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# GST: Farewell to Multilevel Taxation

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## ABSTRACT

*On 8th September 2016, President Pranab Mukherjee approved the government's flagship Goods and Services Tax (GST) Bill. After going through a long journey of more than 16 years which first started in year 2000 in a Committee headed by Asim Dasgupta, GST will finally come into force from 1st April, 2017. GST is a single 'unified' indirect tax levied on goods and services that subsumes multiple taxes levied at the Central and the State level. This paper draws attention to the implications of a 'comprehensive' GST for economic growth, efficient resource allocation, GDP growth, tax compliance and administration, imports and exports, manufacturing sector, tax revenue efficiency and State finances. The findings of various Task forces/Committees conclude that GST may turn out to be a positive-sum game by bringing in "collective gain" for agriculture, manufacturing and trading sectors along with the final consumers and the government. Irrespective of the wide array of opportunities opened up by GST, the government must be mindful of its accompanying challenges such as development of a sound IT infrastructure, tax administration and modern information systems and determination of GST rate, exemptions, etc. The success of the government in addressing these challenges will determine the sustainability of this major indirect tax reform in the long run.*

***Keywords:*** *GST, Indirect taxes, Tax administration, Value added tax.*

## 1.0 Introduction

On 8th September 2016, President Pranab Mukherjee approved the government's flagship Goods and Services Tax (GST) Bill which will subsume a plethora of Central and State taxes and bring about a unified indirect tax structure in the country. After going through a long journey of more than 16 years, it will come into force from 1st April 2017.

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The discussion on GST first started in 2000 by an empowered committee headed by Asim Dasgupta. In 2003, the Kelkar Task Force proposed a comprehensive GST in a move to achieve fiscal consolidation which was the main objective of the Fiscal Responsibility and Budget Management Act, 2003. GST is a single 'unified' indirect tax levied on goods and services that subsumes multiple taxes levied at the Central and the State level. After the introduction of Value Added Tax (VAT), GST will be a further major breakthrough towards an effective indirect tax reform in the country. This paper draws attention to the implications of a 'comprehensive' GST for economic growth, efficient resource allocation, GDP growth, tax compliance and administration, imports and exports, manufacturing sector, tax revenue efficiency and State finances.

**1.1 Objectives**

The objective of this paper is to review the existing literature on GST, paying special attention to reports of various Task forces/Committees constituted for this purpose and to utilise the existing studies to throw light on the following issues:

- What weaknesses in the existing tax system led to the need for a 'unified' GST?
- What should be the guiding principles for a 'flawless' GST?
- What will be the impact of GST on the different sectors of the Indian economy and on public finances?
- What challenges lie ahead of GST?

**2.0 Shortcomings of the existing tax structure**

The deficiencies in the prevalent tax regime, namely the 'cascading' effect of taxes, inadequate taxation of services, taxation of goods at the manufacturing stage and complexity in the tax structure ushered in the need to introduce tax reforms. The existing tax regime was a severe impediment to tax compliance, equity, efficiency and neutrality. This section explains the shortcomings of the prevailing tax structure.

a) *Cascading Tax Structure*: The prevailing multi-level and cascading taxes are one of the major flaws in the Indian taxation system. A cascade tax or a "tax on tax" is one which is levied at every stage of production and distribution till the point of final sale to ultimate consumer. As goods pass through the supply chain (consisting of supplier, manufacturer, wholesaler, retailer and consumer), each successive transfer is taxed inclusive of all previous taxes levied. As a result of this "tax on tax" regime, an extra tax burden is borne by the ultimate consumer.

b) *Inadequate taxation of services*: A major drawback of the existing tax system is the non-inclusion of many services from the tax net. The service sector in India is one of the fastest growing in the world. It has witnessed a remarkable boom since independence with annual growth rate of more than 9% since 2001. According to Economic survey 2014-15, almost 72.4% of India's GDP growth in 2014-15 came from the service sector. Despite being the largest contributor to GDP, the existing distortionary tax system fails to adequately tax services.

According to CRISIL estimates, service tax to GDP ratio was only 8.64% in 2007-08. Many services still remain outside the ambit of service tax levy. This has adversely impacted the tax base and hence, the revenue productivity of the tax system. As a result, this led to higher tax rates on manufacturing sector to maintain the tax-GDP ratio. Higher tax rates on manufacturing sector not only discourage tax compliance, but also lead to inefficient resource allocation. Since the major burden of indirect taxes is borne by consumers of goods and not services, it distorts consumer's preferences in favour of consumption of services.

A recent survey by National Sample Survey Organization (NSSO) shows that the rich spend substantially more on services than the poor, i.e. services are income-elastic in demand. For example, the rich spend a large amount of their income on recreational services (e.g. dining in hotels, restaurants, watching movies in cinema halls), communication services (e.g. mobile bills), beauty parlour services, etc. Therefore, maximum cover of services in the tax net is essential from the viewpoint of equity in taxation.

c) *Taxation of goods at manufacturing stage*: While the Centre has the power to levy taxes on goods up to the production level (e.g. CENVAT is levied on goods produced in India), the States are empowered to levy taxes on the sale of goods. Restricting the tax incidence to the point of manufacture is a severe deterrent to tax efficiency and neutrality.

d) *Complexity*: Economic growth of a country depends upon the tax regime it adopts. Complexity of tax structure not only adversely affects growth and development but also encourages tax evasion. It is also hampers the ease of doing business in a country. India's taxation structure is characterized by excessive and complex tax rates (Ghuge & Katdare). As a result, India's Tax-GDP ratio is very low not only in comparison to other developing nations but also in comparison to the global average. The PWC Paying Taxes Report 2016, stated that India's Tax-GDP ratio was 17.7%, much lower than the global average of 21.82%. According to World Bank Data, India ranks far behind i.e. 157 among 189 countries in overall ease of paying taxes.

### 3.0 The GST Model

A report by Dr. Amaresh Bagchi (Bagchi Report) stated that: “If the ills of the present system are to be remedied, the problems have to be attacked at their roots and not by symptoms. The guiding principles should be neutrality, simplicity and equity”. According to the Report of the Task Force on Implementation of FRBM Act 2003, the goal of fiscal consolidation should be attained by increasing tax revenues rather than curtailing government expenditure. Thus, fiscal consolidation calls for tax reforms. The Task Force outlined the following guiding principles for tax reforms:

- Broader tax base, not higher rates: Higher tax rates encourage tax evasion, thus reducing tax revenues. The aim should be to expand the tax base by removing exemptions and bringing more and more goods and services in the tax net.
- Fewer tax rates: In order to reduce the complexity of the tax system, there should be fewer tax rates. Further, in the arena of indirect taxes, a single tax rate is most desirable.
- Greater equity in taxation: Tax reforms should aim at enhancing both ‘vertical’ as well as ‘horizontal’ equity.
- Switching to levying taxes on final consumption (‘destination’ principle) and removal of ‘cascading’ effect of taxation.
- Establishing a good tax compliance and administration system: This will not only enhance the ease of tax payments and administration but will also ensure transparency, thus boosting public confidence in the system.

The primary objective of tax reforms i.e. introduction of a ‘comprehensive’ Goods and Services Tax (GST), is to establish an efficient tax regime that is easy to administer and comply with, that enhances equity and neutrality of the tax system and is distributionally attractive. A good tax system should promote equal distribution of income in society and at the same time generate tax revenues for the government by widening the tax base to support public expenditure and infrastructure development.

GST is a single ‘unified’ indirect tax levied on goods and services that subsumes multiple taxes levied at the Central and the State level. In the First Discussion Paper on GST by the Empowered Committee (2009), it was recommended that the taxes to be subsumed should form a part of the value chain and should be connected to transactions of goods and services.

Keeping in mind the above-mentioned principles, the following Central Taxes were recommended to be subsumed under GST:

1. Central Excise Duty

2. Additional Excise Duties
3. Additional Customs Duty, commonly known as Countervailing Duty (CVD)
4. Special Additional Duty of Customs (SAD)
5. Service Tax
6. Surcharges, and
7. Cesses.

Similarly, the subsumation of the following State taxes was recommended:

1. State VAT/ Sales Tax
2. Entertainment tax (unless it is levied by the local bodies)
3. Central Sales Tax (levied by the Centre and collected by the States),
4. Luxury Tax
5. Octroi and Entry tax
6. Taxes on lottery, betting and gambling
7. Purchase Tax
8. State Cesses and Surcharge relating to goods and services

**4.0 Features of GST**

a) *Dual Levy of GST*: Following the principles of 'fiscal federalism' in India, GST will consist of two components- Central GST (CGST) and State GST (SGST). In 2007, The Empowered Committee of State Finance Ministers expressed their preference for a concurrent 'dual' levy of GST on goods by the Union and State governments. However, most of the services remained taxable under CGST only. As a result, State GST was largely limited to goods only.

In a further discussion of the Empowered Committee of State Finance Ministers in 2008, a discussion for the concurrent taxation of all goods and services by the Centre and the States was taken. This was also in line with the recommendation of the Kelkar Committee (2002). Hence, both the Centre and the States will levy GST simultaneously on every supply of goods and services (except for the 'negative' list). Moreover, CGST and SGST will be levied on a common tax base i.e. on the same value (price) of goods and services. The input tax credit of CGST and SGST will be allowed for paying CGST and SGST respectively on output. Figure 1 shows the working of the Dual GST Model within a state with the help of an example.

b) *Destination-Based Tax*: Let us first understand the concept of destination based and origin based taxation. According to a report on "Reform of Domestic Trade Taxes in India: Issues and options", National Institute of Public Finance and Policy, New Delhi:

"In principle, VAT can be levied either according to origin, that is, where the goods or services are produced" or on the basis of destination, that is, where they are consumed."

According to a "Report of the Task Force on Goods and Service Tax," also called the 13th Finance Commission: "A GST can be implemented under either the origin or the destination principle. Under the former, the GST is imposed on the value added of all taxable products that are produced domestically; under the latter, the GST is imposed on the value added of all taxable products that are consumed domestically." It has been the unanimous decision of various committees/ task forces that GST will be a destination-based tax levied on the value addition of all goods and services that are consumed domestically.

c) *Removal of 'Cascading' Effect of Tax*: A major breakthrough in the existing tax structure will be achieved through the elimination of the 'cascading' effect of tax. In GST, credit will be allowed for tax paid on intermediate goods and services at every stage of the value chain. A system of providing seamless tax credits up to the retailer's level is in fact, the essence of GST. Owing to the removal of this 'tax on tax' system, the burden of tax on the final consumer will fall. Let us take the earlier example and explain how GST removes the 'cascading effect of tax' and thus, saves tax.

d) *Gradual phasing out of CST*: An essential requirement for the introduction of GST was the phasing out of Central Sales tax. In a meeting of the Empowered Committee held in July, 2005, it was decided that phasing out of CST should be done in a gradual manner. A major concern raised by a number of States was about the loss of their revenue due to the phasing out of CST and hence, they demanded compensation by the Centre through budgetary allocations. In 2006, a Technical Committee was formed to work out a model for providing compensation to the States for loss of tax revenue. After several deliberations, a compensation package was designed to meet the revenue loss of States. In his Budget Speech 2007-08, the then Union Finance Minister announced that CST should be withdrawn by 31st March 2010 and in order to phase out CST gradually, CST rate to be reduced from 4% to 3% w.e.f 1st April, 2007. Later, CST rate was reduced from 3% to 2% w.e.f 1st April, 2008 and it was decided to retain the 2% CST rate till GST is introduced.

e) *Creation of a common market*: A common market is defined as a group of entities, usually countries, that promote free movement of goods and services as well as factors of production such as labour and capital within the group. Rao (2010) stated that a tax regime poses certain barriers to the free movement of goods and services in a country. In India, for instance, because interstate sales are subject to central sales tax (CST), but consignment transfers are not subject to central sales tax (CST), firms would find it optimal to set up depots in all states so as to convert interstate sales into consignment transfers and hence avoid CST. Likewise, since input tax credit for state VAT was only allowed on local purchases, most dealers ended up purchasing locally, rather than from other states. This discrimination between local purchases and interstate purchases implied that economic decisions were being based on tax considerations rather than economic considerations. These distortions can be avoided if taxes on purchases remain the same irrespective of where the purchases are sourced from. If this happens, then inputs will be bought from where they are best available, without consideration of taxation costs. A comprehensive GST will remove all impediments to the development of a single common market and ensure seamless trade across all states of the country.

**5.0 Impact of GST**

GST is India's biggest tax reform since Independence. Therefore, it becomes imperative to analyse its impact on different sectors of the economy and on public finances. According to a report by the Empowered Committee of State Finance Ministers 2013-14, GST may turn out to be a positive-sum game by bringing in "collective gain" for agriculture, manufacturing and trading sectors along with the final consumers and the government. The Report of the Task Force on Goods and Services Tax, Thirteenth Finance Commission has outlined the following implications of switching from the distortionary and cascading taxation regime to a "flawless" GST :

a) *Impact on economic growth*: In a convocation address at Indira Gandhi Institute of Development Research on 6$^{th}$ February 2009, Vijay Kelkar stated that: "A well designed destination-based GST on all goods and services is the most elegant method of eliminating distortions and taxing consumption. Under this structure, all different stages of production and distribution can be interpreted as mere tax pass-through, and the tax essentially `sticks' on final consumption within the taxing jurisdiction". By shifting the tax burden on final consumption rather than production, GST eliminates distortions in the tax system, thereby resulting in efficient allocation of resources and GDP growth.

A study by the National Council of Applied Economic Research (NCAER) for the 13$^{th}$ Finance Commission concluded that the implementation of a comprehensive GST will result in efficient allocation of factors of production i.e. land, labour and capital. This would further give a boost to GDP and exports and enhance economic welfare. The study also showed that "implementation of GST across goods and services is expected, ceteris paribus, to provide gains to India's GDP somewhere within a range of 0.9 to 1.7 per cent."

b) *Impact on tax compliance*: Milka Casanegra (1990) popularly stated that "in developing countries tax administration *is* tax policy" to highlight that the success of any tax policy depends upon how well-executed and effective is its tax administration. A single indirect tax on consumption of goods and services across the country will do away with multiplicity of tax rates and hence, make the tax system easy to administer and comply with. Further, a sound IT system would be a pre-requisite for effective implementation of input tax credits, registrations, returns, etc. For this purpose, Goods and Services Tax Network (GSTN), a non-Government private limited company under Section 25 (not for profit company) was formed. The availability of an effective IT infrastructure to taxpayers across the country will not only make tax compliance easy, but will also pave the path for modernization of tax administration.

c) *Impact on manufacturing sector*: According to the latest 'India Development Update' of the World Bank, GST will be a breakthrough tax reform in the history of India's tax policies. By transforming India into a unified common market and eliminating cascading taxes, it will provide a competitive advantage to Indian manufacturing sector. Manufacturing sector is characterized by high level of competition where firms are constantly trying to reduce the cost of production to gain buyers. The implementation of GST will usher in a systematic procedure of tax credits wherein manufacturers will get full tax credit for all services consumed by them. Similarly, exporting manufacturing firms will also benefit from full refund of GST embedded in their exports. Thus, the absorption of major Central and State taxes in GST, gradual phase out of CST and seamless credit of input taxes throughout the value chain, will reduce manufacturing costs and thus, enhance international competitiveness of Indian manufacturing firms. Growth of Indian manufacturing sector will also lead to employment generation in the country. Lower manufacturing costs will translate into lower prices and thus, benefit the final consumers as well.

d) *Impact on exports*: Implementation of GST will have an enormously positive impact on India's exports. A study by NCAER for the 13$^{th}$ Finance Commission showed that growth in exports may vary between 3.2% and 6.3%. These figures were achieved by using simulation. GST is based on the principle on destination- based taxation. As a result, no output tax will be levied on exports from the country while the input tax paid by exporters will be fully refunded. This makes exports "zero-rated", i.e. tax-free, thus enhancing the competitiveness of Indian exporters. On the other hand, imports will be subject to both CGST as well as SGST. By taxing imports at the same rate as domestically produced and consumed goods, GST will not only offer equal opportunities to domestic industries vis-a-vis imports but will also make them internationally more competitive.

e) *Impact on tax revenue efficiency*: An upsurge in tax compliance on account of a sound IT infrastructure and 'seamless' input tax credits under the GST model will help to control leakage of tax from the system. GST is also expected to reduce compliance costs of taxpayers and tax collection costs of the Government. This will boost the revenue efficiency of the tax system. In the existing tax structure, a major problem was posed by numerous exemptions that narrowed the tax base. The essence of GST is to keep exemptions at a minimum so as to achieve fiscal consolidation by widening the tax base rather than increasing the tax rates. Cleaning up exemptions will enhance revenue productivity of the tax system. This is also consistent with the tax reforms implemented in many developing countries like Chile, South Africa, Nepal, Thailand, etc that have introduced VAT with a wider tax base and few rates.

**6.0 Challenges Ahead of GST**

GST will be a landmark reform in the history of Indian indirect taxes. The process of making a smooth transition to a comprehensive GST is indeed going to be a challenging one. Switching over to this new indirect tax system without adequate preparation may prove counter-productive in terms of revenue productivity and ease of implementation (Rao, 2009). Some of the challenges that may be encountered in implementing GST are as follows:

a) *Estimation of the GST rate*: M.C. Purohit (2010) stated that the GST rate would be determined keeping in mind revenue considerations, total tax burden and political acceptability of the tax rate. The most important question is “Will all the states and the central government get ‘adequate’ revenue at the prescribed rate?” Here, the term ‘adequate’ refers to a revenue neutral rate (RNR) i.e. a tax rate that enables the government to collect the same amount of revenue as received in the existing tax regime. In this context, the Report of the Task Force on “Goods and Services Tax Thirteenth Finance Commission” stated that the CGST and SGST rates should yield the same revenue as collected from the various taxes which will be subsumed in the CGST and SGST.

According to the First Discussion Paper of the Empowered Committee on GST, the state taxes to be subsumed in GST constitute approximately 52% of the states’ own tax revenue. Thus, in order to protect the fiscal autonomy of the states, it is important to ensure that the revenue neutral rate does not hurt the revenue productivity of the states.

Various committees and panels have proposed revenue neutral rates for GST. Some of these are:

- A committee appointed by the government under Chief Economic Advisor, Arvind Subramaniun, who has been pressing for lower GST rates, proposed a RNR in the range of 15-15.5%. However, this rate was not well received by the state governments for concerns over safeguarding their tax revenues.

- The Task Force on Goods and Services Tax of the Thirteenth Finance Commission proposed a RNR for states at 7% and for the centre at 5%, thus putting the combined GST rate at 12%. This rate was also considered too low.
- A Sub-Panel of Empowered Committee recommended a combined GST rate of 26.68% (centre-12.77% and state-13.91%). However, according to Finance Minister Arun Jaitley, this rate is too high and is likely to have an inflationary impact. Analysts, too have warned that a high GST rate is not economically feasible. Satya Poddar, senior tax advisor at Ernst &Young cautioned that a high tax rate is an indicator of a flawed design of GST. Consumers will not accept such a high rate. The rate should be kept low by broadening the tax base.
- A select committee of the Rajya Sabha proposed a moderate GST rate of 20%.
- P. Chidambaram, the lead speaker from Congress said that the GST rate should not exceed 18% because a rate higher than 18% will be inflationary.

Since, the rate of taxation will have a critical impact on the success of GST, there is an urgent need to have a very realistic estimate of RNR that is both, economically as well as politically feasible. This can be achieved by making use of accurate data and reconciliation of various estimates given by different committees.

b) *Fiscal autonomy of States*: The GST bill has created a sense of apprehension among the states that they will lose their fiscal autonomy. Many state governments have expressed their fears and concerns over the loss of autonomy to levy taxes due to the introduction of GST. The reason behind this is that the GST design is based on a uniform tax rate across states and a common base. According to Amaresh Bagchi (2006), taking away the power to levy sales tax, which is the major source of revenue for the states will be detrimental not only to their fiscal autonomy but also accountability as that would make the states merely spending agencies without them bearing responsibility for raising the funds they spend. Rao (2010) states that any tax reform in a multi-level fiscal system involves trade-offs and compromises. The trade-off faced here is between fiscal autonomy of states and tax harmonisation through uniform taxes.

c) *Compensation of revenue loss to states*: It is important to ensure that the GST rate is acceptable to the states who are key partners to the centre in this new tax reform. Many states have been extensively dependent on Central Sales Tax (CST) as their source of revenue. Phasing out of CST with the introduction of GST will limit the revenue of the states from this source. Although an expansion in the tax base under GST may compensate the states to some extent, this may not be true for all states. For instance, a state like Jharkhand which receives bulk of CST from mineral exports will lose more than Rs. 500 crores if CST is eliminated. Since the state's revenue is to be compensated from inclusion of services in the base, if the service base is not large enough, Jharkhand will not be compensated in terms of its revenue productivity. Moreover, the fear of revenue loss is higher in case of manufacturing states like Tamil Nadu, Maharashtra and Gujarat due to the switchover from origin based VAT to destination based GST. Thus, to ensure the success of GST across the states, it is important to draw out a compensation plan to provide a cushion for revenue shortfall of the states. The Constitution (122$^{nd}$ Amendment) (GST) Bill, 2014 states that the Parliament may provide for compensation to states for any loss of revenue from introduction of GST upto a five-year period.

d) *Development of a sound administration system for implementation of GST*: A major challenge in the implementation of GST is augmenting the present tax administration to incorporate the new tax regime. This would require capacity building in areas like computerisation, IT infrastructure, accounting system, forms and procedures, auditing, assessment and dispute resolution mechanism (Rao, 2009). A well-designed computerised information system is also essential to track interstate transactions which is critical for the success of GST.

## 7.0 Conclusion: One Nation, One Tax

There are always advantages and disadvantages of launching a new system. Same is true with respect to the introduction of GST which is going to be a major reform in the arena of indirect taxes. What matters is the overall net impact of GST bill on the economy, trade and current taxation system. As per the report of the Task Force, GST will reap long-term benefits for the Indian economy and the common man. The implementation of GST will lead to unification of the Indian market as impediments to inter-state trade would be removed. According to Union Finance Minister, a single unified market will lead to the achievement of the objective of co-operative federalism in the country. The absorption of major Central and State taxes in GST, gradual phase out of CST and seamless credit of input taxes throughout the value chain, will reduce manufacturing costs and thus, enhance international competitiveness of Indian manufacturing firms. Growth of Indian manufacturing sector will also lead to employment generation in the country. Lower manufacturing costs will translate into lower prices and thus, benefit the final consumers as well. Implementation of GST will have an enormously positive impact on India's exports. A study by NCAER for the 13$^{th}$ Finance Commission showed that growth in exports may vary between 3.2% and 6.3%.

Irrespective of the wide array of opportunities opened up by GST, the government must be mindful of its accompanying challenges such as development of a sound IT infrastructure,tax administration and modern information systems and determination of GST rate, exemptions, etc. All this should be done keeping in the mind the impact on States' revenues. Many state governments have expressed their deep concern over the loss of autonomy to levy taxes due to the introduction of GST. The reason behind this is that the GST design is based on a uniform tax rate across states and a common base. It is important to ensure that the GST rate is acceptable to the states who are key partners to the centre in this new tax reform. The success of the government in addressing these challenges will determine the sustainability of this major indirect tax reform in the long run.

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