BRINGING BACK THE LOCAL IN THE NATIONAL TAX REGIME

A single GST rate of 12% would work if the centre and states share 1/6th of this with local bodies, leading to an urban revolution

Vijay Kelkar

A uniform GST rate will improve compliance, completely do away with distortion and promote growth and employment. PTI

By all accounts, Indian economy today is on a growth turnpike, not very different from the growth miracles experienced by Asian tigers as well as China in earlier decades. India has consistently accelerated its growth rate over the last three decades. Our country has not looked back since 1991 and has, in fact, become one of the best growth performers in the world economy.

The deep determinants of this remarkable growth experience of ours have been institutions, demographic transition, modern technology and accumulation of both human and physical capital. In my view, the most important of these factors has been our democratic framework, a key foundational institution. Our democracy has proved to be sine qua non for effectively formulating key economic policies and conducting policy reforms in a country that is so diverse.

It is also of fundamental importance for maintaining social harmony. I cannot overemphasize the need for maintaining continuous vigilance to safeguard social harmony in our highly diverse society. In this endeavour, the "majoritarianism" will need to be eschewed. As the proverb goes "United we stand and divided we fall."

In a country as beautifully diverse as ours, federalism as an organising principle is clearly the only way to succeed. In the analytical literature, "coming together" and "holding together" are the recognized forms of federalism. United States is the classic illustration of the first whereas the erstwhile Pakistan or Yugoslavia perhaps could be seen as illustrating the second.

EMPOWERING THE THIRD TIER

Fiscal federalism has been one of the most important pillars for the success of our enduring democracy. The fiscal federalism mainly comprises allocation of rights and duties related to taxation and expenditure responsibilities and system of transfers between the different levels of government such as centre, state and the third tier, elected local governments and Panchayats.

LONG STORY

To provide the necessary fiscal base for the 3rd Tier, I would strongly urge to make constitutional amendment to enable both states and the centre to share an equal percentage of their GST, i.e., of SGST and CGST with the 3rd Tier. This will provide a buoyant fiscal base to the 3rd Tier and more importantly align interests of the elected officials with their citizens as GST is essentially a consumption-based tax.

Towards this, I would propose the following rates: A single GST rate of 12% with CGST and SGST of 6% each and both Centre and state would share 1/6th of this with the 3rd Tier. This would enable providing a fiscal base of not less than 1% of GDP to the 3rd Tier in a predictable manner.

Given growing urbanization and the increasing role of the cities in maintaining the country's growth momentum, an adequate fiscal base for the cities can alone ensure the supply of required public goods such as urban mobility, solid waste management, public health, etc. Such a measure will also generate considerable amount of fiscal resources with high buoyancy.

For instance, this year alone it can generate more than ₹2 lakh crore and grow by more than 10% every year. These large resources would be additional to the resources from the property taxes that will continue to be levied by the local bodies. There is, of course, need to reform the property tax system on the lines suggested by the 13th Finance Commission. Such strengthening of the fiscal base can give a major boost for improving greatly the urban infrastructure and strengthen our cities as powerful engine of growth.

With a predictable fiscal base, well-run local governments can also raise additional resources via issuance of long term bonds. Such an approach for sharing taxes with the 3rd Tier has one additional important feature. The proposed sharing procedure is fully "incentive-compatible." GST is a consumption tax and sharing this with the 3rd Tier will align the incentives for the "governed" as well as "governors" thus promoting efficient deployment of these resources.

Cities with better local public goods would increase automatically the tax base of the cities as better public goods will promote growth of economic activities and the resident citizens' incomes and consumption which, in turn, will provide high fiscal resources to the cities' governments. Equally, every citizen will be contributing to the fiscal base as the GST is a consumption tax. Consequently, every citizen will demand high accountability of the governance. In other words, both demand for and supply of good governance will improve quality of life on a sustained basis.

The effective "democratic decentralization" means autonomy of the third tier governments in terms of funds, functions and functionaries. It is my belief that strengthening the fiscal base of the 3rd Tier through sharing of the GST will incentivize the state governments (the 2nd Tier of government) to hand over the control of relevant functions and functionaries to the 3rd Tier and thus truly empower the 3rd Tier.

MORE GST REFORMS NEEDED

Ruefully, the current GST arrangement is rather a weak pillar, and more reforms are necessary to ensure that the GST becomes a firm and important part of our fiscal federalism architecture.

Hence, to achieve this, the government and the GST Council will have to undertake the following important GST reforms (these proposals are based on joint papers with my colleague Dr. V. Bhaskar):

Firstly, GST should include real estate, electricity, liquor, tobacco and the petroleum products. Some of these products can be considered as "sin" goods and a single rate of GST may not be adequate to discourage the consumption of these products. Towards this, one can envisage "nonvattable" levy on these sin goods. Such a surcharge can be imposed by both centre and state equally or by centre alone or states alone. For instance, on tobacco, it can be only by the centre and on liquor, it can be only by the states and on petroleum products both centre and States. Such a flexible approach towards tax jurisdiction for "non-vattable" surcharges will meet the concerns of the state governments.

We need vigilance to safeguard social harmony in our highly diverse society...majoritarianism will need to be eschewed.

MINT SHORT STORY

WHAT

As urbanization quickens and cities play an increasing role in economic growth, a re-thinking of the GST regime may well encourage federalism by further empowering both states and the local bodies.

HOW

To provide the necessary fiscal base for the urban local bodies, a constitutional amendment enabling states and the centre to share their GST, i.e., of SGST and CGST, with the local government is needed.

WHY

Despite the efforts of the GST council, India's tax governance is still centralized. The centre still retains most taxation powers while cities have almost none. This needs to change with the latter's increasing role in growth.

Second important part of the reform is to put exports at "zero rate" which is not yet done. One cannot tax exports as the foreign importers will go to other suppliers even if the Indian exporters are efficient. Such a policy already exists all over the world and it is also WTO compatible. I cannot overemphasize the urgency of this measure as expanding exports will be an important source for increasing growth and employment opportunities.

Thirdly, bringing real estate in the GST will have an additional advantage of imparting transparency in the land and real estate markets and thus substantially reduce generation of black money in our economy. Frankly, to my mind, this measure will yield better results on controlling black money than a measure like demonetization.

Similarly, for reducing transaction cost, we need to reform the integrated goods and services tax and completely do away with the system of e-way bills.

All these measures will allow us to adopt a single rate of 12% of GST where 10% is equally shared as CGST and SGST and 2% to local bodies. A single GST rate is in line with best international practice. Such a single rate will improve compliance, completely do away with distortion and promote growth and employment.

Of course while exports will be zero rated, the rate for food, lifesaving drugs, vaccines and lifesaving medical devices will need to be nil.

Such single rate of 12% will be a revenue neutral rate for both centre and states. This is based on the detailed estimates done by the task force appointed by the 13th Finance Commission.

Finally, we need to recalibrate the GST administrative structure so that a tax payer is required to be audited only by a single tax authority, for a larger taxpayer by the Central authority and for smaller taxpayer by the State authority. The current practice of every taxpayer facing multiple audit agencies for the GST should be eschewed.

NITI AAYOG VER 2.0

I would argue that replacing the Planning Commission, which was promoting regionally balanced growth in India, by NITI Aayog, a think tank, has reduced the government's policy reach. This means that currently India's Fiscal Federalism stands only on one pillar—Union Finance Commission. This is a serious weakness of our present fiscal federalism and needs to be quickly corrected.

Our policy approach of using an additional policy instrument such as the Planning Commission for resource transfers to the states through Plan Grants has been useful in reducing "development imbalance."

The challenge, of course, is how to make it more effective. I would, therefore, argue strongly that there is deep analytical foundation for a case where the NITI Aayog gets significant levels of resources for allocating to the different states.

These resource transfers will be aimed at mitigating development imbalances by promoting accelerated growth of lagging states and sub-regions. Given our political economy, these grants need to be conditional and formulaic. The purpose of these grants would be to enable the lagging states to build capacities in infrastructure sectors such as roads, ports, railways and digital connectivity, supply of power, access to credit and improving governance. This will serve the objective of helping the lagging states and regions to attain growth acceleration and the reduction in developmental gap.

Planning Commission, as is well known, has been using the various forms of the famous Gadgil formula and later the Gadgil-Mukherjea formula for allocating plan grants. Although they did serve the needs of the time, given the acuteness of challenges posed by continued inequalities between and within the states, I believe that we need to reinvent the central grants by using somewhat different variables and formulae, while being mindful of macro-economic conjuncture and structural needs. These grants can be capital or revenue. Equally, these can be either conditional or unconditional transfers.

It is possible to suggest that such allocation of transfer grants be administered by the ministry of finance. But, by nature of its mandate, the ministry of finance is primarily concerned not with structural transformation but rather with the issues related to short and medium term macro-economic stability including managing balance of payments, inflation and business cycle. It is desirable that a functionally distinct entity such as the new NITI Aayog or NITI Aayog 2.0 be put to use to do the job at hand related to the structural issues.

This would mean that the new NITI Aayog or NITI Aayog 2.0 will be responsible for allocating development or transformational capital or revenue grants to the states. Given the overall resource constraints, what this would mean is that the future Finance Commissions, as against what has been done by the 14th FC, will have to revert to the modest percentages in their devolution formula as was indeed the historical trend.

NITI Aayog has reduced the government's policy reach. A new NITI Aayog is needed to allocate development capital to the states.

This, of course, does not mean an overall reduction in the overall transfers but only in their composition and their source.

Needless to say, the overall levels of such transfers will be determined by the ministry of finance keeping in mind the FRBM regime in place. I dare say that such an approach will help in strengthening cooperative federalism as an acceleration of lagging regions will lead to higher growth in all the regions.

IN CONCLUSION

Let me hasten to add that I am not suggesting for a moment that NITI Aayog 2.0 should take the form of the old Planning Commission. In the age of globalization and open economy, macro-economic framework has to be different in terms of analytical framework and approach. It should take care to eschew yesteryears micro-management vis-à-vis central ministries and the state governments via excessive bureaucratization.

Similarly, NITI Aayog 2.0 need not be involved with the approval of the states' annual expenditure programs. It should rather strive to be a think tank with "praxis", possessing considerable financial muscle and devote its energies to outline coherent medium and long-term strategy and corresponding investment resources for transforming India. Towards this, my preliminary study suggests that the NITI Aayog 2.0 will annually need the resources of around 1.5% to 2% of the GDP to provide suitable grants to the states for mitigating the development imbalance.

In order to make the new NITI Aayog more effective, it is essential to ensure that the institution is at the 'High Table' of decision making of the government. This means the vice chairman of the new NITI Aayog will need to be a permanent invitee of the Cabinet Committee on Economic Affairs. Thus, the new NITI Aayog will make available to the highest level of policy making the knowledge-based advice and provide the national and long-term perspective on the policy proposals. Today, there is no such advice available to our cabinet.

Edited excerpts from the Professor Sukhamoy Chakravarty Memorial Lecture, delivered at the 55th annual conference at the Indian Econometric Society, Mumbai.

Vijay Kelkar is chairman, National Institute of Public Finance and Policy.