

# Finally a goods and services tax but what lies ahead?

*The experience of the past eight months has shown how the Central and state governments, ruled by competing political parties, can effectively work together*

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**T**he 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.

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

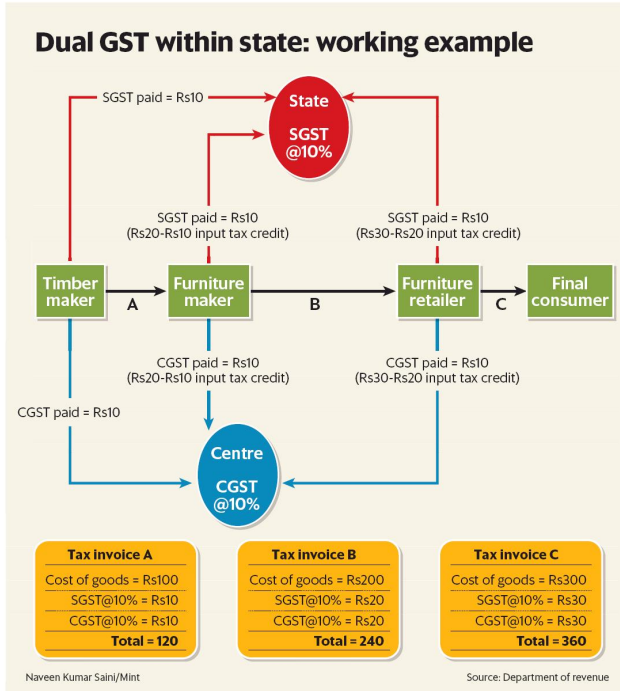
critical for successful roll out of GST. GSTN chief executive officer Prakash Kumar has asserted that the system will be ready on time, pointing out that returns filing will start from 1 August, not 1 July. However, registration of taxpayers for GST must be completed well before that so the system has 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 its 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 need not 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,



**The potential gains in logistics efficiency from a common market with no artificial barriers between states are enormous**

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, road it is difficult to say but it will be significant resource across sectors as well as

There is uncertainty a national common market in logistics efficiency is with no artificial barriers enormous. It could signify across the board, with India's competitive markets. How much of ized remains a question suppliers operating in ter in each state is already inter-state trade.

Rent seeking from inter-state trade has been decades. Those who station of such inter-state working overtime in name of checking vehicle contraband goods and How the national com through GST plays out soon see in the months

These many uncertainties my personal view is that a major step forward in the GST, as it has been administrative arrangements. But these defects if not altogether eliminated improvement, v time, has been the hall India during the past 4 India's GST system will global best practice in tax for complex federal ping tax jurisdictions li

Quite apart from the altogether different di which is at least as important. Some have argued states have ceded some Centre. This is incorrect ceded some powers to has the Union government is not a Central government federal body. Voting p carefully balanced. W ment can veto a decisio of states can also come proposal of the Union; ence of the past eight n Central and state gover ping political parties together when the inct to cooperate. The GST a template for reform of cooperative federal inter-state council whi from the very outset.

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