GST for India: Some Basic Questions

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Even after two decades of reforms the system of domestic trade taxes in the country remains deficient. Union Finance Minister's announcement in this year's budget of his intent to usher in a "national Goods and Services Tax'" by 2010 is thus to be welcomed. However, at the moment, GST remains a vague concept, with no clarity on its design or the institutional infrastructure for its implementation. Given the complexities, a lot of preparatory work would be needed to carry out this task.

Several questions need to be addressed upfront and acceptable answers found. First , at what level should the tax be levied , exclusively by the Centre or only by the States, or by both? If by both, what should be its design, the base and the rates and the system of implementation? How will the system be harmonized, in case the tax is levied at more than one level? The issues involved and the alternatives need to be debated at greater length than has taken place so far. We seek to initiate the debate with a three-part contribution in these columns. We take up the first issue first, viz., at which level should the tax be levied ?

Ever since the idea of a 'unified GST ' was mooted by the Kelkar Task Force two years back, a widely held presumption has been that GST will be a single VAT to be levied nationally replacing both the CENVAT and the VATs now being levied at the state level. The Finance Minister's statement setting a target date for having a "national GST' in place "that should be shared between the Centre and the States" may seem to strengthen this presumption. .

The idea of a single, unified tax on goods and services administered only by the central government is hugely attractive to many, particularly businesses. It is widely felt that the operation of the common market in India desperately needs a unified GST levied nationally. That apart, implementing a destination based VAT at the state level in a federation with no inter-state border controls poses acute problems and could open up wide opportunities for fraud. Thus, it was thought for a long time that administratively only a centrally administered VAT is suitable for federations. That may have been one of the considerations in the adoption of GST in Australia as a federal tax. However, for

reasons mentioned below the idea of a single national VAT to replace the CENVAT and the state VATs is not tenable for India.

First and foremost, for the States the power to levy sales tax constitutes the most important tax power at their command. Taking it away will grievously reduce their fiscal autonomy which is essential for responsible fiscal behavior. It will make them even more dependent on the Centre than they are at present and reduce them to mere spending agencies with little responsibility for raising what they spend. Sharing the revenue from a tax is no substitute for sharing the tax power. Those who feel fascinated by the idea of a single national trade tax should realize that ours is a most heterogeneous country unlike Australia and can survive only as a genuine federation. Nothing should be done to damage the federal fabric. Anything that emasculates the revenue powers of the States should be avoided.

The idea that in a federal country VAT cannot be administered properly except at the national level is also no longer valid. Recent literature shows that several models are now available for operating a state-level VAT in a federal country without border controls. Even in India, many states operate VAT without any check posts or other forms of border controls. Where the border controls do exist, they have not had any perceptible impact on revenue collections.

Moreover, the proposal for an exclusively national VAT will not fly for the simple reason that it would require the sales tax administering establishments in the States to be wound up or taken over by the Centre and that, almost certainly, will not be acceptable to the States. For the power to levy sales tax is a 'power' in itself and not just revenue power. .Moreover, for the Centre to administer a tax with such "local moorings" as the sales tax throughout the the length and breadth of the country is not going to be simple.

Thus, for both political and administrative reasons, in heading for a regime of GST one has to think of alternatives. One alternative is to have the tax at two levels levied and administered more or less independently. Brazil's experience with such a VAT cautions against moving in that direction. A 'dual VAT' of the kind operating in the province of Quebec in Canada seems to offer a better choice.

Canada is having a federal level GST since 1991 while the provinces (barring Alberta) have their own sales tax or VAT. Quebec has its own VAT (QST) on a base that consists of both goods and services and that is largely harmonized with the federal GST.

Both taxes are administered by the revenue authorities of Quebec. Audit of tax returns is undertaken in close collaboration between the two governments.

Canada runs another model of dual VAT with three Maritime provinces harmonizing their VAT with the federal GST, called the Harmonized Sales Tax (HST). The two taxes are levied at a single composite rate, and administered by the federal government. Revenues from the tax are allocated to the participating governments on the basis of statistical calculations of the tax base. In broad design, it operates in a manner similar to what Kelkar Task Force has recommended for India. This model, while simplifying compliance, unduly restricts the autonomy of individual states to make any base or rate changes.

All in all, the Quebec model is reported to be working well and with some modification merits serious consideration for implementing GST in India. What should be the design of the tax, the base and the rates and how it should be administered will be taken up next

GST Roadmap II:
Balancing Harmonization and Fiscal Autonomy

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As explained in our last column, the preferred form of GST for India alluded to by Finance Minister Chidambaram cannot be a single national VAT. It has to be a 'Dual VAT' consisting of a Central GST (CGST) and a state GST (SGST). Both should be imposed on a comprehensive base covering goods as well as services.

While the design of the CGST can be relatively straight forward, SGST will require a delicate balance between the fiscal autonomy of the states and the need for harmonization across the thirty five states and union territories so that the common market of India can flourish without any tax hindrance. An important question then is what should be the desired degree of harmonization.

Harmony in procedures and administrative systems should pose no problem as they do not impinge on the states' autonomy in any significant way; nor should harmonization of the tax base. In fact the dual VAT in Canada works on a practically harmonized base. In the EU too, the VAT base of member countries follows a standard pattern laid down in the Sixth Directive of the European Commission. It is the harmony in rates that raises questions about the states' fiscal autonomy. For the power to fix the rate is central to any tax power and so any limitation in this regard cannot but whittle down the tax power in question.

In a federal set-up, the state governments should observe two basic rules in exercising their tax powers: one, no state should export its taxes to other states, and two, there should be no unfair tax competition. The former requires that the state tax be levied on the basis of the destination principle (i.e., the tax should not apply to inter-state sales and exports, but extend to inter-state purchases and imports on the same footing as local

products), and the latter that there be a floor below which no state can go in fixing its tax rates.

To start with, ideally the GST, whether of the Centre or of the states, should be levied at a single rate (not necessarily the same at both levels or across states) on all goods and services. The single rate can be supplemented by an additional tax on certain products such as motor fuels, tobacco, and alcohol. Multiple rates, often justified for basic necessities to lessen the burden on the poor, lead to classification disputes and increase the costs of compliance and administration. Also, they are an inefficient means of helping the poor as the benefit of lower rates accrues to all, regardless of their income status.

The current model of 4% and 12.5% state VAT rates is violates this dictum and vividly illustrates how rate multiplicity generates complexity and inefficiency. The 4% rate has been extended to a large basket of goods consisting of food, utensils, fabrics and garments, paper, sporting goods, as well as industrial inputs, and IT products. Classification of goods between the two rates is often arbitrary and cannot be seen in any way to be helping the poor. The two rates can be replaced by a single revenue-neutral rate, which could be as low as 6% (with no change in the higher rate on motor fuels). A tax at this rate would not only be simpler, but should also lead to a significant improvement in compliance. It would also facilitate calibrating the CGST to achieve an acceptable aggregate level of trade taxation in the country.

If, however, the tax has to be levied at more than one rate, there should be only two rates: a standard rate and a lower rate applicable to a narrow list of basic necessities. The Centre and the states should adhere to a common classification of commodities eligible for the lower rate. While inter-state uniformity in rates is highly desirable to minimize tax-induced shifts in trade, flexibility could be provided to the states to levy the SGST at different rates (not more than two in any case) as long as they adhere to the fixed categories of goods, i.e., all commodities in a given category are taxed at the same rate.. States should also agree not to go below specified floor rates for the two categories.

Taxation of services and intangible property (e.g., copyright, film distribution rights, and information services) by the states poses a difficult challenge in defining the place of supply or consumption of the service. For example, if a telephone call is made from Delhi to Kolkata, is the telephone service to be taxable in Delhi or Kolkata? Similar issues arise in the case of services with no single place of performance, consumption or use. (e.g., advertising on a national TV channel, postal services, credit card services, inter-state transportation and countrywide consultancy or data processing services).

To avoid gaps or overlaps in the taxation of such services, it would be necessary for the states to agree upon a common set of so-called 'place of supply rules'. For example, passenger transportation could be taxable in the state where the journey begins or ends, or on the basis of distance traveled in a state. Once the agreement is reached, the rules can be made to work as the EU and Canadian experience shows.

Harmonization of rules and procedures should be simpler to achieve as inter-state variation serves little social or economic policy objective. The areas for full harmonization should include taxpayer registration system, taxpayer identification numbers, tax forms, tax reporting periods and procedures, invoice requirements, cross-border trade information system and IT system. This would result in significant savings in the costs of implementing VAT by avoiding duplication of effort in each state as well as in recurring compliance costs. It should also permit sharing of information among governments which is essential for effective monitoring of cross-border transactions.

Harmonization should extend to tax legislation as well. Interstate variation in the wording and structure of tax provisions is often an unnecessary source of confusion. A common GST law would facilitate common approach in the interpretation of the tax laws and rulings, e.g., about classification of goods and services, determination of taxable consideration, and definition of export and import. Transitional issues and how to enforce harmonization will be taken up in our next column.

GST Roadmap III:
The long road ahead to GST

In a recent poll of four hundred and sixteen tax directors and executives from Asia-Pacific, India topped the list of tax authorities that companies find the most difficult to deal with. (International Tax Review, September 2006). Tax laws figure prominently among the factors contributing to this perception. A well designed and well administered GST could go a long way to correct such negative perception.

As discussed in our previous columns (ET 13 and 26 Sept), the most suitable GST for India would be the Dual GST, a combination of Centre and State GSTs, each levied at a single rate on a comprehensive base consisting of both goods and services. While the Centre and the states would have the autonomy to set their tax rates subject to a floor , there would have to be full harmonization of the tax base, laws, and administrative procedures. A major overhaul of our institutional and administrative infrastructure would be required to enable implementation of such reforms.

To start with, the Constitution of India would need to be amended to empower the Centre and the states to levy the GST. Currently, the Centre is precluded from taxation of purchase or sale of goods, which is an exclusive preserve of the states. In turn, the states are precluded from the taxation of services. This division of taxation powers is archaic. The distinction between goods and services is becoming increasingly blurred as goods get digitized, bundled with services, and delivered through internet on as needed basis.

Both levels of government should have concurrent powers to tax all sales (called supplies in VAT terminology), whether of goods or services. The powers would extend to taxation of land and buildings, as modern value-added taxes draw no distinction between consumption of real property and that of other goods and services. To prevent extra-territorial application, state taxation would be limited to transactions within the state.

Many of the specific entries in the Constitution would become redundant with this concurrent taxation power. An expert panel should be formed to draft the suitable enabling provision for the concurrent taxation powers and to recommend consequential modifications to the Constitution.

The constitutional powers would be exercised within the framework of a national harmonization agreement, which would bind the Centre and the States to **a** common tax base, laws and administrative procedures. An important part of this agreement would be delegation of responsibility for the design of harmonization elements and modifications thereof to an institution, which could be the Centre, or a newly created Centre-State body funded by and accountable to both levels of government. This body would be responsible for only the design and policy aspects of GST administration. Actual operations and delivery would be the responsibility of each government in their respective jurisdictions.

The harmonization agreement would be supplemented by two additional agreements: an agreement on place-of-supply rules, and a Centre-state tax collection agreement. The place-of-supply rules will define the origin and destination of inter-state goods and services (e.g., telecommunication, transportation, and Pan-India advisory services), and which states will have the right to tax them. These rules are essential in order to avoid gaps and duplication in the taxation of cross-border supplies. The rules for defining the place of origin/destination of inter-state supplies of goods are already well developed in the Central Sales Tax (CST) Act and could be readily adapted for the GST. Parallel rules would need to be developed for services.

The place-of-supply rules would need to be supplemented with a new mechanism for reporting and monitoring of inter-state transactions and for collection of tax on them. The Trade Information Exchange System (TINXSYS), already developed for the Empowered Committee, can be a valuable tool for the monitoring of such transactions.

A Centre-State tax collection agreement would also be needed, should the Centre decide to delegate or outsource the collection of all or part of the Central GST to the states, as under the Canada-Quebec model.

A critical component of the new infrastructure for the implementation of GST would be a mechanism for the enforcement of the various agreements noted above. The current approach of voluntary cooperation and consensus being followed by the Empowered Committee of the State Finance Ministers has not been effective.. States have deviated from the agreed rate structure with impunity. This has to stop.

Using the system of grants from the Centre to arm-twist the states to fall in line would not be desirable. Besides, there is no legal authority for the Centre to use grants to compel the states to abide by agreements arrived at among themselves such as to harmonize their rates and not to indulge in harmful tax competition or competitive subsidization (that is negative taxation) of industries set up in their jurisdiction.

No doubt the courts are there to see that the Constitution is duly respected by all. However, our courts have no authority to enforce agreements voluntarily reached by the states either with the Centre or among themselves. In the European Union, all matters relating to violation of Community treaties and directives are decided by the European Court of Justice by virtue of an express mandate. That is not the case in India.

Fortunately, our constitution makers, while mandating the free flow of “trade, commerce and intercourse” in the Indian Union (under Article 301) also provided for the creation of an institution to oversee the enforcement of that mandate (Article 307).

This Article should be invoked to create a new authority, with quasi-judicial powers, to monitor and enforce compliance with the mandate of Article 301 and inter-governmental agreements for the GST.

Creation of a similar body was strongly recommended by the Sarkaria Commission on Centre-state relations. Unfortunately the recommendation did not find favor with the

Inter-State Council. It deserves to be reconsidered in the context of GST and the smooth operation of India's common market.

The above is illustrative of the many complex elements in the design and implementation of the GST. At the moment, the GST remains a vague destination and the road to it is nonexistent. The governments urgently need to start deliberations on the subject, with a mandate to make the Finance Minister's promise of GST by 2010 a reality.