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Present state of goods and services tax (GST) reform in India

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Abstract

To remove cascading effect of taxes and provide a common nation-wide market for goods and services, India is moving towards introduction of Goods and Services Tax (GST). Under the proposed indirect tax reform both Central and State Governments will have concurrent taxation power to levy tax on supply of goods and services. It is expected that the proposed regime will improve tax collection and minimize leakage, as both Central and State Tax Administrations will monitor and assess the same set of taxpayers. There are several challenges before introduction of GST and these can be classified into two broad heads – a) GST Design and Structure related, and b) GST Administration and Institutional. On design related issues, broad consensus on choice of revenue neutral rates (RNRs), harmonization of GST rate(s) across States, harmonization of list of exempted and excluded goods and services and thresholds for mandatory GST registration across States are yet to be reached. Similarly, there are several issues involved in tax administration (between Central and State Tax Administrations and also across State Tax Administrations) which are not yet solved. Taking cognizance of discussion available in the public domain this paper attempts to provide a broad contour of the proposed GST regime and highlights major challenges which require immediate attention of the Governments.

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Keywords: Goods and Services Tax, Value Added Tax, Design and Administration of Taxation, Fiscal Federalism, Indirect Taxation, India.

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1. Introduction

India is moving towards introduction of Goods and Services Tax (GST). The GST would be a multistage comprehensive value added tax encompassing both goods and services. In the federal structure of India and under the constitutionally assigned taxation powers to different governments, GST would be a major indirect tax reform, as both the Centre (the Union Government) and State Governments have rights to tax goods as well services at every stage of production and distribution.

The proposed GST builds on a series of reforms of indirect taxation. The introduction of Value Added Tax (VAT) at State level, since April 2005, resulted in a first round of cleaning up of hidden indirect taxes which facilitated expansion of the tax base (Aggarwal 1995),¹ better tax compliance and higher tax buoyancy for the majority of Indian States. It is envisaged that the proposed GST will further clean up the indirect tax system by reducing cascading of taxes and facilitating a nation-wide market for goods and services. Under GST, it is expected that harmonization of indirect tax structure (tax rates and tax base across States), concurrent taxation power of Centre and States on consumption of goods and services and joint monitoring of same taxpayers would result in better tax compliance, reduce leakage of revenue and better tax coordination between Central and State tax administrations. The reduction of cascading of taxes and transaction costs associated with inter-State sales of goods could facilitate higher economic growth by attracting investment.² It is the expectation of the Central Government that introduction of GST will improve India's ranking in World Bank's ease of doing business as it will remove cascading of taxes as well as transaction costs involved in distribution of goods and provide services across States.³

Major fiscal motives behind the proposal to introduce GST include the expansion of fiscal space of the Central and State governments to address rising demands for public expenditure and revenue constraints; overcoming the Constitutional barriers relating to taxation by removing definitional differences between goods and services and the manufacturing and distribution of goods; and achieve greater fiscal prudence by aligning taxation powers to expenditure commitments/responsibilities under fiscal federalism.

The adoption of a rule-based fiscal management system in India under the Fiscal Responsibility and Budget Management (FRBM) Act, 2003 has resulted in better fiscal management in the majority of Indian States. Under the Act, individual States are required to maintain zero revenue deficits and limit the fiscal deficit of maximum 3 per cent of Gross State

¹ For majority of Indian States, sales tax was first point tax on sales which was not able to capture value addition in subsequent sales (Aggarwal, 1995).

² Underlying rationale behind attracting additional investment is that proposed GST will remove cascading of taxes (including transaction costs involved in inter-state sales of goods) and release working capital which is currently blocked as unpaid ITC.

³ India's rank in World Bank's ease of doing business is 130 out of 189 countries, as on June 2015 (Source: <http://www.doingbusiness.org/rankings>, last accessed on 12 November 2015).

Domestic Product (GSDP).⁴ While most States meet their FRBM targets at least in revenue deficits, the Central Government is not able to contain its revenue as well as fiscal deficit to meet FRBM targets. The major reasons for low fiscal performance of the Central Government are its falling share of indirect tax in GDP since 1987-88 and low indirect tax buoyancy: the average buoyancy with reference to GDP is well below 1 per cent since the introduction of economic liberalization in 1991, whereas indirect tax buoyancy of States is well above the Centre since 2008-09. It is expected that under the proposed GST system, the Central Government will share tax buoyancy of indirect taxes with States and vice versa. The resulting effect of this sharing could be a win-win situation for both stakeholders.⁵

Stated objectives of proposed GST reform are – a) widening the tax base by expanding the coverage of economic activities under GST and cutting down exemptions, b) achieving better tax compliance through mitigation of tax cascading, double (multiple) taxation and by lowering tax burden under GST, c) improving the competitiveness of domestic industries in international market by removing hidden and embedded taxes and d) achieving common national market for goods and services by unifying the tax structure across States (Government of India, 2015).

The present paper attempts to review these objectives by considering the design and structure of GST, based on information available in the public domain. We briefly discuss the present system of indirect taxation of India in the next section and highlight the major drivers for introduction of GST in India. In section three, we present the proposed structure and design features of GST. In section four, we discuss the challenges in design and administration of GST and possible scope for tax coordination. We provide a brief discussion of GST institutions in section five and draw our conclusions in the last section.

2. Present System of Taxation of Goods and Services in India

The indirect tax system in India has gone through several reforms in the last two decades (Rao and Rao, 2005).⁶ At the Central level, introduction of Central Value Added Tax (CENVAT) in 2000-01 and Service Tax in 1994 were the major reforms. Following the recommendations of the Tax Reform Committee,⁷ CENVAT was introduced in India which gradually unified tax rates on manufacturing and gave greater importance on account-based administration in addition to allowing for input tax credit against inputs and capital goods up to the

⁴ Revenue Deficit is defined as the difference between Revenue Expenditure and Total Revenue Receipts. Fiscal Deficit = Revenue Deficit + Capital Expenditure + Loans and Advances Disbursed (Expenditure) during the year - Loans and Advances (Receipts) – Miscellaneous Capital Receipts

⁵ Currently taxation power of services lies with Centre and under the GST States will also have power to tax services and therefore will share tax buoyancy of services with Centre.

⁶ Liberalization of Indian economy in 1991 associated with major changes in the tax system and the recommendations of Tax Reforms Committee (TRC) played an important role in modernizing the tax system. A comprehensive review of the present indirect taxation system is presented in Rao and Rao (2005).

⁷ Tax Reform Committee was set up in 1991 under the Chairmanship of Dr Raja J. Chelliah and the Committee submitted three reports during 1991-93 (Bird, 1993). Recommendations of the Committee helped to modernise Indian taxation system.

manufacturing stage. Before introduction of CENVAT, a manufacturing level VAT system (Modified Value Added Tax, MODVAT) had applied since 1986. The MODVAT had limited coverage and provision for input tax credits (Aggarwal, 1995).⁸ In 1994, the scheme was expanded and credit of duty paid on capital goods was also brought under the scheme. The MODVAT system was inspection-intensive requiring physical verification of goods and the allowance of input tax credit based “on a one-to-one correspondence between inputs and outputs” resulted in substantial administrative and compliance costs (Rao and Rao, 2005). Introduction of CENVAT widened the tax base and allowed input tax credits without physical verification.

At the Central Government level, service tax was introduced in 1994 with tax initially on three services.⁹ Gradually, the number of services under service tax was expanded combined with rationalization of tax rates (Rao and Chakraborty, 2013). In 2004, the input tax credit scheme for CENVAT and service tax was merged to permit cross flow of credit across these taxes. In the Union Budget 2012-13, the concept of a “negative list” for taxation of services was introduced with a list of 17 services excluded (as at 2013-14). Introduction of negative list based taxation of services resulted in transition from selective list based taxation of services to comprehensive approach where all services, except those are in the negative list, are brought under the service tax. However, a number of services which are in the negative list are either taxed by the State Governments (e.g., service of transportation of passengers, services by way of transportation of goods, betting, gambling or lottery, access to a road or a bridge on payment of toll charges, Trading of Goods) or by the Central government by other taxes (e.g., processes amounting to manufacture or production of goods).¹⁰

Prior to introduction of VAT at State level, there was tax competition between States (Rao and Vaillancourt, 1994) and disharmony in tax rates, number of tax schedules and exempted items.¹¹ VAT introduced since 2005 replaced the sales tax system¹² which encompassed sale of goods up to the retail stage. VAT is levied on intra-State sale of goods, but input tax credit on inputs and capital goods is available only for intra-State purchases of these goods. VAT credits are adjusted against VAT and/or CST liabilities.¹³

Introduction of VAT could be termed as the first coordinated tax reform initiative in India since independence and it achieved many milestones. First, an Empowered Committee of

⁸ MODVAT excluded textiles, petroleum and its products, tobacco and its products (Aggarwal, 1995).

⁹ Tax on telephone billing, tax on general insurance premium and tax on stock brokerage commission.

¹⁰ Public good nature of some services (e.g., services provided by government or local authority, services provided by Central Bank (Reserve Bank of India), services provided by a foreign diplomatic mission located in India) make difficult to tax.

¹¹ As for example, there were minimum 7 (in Odisha and West Bengal) to maximum 25 (in Gujarat) tax rates and sales tax general rate used to vary from 4 to 12 percent. In addition, a wide variation in sales tax rate around the general rate was also reported across the States (Aggarwal, 1995).

¹² Except for a few petroleum products (motor spirit/ gasoline, diesel, and aviation turbine fuel), crude petroleum, natural gas and alcohol.

¹³ Central Sales Tax (CST) is a central levy on inter-State sales of goods. However, it is collected and retained by the State Governments.

State Finance Ministers was formed to build a bridge across States as well as Central Government. The Committee played a crucial role to build consensus among States and Central Government to roll out VAT. Second, the relatively harmonized tax structure, rates, tax schedules and tax base are achieved under VAT which resulted in cleaner tax system for State tax administration and harmonization of rules and regulation created a favorable environment for economic activities. Third, introduction of pre-announced (informed) audit instead of surprise inspection of premises resulted in greater reliance on voluntary compliance by taxpayers. Fourth, by allowing input tax credit against inputs as well capital goods, the system facilitated State tax administrations to get familiar with processes of refunds which prepared the base for further tax reforms like GST. Fifth, adoption of information technology-intensive infrastructure empowered State tax administrations to sharpen their skills in more crucial parts of tax administration (e.g., scrutiny assessment, risk analysis, fraud detection). Sixth, by allowing input tax credits, the system unlocked substantial working capital previously locked in as unpaid credits, and provided incentives to taxpayers for voluntary compliance.

2.1. Taxation of Goods

There are four major taxes on domestically produced goods in India. First, CENVAT is a value added tax levied and collected by the Central Government on the manufacture of goods. CENVAT is uniform across States and input tax credits (CENVAT Credit) are allowed against Central Excise Duty, service tax (since 2004), as well as Countervailing Duty and “cesses” thereof (for imported goods/ inputs) (since the era of MODVAT). Among the other three taxes, State sales tax or VAT and Entry Tax (in lieu of Octroi) are levied, collected and retained by the State Governments.¹⁴ The Central Sales Tax (CST) is levied by the Central Government on inter-State sales of goods but it is collected and retained by the exporting States.

The rates of State taxes vary across States as do the rules and regulations to allow input tax credits. For example, the standard VAT rate varies from 12.5 per cent for the majority of States to 14.5 per cent (e.g., in Assam, West Bengal, Rajasthan). For goods which are under State VAT, input tax credits against in-State purchases are allowed. For the majority of States, Entry Tax (in lieu of Octroi) is commodity specific (e.g., Bihar, Himachal Pradesh, Gujarat) and some States do not allow an input tax credit against Entry Tax (e.g., Assam, Karnataka, Odisha). Entry tax rates vary across States and commodity. CST is levied on inter-State sales.¹⁵ It is expected that under GST regime, the tax structure across States will be harmonized and multiple taxes will be subsumed under GST. The present system results in substantial transaction costs for businesses, as they have to comply with different State tax

¹⁴ Also oblige to share with local bodies (Urban and Rural) as per the recommendation of State Finance Commission.

¹⁵ A tax on inter-State sales of goods levied by the Central Government (the Central Sales Tax (CST) Act, 1956) but collected and retained by exporting States.

rules and regulations with different tax rates for same commodity, and it discourages voluntary compliance which leads to revenue leakage.¹⁶

The present system of taxation of goods can best be described as an origin-based tax system where the manufacturing (origin or exporting) State collects CST on goods being sold inter-State. Since it is a tax collected by the origin State, the destination (importing) State does not allow input tax credit against CST. Therefore, CST remains a stranded cost for inter-State dealers and manufacturers using goods procured from other States. Though input tax credit against CST sales is allowed, withholding of input tax credits for various reasons is common in many States (e.g., in case of consignment / branch transfers). The present rate of CST is 2 per cent (maximum limit) at which States could levy entry tax. Many States, mostly special category States, do not levy CST. However, if the goods are sold from the origin State to final consumer (B2C transactions), the origin State levies CST at the rate equivalent to State VAT whereas the destination State does not get any tax on the transaction. However, if the incoming good is imported for trading (B2B transactions), the import attracts full State VAT in addition to Entry Tax depending on the type of the good and State of operation. In States where entry tax is collected on behalf of local governments and the revenue is passed on to them, Entry Tax remains a stranded cost for these States (e.g., Karnataka, Odisha) as no input tax credit against Entry Tax is allowed.¹⁷ A few States provide input tax credits against Entry Tax provided the goods are meant for further value addition or trade in the State concerned (e.g., Bihar, Gujarat).

The present system of tax on inter-state movements of goods provides an incentive to manufacturers to either locate their branch offices and/ or set up their own distribution networks across all the States of their operations so that they could send the goods as branch/ consignment transfers and avoid paying CST and Entry Tax.¹⁸ The present system does not allow the generation of a seamless common market for goods and services. In addition, business faces different tax rates across States and differing rules and regulations for input tax credits. Since legal trade attracts multiple taxes, the system also encourages illegal trades at least of high value goods (e.g. tobacco products, alcohol). Therefore, the removal of CST and Entry Tax from inter-State movements of goods will help to shift indirect taxation system from origin-based to destination-based which is desired outcome of the proposed GST regime. At present, consumers in importing States pay taxes to exporting States where manufacturing is taking place. Since the manufacturing base in India is not evenly distributed across States, a few States gain from this distortionary tax system.

Depending on the definitions of goods and services, and the stage of value addition (production or distribution), the Constitution of India assigns taxation power to Centre as well

¹⁶ It is expected that under GST, rules and regulations related to indirect taxes will be harmonized across States which will allow ease of doing business.

¹⁷ In addition to Central Excise and VAT, Central sales tax (CST) is collected on inter-State sales of goods.

¹⁸ Provided input tax credit is not allowed against Entry Tax.

as State Governments. The CENVAT is levied on manufactured goods at the factory gate whereas manufacturers also attract State sales tax or VAT on sale of the goods.¹⁹ Since manufacturers are assessed on State sales tax/ VAT, input tax credits are allowed on purchases of inputs (including capital goods) within the State adjusted against VAT or CST payable to State Government. Similarly, manufacturers adjust input taxes paid on input goods (CENVAT and/or CVD), plants and machinery, and services (service tax) against tax payable to Central Government. Since traders (distributors) are not liable to tax under CENVAT, taxes paid by manufacturers (Central Excise Duty) remain a stranded cost for traders. The service taxes paid on input services by traders are not adjusted against their tax liability to State Government. Similarly service providers are not liable to State VAT. So, any VAT paid on input goods remains a stranded cost for them.

The non-allowance of input tax credits breaks the chain, leading to cascading which is not conducive for businesses as it causes substantial locking up of working capital as unpaid credits. The system also does not provide enough incentives to businesses to take registration. Non-inclusion of a large section of businesses under the tax net is not conducive for the economy as well as taxation system. These features of the present indirect taxation system encourage a large part of economic activities to evade taxes and generate unaccounted income (NIPFP, 2014). For the tax department, non-participation by a segment of the economy can induce lower confidence in the tax regime resulting in higher non-compliance even among segments which would normally pay taxes. In addition, input taxes are adjusted only against tax payable to output whereas duties, surcharges and cesses paid on input goods and services remain stranded costs for assessee.

2.2. *Taxation of Services*

Service tax is a Central Tax levied by the Central Government on all services except a few services which are exempted (e.g., education, medical and health services) by keeping them under negative list in the Union Budget 2012-13. Since these are not zero rated, the exempted services cannot claim refund of CENVAT paid on purchase of goods and services tax paid on services and those remain stranded costs for them. Central government allows selective cross credits across CENVAT and service tax provided the assessee falls either under Central Excise and/or Service Tax assessment.²⁰ State governments also levy stand-alone taxes on a few services (e.g., passenger and goods tax, luxury tax on hotels and lodging houses,

¹⁹ The Constitution assigns taxation of alcoholic beverages for human consumption to State Governments and taxation of certain tobacco (including manufactured tobacco products) to Central Government. However, in the present system State Governments can impose an additional excise duty on tobacco products. Under GST, taxes on tobacco and tobacco products will be subsumed under Central GST and States cannot levy and collect any tax on tobacco and tobacco products.

²⁰ "At the stage of determining eligibility for CENVAT credit, provisions of CENVAT Credit Rules, 2004 since its inception have contained requirement to establish nexus between the activity of manufacture/provision of service and goods/service in respect of which credit is being claimed. The nexus theory has been interwoven in the definitions of capital goods, inputs and input services providing that in order to be eligible for CENVAT credit, goods/ services should have been used 'in the factory of manufacture of final goods' or 'for providing output service' or 'used in or in relation to manufacture of final products and clearance of final products up to the place of removal', etc." (Source: http://www.taxindiaonline.com/RC2/print_story.php?newsid=16827, last accessed on 20 September 2015).

entertainment and advertisement tax) but do not allow input tax credits against their VAT purchases. In addition, being assessee of Central Government, service providers cannot claim ITC against VAT purchases of goods.

3. Proposed System of Goods and Services Tax (GST) in India

The key features of the proposed new GST regime are briefly summarized as follows:

1. The tax is to cover all goods and services; it is however, proposed that there would be a small negative list of goods and services which will not be taxed under GST. All other supplies of goods and services would be subject to tax.

2. Dual GST: there will be two taxes levied on each supply – one as a part of the Central GST and the other as a part of the State GST.

3. It is proposed that the GST regime would have two rates of tax, a lower rate for supply of specially identified goods and services and the rest of the supplies would be taxable at a standard rate.

a) Some supplies that are to remain outside the base for GST are petrol, diesel, ATF, crude petroleum, natural gas, alcoholic beverages for human consumption, real estate and electricity.

b) The constitutional amendment allows for the incorporation of petrol, diesel, ATF and crude petroleum in the base at a subsequent date.

4. On inter-state supplies, it is proposed that the Centre will levy and collect Integrated GST (IGST) – the importing dealer can claim input tax credit for IGST paid on these goods against taxes payable on subsequent transactions.

a) While in principle, all governments are in agreement that Central Sales Tax regime would be removed when GST is introduced, this tax would remain on goods and services which are explicitly excluded from the GST regime.

5. It is proposed that for the standard rate there would be a band which allows the states some flexibility in fixing rates.

6. In order to protect the states from any loss of revenue in the process of reform, Central government has proposed to compensate for any loss of revenue.

a) Another measure which has been introduced in the same spirit is a temporary levy of 1 percent on inter-state supply of goods to be collected and transferred to the exporting state.

This levy is initially proposed for a period of two years, to be subsequently reviewed by the GST Council.

7. So as to put in place a mechanism which ensures the creation and sustenance of GST which is comprehensive and comparable across States, all policy decisions regarding GST are to be taken on the advice of the GST Council where the Central government is to have a 33.33 percent vote with the rest being assigned to the states.

8. GST is to be administered separately by the Central and State Tax Administrations. It is proposed that there would be common registration and common portal for filing of returns. There are no clear decisions available in the public domain on whether there would be further coordination between the two sets of tax administrations.

In the proposed system of GST, both Central and State Government will have concurrent taxation power of goods and services at all stages of value addition (production and distribution or trade). The proposed system is an improvement over the present system. It will reduce the cascading of taxes arising due to non-allowance of input tax credits for input goods (or services) for production/ distribution of services (or goods)²¹ due to inter-jurisdiction (cross tax authority) nature of taxes, as well as differences of a non-overlapping nature in taxation power of goods and services. Second, it will reduce cascading from non-allowance of input tax credits against inter-State sales. However, inconvenience arising due to non-allowance of inter-jurisdiction (cross Tax Authority) input tax credits may not arise, even though under the proposed GST regime inter-jurisdiction ITC flow is not allowed.

Under the proposed system there will be parallel tax payment and credit systems – one for Central GST (CGST) and another one for State GST (SGST), where input tax credits for each tax will be adjusted before paying taxes to respective tax authorities. Since GST is a multistage value added tax, tax liability will depend on level of value add. Under the proposed system, continuation of input tax credit chain is ensured even for inter-State sales. For inter-State sales, the exporting dealers will pay Integrated GST (IGST) to Central Tax Authority by adjusting input tax credits arising against SGST, CGST and IGST (if any). The IGST liability will comprise of CGST, SGST (rate prevailing in destination State) and any other taxes imposed on inter-State sales of goods. Dealers in the destination State will pay CGST and SGST liabilities on subsequent sales by adjusting IGST credit pool. First, IGST will be utilized to pay CGST and then SGST.

The proposed system, although it seems complex, is an improvement from the present system. However, under the proposed system, there will be substantial compliance cost if SGST rates vary across States. In addition, the present discussion on levying 1 per cent

²¹ As under the present system power of taxation of services goes with Central Government whereas the taxation of goods attracts both Central Excise Duty (up to manufacturing stage), and State VAT/ Sales Tax (beyond manufacturing). Input tax credits against Central taxes (CENVAT and Service Tax) are not available to traders (distributors) similarly service providers are denied input tax credit against VAT/ Sales Tax.

additional CST type tax on inter-State sales (excluding Branch/ Consignment Transfer) of goods for initial two years and subsequent to decision of the GST Council will break the input tax credit chain. This would be very much against the spirit of the tax reform.²² It is prescribed that Government of India (Central Tax Authority in practice) will levy and collect the additional tax and pass on the net proceeds to the exporting (origin) State (Government of India, 2015).²³ Though the interests of the manufacturing States will be protected through imposition of the additional tax, this will generate cascading of taxes.

In addition, non-inclusion of goods and services under GST will also generate cascading of taxes. Therefore the very purpose of having GST will be diluted. Non-inclusion of certain fossil fuels (e.g., petrol, diesel, ATF, natural gas and crude petroleum) and electricity which are directly and indirectly used as inputs for all goods and services, will result in cascading of taxes across all sectors and will hamper competitiveness of domestic industries in international market (Mukherjee and Rao, 2015a). Given these various criticisms, it is worthwhile to raise the question whether it is desirable to introduce GST with so many structural defects.²⁴ Definitely it would provide relief to business community as they do not have to block substantial working capital as unpaid input tax credits.²⁵

4. Challenges in Designing and Administration of GST

The benefits of the proposed GST system could only be reaped if certain challenges related to design and structure of GST, are addressed by the governments. These can be classified under two broad heads: GST design and structural issues; and GST administration and institutional issues.

4.1. Challenges in Designing GST

Learning from international experience, it is not expected that a faultless GST could be designed and rolled out in India as a single event, but some structural faults could easily be addressed and rectified without hampering basic spirit of the reform.

4.1.1 Limitations in Capturing GST Base and Estimation of Revenue Neutral Rates

Capturing GST base is important to understand the tax potential and estimation of tax rate(s) to achieve revenue neutrality. Successful capturing of GST base depends on several structural features of GST design. The most important are - a) whether proposed GST would be origin (production) or destination (consumption) based, b) whether income or consumption type, c)

²² It is not clear what the purpose this additional levy would serve when full compensation of revenue to States for switching over to GST is assured by the Centre for first five years.

²³ This goes against the destination principle of GST.

²⁴ Several scholars criticized the proposed structure of GST for many reasons, for example see Shome (2015) and Vaitheeswaran and Datar (2015).

²⁵ It is argued that proposed GST will favour big manufacturing firms having pan India operations whereas small and medium businesses will be marginalized. Compliance burden is cited as one of the obstacles for small and medium businesses to take part in the GST.

whether implemented with credit (input tax) invoice based subtraction method or formula based (ad hoc) subtraction method for allowance of credit against input taxes and d) having many or a few exemptions (Rao and Chakraborty, 2013). The proposed GST will be a destination based, consumption type system and it would be implemented with credit invoice based method with a few exemptions. In addition to these, there are also issues related to turnover based threshold for mandatory GST registration, special scheme for small and medium enterprises (e.g., composition / compounding scheme) and exclusions of goods and services from GST system which all make the design complex.

Estimation of a revenue neutral rate for GST is a complex issue. Setting a perfect revenue neutral rate for GST cannot be a onetime event; the option should be kept open to adjust the rate in future, based on trial and error process and depending on revenue targets of the governments. Given the dual nature of GST, there will be two revenue-neutral rates: one for Central Government on which CGST will be levied and another one for State Government. However, there is no consensus whether a single SGST rate will prevail across all States. It is also not clear whether within SGST it would be single rate or there will be two (or multiple) rates. The Rajya Sabha Select Committee suggested that GST rates will be levied with floor rates and with bands, where a band is defined as “Range of GST rates over the floor rate within which Central Goods and Service Tax (CGST) or State Goods and Services Tax (SGST) may be levied on any specified goods or services or any specified class of goods or services by the Central or a particular State Government as the case may be” (Government of India, 2015). There are also discussions that maximum 1 to 2 per cent deviation from the floor rate should be allowed. However, if the suggested deviation is accepted it may hamper the fiscal autonomy of the States, as their freedom to set tax rate depending on revenue needs will be hampered. In the long run it will affect the fiscal relationship between the Centre and the States.

The revenue importance of the tax base on which GST would be levied is different for different States, and given the federal structure of India, protecting revenue is the foremost priority of the States. Therefore, any rule based restriction on fiscal decisions of the State will go against the spirit of cooperative federalism. There is always a tradeoff between harmonization of tax system and fiscal autonomy of States. Given the federal structure of India, it is desirable that tax rates will be harmonized across States to minimize the compliance burden. Harmonization of tax rates across States is expected to minimize rate wars across States and rein in revenue leakage due to cross border tax shopping. Moreover, harmonization of tax rules and regulations is more important than harmonization of tax rate from business perspective.

There have also been discussions on a legal restriction for the GST rate at maximum 18 per cent (Government of India, 2015). However, any attempt to put a cap on the GST rate will restrict the fiscal freedom of governments as they cannot set their fiscal priorities depending on their revenue needs. Ideally, estimation of a revenue neutral rate should reflect behavioral

responses to the tax rates also. The GST rate depends on dynamics of the economy and if introduction of GST improves economic efficiency, it will attract investment which would have multiplier impacts on the economy and may require lower rate to achieve revenue neutrality.

4.1.2 Revenue Consideration under GST

The proposed tax system will subsume both Central and State indirect taxes and levies. On the combined tax base a dual GST (CGST, SGST and IGST) will be levied. The details of State and Central taxes those will be subsumed under GST are presented below.

State Taxes	Central Taxes
<ul style="list-style-type: none"> • State Value Added Tax/Sales Tax • Entertainment Tax (other than the tax levied by the local bodies), • Central Sales Tax (levied by the Centre and collected by the States), • Entry tax (in lieu of Octroi), • Purchase Tax, • Luxury tax, • Taxes on lottery, betting and gambling; and • State cesses and surcharges (related to supply of goods and services) 	<ul style="list-style-type: none"> • Central Excise Duty • Additional Excise Duty • Excise Duty levied under the Medicinal and Toilet Preparations (Excise Duties) Act, 1955 • Service Tax • Additional Customs Duty commonly known as Countervailing Duty • Special Additional Duty of Customs, and • Central Surcharges and Cesses (related to supply of goods and services)

Source: Government of India (2015)

Non-inclusions of a few petroleum products and alcohol for human consumption make estimation of revenue baskets for Central and State Government difficult, given the level of disaggregated data available in the public domain. State data presented by Rao and Chakraborty (2013) for 2009-10 on taxes that will be subsumed under GST are considered here for our analysis.²⁶ To clean out the Central Government tax collection from non GST goods, we have used detailed tax collection data as available in the Receipt Budget of Union

²⁶ Rao and Chakraborty (2013) received the detailed information on State tax data of revenue collection (excluding non-GST goods) from Empowered Committee of State Finance Ministers. The set of data for recent years is not available in the public domain. However, 2009-10 is a "non-representative" year for Central government since tax rates were below "normal", due to stimulus package announced by the State Governments in the aftermath of global recession.

Government for the year 2009-10 (available in the Union Budget 2011-12) and commodity-wise Central Excise and Custom Duty collection from the Central Excise and Customs database for 2009-10 as available in the Annual Publication of Directorate of Data Management, Central Board of Customs and Central Excise (CBEC).

Table 1 shows that total revenue estimated under GST is only Rs. 3,31,671 crore of which States' share is 53.2 per cent (Rs. 1,76,419 Crore) and Central Government share is 46.8 per cent (or Rs. 1,55,252 Crore). The removal of cascading of taxes under GST will further shrink the revenue due to input tax credits to be adjusted against final tax payment. For State Governments, the revenue under consideration contributes only 22.3 per cent of revenue receipts, 32.5 per cent of total tax revenue, 46.7 per cent of own tax revenue. This could finance only 16.9 per cent of total expenditure (revenue and capital together).

For the Central Government, the revenue under consideration contributes only 27.1 per cent of revenue receipts, 24.9 per cent of gross tax revenue (or 34.01 per cent of net tax revenue – after deduction of States' and United Territories' share in Central Taxes). However, the entire revenue raised under GST for the Central Government will not be available to finance Central Government expenditures alone, as a part of net revenue from CGST (after deduction of cost of collection) must be shared with State Governments according to the recommendation of the Finance Commission.²⁷

Non-inclusion of major revenue earning goods under GST (like alcohol and petroleum products), reduces the revenue importance of GST and also renders the GST design as complex as the present system. However, through a gradual inclusion of excluded goods under the GST system, governments could clean up and broaden the indirect tax base. However, inclusions of these goods under GST will raise the standard GST rate. Therefore, the argument of an ideal model of broad based low rate consumption tax may not hold for the proposed GST. It is expected that the proposed GST system would be relatively cleaner and enhance the ease of doing business; this could not only reduce unwarranted workload of tax administrators but also improve tax compliance. A cleaner taxation system with clear rules and regulations (with little scope for alternative interpretations) is easy to administer and could reduce litigations/ disputes. In cleaner tax system, tax administrator could devote more time to more sophisticated parts of tax administrations – scrutiny assessment, audit, risk analysis and fraud detection etc. A cleaner tax system is likely to reduce both transaction and compliance cost and induces voluntary tax compliance.

We estimate that the inclusion of out of VAT items under GST could expand the combined (Centre and all States together) revenue under consideration by 1.4 times for 2009-10 or Rs. 4,67,124 crore. The revised States' revenue under consideration under GST would be Rs. 2,55,111 crore, which will be 32.2 per cent of revenue receipts, 47 per cent of total tax

²⁷ According to the recommendation of the Fourteenth Finance Commission 42 percent of Net Tax collection needs to be shared with State Governments.

revenue, 67.6 percent of own tax revenue and 24.4 per cent of aggregate expenditure. For Central Government, revised revenue would have been Rs. 2,12,013 crore, which will be 37 per cent of revenue receipts, 33.9 per cent of gross tax revenue and 20.7 per cent of aggregate expenditure. By excluding goods of major revenue importance (like petroleum products and alcohol) from the GST, both Central as well as State Governments protect their respective fiscal autonomy although this results in continuation of tax cascading and hamper export competitiveness of domestic industries: the cascading of taxes generates revenue for government though it goes against the interest of business. Removal of tax cascading would also affect different governments differently depending on their revenue importance of taxes subsumed under GST. In addition, more harmonized taxation system (like GST) leads to little fiscal freedom for individual governments to deviate from common harmonized tax structure. In the long run, it could erode fiscal autonomy of governments to protect revenue by changing tax rates or any other policy measures to generate revenue.²⁸

²⁸ It would be difficult for States to deviate from common harmonized structure of GST. Therefore tax effort (e.g., strengthening tax administration) and non-tax revenue mobilization would be playing important roles in mobilising additional revenue to keep the pace of rising demand for public expenditure.

Table 1: Revenue under GST for All States and Union Government: 2009-10 (Rs. Crore)²⁹

State Taxes	State Governments*	Central taxes	Union Government**
VAT/ Sales Tax ^a	138,655	Central Excise Duties ^d	46,730
Entertainment tax ^b	904	Service Tax ^e	58,422
Central Sales Tax ^c	23,255	Customs ^f	50,100
Luxury Tax	1,204		
Taxes on lottery, betting and gambling	531		
States cesses and surcharges in so far as they relate to supply of goods and services	1,971		
Entry tax not in lieu of octroi	8,381		
Purchase tax	1,518		
Total State Taxes	176,419	Total Central Taxes	155,252
Revenue Receipts	791,429		572,811
Total Tax Revenue	542,390		
Own Tax Revenue	377,377		624,528 [^]
Aggregate Expenditure	1,043,860		1,024,487

Notes:

*-Including NCT of Delhi and Puducherry

**-Excluding United Territories

[^] - Gross Tax Revenue (includes States' share in Central taxes and taxes collected from United Territories)

^a Excluding tax on petroleum products and liquor

^b Unless it is levied by the local bodies

^c Includes ITC adjustment and excludes taxes collected from crude petroleum and petroleum products (petrol, diesel and ATF)

^d Excludes basic excise duty, additional duties, cesses and surcharges on petrol, diesel, ATF and crude petroleum.

^e Includes education cesses

^f Includes Additional Duty of Customs (CVD), Special CV Duty, NCCD, and Education Cesses and excludes all duties and cesses on petroleum products.

Data Sources: Rao and Chakraborty (2013), Receipt Budget (Union Government): 2011-12, Customs and Central Excise 2009-10: Annual Publications of Directorate of Data Management, CBEC, New Delhi.

²⁹ 1 crore = 10 million

4.1.3 Estimation of GST Rate: An Alternative Approach

In this part, we attempt to estimate the tax rate for the proposed GST in India drawing on a measure of efficiency and breadth of the GST base (or GST coverage of goods and services). This estimate is based on the average so-called 'C-efficiency' of lower middle income countries and that of Asia/ Pacific region. The C-efficiency is a measure to assess the performance of VAT (Keen 2013).³⁰ Keen (2013) defines 'C-efficiency' as "an indicator of the departure of the VAT from a perfectly enforced tax levied at a uniform rate on all consumption". Apart from 'C-efficiency', depending on differentiation in tax rates across goods and services and exemptions, tax collection under VAT varies. 'C-efficiency' is defined as:

$$C\text{-efficiency} = (VAT\ Revenue) / (Tax\ Rate * Consumption\ Expenditure) \quad (1)$$

$$\text{Therefore, Tax Rate} = (VAT\ Revenue) / (C\text{-efficiency} * Consumption\ Expenditure) \quad (2)$$

For a given C-efficiency and Consumption Expenditure, we have estimated the tax rate in Table 2. The estimated tax rates for the proposed GST system would vary from 23.5 to 19.2 percent depending on average 'C-efficiency' targets that we would like to achieve. Table 2 also shows that with more inclusive GST, tax rate will rise, given the target for C-efficiency. The estimated tax rates are not very different from the rates estimated for 2009-10 by Rao and Chakraborty (2013) for the proposed GST regime, if one combines revenue neutral rates for both Centre and States together.

Table 2: Estimation of GST Rates Based on C-Efficiency

Description	2009-10	
Private Final Consumption Expenditure (A) (Rs. Crore)	37,07,566	
Adjusted Pvt. Final Consumption Expenditure ¹ (B) (Rs. Crore)	2,969,040	
Adjusted Pvt. Final Consumption Expenditure ² (C) (Rs. Crore)	31,39,618	
Government Final Consumption Expenditure - Net Purchase of Commodities & Services ³ (D) (Rs. Crore)	168,717	
Total Adjusted Consumption Expenditure (E=B+D) (Rs. Crore)	31,37,757	
Total Consumption Expenditure (F=C+D) (Rs. Crore)	33,08,335	
Revenue Consideration under Proposed GST ⁴ (F) (Rs. Crore)	3,31,671	
Revenue Consideration under All Inclusive GST (G) (Rs. Crore)	4,67,124	
GST Rate Estimation (%)	Proposed GST	All Inclusive GST
C- Efficiency	Tax Rate	Tax Rate ⁵

³⁰ For other measures of VAT efficiency, see Martinez-Vazquez and Bird (2010).

Average of Lower Middle Income Economies (2009): 45%	23.5	31.4
Average of Asia / Pacific (2009): 55%	19.2	25.7

Notes: ¹ excludes consumption expenditures on electricity, other fuel (other than LPG & kerosene), beverages (alcohol), education, medical care & health services, and gross rent & water charges

² excludes consumption expenditures on education, medical care & health services, and gross rent & water charges.

³ excludes expenditures on compensation of employees and consumption of fixed capital from Government Final Consumption Expenditure

⁴ excludes taxes on tobacco & tobacco products, alcoholic beverages, petroleum products

⁵ under this scenario all excluded goods (alcoholic beverages and petroleum products) are taken under GST

Data Source: CSO (2014), Rao and Chakraborty (2013), and Keen (2013)

4.1.4 Non-inclusion of Goods under GST

The proposed design of GST does not include a) alcoholic liquor for human consumptions, b) electricity, and c) real estate. In addition, inclusions of petroleum products (petrol, diesel and ATF), crude petroleum and natural gas have been postponed to an unspecified future date that would be decided by the GST Council. Non-availability or partial availability of input tax credits will result in stranded costs for some sectors (where direct use of out of GST items are high) but the costs will be spread across all sectors of the economy, through sectoral interlinkages. By not including electricity and some other sources of fossil fuels (like petrol, diesel, ATF, natural gas and crude petroleum), the proposed GST system will retain substantial cascading of taxes which will be detrimental for achieving export competitiveness of Indian industries in the international markets (Mukherjee and Rao, 2015a).

Mukherjee and Rao (2015a) suggest an alternative design of GST inclusive of petroleum products and electricity which would reduce tax cascading, prices fall and the Government revenue remains unchanged. Dismantling the administered pricing mechanism for diesel along with introduction of comprehensive GST for petroleum products could benefit both upstream and downstream sectors. Being a final consumption good, excluding alcohol from GST does not result in cascading of taxes but some researchers argue that the present system of multiple taxes and without provision for input tax credit encourages illegal (tax avoided) sales and sales of counterfeit (spurious) alcohol (hooch) which is an important issue specially after deaths of many people due to consumption of counterfeit alcohol. However, unpaid input tax credit may not be substantial for alcohol; therefore the benefits of unaccounted sales and selling spurious liquor will still remain substantial.

Under the present system, real estate transactions attract stamp duty and registration fees. In addition, some States have also brought real estate promoters under the preview of VAT registration where VAT is levied on jobs contract. Non-inclusion of real estate under GST

will mean input tax credits are not allowed and the sector cannot pass on the benefits to customers where property is purchased for commercial/ business purposes, which constitutes 80 per cent of real estate transactions.

However, there is a common misconception that inclusion of these excluded goods and services under GST could expand the GST base and therefore a lower GST rate would be needed to achieve revenue neutrality. In fact, goods which are presently kept out of GST (e.g., petroleum products) make up a substantial share of the total tax base of the Central and State Governments and attract tax rates which are substantially higher than standard CENVAT and/ or VAT rates. For example, effective tax rate on petroleum products (other than natural gas and crude petroleum) is 40 per cent (Mukherjee and Rao, 2015a). Therefore, if these goods are included under GST, GST revenue neutral rate will go up. Table 2 supports this claim. For example, an additional 3 per cent tax, over and above the standard GST rate (i.e., 20 per cent, assumed), would be required to include all petroleum products and electricity under GST (Mukherjee and Rao, 2015a).

There are some other misconceptions regarding GST which require clarification. First is the assumption that introduction of GST will broaden the tax base by expanding coverage of economic activities under the tax net and reducing the list of exemptions. This is not, on the whole, correct because most economic activities are presently taxed either by Central and/ or State Governments. There is not much scope for further expanding the tax base by bringing more goods and services under the purview of GST unless we reduce the list of goods and services that kept under the exemption list.³¹ No consensus on thresholds and exemptions has been reached among the concerned governments yet, or the information is not available in the public domain. The only other possibility of expanding GST base would be for services in the negative list for services tax to be brought under the GST. However, there are only a few services in the negative list that do not attract some other tax.

Secondly, it is a common view that mitigation of cascading and double (multiple) taxation and an overall lower tax burden under GST would induce better tax compliance. The problem is that under the proposed design of GST with exclusion of goods like electricity and petroleum products, cascading of taxes would remain (Mukherjee and Rao, 2015a). Taxpayers who hitherto were faced with single tax administration (e.g. retailers, service providers) would face two tax administrations. Complying with different tax authorities for single transaction could enhance the compliance costs and this could work against voluntary compliance. Therefore, the argument on possibility of “lowering of overall tax burden on goods and services” (Government of India, 2015) does not have any basis.

³¹ Being a consumption based tax, if proposed GST could induce behavioural changes in the consumption patterns of households and for that overall consumption expenditure increase, there might be a possibility of more revenue collection under GST. However, consumption pattern depends on income and prices, and if the proposed GST regime influences these factors in favour of consumers, a possibility of expansion of tax revenue under GST arises.

Thirdly, it is envisaged that competitiveness of domestic industries in the international market will improve as the system will remove latent and embedded taxes. However, by keeping major revenue earning as well as major energy sources like electricity, petroleum products (petrol, diesel and ATF), natural gas, crude petroleum out of the GST, the removal of cascading will be limited and therefore the impact on export competitiveness of Indian industries would be limited (Mukherjee and Rao, 2015a).

Fourthly, it is assumed that GST will provide common national market for goods and services by unifying the tax structure across States. However, as explained, with the present discussion on additional 1 per cent tax on inter-State supplies of goods, and since there is no consensus on common GST rates, threshold and exemptions across States, providing common national market for goods and services is very much under question.

4.1.5 Consequences of GST on Inequality

The impact of GST on different strata of society will be different depending on composition of their consumption basket. Under the present system different goods attract different tax rates (both CENVAT and VAT rates vary). The purpose of having multiple tax schedules is to minimize tax incidence on poor section of the society. If a single rate is proposed under GST (both for CGST and SGST) with a few exemptions, the resultant tax system could be regressive.³² Therefore, it is expected that introduction of GST would have an immediate impact on prices of goods and services and this will induce behavioural changes among consumers, provided the benefits of removal of cascading of taxes and/or costs of additional tax burden are passed on to consumers. Different group of consumers will have different response to changes in prices. In the long run it is expected that inflationary pressure will subside due to removal of cascading of taxes under GST. However, given the criticism that VAT (or GST) is regressive (Emran and Stiglitz, 2007), we suggest that a detailed tax incidence analysis should be carried out to understand the consequences of GST adoption on different strata of the society.

4.1.6 Consequences of GST on Informalization

There is some suggestion in the literature that the introduction of a broad based GST may induce informalization of the economy for developing countries like India (Emran and Stiglitz, 2005; Piggott and Whalley, 2001). Given the large informal sector that escapes tax net and substantial cash transactions, the opportunity cost of being in the tax system will not always outweigh the benefits. The presence of informal credit and labour markets and large domestic demand for locally produced goods and services often lead to unaccounted incomes and avoid taxes. A recent paper by Mukherjee and Rao (2015b) shows that facilitating access to formal credits and government assistance in financial loan, subsidy, machinery/ equipment, training, marketing and raw material could encourage enterprises to register under VAT.

³² Unless commodity-wise impact analysis is carried out it would be difficult to decide on tax rates for each commodity.

4.2. Challenges in GST Administration

With some progress in the design of Goods and Services Tax (GST), there is an emerging need to explore the options for administering the new tax regime. From the discussions and decisions taken so far, one of the important parameters of the new regime is the applicability of two taxes (Central GST, CGST and State GST, SGST) on each and every transaction of supply of good and/or service in the country. The central tax would accrue to the Central government and the state tax would accrue to the State governments.

Compared to the existing regime, the proposed tax represents a significant change in the tax administration. The proposed design is for a dual GST where CGST and IGST will be administered by the Central Board of Excise and Customs (CBEC) and the SGST will be administered by the State Commercial Tax Department of the respective State Governments. From available policy documents in the public domain it is not clear whether in the proposed system certain common administrative functions (e.g., taxpayer registration, return filing) will be undertaken jointly or independently by each of the administrations. Since both the tax administrations will deal with same set of taxpayers (ideally), separating common administrative functions will add compliance costs to taxpayers and additional burden on tax administration.

It is not clear whether there will be a common threshold for mandatory registration for all taxes under GST (CGST, IGST and SGST) or separate thresholds for Central and State taxes.³³ Harmonization of thresholds across States for registration under SGST is another area of concern which requires broad consensus among States. The issue of single registration for all States or separate registration for each State of functions/ operations for multi-State nature of businesses/ services requires clarity. For example, whether Commercial Banks require to register in each State of their operation and pay due taxes separately or a Single nation-wide registration and payment of due taxes under GST through Head Office will suffice is not clear yet. The issue of apportionment of revenue for multi-State nature of services (e.g., telecom) is an area which requires clarifications. The issue of point of taxation and place of supply rules for taxation of services are not available in the public domain yet.

The central tax administration would need to deal with wholesale and retail traders in addition to its existing taxpayers (e.g., manufacturers, service providers). Similarly, the state tax departments would need to deal with service providers. The workload per employee as well as the skill set associated with tax administration would have to undergo a sharp change if the taxes are to be administered by maintaining a status quo on the forms of administration. In

³³ One option to overcome the differences in setting thresholds for CGST and SGST may be to allow uniform threshold where States will get additional power to administer CGST for those tax payers whose turnover falls below the desired turnover of the Central Tax Authority. Tax collected by the States on CGST part may be transferred to Centre after deducting the cost of collection. Alternatively, the same proceed could be utilized for making payment to States for GST compensation.

other words, grafting the new tax on to existing tax administrations would impose a significant cost of transition in addition to higher costs of collection.

Some taxpayers will face a sharp change in the tax environment. All taxpayers other than manufacturers who had faced one tax and one tax department (e.g., wholesale and retail traders), under new regime potentially they will face two tax departments, and potentially an increase in the compliance cost associated with the new regime, thereby raising the opportunity cost of being in the tax system. The result could either be higher evasion or higher resistance to the new tax regime. Some segments of the tax payers are already articulating a demand for addressing the sharp increase in the compliance requirements of the new regime.

Rao and Mukherjee (2010) explore various options for GST administration and one of their suggestions is joint administration for common functions (highlighted in the Figure below).³⁴ In addition adoption of functional specialization based scrutiny assessment of tax payers could reduce compliance as well as administration costs. For example, the Central tax authority has long experience in dealing with service providers and they have a better understanding to deal with service taxpayers as compared to any State tax administration. Similarly, all State tax administrations are well conversant in dealing with traders/ distributors. Therefore, coordination across tax authorities by assigning superiority of decisions taken by one tax authority over other could be mutually beneficial.

Figure: 1: GST Administration – Possible Scope for Joint Administration

Identification				
Registration				
Tax Payer Services				
Advance Ruling				
Returns filing	Payments	Assessment/ Reassessment	Revenue Accounting	Taxpayer Accounting
Arrears collections				
Audit				
Appeals/Dispute settlement				
Special Investigations				

Source: Rao and Mukherjee (2010)

³⁴ One of the suggestions of the paper was to set up Semi-Autonomous Revenue Agency (SARA) by comprising both Central and State tax administrators and delegating the task of GST collection to the agency.

4.2.1 Bringing Informal Sector under GST

The proposed transition to the GST regime is expected to bring in a significant change in the economic environment of the country. With a reduction in the extent of cascading in the tax regime, it is argued by some that moving to GST would result in expansion of economic activity. Since this new tax regime works through more integrated and redefined supply chains, for units to benefit from this new tax regime and for the success of the new regime, it is important that more and more firms find it useful to be a part of the GST regime. While firms and enterprises in the organized sector do participate in the GST regime, those in the unorganized sector may not be as well integrated. This poses a problem both for the units and the tax administration. For the former, apart from being unable to benefit from the growth enhancing processes in the economy, these units may also be subject to irregular visits by various authorities often associated with the payment of bribes (Rao et al., 2014). For the tax department, non-participation by a segment of the economy can induce lower confidence in the tax regime resulting in higher non-compliance even among segments which would normally pay taxes.

Depending on respective turnover based threshold set for VAT registration by State Governments, different State tax administration face different level of challenges of bringing unincorporated enterprises under the tax system. Since, the exemption from registration under CENVAT is up to annual turnover of Rs. 1.5 crore, until now the challenge of bringing unincorporated enterprises under tax system is not severe for Central tax administration (Central Excise and Customs). If the threshold for registration for Central GST remains same under the forthcoming Goods and Services Tax (GST) regime, the challenge for Central tax administration will not be much different from the present.

However, to integrate the unincorporated enterprises with the rest of the economy, it is imperative to bring the enterprises under the tax system. Though there are costs associated with remaining outside the tax system, a number of enterprises and firms choose to do so. It appears that the self-policing dimension of the VAT regime does not provide adequate benefits. Even the presently existing tax compounding schemes do not seem to be attractive enough to bring the small dealers into the system. Mukherjee and Rao (2015b) based on NSS 67th round Enterprises Survey explore factors which influence decision of unincorporated enterprises to register under VAT. From the results in the study, it appears that facilitating access to formal sector credit might be one such instrument. The other can be a focus on expanding the consumer's incentives to ask for an invoice. If larger segments of the economy ask for invoices for the purchases made, the incentive and the option to remain out of the tax regime would be correspondingly reduced. Designing appropriate incentives structure for consumers to ask for invoice and setting up an information exchange between tax authorities and consumers could reduce the possibility of under reporting of sales / income.

5. GST Institutions

For successful adoption of GST framework in India, establishment of GST institutions is very important. Given federal structure of India, the character of the institutions should be neutral and both Centre and State government should have equal space (opportunities) in these institutions to propagate the spirit of cooperative federalism.

5.1. GST Council

The GST Bill proposed establishment of a GST Council which will be the highest body to examine and make recommendations on issues related to GST to Central as well as State Governments. The broad contours of the structure and roles and responsibilities of the Council is available from the Bill (Government of India, 2015) but the details on roles and responsibilities and Constitutional power of the Council are yet to be decided.

The Council will comprise the Union Finance Minister as Chairperson and a Vice Chairperson who will be selected among the members. The Union Minister of State in Charge of Revenue or Finance will be another representative from the Central Government to the Council. From each of the States, the Minister in charge of Finance or Taxation or any other minister as nominated by the State Government will be a member of the Council. Every decision of the Council shall be backed by a majority of the members and it cannot be less than three-fourths (75 per cent) of the weighted votes of the members present and voting. The weightage of vote of the Central Government will be one-third (33.33 per cent) of the total votes cast and that of State Governments taken together will be two-thirds (66.67 per cent).

From the broad design of the Council, it can be concluded that the Central Government will have veto power on each and every decisions of the Council and it could throw its weight for any decision that will be in line with revenue interest of the Centre. However, the proposed design will make impossible for any individual State or group of States to change the decision in favor of its/ their own interest. This disproportionate power relationship is not conducive for fiscal federalism for federal country like India.

For example, if any State wants to deviate from a harmonized GST rate for revenue consideration, it cannot unless it is backed by all other States and the Centre. Even if all States come together, unless the Central Government supports the resolution, it cannot be passed; this is very unlikely. Therefore, the proposed design will hamper the fiscal autonomy of the States. However, harmonization of tax rates is conducive to minimize tax competition across States and for the emergence of common market across Indian States. It is also not clear whether the GST Council will act as a recommending body or as a decision making body and what will be the dispute settlement mechanism for any dispute arising due to decision taken by the Council. For example, if any State deviates from harmonized structure of GST what will be the mechanism to handle the deviation? It is also not clear what will be the degree of fiscal

freedom (or limit of tolerance) at which individual States could take their decision to secure their respective revenue interests.

5.2. *GST Network (GSTN)*

Modern tax administration is very much dependent on IT infrastructure. The achievements of the coveted objectives of the proposed GST system depend on establishing an effective IT system and integrating the IT systems already prevailing across State and Central Governments. Integration of the IT system will provide smooth transfers of input tax credits across States and act as tax clearing house for inter-State transactions. The same platform could also provide seamless automatic transmission of information across governments.

To achieve the objectives, the GST Network (GSTN) has been formed as a Section 25 (not for profit), non-Government private limited company.³⁵ It was incorporated on 28 March 2013 and the Authorized Capital of the company is Rs. 10 crore. The Government of India holds 24.5 percent equity in GSTN and all States of the Indian Union, including NCT of Delhi and Puducherry, and the Empowered Committee of State Finance Ministers (EC), together hold another 24.5 percent. Balance 51 percent equity is with non-Government financial institutions. The Company has been set up primarily to provide IT infrastructure and services to the Central and State Governments, taxpayers and other stakeholders for implementation of the GST.

However, Public Sector Banks do not have an equity share in the GSTN, an issue which has been highlighted by the Rajya Sabha Select Committee. Being a major interface between governments and taxpayers in collection of taxes, it is desirable that public sector banks could be given opportunities to bring forward their views in designing the IT platform. Given the information available in the public domain, present status of development of the IT platform is not clear. Simplification of the procedures and common harmonized structure for return submission could induce voluntary compliance and therefore it is expected that minimum burden on tax payers in terms of information sharing could induce them for better tax compliance.

5.3. *Other GST Institutions*

5.3.1 A GST Dispute Settlement Authority?

The GST Council will be established by the GST Act as a Constitutional Body, comprising of Legislators only. The Council will make recommendations on GST related issues. However, no dispute settlement authority is established. Given the federal structure of India and constitutionally assigned fiscal powers, it would be detrimental for cooperative federalism if any entity tries to encroach upon other's freedom. On the one hand, there is the need for fiscal flexibility of each of the stakeholders and on the other hand, a failure to establish a dispute

³⁵ <http://www.gstn.org/Organization-Profile.html> (last accessed on 10 September 2015)

resolution authority which has a judicial character, above the GST Council, could lead to the complete failure of the Council which may go against the spirit of the taxation reform.

The GST Amendment Bill, as passed by the Lok Sabha, proposed that "The Goods and Services Tax Council may decide about the modalities to resolve disputes arising out of its recommendations". It is not clear how a recommending or decision making body could act as dispute settlement body also for disputes arising due its own decision. However, the earlier Amendment Bill [The Constitution (One Hundred Fifteenth Amendment) Bill, 2011] "proposed to set up Goods & Services Tax Dispute Settlement Authority (Article 279B), which may be approached by the affected Government (whether the Centre or the States) seeking redressal for any loss caused by any action due to a deviation from the recommendations made by the Goods & Services Tax Council or for adversely affecting the harmonious structure and implementation of the GST."

The main objection behind the setting the Authority was that "...this authority shall have powers of overriding the supremacy of the Parliament and the State Legislatures. It shall affect the fiscal autonomy of the States."³⁶ (Government of India, 2013). By not having the dispute settlement authority, it is expected that both Centre and State Governments would agree to follow all the recommendation or decisions taken at the GST Council and there will be no deviation from common harmonized structure of GST, even in the event of revenue shortfall, which quite unlikely for federal country like India.

5.3.2 A GST Compensation Fund?

The GST Bill [The Constitution (122nd Amendment) Bill 2014] envisages that States will be fully compensated from the Central Government for any loss of revenue due to implementation of the Goods and Services Tax for a period of five years. The Rajya Sabha Select Committee on GST Bill recommends for establishment of a Goods and Services Compensation Fund under the administrative control of the GST Council into which the Central Government shall deposit the GST Compensation. It is expected that the establishment of such a fund will only build the credibility of the Central Government and regain the trust of the States where their past experience of getting compensation for loss of revenue in VAT implementation or phase out of CST resulted in trust deficit. On the basis of past experience of the States, timely payment of compensation in every financial year is a vital issue which is highlighted before and by the Rajya Sabha Select Committee.

³⁶ The Attorney General of India's comments on the objection was "The Dispute Settlement Authority is primarily with regard to the aspect of disputes in relation to deviation from any recommendation of the GSTC, and it is not just any deviation but a deviation which results in loss of revenue to a State Government or the Government of India, or affects the harmonized structure of the Goods and Service Tax. Notwithstanding the decision on the DSA, the ultimate control over finance will always be that of the legislatures." (Government of India, 2013)

6. Conclusions

The GST reform is important for the country, in spite of the criticisms made in this paper. The Lok Sabha (Lower House of the Parliament) passed the Bill on 6 May 2015 and passed on the same to Rajya Sabha (Upper House of the Parliament) for consideration. The Rajya Sabha referred the Bill to its Select Committee on 14 May 2015 and the Select Committee of Rajya Sabha submitted their report on the Bill on 22 July 2015. The Committee accepted majority of provisions of the Bill and recommended that a few changes. However, the Bill could not be taken up for voting in the monsoon session of the Parliament (21 July – 13 August 2015). After passing the Bill in the Rajya Sabha, it will again come back to Lok Sabha for final approval and then it will be sent to the President of India for his final approval. After passing the Bill, it needs to be ratified at least half of the States to become a law. There are also three Bills that need to be passed – one by the Parliament and two by State Legislative Assembly – before GST is implemented.

Until recently, all decisions on GST have been taken without consultation with major stakeholders like businesses and citizens (consumers).³⁷ The decisions taken by the Empower Committee of State Finance Ministers and the Central Government are not available in the public domain and therefore it is difficult to get clarity on various aspects of GST. Since businesses are not consulted, their views on the present design and structure of GST are not clear. This may lead to resistance to the tax reform and/or negotiated tax environment which are not conducive for a modern rule based tax system. Keeping major stakeholders out of the discussions on GST is not a good sign for any tax reform as decisions taken by the governments will influence their day-to-day decisions. It is desirable that more transparent approach would be followed to disseminate the decisions among stakeholders and taking into account their views in policy designs.

This paper argues that reform in tax administration is as important as tax policy for mobilization of revenue, given the present state of diversities in tax administration across governments, it is expected that tax administration reforms will be taken up sooner rather than later, to enable tax officials to administer the GST efficiently. By moving towards GST, it would be difficult for individual States to deviate from harmonized structure of GST and it will further enhance the importance of tax administration to achieve revenue objectives of the State Governments. The present state of investment in tax administration is miniscule. Large scale vacancies in tax departments, limited availability of infrastructure are major constraints which influence tax efficiency. A large section of tax officials are engaged in carrying out routine works, there is hardly any scope for skill development and specialization in tax administration. Modernization of tax administrations by investing in manpower and infrastructure along with continuous research and training could inculcate the desires for specialization in various aspects of tax administration.

Finally, the success of the proposed GST in terms of compliance and revenue mobilization will largely depend on provision of incentives for tax invoice based transactions and simplification of tax administration. Based on the proposed design, a large part of transactions (both in goods and services) remain outside the tax net. Even there is no mechanism to verify the originality of the tax invoice issued by the vendors or service providers. Prevailing system of without-invoice transactions results in generation of unaccounted income as it escapes tax nets of both direct and indirect taxes. The present system of separate tax administrations by Centre and States is not conducive for GST like tax system and it will increase both compliance and administrative costs. Therefore, options for joint tax administration may be explored.

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