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National Level Goods and Services Tax (GST): Towards Cooperative Federalism

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ABSTRACT

The GST has been an initiative that has commanded broad consensus across the political spectrum. It has also been a model of cooperative federalism in practice with the Centre and states coming together as partners in embracing growth and employment-enhancing reforms. It is a reform that is long awaited and its implementation will validate expectations of important government actions and effective political will. Given the historic opportunity afforded by the GST, the aim should be to clean up an Indian tax system that has effectively become an *exemptions raj* with serious consequences for revenues and governance. By improving efficiency as well as revenues, GST can add substantially to growth as well as helping government finances.

Keywords: *Goods and Service Tax, Federalism, Value added tax, State taxes* .

1.0 Introduction

GST is India's most ambitious indirect tax reform plan. Its objective is to levy a single national uniform tax across India on all goods and services. GST, as and when implemented, would replace a number of Central and State taxes, make India more of a national integrated market, and bring more producers into the tax net. By improving efficiency as well as revenues, it can add substantially to growth as well as helping government finances.

1.1 Current structure of commodity taxes

The current structure of taxes on goods and services in India is highly complex, highly leaky (riddled with exemptions), and complicated. In relation to goods, the Centre has a very complex tax structure, more complex than that of most of the States.

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It encompasses customs, central excise, cesses, countervailing and special additional duties, extensive exemptions, and a multiplicity of rates (ad valorem and specific rates). In relation to services too, the Centre has a complicated rate structure. Although there is one statutory rate, in practice there are 10 other rates because of the so-called *abatement* which amounts to fixing a rate different from the standard rate and not allowing further input tax credits. Abatement is necessitated in some part because of uncertainty in the base, and specifically being unable to distinguish *goods* from *services*. Further, there is incomplete provision of input tax crediting for goods, and incomplete cross-crediting between goods and services. Added to this is the Central sales tax (CST) which is levied on the sale or purchase of goods in the course of inter-State trade.

In relation to goods, the States have structures characterized by a base that is complete in extending all the way to the retail stage, an exemptions threshold that varies across States, provision for *compounding* that also varies across States in design, a multiplicity of rates, including the VAT but additional taxes on inter-state trade (octroi, entry tax).

In short, indirect tax system of India is currently mired in multi-layered taxes levied by the Central and State Governments at different stages of the supply chain, viz. excise duty, value added tax (VAT), octroi and others. GST, when implemented, will subsume all these taxes under a single regime.

National level GST, therefore, affords a unique opportunity to simplify and rationalize the structure and also eliminate serious anomalies to make it consistent with policy objectives

2.0 What is GST?

GST is a part of the proposed tax reforms to evolve an efficient and harmonized consumption tax system in the country. Presently, there are parallel systems of indirect taxation at the Central and State levels. Each of the systems needs to be reformed to eventually harmonize them.

GST is proposed to be a comprehensive indirect tax levy on manufacture, sale and consumption of goods as well as services at the national level. GST would give India a world class tax system and improve tax collections. It would end the long standing distortions of differential treatment of manufacturing and service sector. The introduction of GST will lead to the abolition of various Central and State indirect taxes and eliminate the cascading effects of multiple layers of taxation. It is claimed that GST will facilitate seamless credit across the entire supply chain and across all states under a common tax base.

The changeover to GST will be a game-changing tax reform measure which will significantly contribute to the buoyancy of tax revenues, acceleration of growth, and generation of many positive externalities.

2.1 The background

The strategy of the Government in respect of indirect taxes is to continue the tariff reform process towards mean ASEAN levels of customs tariff, convergence towards CENVAT rate for excise duty, widening of service tax base and phased move towards a fully-integrated goods and services tax. GST was first recommended by the Kelkar Task Force on Implementation of the Fiscal Responsibility and Budget Management (FRBM) Act, 2003.

In his 2006-07 budget speech, the Union Finance Minister observed, "It is my sense that there is a large consensus that the country should move towards a national level Goods and Services Tax (GST) that should be shared between the Centre and the States. I propose that we set April 1, 2010 as the date for introducing GST. World over, goods and services attract the same rate of tax. That is the foundation of a GST. People must get used to the idea of a GST".

While presenting the budget for 2010-11 to the Parliament on February 26, 2010, Minister of Finance Shri Pranab Mukherjee, rescheduled the time limit for the implementation of GST and expressed the hope that GST, along with the Direct Tax Code (DTC), would be introduced from April 1, 2011.

2.2 Salient Features of GST

The introduction of GST would be a significant step in the field of indirect tax reforms in India. By subsuming a large number of central and state taxes into a single tax, it would mitigate cascading or double taxation in a major way and pave the way for a common national market. Introduction of GST is also expected to make Indian products competitive in domestic and international markets.

The broad features of the proposed GST model are as follows:

a) GST would be applicable on supply of goods or services as against the present concept of tax on the manufacture or on sale of goods or on provision of services.
b) GST would be a destination-based tax as against the present concept of origin-based tax.
c) It would be a dual GST with the Centre and the States simultaneously levying it on a common base. GST to be levied by the Centre would be called Central GST (CGST) and that to be levied by the States would be called State GST (SGST).

d) An integrated GST (IGST) would be levied on inter-state supply (including stock transfers) of goods or services. This would be collected by the Centre so that the credit chain is not disrupted.
e) Imports of goods or services would be treated as inter-state supplies and would be subject to IGST in addition to the applicable customs duties.
f) CGST, SGST, and IGST would be levied at rates to be recommended by the Goods and Services Tax Council (GSTC) which will be chaired by the Union Finance Minister and will have Finance Ministers of States as its members.
g) GST would apply to all goods and services except alcohol for human consumption. Implementation of a comprehensive GST in India is expected to lead to efficient allocation of factors of production thus bringing about gains in national income and exports.

2.3 Benefits of proposed GST

Many benefits are claimed for the GST. Some of these have been listed below.

2.3.1 Higher Investment and Growth: An oft-cited study by the NCAER suggested that growth would increase by 0.9-1.7 percent of GDP, purely based on the elimination of the cascading of taxes on exports. (NCAER, 2001). Under the current tax system, while the Union excise duties and State VAT applies to all capital goods, input tax credits are generally limited to manufacturing plant and equipment. For example, no input tax credits are allowed for the Union excise duties on capital equipment acquired for use in transportation, infrastructure, distribution, or construction sectors because these sectors are all outside the scope of excise duties which are applicable to manufacturing only. Similarly, no credit is allowed for the State VAT on capital goods acquired by the service sector (e.g. telecommunications, transportation, finance, insurance, and IT services).

If the GST could provide for a more seamless and efficient crediting of taxes paid on capital goods, then capital goods prices would become effectively 12-14 per cent cheaper (because they are taxed at the standard rate of 12.5 per cent currently by the Centre), increasing the demand for capital goods, raising investment and hence growth.

Prior to the introduction of GST in 1991, Canada also had an excise duty regime similar to that in India. Studies for Canada estimated this beneficial impact of GST to be 0.5 percent as a result of the GST at the federal level only. The extent of tax cascading in India is much greater because of more stringent rules in India for claiming tax credits.

In sum, investment is discouraged under the current system through the application of excise duties and VAT to capital goods, for which no set off or input tax credit is provided. This increases the cost of capital goods and reduces investment, which in turn leads to lower employment and output.

2.3.2 Curbing Black Money: The government has placed a great deal of emphasis on curbing black money reflected in the Black Money Bill. These measures can be significantly complemented by a GST which—especially if it is extended to alcohol, real estate and precious metals—can be a less intrusive, more self-policing, and hence more effective way of reducing corruption and rent-seeking.

Under the GST, this can happen in two ways. The first relates to the self-policing incentive inherent to a valued added tax. To claim input tax credit, each dealer has an incentive to request documentation from the dealer behind him in the value-added/tax chain. Provided, the chain is not broken through wide ranging exemptions, especially on intermediate goods, this self-policing feature can work very powerfully in the GST.

According to Pomeranz (2013), "The Value Added Tax (VAT) is a stark example of a tax believed to facilitate enforcement through a built-in incentive structure that generates a third party reported paper trail on transactions between firms, which makes it harder to hide the transaction from the government.

The best evidence of the impact of the paper trail on evasion comes from an experiment in Chile which shows that firms that are part of the VAT chain are less responsive (in terms of evasion) to announcements of an increase in audit, suggesting that being part of the VAT itself performs the self-auditing function. Moreover, the study finds that increasing the audit probability of firms suspected of evasion generates spillovers up the VAT paper trail that lead to an increase of their suppliers' tax payments. In a sense, the supplier, because of the paper trail left by the VAT, knows that his evasion will be more likely to be detected once his client is audited.

Second, the GST will in effect have a dual monitoring structure—one by the States and one by the Centre. Hence, there will be a greater probability that evasion will be detected. Even if one set of tax authorities overlooks and/or fails to detect evasion, there is the possibility that the other overseeing authority may not.

2.3.3 Single Well-integrated National Market: The current tax structure unmakes India, by fragmenting Indian markets along state lines. This has the collateral consequence of favouring imports and disfavouring domestic production.

These distortions are caused by three features of the current system: (a) the Central sales tax (CST) on inter-state sales of goods, (b) other numerous inter-state taxes that will be replaced by the (one) GST and (c) the extensive nature of countervailing duty (CVD) exemptions.

A. Central Sales Tax (CST): The 2 percent CST on inter-state sales of goods leads to inefficiencies in supply chain of goods[1]. Goods produced locally within the jurisdiction of consumption attract lower tax than those produced outside. This tax encourages geographic fragmentation of production. The tax can be avoided partially through branch/stock transfers by manufacturers. However, the tax savings from branch transfers get substantially offset by the incremental costs of logistics and warehousing of goods in multiple locations.

B. Eliminating other Inter-state Taxes: Currently, there are a number of inter-state taxes that are levied by the States in addition to the CST. These include: entry tax not in lieu of octroi and entry tax in lieu of octroi. Under the GST, all these taxes would be folded into the GST with enormous benefits. What are the benefits?

There is ample evidence to suggest that logistical costs within India are high. One study suggests that in one day, trucks in India drive 280 kilometres while the figure for US is 800 kilometres). This raises direct costs (wages to drivers, passed on to firms), indirect costs (firms keeping larger inventory), and location choices (locating closer to suppliers/customers instead of lowest-cost location in terms of wages, rent etc.). Further, only about 40 percent of the total travel time is spent driving, check points and other official stoppages take up almost one-quarter of total travel time. Eliminating check point delays could keep trucks moving almost 6 hours more per day, equivalent to additional 164 kilometres per day, thus, pulling India above global average and to the level of Brazil. Thus, logistics costs (broadly defined, and including firms' estimates of lost sales) are higher than the wage bill or the cost of power, and 3-4 times the international benchmarks. (JPS Associates, 2011)

All of these barriers to inter-state trade become even more important in India because the share of roads in freight traffic is high (about 72 percent). The implication is that it is especially important for India to reduce costs to inter-state trade because of the excessive reliance on roads for movement of goods.

C. CVD and SAD Exemptions: It is a well-accepted proposition in tax theory that achieving neutrality of incentives between domestic production and imports requires that all domestic indirect taxes also be levied on imports. So, if a country levies a sales tax, VAT, or excise or GST on domestic sales/production, it should also be levied on imports. In India, this is achieved through the CVD/SAD which is levied on imports to offset the impact of the excise duty levied on domestically manufactured goods.

However, CVD/SAD exemptions act perversely to favour foreign production over domestically produced goods, i.e. they provide negative protection for Indian manufacturing. Moreover, CVD/SAD, which is levied to offset the excise duty imposed on domestic producers, is not applied on a whole range of imports.

Two defenses of CVD exemptions are typically made. First, that CVD exemptions on inputs help manufacturers by reducing their input costs. But under the current system and in future when the GST is implemented, the CVD on inputs can always be reclaimed as an input tax credit. So, CVD exemptions do not provide additional relief. In fact, they help collection efficiency because they are levied at customs.

The second rationale advanced for exempting many imported goods from CVD is that there is no competing domestic production. This argument is faulty because the absence of competing domestic production may itself be the result of not having the neutrality of incentives that the CVD creates. Domestic producers may have chosen not to enter because the playing field is not level.

Indian tax policy is therefore effectively penalising domestic manufacturing. How can this anomaly be remedied? Simply by enacting an exemptions-free GST, in one stroke the penalties on domestic manufacturing would be eliminated because the GST (central and state) would automatically be levied on imports to ensure neutrality of incentives. In effect, India would be promoting domestic manufacturing without becoming protectionist and without violating any of its international trade obligations under the World Trade Organization (WTO) or under India's free trade agreements (FTAs).

3.0 Roadmap for GST

While declaring its intention to introduce GST from April 1, 2010, the Central Government had indicated that the Empowered Committee of State Finance Ministers would work with the Central Government to prepare a road map for introduction of GST. The Empowered Committee of State Finance Ministers prepared a report on a model and road map for GST.

In November 2007, a Joint Working Group consisting of representatives of the Empowered Committee and the Government of India prepared a report on the changeover to GST. This report was discussed by the Empowered Committee, which then prepared *A Model and Road Map for Goods and Service Tax in India* (April 2008). The model and roadmap, while recommending that a dual GST be put in place, also provided preliminary views on the Central and State taxes to be subsumed within the GST.

The model detailed the operational issues which needed to be addressed, including the number of rates, exemptions and exclusions from GST, as well as the treatment of inter-state transactions. The roadmap outlined the legal and administrative steps which needed to be taken in order to comply with the April 1, 2010 deadline.

The comments of Government of India on the proposed design of GST were sent to the Empowered Committee in January 2010. A joint group of officers was constituted to prepare draft Constitutional Bill, Central GST legislation, model State GST legislation and rules required to introduce GST.

To operationalize the GST, the Constitution (115th Amendment) Bill was introduced in the Lok Sabha in March 2011 to enable Parliament and State Legislatures to make laws for levying GST on every transaction of supply of goods or services or both. Some goods, namely crude petroleum, diesel, petrol, aviation turbine fuel, natural gas and alcohol are not to come under the purview of the GST.

3.1 GST Council

The Constitutional Amendment Bill also seeks to empower the President to set up within 60 days of the passage of the legislation, a GST Council with the Union Finance Minister as chairperson and Union Minister of State for Revenue and Finance Ministers of all the states as members. The GST Council is to work on the basis of consensus and make recommendations on issues like GST rates, exemption lists, and threshold limits.

Further, the Bill provides for setting up of a GST dispute settlement authority, comprising a chairperson and two members to resolve disputes arising out of deviations from the recommendations of the GST Council either by the Central or State Governments. The draft Bill has since been referred to the Parliamentary Committee on Finance for examination.

Getting the design of the GST right is therefore critical. Specifically, the GST should aim at tax rates that protect revenue, simplify administration, encourage compliance, avoid adding to inflationary pressures, and keep India in the range of countries with reasonable levels of indirect taxes.

Choices that the GST Council makes regarding exemptions/low taxation (for example, on gold and precious metals, and area-based exemptions) will be critical. The more the exemptions that are retained, the higher will be the standard rate. There is no getting away from a simple and powerful reality: the broader the scope of exemptions, the less effective the GST will be. For example, if precious metals continue to enjoy highly concessional rates, the rest of the economy will have to pay in the form of higher rates on other goods, including essential ones.

3.2 GST Network (GSTN)

Among the other steps that are being taken for the introduction of GST is the establishment of a strong information technology (IT) infrastructure. For this purpose the Government has set up an Empowered Group (Chairman: Nandan Nilekani). Significant progress has been made in the conceptualization and design of the GSTN—a common portal for the Centre and States that will enable electronic processing of the key business processes of registration, returns, and payments. For this purpose, the structure of these processes is in advanced stages of finalization.

The National Securities Depository Limited (NSDL) has been selected as technology partner for incubating the National Information Utility that will establish and operate the IT backbone for the GST. In this regard the NSDL has set up a pilot project in collaboration with 11 States prior to its roll-out across the country. Three Joint Working Groups of officials have also been constituted comprising officials from the Central Government, State Governments, and an Empowered Committee of State Finance Ministers to work on legislation, business procedures and IT infrastructure respectively.

The structure of GSTN has been approved by the Empowered Committee of State Finance Ministers. GSTN will be set up as a National Information Utility. GSTN will implement common PAN-based registration, returns filing and payments processing for all States on a shared platform. The use of PAN as a common identifier in both direct and indirect taxes, will enhance transparency and check tax evasion.

3.3 Phasing out of Central Sales Tax (CST)

To prepare for the implementation of GST, Central Government has also begun a phased reduction of CST. The Central Government has brought down the level of CST over the last few years from 4 percent to 2 percent as a precursor to rolling out GST. This is because CST, which is an origin-based tax, is inconsistent with value added taxes, which are destination based—the two should not co-exist. As revenue from CST was transferred to the States, they are to be compensated by being given the right to levy service tax on certain commodities.

4.0 Twelfth Five Year Plan (2012-17) on GST

Once the integrated GST across the country is introduced, it will simplify tax administration and eliminate cascading of taxes. It will lead to reduction in the distortions in the structure of production, consumption and exports and further to a more efficient allocation of resources. The demand for manufactured goods can be expected to grow significantly. In this connection, the Twelfth Five Year Plan (2012-17) remarked, “The Centre must persevere with reforms of the tax structure, notably the introduction of Good and Services Tax (GST), which will represent a major modernisation of the indirect tax system. GST will greatly simplify the system and improve revenue mobilisation, primarily by plugging loopholes. Since introduction of GST requires a Constitutional amendment, it needs a broad political support which has taken time to build. However, if it can be introduced soon, it will give a boost to efficiency and to revenue mobilisation without raising rates”. (Government of India, 2012-17)

5.0 Implementation of GST

For nearly ten years, India has been on the verge of implementing a GST. But now, with political consensus close to being secured, the nation is on the verge of executing one of the most ambitious and remarkable tax reforms in its post-Independence history. Implementing a new tax, encompassing both goods and services, to be implemented by the Centre, 29 States and 2 Union Territories, in a large and complex federal system, via a constitutional amendment requiring broad political consensus, is perhaps unprecedented in modern global tax history.

Hoping for the early implementation of the GST, the Finance Minister in his 2013-14 Budget Speech observed, “Hon’ble Members will recall that I had first mentioned the Goods and Services Tax (GST) in the Budget speech for 2007-08. At that time, it was thought that GST could be brought into effect from 1.4.2010. Alas, that was not to be, although all States swear by the benefit of GST. However, my recent meetings with the Empowered Committee of State Finance Ministers has led me to believe that the State Governments—or, at least, the overwhelming majority—are agreed that there is need for a Constitutional amendment; there is need for State Governments and the Central Government to pass a GST law that will be drafted by the State Finance Ministers and the GST Council; and there is need for the Centre to compensate the States for loss due to the reduction in the CST rate. I hope we can take this consensus forward in the next few months and bring to this House a draft Bill on the Constitutional amendment and a draft Bill on GST. Hope inspires courage. I propose to take the first decisive step by setting apart, in the Budget, a sum of ` 9,000 crore towards the first instalment of the balance of CST compensation. I appeal to the State Finance Ministers to realise the serious intent of the Government to introduce GST and come forward to work with the Government and bring about a transformational change in the tax structure of the country”. (Government of India, 2013-14)

In his Budget Speech to the Parliament on June 10, 2014, the Finance Minister made the following observations regarding GST, “The debate whether to introduce a Goods and Services Tax (GST) must now come to an end. We have discussed the issue for the past many years. Some States have been apprehensive about surrendering their taxation jurisdiction; others want to be adequately compensated. I have discussed the matter with the States both individually and collectively. I do hope we are able to find a solution in the course of this year and approve the legislative scheme which enables the introduction of GST. This will streamline the tax administration, avoid harassment of the business and result in higher revenue collection both for the Centre and the States. I assure all States that government will be more than fair in dealing with them”.

In his Budget Speech to the Parliament on February 28, 2015, the Finance Minister observed on GST as follows, "We need to revive growth and investment to ensure that more jobs are created for our youth and benefits of development reach millions of our poor. We need an enabling tax policy for this. I have already introduced the Bill to amend the Constitution of India for Goods and Services Tax (GST) in the last Session of this august House. GST is expected to play a transformative role in the way our economy functions. It will add buoyancy to our economy by developing a common Indian market and reducing the cascading effect on the cost of goods and services. We are moving in various fronts to implement GST from the next year".

Lok Sabha passed the 122nd Constitutional Amendment—Goods and Services Tax Bill on May 6, 2015. Currently, the hope is that GST will be implemented from April 1, 2017. Once the Parliament passes the GST Bill, 50 percent of the States have to ratify it and then both the Centre and States have to pass Central GST and State GST Bills respectively and rules have to be made under them. So far, the Government has failed to push the constitutional amendment bill in the Rajya Sabha.

6.0 Conclusion

To sum up, as the world economy slows, and increasing financial volatility and turbulence become the *newest normal*, only a few economies have the resilience to be a refuge of stability and the potential to be an outpost of opportunity. India is one of those few. As oil and commodity prices continue to be soft, macro-economic stability seems reasonably assured for India. This bedrock of stability coupled with reforms can propel the economy to a high growth trajectory. Key amongst these reforms is the national level goods and services tax (GST).

The Indian GST is expected to represent a leap forward in creating a much cleaner dual VAT which would minimize the disadvantages of completely independent and completely centralized systems. A common base and common rates (across goods and services) and very similar rates (across States and between Centre and States) will facilitate administration and improve compliance while also rendering manageable the collection of taxes on inter-state sales. At the same time, the exceptions—in the form of permissible additional excise taxes on petroleum and tobacco for the Centre, and petroleum and alcohol for the States)—will provide the requisite fiscal autonomy to the States. Indeed, even if they are brought within the scope of the GST, the states will retain autonomy in being able to levy top-up taxes on these goods.

Provided it can be reasonably well-designed, the Indian GST will be the 21st century standard for VAT in federal systems. It is, therefore, imperative to ensure that the design and implementation of this policy is done right.

GST, as and when implemented, would be a major milestone in reforming India's indirect tax system. Replacing all existing indirect taxes by the GST would: (a) eliminate cascading effects of commodity taxes, (b) create a national market, and (c) align taxation of imports and exports correctly. It would also improve the competitiveness of production and export from India. Implementation of a Central GST (CenGST) could be the first step towards the GST. Once the CenGST is implemented, it would be easier for the Central and State Governments to switch over to GST.

This is a historic opportunity for India to implement a game-changing tax reform. Domestically, it will help improve governance, strengthen tax institutions, facilitate *make in India by making one India*, and impart buoyancy to the tax base. It will also set the global standard for a value-added tax (VAT) in large federal systems in the years to come.

The GST has been an initiative that has commanded broad consensus across the political spectrum. It has also been a model of cooperative federalism in practice with the Centre and states coming together as partners in embracing growth and employment-enhancing reforms. It is a reform that is long awaited and its implementation will validate expectations of important government actions and effective political will that have, to some extent, already been *priced in*. Given the historic opportunity afforded by the GST, the aim should be to clean up an Indian tax system that has effectively become an *exemptions raj* with serious consequences for revenues and governance.

Endnotes

1. The proposed Constitutional Amendment bill provides for a 1 percent duty on inter-state sales for a limited period.

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