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How Realistic is the GST 'Promise Land'?

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***Abstract:** Goods and Services Tax (GST) is being touted as the "next logical and comprehensive indirect tax reform" that has been long overdue. With the GST Council scheduled to meet on 31st March 2017 to decide on 'fitment rates', administrative rules of GST etc. and the lower house of the Parliament having already passed the CGST, IGST, UGST and States Compensation Bills, this paper uses existing literature, media reports, PIB releases and the Gazette of India to understand the complex Indirect taxation structure of India and the changes to it brought about with the introduction of GST. Admittedly, there is a degree of vagueness associated with GST as of today but from a broad overall structure emerging from the 122nd Constitutional Amendment and the twelve meetings of GST council, an attempt has been made to critically analyze the efficacy or validity of the positive changes as well as the shortfalls associated with the 'new regime' which, though an improvement over its predecessor, leaves much more to be desired.*

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I) INTRODUCTION

A Government's power to rule springs from its control over the strings of the public purse. For the Indian case, the size of this purse, excluding the borrowings and share of states, is projected to be around 16.02 lakh crores for the year 2017-18 (Budget at a Glance, Ministry of Finance). Indirect taxes have always been a major contributor to this purse with their projected collection amounting to around 5.5% of GDP for the year 2017-18 (figure 1). The low base of direct taxation because of historically low incomes, keeping agricultural income outside the tax net and inefficient administration especially prior to 1990s meant that the major burden of raising revenues had to be borne by indirect taxes at central level (NCAER Report, 2009). At the state level too, the last and major option to rely for revenue collection has been the states sales tax and subsequently the state VAT. Given this centrality of indirect taxes in the overall scheme of revenues, these taxes have been the subject of several discussion and debates about their structure, base, rates, exemptions and administration. These debates have, in turn, led to a series of progressive reforms which not only improved the existing taxation systems but led to certain new contradictions and limitation that warranted further reforms. And since reforms, as correctly pointed out by M. Govinda Rao, "are a process and not an event" (Rao, 2010), it is the GST which is considered to be the next logical step in the culmination of this long process.

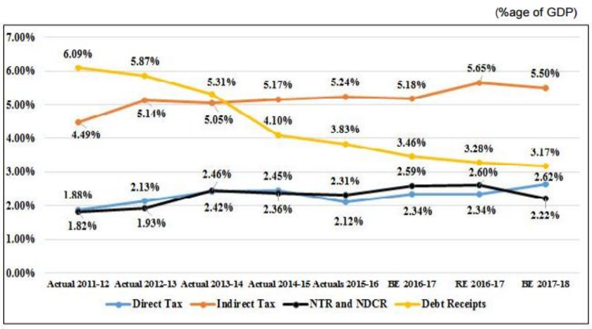

Figure 1

(Source: Budget at Glance, http://indiabudget.gov.in/ub2017-18/bag/bag5.pdf)

With the pressing need for raising more revenues with increased efficiency in order to simultaneously meet the targets of fiscal deficits stipulated under the FRBM Act of 2004 while increasing social welfare expenditure like the Expenditure on Health to 2.5% of GDP by 2025 as stipulated in the draft National Health Policy approved by the Cabinet, the streamlining and consolidation of revenues is more than imperative upon the State. But Goods and Services Tax is more than just a revenue augmentation strategy, if implemented cautiously and rigorously it could be, as M. Govinda Rao puts it, a 'win-win' strategy for all including the centre, states, business and consumers (Rao, 2010). Since GST is next step in the long march of complicated tax reforms, it is relevant to understand the current system of indirect taxation in India which GST intends to improve upon. The analysis of the historical evolution, current structure and most importantly the existing limitations of the current Indirect Taxation system form the content of **Section II**. This section must serve as the primer for understanding GST. **Section III** then documents the intended (from the First Discussion Paper on GST) as well as evident (from the decisions of the GST council) features of GST that aim to improve the existing structure. Some of these features and their consequent implications are then picked up selectively for critical analysis in **Section IV**. The basic question is to what extent have the lacunas of the previous regime been overcome and what new complications have been created in the due process. **Section V** finally has some concluding remarks to offer.

II) THE CURRENT REGIME: HISTORICAL EVOLUTION, FEATURES AND SHORTFALLS

Since its first introduction by Maurice Laure, a French Economist, in 1954, Value Added Tax has turned out be one of the most promising fiscal innovations of the 20th century with more than 140 countries including India adopting one form of VAT or the other (Rao, 2011). The current VAT in India, which the GST seeks to replace, has gradually evolved from its predecessors i.e. several archaic and complicated taxes at both the central as well as state levels. The coverage of Central Excise tax expanded gradually during the period from 1950s to 1970s before the setting up of the Indirect Tax Enquiry Committee under L K Jha in 1976 which hinted at the low coverage and high cascading effects in indirect taxation. Introduction of MODVAT (Modified VAT) in 1986 which had limited coverage but provided input tax credits could be termed as the turning point in indirect tax reforms even though it faced the problem of very high compliance and administrative costs (Mukherjee, 2015). Post reforms, the Tax Reform Committee under Raja Chelliah in 1991 and the Kelkar Task Force of 2003 have completely changed the taxation structure of India for the better. MODVAT was transformed to CENVAT in 2000 which was more comprehensive in coverage and input tax credit reimbursement. Service taxation in India has evolved from taxing just three services (telephone bills, insurance premiums and stock brokerage) in 1994 to the comprehensive taxation of services based on 'negative list' since the budget of 2012-13 (Mukherjee, 2015). Indirect taxation at the state level has also had a tumultuous history of its own. Prior to 2005 there was no element of 'harmony' in the indirect taxation as different commodities were taxed with different rates in different states. Also there was an unhealthy competition among states leading to the so called "rate wars" resulting in revenue losses for the states. This has altered to a great extent post the 1990s with the formation of Empowered Committee of State Finance Ministers that has come to collective agreements on uniform floor rates and other procedural aspects of tax administration finally leading up to rolling out of State level VATs since April1, 2005 (GOI, First Discussion Paper on GST,2009).

After all these altercations, as it stands today, prior to the introduction of GST, there are four major types of indirect taxes levied by centre and states on goods that are domestically produced and sold. Firstly, the **CENVAT** duty or the Central Excise Duty is levied and collected by the Centre Government at a uniform rate across states on the manufacture of goods. The exemption limit is the annual turnover of up to rupees 1.5 crores and input tax credit (i.e. the reimbursement for the tax paid on the inputs used) is provided for CENVAT itself, service tax or any other cess or countervailing duty paid on the inputs used. The second major tax, **Service Tax**, is also levied and collected at the central level and applies to all services except those mentioned in the 'negative list'. Input tax credits against the Service tax paid are available for CENVAT and Services tax only and not for any other state level tax paid. Some services like entertainment, luxury hotel and advertisements are taxed by State Governments too. **State level VATs**, the third major type of indirect taxes, are often caricatured and held responsible for their role in the economic distortion along with the absence of 'harmonization' in tax structure and a pan India market. Each state levies, collects and retains a state level VAT on goods sold within its territorial boundary. Even after attempts to harmonize the rates and structure after the inform arrangement of Empowered Committee, there still remain variations among rates and overall tax structures. For example standard VAT rate varies across States - from 12.5 percent for majority of States to 14.5 percent in states like West Bengal and Rajasthan (Mukherjee, 2015). Finally, the **Central Sales Tax** is a tax levied on the inter-state sale of goods by the centre and collected and retained by the exporting states. This tax is the major target of the GST reforms as input tax credits are not available to the imports in the destination sates since the importing states have no funds to reimburse because the tax at the earlier stage is paid to a different authority i.e. the exporting state.

So, what are the shortfalls with this system? The most striking feature of the current tax regime is the separation of the tax bases of the centre and the states. The centre can tax goods up to the manufacturing stage while the taxation of sale or distribution of goods at all stages beyond manufacturing remains with the respective states. Similarly, states cannot tax services at all. This separation of bases has led to mutually exclusive spheres of taxation which stymie the flow of input tax credits along the supply chain. For example, the CENVAT duty paid at the time of manufacturing is added to the taxable price of the good and is taxed again and again at all further stages during its supply chain at the state level. Similarly, the service tax paid on the service used as inputs at the state level supply chains are not set off because the state has no pool to reimburse as the service tax paid at the earlier level accrued to the Centre and not the states. In simple words, the taxable amount at one stage includes the amount of tax paid at the earlier stage which leads to what the First Discussion Paper on GST calls the "tax on tax" (GOI, 2009). This lead to a '**cascading effect**' which can be explained in simple terms as follows: "a cascade is a waterfall or series of waterfalls. The illustration serves to emphasize that at each stage of production, the same tax is included in each product, so the final consumer faces the burden of a series of taxes like a cascade or waterfall"(Bandopadhyay, 2010). This has implications for consumer price, spatial distribution of economic activity, competitiveness and economic efficiency.

The second major area of concern under the current tax regime is the **Central Sales Tax** as the inter-state dealers in the importing states cannot claim input tax credit against the taxes that they themselves pay during further sale or value addition of the good imported simply because the CST at the previous stage was paid to the Government of the exporting state and not their Government. This too leads to 'cascading effect' as discussed earlier. Further, CST is an 'origin based tax' which goes against the basic premise of the general class of indirect taxes that are usually 'destination based' taxes. This feature skews the tax collections in favor of a few 'manufacturing power houses' with the taxes coming from the pockets of consumers in the relatively agrarian states. Another interesting implication of this tax, as noted by the Economic Survey, is that it can be one of the explanations to the relatively higher inter-state trade in India which is 54 percent of GDP and 1.4 percent higher than its external trade. When the inputs or consumption goods that manufacturers use are in the 'negative lists' of goods against which input tax credit is not given by the state, the firms might end up buying it from other states and paying the CST at 2 percent (Economic Survey, 2017).

Also, under the current VAT regime, inputs and outputs are taxed under different rates (4 % and 12.5% respectively) which create problems as it is very difficult to distinguish between the two. Sugar, for instance, is an input for a restaurant but for a household it is an output (Rao, 2009). The labyrinth of rates of taxation and exemptions along with the arbitrariness of classification of goods into different rates at the State level result in both high administrative cost and high compliance costs which leads to compliance gaps creating incentives to pick loophole and bypass the laws altogether. This arbitrariness in classification of goods, evident from the 1 % VAT in many states on precious metals and jewellery, has more to do with the political pulls and pressures rather the taxation structure as such (Bandopadhyay, 2010). Exemptions from CENVAT also encourage firms to report their production from the exempted states like Himachal Pradesh, Uttarakhand and Kutch region in Gujarat (Economic Survey, 2017). Finally, as the distinction between goods and services is getting blurred and it is becoming difficult to separate the software (good) from its upgrade (service) with the advancement of information technology and digitization, the distinct structures of VAT and Service Tax are making the seamless taxation of the 'whole bundle' together nearly impossible (Poddar & Ahmed, 2009). All this baggage put together acts as a drag on economic activity affecting the competitiveness of both domestic producers and exporters as well as the welfare of the consumer while simultaneously leading to revenue losses to the exchequer.

III) GOODS AND SERVICES TAX: WHAT ARE WE EXACTLY UP TO?

"One Nation, One Tax, One market", the enigmatic rationale for GST sounds too catchy to be ignored. So does the promise of GST to 'harmonize' the tax structure of the country. But looking at the "Sixth directive" of the EU one must ask whether a common market must necessarily have just one tax? To what extent and aspects should harmonization be brought about? And what would be a reasonable traded off for this harmonization? But before that we must look more closely into the promises that GST holds and the way these promises are actuated through its structural design. GST is envisaged as a 'multi-stage comprehensive destination based' value added tax which gives both the centre as well as the states the power to concurrently tax goods as well as services while providing a continuous and seamless flow of input tax credits at all levels in the supply chain. The CST will be replaced by IGST that will be collected by a central agency. According to GOI, this will lead to a widening of tax base for the states as well as the centre, a reduction or near elimination of cascading effects as the input tax credit flow is supposed to be seamless, a merging of several embedded or hidden taxes under a common tax with harmonized rates across states and finally an increased compliance or minimized revenue leakages resulting from better coordination among states along with synchronized tax rates, tax base and administrative rules on registration, returns and exemptions promoting voluntary compliance (Mukherjee, 2015). All this will further reduce compliance cost or transactions costs as every entity will face just one tax authority (centre or state) resulting in increased competitiveness for domestic producers as well as exporters and improving India's 'Ease of doing Business' ranking. Though based on restrictive modeling and econometric assumptions, some studies have claimed an immediate increase in GDP growth rate within the range of 0.9 % to 1.7% along with gains over and above the future growth rates (NCAER Report, 2009).

How is this vision actuated through constitutional, legal and administrative changes? It all began with the 122nd Constitutional Amendment which, along with making other changes like defining 'service' to be anything other than a good, amended Article 246 A and 269 A to give both the states as well as the centre the concurrent power to tax goods and services. This concurrent power is exercise through the setting up of GST council under Article 279 A which is supposed to make recommendations to the Centre as well as the States on the various issues of tax rates, exemptions, threshold limits and administering of tax (The Gazette of India, September 8, 2016). This council, which is mandated to take decisions with a three fourth majority with one third of the voting rights given to centre and two thirds to states collectively, has met twelve times so far till March 30, 2017 giving us a broad outline as to what the overall structure of the upcoming GST is expected to be.

IV) THE GST PROVISIONS: A CRITICAL ANALYSIS

Firstly, the proposed GST is to be levied at five rates 0%, 5%, 12%, 18% and 28% with an additional cess on "sin goods" over above the 28% to be used for the compensation to States in lieu of their revenue loss against CST (PIB, 14-12-2016). So we are far from "one tax" for the whole nation which might be a blessing in disguise given the impact of a single tax rate on distributional aspects and equity. From a broader perspective, this setting up of the GST Council and the application of uniform rates could be seen by some as an attack on the Federal Structure of India. Amresh Bagchi, using the example of the uniform floor rates in EU, has argued that 'harmonization' may just involve uniform tax base, procedures, exemption etc. and not the tax rates. Absence of uniform rates does not prevent EU from being a common market while their presence might severely restrain the autonomy of Indian states to raise future revenue to expand their social sector spending (Bagchi, 2005). Others like M. Govinda Rao see a tradeoff between fiscal autonomy and harmonization while emphasizing the need for 'harmonization' to prevent distortions (Rao, 2011).The Finance Minister, on the other hand has called the GST council the "first truly federal institution" wherein not just the States but the Centre too has given up its sovereignty and the "pooled sovereignty" of the Centre and States is manifested in the GST Council which has taken all its decisions by unanimous agreement. But it is the more important tasks of fitting the goods into different rates and sub-dividing the rates into CGST and SGST that await this council as of now.

Secondly, the threshold limit for exemption from GST levy would be 20 lakhs for normal states and 10 lakhs for Special Category States (PIB, 14-12-2016). This is a positive step as it brings symmetry to the overall structure of exemptions against the backdrop of current myriad exemption thresholds of the States. Similarly, all entities exempted by different states as well as the centre must now pay the GST levy initially and then if the states or the centre decides to give exemptions/incentives they must do it by 'reimbursement mechanism' (PIB, 14-12-2016). Both these steps simplify the administration to a great extent. Also, the 'Composition Scheme', wherein the small enterprises with annual turnover below 50 lakh can file quarterly returns with a tax of 5%, is also a step in the right direction. The Council has agreed to compensate the states for revenue loss for the next 5 years in case of shortfalls in the revenues of the States taking the Revenue for the year 2015-16 as given and applying a growth of 14% per annum. The Council has also approved the "Anti-Profiteering Clause" that makes sure that the benefits of reduced prices are necessarily passed from business to consumers (Deccan Chronicle, February 18,2017).

The impression that GST can widen the tax base is rather misplaced as almost all economic activities are already covered under either state or central taxes and the only possible area is the exempted list. Further, as predicted by few, GST might not lead to instant formalization of the informal sector simple because the decision of any enterprise to remain in the informal sector is governed by several factors like informal credit and labor markets along with the availability of local demand (Mukherjee, 2015). Also, the decision of the Council on 'Cross Empowerment' wherein all the enterprises below the annual turnover limit of 1.5 crores are to be assessed by the States whereas all those above the limit are to be jointly assessed by Centre and States has meant that the effective tax base of the Centre has shrunk to just around 7 lakh while leaving such a larger tax base for state administrations might simultaneously lead to wastage of expertise accumulated at CBEC as well as inefficiencies, corruption and revenue losses because of the relative inexperience of state official in handling new assesses (Business Line, March12,2017).

Finally, the biggest promise of the new regime i.e. to remove the cascading effects might fall short of expectation as items like crude oil, natural Gas and Real Estate are kept out of the GST ambit for the time being. Since crude oil is a major input to all manufacturing, this decision along with 1% additional levy going to the origin state in case of inter-state goods might mean that not all tax paid on inputs will be credited and we are still imposing "tax on tax".

V) CONCLUSION

An ideal taxation system is supposed to result in enhanced revenues, distributional equity along with promoting economic efficiency and consumer welfare. Ideal taxation systems are therefore as scarce as the ideal scenarios to which they must apply. But what we have in the form of GST is an improvement over the existing indirect tax regime in some ways while simultaneously leaving some major challenges in the state autonomy unanswered. GST is still in its nascent stage and hence any final judgment on it must be suspended until knowledge is more comprehensive. But what we can say for sure is that we are in a qualitatively different regime, a regime that will depend even more on IT in the entire process from registration to filling returns, a regime that solves some existing issues while throwing up some new ones. Finally, as international experiences teach us, given our complicated federal structure the GST we adopt finally must be “a genus like Primates and not any particular species like Apes or Chimpanzees” (Rao, 2009).

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