

First step, but with birth defects

A close examination of the Constitution amendment Bill shows that the structure envisaged is fraught with flaws

The speed and urgency with which the Union finance minister has placed the 122nd Constitution Amendment Bill in Parliament must be commended. This clearly shows the importance and urgency he attaches to reform the domestic trade taxes in India by introducing the GST at Union and state levels. At the same time, it is important to be realistic in our assessment of both the speed and content of this reform and what it can achieve. Undoubtedly, this is an essential step which will create the enabling framework for the reform. The architecture, engineering and management aspects of the GST and the speed at which this can be implemented will unfold as the decisions in regard to these aspects are finalised. This will happen only after protracted negotiations between the Union and the states and among the states inter-se.

There is no doubt that the introduction of GST, replacing a plethora of Union and state indirect taxes, is an important reform. This is expected to reduce the three costs associated with taxes—collection cost, compliance cost and cost in terms of allocative distortions. This will improve the ease of doing businesses, enhance efficiency in the supply chain by obviating the need to have branch offices (created to avoid the inter-states sales tax), reduce transactions costs by ensuring seamless trade in commodities and services across the country and improve export competitiveness by providing comprehensive relief from domestic taxes. Indeed, the extent to which these can be accomplished will depend upon the ultimate structure and operational details that will emerge. As I had argued in my previous column ("Final GST no game changer", January 6, goo.gl/oXtYzN), given the nature of Indian polity and the fact that the interests of the Union and states on the one hand and those of producing and consuming states on the other do not coincide, it will not be a flawless GST. Therefore, it should only be seen as the next stage of consumption tax reform and not as a "game changer" or the "reform of the century". Unrealistic expectations will

only bring despair later.

The Constitution Amendment Bill proposes to add a new Article 246A which will enable both the Union and the states simultaneously levy the tax on goods and services. However, the tax on inter-state transactions in goods and services can be levied only by the Union government. In the case of the Union government, excise duties on crude oil, motor spirit, high-speed diesel, natural gas, aviation turbine fuel and tobacco products have been kept out of the purview of the GST. These commodities will continue to be subject to Union excise duty. In the case of the states, besides crude, petroleum products and natural gas, alcoholic liquor for human consumption is kept out and these will be subject to special rates of sales tax. Entry 52 in the State List, enabling the levy of the tax on the entry of goods into a local area for consumption, use or sale is omitted,

and hence, people can get relief from Octroi. Entertainment tax levied by the states will be subsumed in the GST but those levied by the local governments will continue. Most importantly, the Bill proposes to levy an additional tax of not exceeding 1% on the supply of goods in the course of inter-state trade, to be levied and collected by the Union government and distributed to the state of origin. This levy will continue for 2 years or such other period as the GST Council may recommend.

The Bill also provides for the establishment of the GST Council with the Union finance minister as the chairman, and comprising of the Union minister of state and the minister of finance or any other minister nominated by each of the states. The vice-chair-



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man of the Council will be chosen from among states' ministers by them in the Council. The Council will determine the taxes to be subsumed, list of exemptions, thresholds, the rate structure including the floor rates or the band, principles governing the place of supply rules, model law, special position of the states in the North East, Himachal Pradesh, Jammu and Kashmir and, Uttarakhand. The Council will also determine the dates from which the GST will be extended to petroleum products and natural gas. The decisions in the Council will be taken when it is approved by three-fourths of the weighted votes of the members present and voting. Union government will have one-third of the weight in the votes and each state has equal vote in the remaining two-thirds.

A close examination of the Constitution amendment Bill shows that the structure envisaged is far from being flawless. First, the Bill provides only a minimalist framework for the levy. The details of the structure and operation of the tax including the exemptions, rate structure and thresholds will be determined through negotiations in the GST Council. Second, keeping out petroleum products, and natural gas out of the VAT chain will not only cause relative price distortions due to cascading but also create administrative complexities. Both the Union and the state governments want to continue with high tax rates on petroleum products prevailing at present. Third, the most undesirable compromise is the decision to continue with inter-state sales tax of 1%. While the present inter-state sales tax is only on goods, new levy will tax the supply of

both goods and services. This will negate a major gain from the levy of GST by making the tax partly origin-based, violating the federal principle of providing seamless tax credit and continuing with cascading element in the tax by denying input tax credit on this element.

In this context, three issues must be noted. First, given the nature of Indian polity, there is no incentive to the states to correct the birth defects implicit in the proposed GST. The inter-state sales tax is proposed to be withdrawn only when the GST Council decides so, and given that every state gets some money from inter-state trade, there is no constituency for abolishing it. Similarly there will be no incentive to rationalise the taxes on petroleum products. Many more anomalies are likely to come up and the structure and operational details are worked out by the GST Council. Second, it would be too ambitious to presume that all the issues relating to the determination of the structure and operation of the tax including the administration, capacity building and application of technology for GST networking can be accomplished within the next 11 months for introducing GST by April 2016. If indeed they must be accomplished, the Empowered Committee will have to come up with a detailed action plan with month-wise targets and monitor the implementation mechanism. There is, as yet, no such action plan in the offing. Finally while GST is an important reform, it is unlikely to be flawless and therefore, will not be a game-changer. We should see this as a process, the next stage of reform and continue to improve it upon over time.

As an aside, let me also hope that the Parliamentarians will have the wisdom to replace the word "Centre" in the draft Bill with "Union" before the amendment is passed. Otherwise, "Centre" will creep into even the Constitution!

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