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Finally a goods and services tax. But what lies ahead?

The past eight months have shown how the central and state governments, ruled by competing political parties, can effectively work together

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The finance ministers of all states were able to finalize the GST within eight months under the leadership of finance minister Arun Jaitley. Photo: Reuters

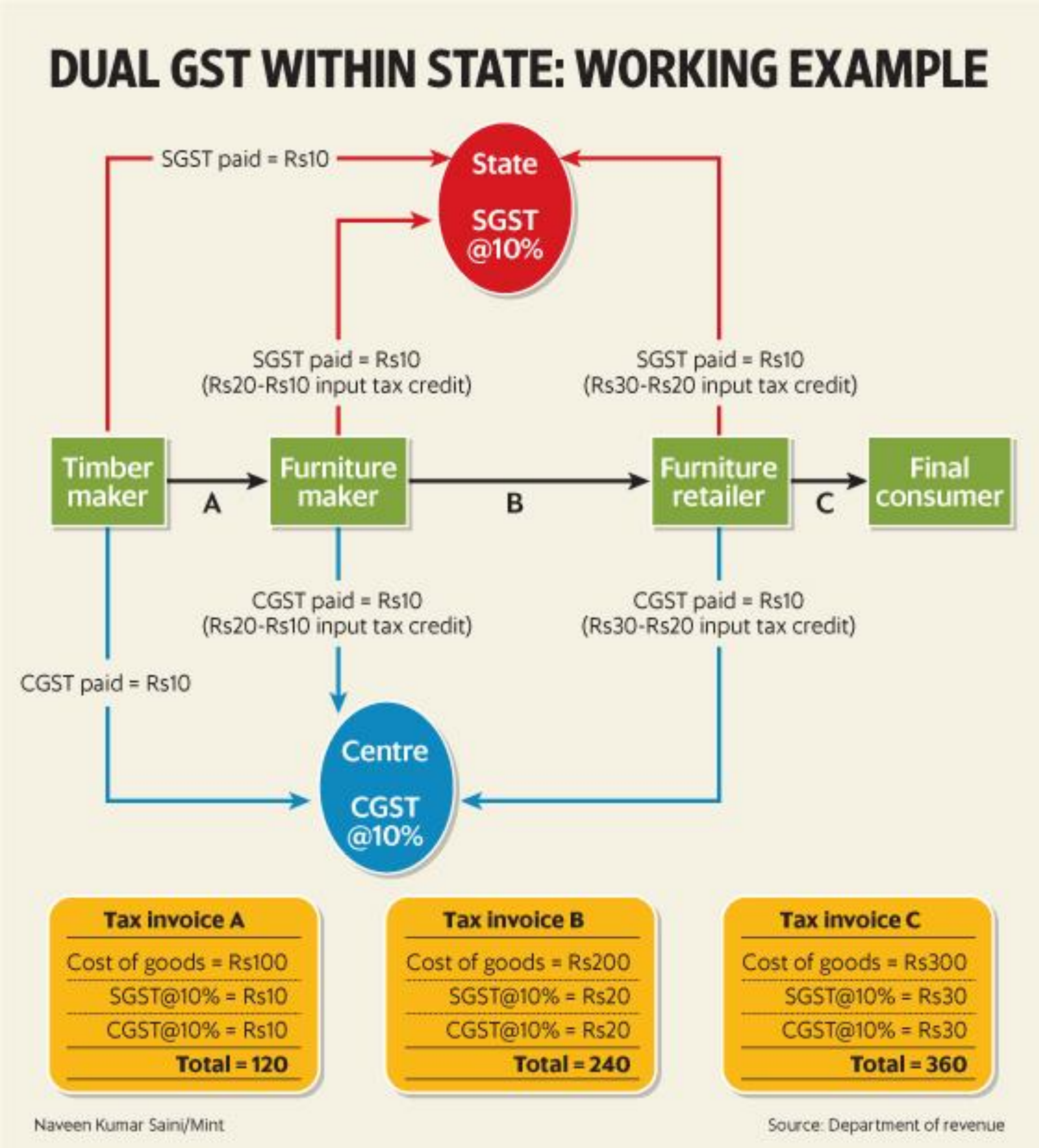
The goods and services tax (GST) will be rolled out on 1 July. Arguably the most important economic reform since the liberalization of 1991, it will usher in a far-reaching transformation of the indirect tax system that has been in operation since independence.

Getting here has been a long journey. The core concept of the GST, a value-added tax (VAT) with crediting for taxes paid on inputs, was introduced 36 years ago as the modified value-added tax (Modvat) in V.P. Singh's budget of 1981. Modvat was limited to Central excise because under the Constitution, Parliament did not have the power to legislate on state taxes. The gradual reform and harmonization of state sales taxes, preparing the ground for a value-added sales tax at the state level took another 25 years. By 2005, most states had reformed their sales taxes as state VATs.

Subsequently, P. Chidambaram proposed in his 2006 budget that a nationwide GST should be launched by 2010. But it took another 10 years and many iterations at the technical and political level through an empowered committee of state finance ministers, the Lok Sabha and the Rajya Sabha under two governments and a standing committee of Parliament before the 101st Constitution Amendment Act, enabling establishment of a national GST, was finally approved by the President on 8 September 2016.

The Union and state governments then proceeded with their required legislation and the centre of action shifted to the GST council of state finance ministers, chaired by the Union finance minister. The GST council was mandated by law to determine the detailed design of the Central and state GSTs, the inter-state GST, the rates, exemptions, administrative jurisdictions, etc. In a remarkable exercise of cooperative federalism, the finance ministers of all the states, representing competing political parties, were able to complete this Herculean task within eight months under the leadership of Union finance minister Arun Jaitley.

Only a few minor details remain to be sorted out at the next council meeting before the GST is rolled out on 1 July. The Central indirect taxes it will subsume include the Central excise duty, additional excise duty, service tax, additional customs or countervailing duty and special additional customs duty. The state-level taxes to be subsumed include state VAT, entertainment tax, Central sales tax, octroi and entry tax, purchase tax, luxury tax and taxes on lottery, betting and gambling. The accompanying figure from the revenue department website explains how GST with input tax crediting will work.



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One long journey has ended, but another journey begins now. There have been innumerable assessments and commentaries on the GST but these are necessarily speculative. The actual proof of the pudding will lie in the eating. Many uncertainties remain.

First, effective working of the GST Network (GSTN), the IT backbone of the new tax regime, is critical for successful roll-out of GST. GSTN chief executive officer Prakash Kumar has asserted that the system will be ready on time, pointing out that returns filing will start from 1 August, not 1 July. However, registration of taxpayers for GST must be completed well before that so the system has to be up and running by 1 July. West Bengal finance minister Amit Mitra and others have raised some doubts about the readiness of GSTN. In a couple of weeks, we will know who is right.

Another administrative uncertainty is about the consequences of the messy overlapping jurisdiction of multiple tax authorities. All except the smallest taxpayers will be under dual control of both the state and Central tax authorities. Moreover, suppliers operating in multiple states are required to register in every state where they operate. In other words, taxpayers will be in the administrative jurisdiction of all these tax authorities at the same time and could be audited by any of them. This imposes a huge compliance burden on the taxpayer and opens the door wide for selective rent-seeking. In the GST council, ministers focused on their revenue take while officials driving the exercise focused on preserving their turf. The taxpayer had no voice in the council's deliberations. Will she, an intended major beneficiary of the new arrangement, turn out to be it's worst victim?

The revenue impact is a third area of uncertainty. The GST was intended to be revenue neutral, but that seems unlikely. GST being a consumption tax, producing states are likely to lose revenue. Also, tax rates for most items, barring a few, have been fixed close to or below the prevailing rates. Hence, after netting input tax credits and the elimination of cascading, i.e., tax on tax, indirect tax revenue is bound to fall. The states needn't worry about this since the Central government is committed to compensating their losses for the next five years. But who will compensate the Centre? Will the additional cess being collected by the Centre be enough or will the new tax result in large revenue shortfalls? If that happens, coming on top of the recent rise in fiscal deficits of several states and the expected fiscal burden of debt relief for farmers, bank loan defaulters and telecom companies, we can say goodbye to fiscal consolidation.

Closely related to the issue of revenue impact is the question of tax evasion. One of the claimed advantages of a value-added tax like GST is that the input tax credit system creates a paper trail of transactions and an incentive for those outside the tax net to be brought into it, reducing tax evasion. Were that to happen, this strong positive revenue effect could offset the revenue loss from input tax crediting and the elimination of cascading mentioned above. However, sceptics maintain that determined tax-evaders will find a way to game the system. The filing of returns over the next few months should resolve this uncertainty.

The impact of GST on resource allocation is yet another uncertainty. When commodities, including services, are taxed at different rates that changes relative prices. Commodities taxed at higher rates become more expensive relative to those taxed at lower rates. If demand is price sensitive, it shifts away from items that have become relatively more expensive. Resources get reallocated accordingly. There is an arcane literature on optimal tax theory which produced many PhDs, fine theorems and some analytical insights on this issue but not much guidance for practical action. One way of minimizing such tax driven relative price distortions is to tax all commodities at just one rate or a zero rate for necessities and one rate for the rest.

In contrast to such a norm, the GST council has adopted a five-rate structure: 0% (exempted items), 5%, 12%, 18% and 28% plus cess. Now it has inexplicably added a sixth rate of 3% for gold! Moreover, large groups have been left out of the GST structure, adding up to about half the gross domestic product, according to some estimates. With such differential tax treatment of different goods and services, relative prices of most inputs and outputs will obviously change. Exactly what the picture will look like a year or so down the road it is difficult to anticipate. But clearly there will be significant resource re-allocation effects across sectors as well as geographies.

There is uncertainty also about the creation of a national common market. The potential gains in logistics efficiency from a common market with no artificial barriers between states are enormous. It could significantly reduce costs across the board, with consequent gains in India's competitive strength in international markets. How much of this potential will be realized remains a question. The requirement that suppliers operating in multiple states must register in each state is already an artificial barrier to inter-state trade.

Rent-seeking from such artificial barriers to inter-state trade has been a lucrative business for decades. Those who stand to lose from the elimination of such inter-state trade barriers must be working overtime to develop new barriers in the name of checking vehicle registration, pollution, contraband goods and who knows what else. How the national common market created through GST plays out on the ground, we will soon see in the months ahead.

These many uncertainties notwithstanding, my personal view is that the GST will prove to be a major step forward in tax reform. Undoubtedly the GST, as it has been designed, and the related administrative arrangements are flawed in many ways. But these defects can be reduced over time if not altogether eliminated. Gradual but sustained improvement, with reversals from time to time, has been the hallmark of tax reform in India during the past 40 years or so. In time, India's GST system will come to be recognized as the best practice in designing a value-added tax for complex federal systems with overlapping tax jurisdictions like ours.

Quite apart from the economic aspects, an altogether different dimension of this reform which is at least as important is the political aspect. Some have argued that with the GST states have ceded some of their powers to the Centre. This is incorrect. The states have indeed ceded some powers to the GST council but so has the Union government. And the GST council is not a Central government institution, it is a federal body. Voting power within the council is carefully balanced. While the Union government can veto a decision of the states, a majority of states can aslso come together to overrule a proposal of the Union government. The experience of the past eight months has shown how the Central and state governments, ruled by competing political parties, can effectively work together when the incentives are right for them to cooperate. The GST council can now serve as a template for reforming other such institutions of cooperative federalism, starting with the inter-state council, which was rendered toothless from the very outset.

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