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GST REFORM NEEDS A NEW GRAND BARGAIN

Relevant for: Indian Economy | Topic: Issues relating to Growth & Development - Public Finance, Taxation & Black Money incl. Government Budgeting

Three years ago, the Centre and the States of the Union of India struck a grand bargain resulting in the launch of the unified Goods and Services Tax (GST) era. The States gave up their right to collect sales tax and sundry taxes, and the Centre gave up excise and services tax. The nationwide GST promised frictionless commerce across State borders,buoyant and leakproof tax compliance, and removal of inefficiencies like the cascade of “tax on tax”. This historic grand bargain was the result of painstaking consensus building, which *inter alia* involved addressing the apprehension of States, of revenue loss due to the GST.

Their consent was secured by a promise of reimbursing any shortfall in tax revenues for a period of five years. This reimbursement was to be funded by a special cess called the GST compensation cess. The promised reimbursement was to fill the gap for an assured 14% year on year tax growth for five years, and it was generous to a fault. Neither the national aggregate nor any of the major States had this record for the previous five years.

Also read | Borrow from RBI to bridge GST gap, Centre tells States

But that was not the only fault with the design, which had also failed to learn from the successful design of harmonising Value Added Tax (VAT) rates across the nation, implemented just a decade ago. VAT was the precursor to GST and also needed a consensus. That design too had an inbuilt reimbursement formula. But that tapered over the years, making room for incentives for tax effort from the States, sort of “skin in the game”.

As the economy battles a pandemic and recession, the tax collection has dropped significantly, while expenditure needs are sharply higher, especially at the frontline of the battle, at the State level. But it seems that the States have been told that they are on their own to meet the shortfall in revenues. Using an equivalent of the *Force Majeure* clause in commercial contracts, the Centre is abdicating its responsibility of making up for the shortfall in 14% growth in GST revenues to the states.

This is wrong on many counts. First, the States do not have recourse to multiple options that the Centre has, such as issue of a sovereign bond (in dollars or rupees) or a loan against public sector unit shares from the Reserve Bank of India. Second, the Centre can anyway command much lower rates of borrowing from the markets as compared to the States. Third, in terms of aggregate public sector borrowing, it does not matter for the debt markets, nor the rating agencies, whether it is the States or the Centre that is increasing their indebtedness. Fourth, fighting this recession through increased fiscal stimulus is basically the job of macroeconomic stabilisation, which is the Centre’s domain. Fifth, and most importantly, breaking this important promise, using the alibi of the COVID-19 pandemic causes a serious dent in the trust built up between the Centre and States.

Comment | Making up for shortfalls in GST collection

Cooperative federalism is in the nature of a “repeated game” between the two entities, and every action must think of the future consequences, not just the immediate ones. Will it not weaken the foundation of trust?

Kautilya too would have advised the sovereign against reneging on the promised bailout, as fulfilling the obligation helps build trust with sub-sovereigns.

Also read | Centre's GST compensation options 'betrayal of spirit of cooperative federalism': Punjab FM

The issue of GST compensation to the States is just the latest in the bumpy three-year journey of the new tax design. It is clear that the design needs a radical overhaul. Just tinkering with the compensation mechanism, or frequently changing rate slabs, or pushing more goods in the "sin tax" cess category, to earn revenue that is not shareable with the States, is not the way forward. What we instead need is a Grand Bargain 2.0 between the sovereign and the sub-sovereign entities.

What would this be based upon? We have to go back to first principles. GST is a destination-based consumption tax, which must include all goods and services with very few exceptions, such as food and medicine. That widening of the tax base itself will allow us to go back to the original recommendation of a standard rate of 12%, to be fixed for at least a five-year period.

Editorial | Digging deeper: On GST compensation

A comparison with Australia which also coincidentally shares its GST anniversary with India, is apt. For the past two decades their GST rate has been constant at 10%. Of course India's single rate of 12% has to cover petrol, diesel, electricity, transport and real estate as well. Some extra elbow room for the States' revenue autonomy is obtained by allowing the States non VATable surcharges on a small list of "sin" goods such as liquor, tobacco, polluting goods such as sport utility vehicles, and industrial fuels such as diesel, aviation turbine fuel and coal. A low moderate single rate of 12% encourages better compliance, reduces the need to do arbitrary classification and discretion, reduces litigation and will lead to buoyancy in collection.

Incidentally this redesign will scrupulously avoid the bogey of a "revenue neutral rate" (RNR) which needlessly occupied the attention of lawmakers and officials. GST is a long-term structural reform, while RNR is a short term and basically an elusive concept. In the long term there are many changes in consumption patterns, production configurations and locations, which cannot be anticipated and hence a static concept of RNR cannot be reference. The commitment to a low and stable rate, à la Australia and many other federal democracies, is a must. Of course the compensation-cum-reimbursement incentive can remain, but more in the nature of what was done for VAT harmonisation.

Also read | Kerala FM chairs meeting of States on Centre's GST dues

This new grand bargain must recognise the increasing importance of the third tier of government. Even after 28 years of the 73rd and 74th Amendments, the local governments do not have the promised transfer of funds, functions and functionaries. These local bodies face increased responsibility of providing government services especially in view of increased urbanisation and decentralisation. Of the 12% GST, 10% should be equally shared between the States and the Centre, and 2% must be earmarked exclusively for the urban and rural local bodies, which ensures some basic revenue autonomy to them. The actual distribution across panchayats, districts and cities would be given by respective State Finance Commissions. GST consumption tax paid by every citizen establishes a tighter link between the governed and the government. The quality of governance improves as also, the tax base is better aligned with responsibilities of various tiers of government.

Also read | Centre must borrow and pay States' GST dues: Kerala

This fresh approach also calls for an overhaul of the interstate GST and the administration of the e-way bill. Research papers by Bhaskar and Kelkar (*Reforming Integrated GST: Towards accelerating exports Policy Brief by Dr. V. Bhaskar and Dr. Vijay Kelkar* and *National Agenda for 2019 – A proposal for the GST reform by Dr. V. Bhaskar and Dr. Vijay Kelkar*) describe the simplified mechanism, which essentially reduces the transaction costs drastically. The current system is too complex and burdensome. We also need to zero rate exports. GST is a crucial and long-term structural reform which can address the fiscal needs of the future, strike the right and desired balance to achieve co-operative federalism and also lead to enhanced economic growth. The current design and implementation has failed to deliver on that promise. A new grand bargain is needed.

Vijay Kelkar and Ajit Ranade are, respectively, Vice-President and Member, Pune International Centre has helped us keep apace with events and happenings.

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