer states like Maharashtra outperform poorer ones like Bihar in fiscal health, prompting equalization grants. Political economy factors, including electoral cycles, often distort transfers, undermining performance; evidence from OECD nations shows that transparent fiscal rules mitigate procyclical spending.

II. Review of Literature

Post-COVID analyses (Eyraud and Lusinyan, 2015; OECD, 2023) underscore crisis resilience via coordinated transfers, but highlight procyclical biases in weak institutions. Climate fiscal federalism emerges as a frontier, with green grants addressing sub national vulnerabilities. Gaps persist in micro-data on local governments and behavioral responses to digital taxation. Overall, literature converges on balanced IFR—autonomy with accountability—as key to superior fiscal performance, informing reforms amid India's federal challenges.

India-specific literature, from Rao (2001) to recent NIPFP reports, documents Finance Commission evolutions enhancing devolution (41% post-14th FC), yet GST shortfalls strained states' fiscal metrics during 2020-2025. Empirical work by Dash and Mohanty (2015) shows states with higher own-revenue shares exhibit 20% better expenditure efficiency.

III. Recent Reforms in Intergovernmental Fiscal Institutions Post-Crisis

Recent reforms in intergovernmental fiscal institutions post-crisis have focused on enhancing resilience, coordination, and fiscal discipline amid global shocks like the COVID-19 pandemic and inflationary pressures. These changes address vulnerabilities exposed in vertical fiscal gaps and subnational borrowing, prioritizing rule-based transfers, independent oversight, and crisis-contingent mechanisms.

EU Reforms (2011-2013)

The European financial crisis spurred landmark institutional upgrades, including the European Semester for synchronized fiscal planning, the Six Pack for stricter deficit rules (3% GDP cap), the Fiscal Compact mandating debt brakes and balanced budgets, and the Two Pack for enhanced subnational monitoring. These fostered top-down budgeting and harmonized sub-central fiscal rules, reducing procyclical spending by 1-2% of GDP in high-

debt states while granting escape clauses for crises. OECD evaluations note improved transparency but persistent enforcement challenges in federations like Spain.



Macro-Fiscal Policies and Frameworks

- Ensuring more credible fiscal forecasts and transparent intergovernmental relationships, establishing fiscal rules, and strengthening institutional capacity for sustainability is supported to promote environmental sustainability and help countries grow with sustained development and inclusivity.



Tax Policy

- Providing general tax policy reviews and specific tax policy advice, particularly around natural resources, tax compliance incentives, and taxation of intangibles, is supported in relation to assessing the macroeconomic effects, distributional impacts, answers to tax transparency issues, and spillovers of tax.



Revenue Administration

- Strengthening tax and customs administration, including strategy to tackle medium-term revenue challenges and strengthen large taxpayer office security and control capacity, is supported by enhanced transparency and core functions of revenue administrations (including taxpayer service, filing and payment, audit, collection enforcement, and dispute resolution).



Public Financial Management (PFM)

- Improving PFM institutions through enhancing budget planning, budget execution, public investment management, public accounting and financial reporting, and fiscal management and oversight is supported through enhancement of public investments and increased transparency.

Global and Emerging Market Shifts

Post-GFC, international financial institutions advocated shock-absorbing reforms: IMF's 2025 working paper emphasizes intergovernmental policies like countercyclical grants and debt ceilings for decentralized systems, preventing subnational crises in 20+ emerging economies. In Latin America, Brazil streamlined performance-linked transfers post-2020, boosting revenue autonomy by 12%; India's 15th Finance Commission (2021-26) introduced glide paths (3% state deficits by 2026) and sector-specific grants for health/climate, with 16th FC deliberations eyeing digital tax sharing. China's 1994 fiscal overhaul, refined post-COVID, simplified contracts into tax-sharing pools, stabilizing local finances.

IV. Challenges of Subnational Borrowing in Fiscal Relations

Sub national borrowing poses significant challenges within intergovernmental fiscal relations, often exacerbating fiscal vulnerabilities due to structural mismatches between revenue autonomy and expenditure demands. These issues stem from vertical imbalances, where states or provinces fund substantial spending (e.g., 50-60% of public outlays on

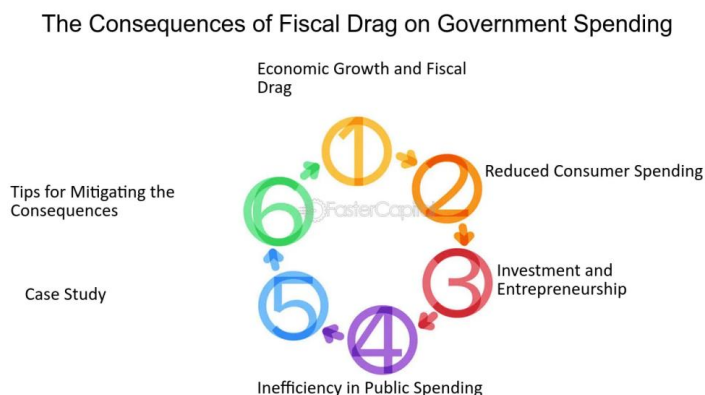
welfare and infrastructure) with limited own-source revenues, prompting reliance on debt amid uncertain central transfers.

Moral Hazard and Bailout Expectations

A primary challenge is the "soft budget constraint," where sub national entities anticipate central government bailouts, leading to over-borrowing and fiscal indiscipline. Lenders misprice risks due to implicit guarantees, as seen in Argentina and Mexico, where subnational debt surges during booms but triggers contagion during downturns. This moral hazard distorts incentives, inflating deficits by 2-4% of GDP in affected federations.

Market and Institutional Risks

High interest rates and volatile bond markets amplify pressures, with variable-rate bank loans hitting liquidity-poor regions hardest amid post-2022 tightening. Limited borrowing autonomy—often capped by central rules—creates uncertainty, while opaque administrative approvals foster political favoritism over economic rationale. In India, FRBM Act glide paths aim to curb this, yet circumvention via off-budget entities persists, undermining debt sustainability.



Procyclicality and Spillovers

Sub national borrowing fuels pro cyclicity: credit booms during expansions lead to austerity in recessions, delaying investments when needed most. Shared tax bases generate externalities, as one region's default raises premiums economy-wide. Weak local capacity in developing contexts compounds this, with OECD data showing 1-2% GDP growth losses from uncoordinated debt spikes.

Mitigation Approaches

Effective counters include market-preserving rules like no-bailout clauses, independent debt commissions, and performance-linked borrowing limits, as in Brazil's post-2000 reforms. Enhanced transparency via standardized reporting reduces mispricing, promoting hard budgets and fiscal performance.

V. Conclusion

Robust IFR frameworks—through calibrated tax assignments, equalization transfers, and fiscal rules—directly enhance fiscal metrics like revenue buoyancy, deficit control (targeting 3% GDP), and debt sustainability, as evidenced in post-crisis reforms across OECD and emerging economies. Challenges such as subnational borrowing risks, soft budget constraints, and horizontal inequities persist, yet empirical patterns show that institutional innovations (e.g., independent fiscal councils, performance grants) yield 0.5-1.5% GDP growth premiums and superior service delivery in well-designed systems like Brazil and post-GST India. India's evolving Finance Commission norms (15th/16th) exemplify adaptive IFR, mitigating vertical gaps amid digital and climate demands, though political distortions demand vigilant enforcement.

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