Why the Fight for a GST?*

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The Constitution (122nd Amendment) Bill, 2014, that, if passed, would introduce a Goods and Services Tax (GST) system in India, faces a still uncertain future because of opposition in the Rajya Sabha, the upper house of the Indian Parliament. The Lok Sabha passed the bill in December last year. With the Congress and other opposition parties demanding major amendments to the provisions of the Bill, and given the relative strength of the ruling coalition in the upper house, it may have to be held back for further discussion to generate a consensus. What underlies the controversy?

Many have heralded the GST as among the most radical of efforts to reform the indirect tax system in India so as make it more efficient. That makes opposition to the bill appear to be merely political and not based on sound reasoning—a view supported by the fact that it was the Congress through Finance Minister P. Chidambaram that initiated the debate on transiting to the GST. As has been repeatedly stated, the GST is nothing but a hybrid version of the Value Added Tax (VAT), modified to suit the complexities of a federal system. India's experiments with this kind of taxation began in 1986, when the modified value added tax (MODVAT) was first introduced. Initially, VAT was restricted to manufacturing and combined with excise duties and sales taxes at the central and state levels. Soon state governments also began adopting a VAT system for some commodities. And, finally, in 2007 the government declared that a full-fledged, national VAT-based system in the form of the GST, which covers both manufacturing and services, would be implemented, with a target date of 2010. But that goal has been elusive. Even now, in mid-2015, the transition seems uncertain. Moreover, the system that the 122nd Amendment Bill would introduce would be a much-watered-down, 'modified' version of a truly comprehensive VAT system.

Many of the benefits being claimed for the GST emerge from the benefits conceptually seen as emanating from a VAT system. Prime among these benefits is the elimination of cascading effects that characterize a system of excise duties and sales taxes. Since such taxes are included in the price of goods when they are sold to buyers, they enter as a cost into the values of goods produced with purchased inputs subject to such taxes. If, in turn, a sales tax is applied on the value of the second-stage good, it includes a component that is a tax on the earlier paid tax, as well as a component that is a tax on a value (of the input) that has already been taxed at a lower point in the chain. Applying a tax on value added eliminates this repetitive taxation and the tax-on-tax.

VAT is administered by computing tax payable at the relevant rate on sales receipts of firms at each stage of a production process, with provision for the subtraction of costs and offset of value-added taxes paid by it as reflected in invoices of purchases made by the firm from its input suppliers. This not only makes the implementation of the tax easy, but also increases compliance, since suppliers would be required to declare clearly the prices and taxes that they are charging on their sales of goods and services to upstream producers, so that the latter can claim their offsets.

Because value added is the excess of sales of the firm over cost of materials consumed in production, it captures that firm's contribution to the market value of the good. And at each stage the tax paid is only on that contribution. Since the cost of earlier stage inputs is excluded in the computation of value added, if a duty or tax is applied on value added rather than the value of sales, the cascade effects of such taxation can be avoided. That is, multiple taxation of the same input at the intermediate and final stages is eliminated.

There are other benefits that are seen to accrue as a result. With repetitive taxation at multiple points addressed, the VAT rate reflects the extent of taxation of the value created only at the concerned point in the value chain and makes clear the incidence of taxation on particular products and their buyers. This “transparency” makes it possible to reduce the number of rates in the indirect tax structure. Commodities and services can be split into a few groups (or even included in just one group), each subject to a flat VAT rate, which rationalizes the indirect tax structure. Thus, commodities can be split into those that are essentials, necessaries or luxuries (say), and each of those made subject to a rate that increases as we move from essentials to luxuries. But that would still imply only three rates, while retaining an element of equity or “progressiveness” in taxation. Further, it is argued, this allows preferential tax benefits to be selectively targeted at specific segments of a production chain, such as raw cotton producers as opposed to mills, with a lower VAT rate on outputs produced by the former.

There is one potential disadvantage. One aspect of the rationalization that is sought to be achieved through the transition to the GST is that not only should the number of VAT rates be reduced to a very few, but that these rates should be the same across states so as to create a common indirect tax regime within a single market. Under the current dispensation in which some indirect taxation powers are devolved to the states, the rate of sales tax imposed on a particular commodity within the boundaries of each state is decided by the state government concerned. These tax rates vary across states. Homogenizing rates across states would therefore amount to eroding the autonomy of the state in exercising its already limited tax powers.

In sum, VAT is an indirect tax, with a change in the method of computing the tax when compared to sales taxes or excise duties. Not surprisingly, with a few exceptions such as petroleum products, tobacco and alcohol, sales taxes and excise duties payable at state and central levels are to be subsumed under VAT, once legislation is passed and the new system implemented. Legislation is needed because transition to the new system requires amending the provisions in the Constitution defining the relative tax powers of the Centre and the states, the distribution of centrally mobilized taxes between the two, and the distribution of the states’ share among them.

Put in this way, the reason for all the fuss about shifting to a fully-VAT based system seems difficult to understand. In fact, no party in the political debate is opposing in principle the transition to VAT. The tussle is really over (i) the implied erosion of taxation powers between the Centre and the states; (ii) the distribution of the taxes mobilized between the Centre and the states and among the states themselves; and (iii) the way in which a probable decline in revenue mobilization capacity of some or all states after the transition to GST would be addressed. The Centre would like to protect and increase its share of indirect taxes extracted from the system vis-à-vis the states, and the states would, as a group, like to increase their share relative to the Centre and individually vis-à-vis each other.

The long drawn out effort to arrive at a consensus needed to get the required Constitutional amendments passed has resulted in substantial modifications to a “pure VAT’ system. In a quasi-federal system like India’s, this is inevitable. But the question that arises is whether the changes needed to arrive at a consensus substantially dilute and defeat the original purpose of the transition. The first modification is that it has been decided to have two parallel GST systems: the central GST and the state GST. This was the way in which the erosion of the tax powers of the states has been addressed.

However, that power has been circumscribed. The elements of the GST, including incidence and rates, are to be discussed, decided upon and embodied in recommendations of a GST Council. The Council is to be chaired by Finance Minister, the Minister of State in charge of Revenue at the Centre, and the Ministers of Finance or Taxation or any other Minister from each state as members. Decisions would be based on voting, with a weight of 33 percent for the Centre’s vote and 66 per cent for those of the states as a group. The GST Council will make recommendations to the Union and the states about the rates to be charged and goods and services to be included or exempted, guided by the need for a harmonized GST system and a harmonized national market.

Since the Centre has the right to impose most direct taxes, it was inevitable that the states should be given significant powers for imposing value added taxes. In the final framework of VAT proposed by the Empowered Committee of State Finance Ministers, the Centre's right to indirect taxation using VAT is reserved only for goods sold across state borders. States will be able to generate revenues from taxes on the value added on goods and services produced and sold in the state. This would affect the revenue generating capacity of the Centre through indirect taxation. It will also affect the states' resource position relative to their abilities when they could levy a sales tax on the whole value of the sale of any good sold within their borders.

The resulting skepticism of some states is compounded by the fact that VAT is a tax at destination, not origin. So a state that produces a commodity that is sold elsewhere will not have the right to impose a tax on the value added in that stage of production. Rather, the Centre under the central GST will tax the commodity, and the Centre and the states will share the proceeds. This obviously will be resented by the producing states, which will get a small share of that tax revenue, as compared with the whole of it earlier.

Given the uncertainty as to what the revenue outcomes would be for the Centre and the states as a group and for individual states, three major compromises have been worked out. The first is to keep a set of five petroleum products which account for a substantial share of indirect tax revenues generated by both the Centre and states out of the GST system, giving the Centre the right to impose excise duties on these products and the states the right to impose sales taxes on them. That is, revenue generation capabilities in a sector that makes a major contribution to indirect tax mobilization are to be left untouched for the time being. That decision is being written into the Constitution and would require another amendment for it to be changed. The second compromise is that alcoholic liquor is exempt from GST and while tobacco and tobacco products are subject to GST, the Centre can impose excise duties on them. Taxes on alcohol fall in the state list. So this seems a compromise in which GST has been modified to give the states a revenue handle, in return for which the Centre has been provided some flexibility with respect to tobacco. Thirdly, to accommodate the demands of the 'producing states', the Bill empowers the Centre to impose an additional tax of up to 1 per cent on the inter-state supply of goods for two years or more, the revenue from which will accrue to states from where the supply originates.

Thus, the GST as is to be introduced if the Bill passes through the Rajya Sabha is a completely distorted form of the ideal VAT system. The cascading effect of petroleum taxes, which are severe because these are universal intermediates, would be large. Alcohol is to be kept out the system. And, the destination principle is to be diluted with a one per cent "cess", at least for two years. Despite this there remains uncertainty as to what the effects on revenues would be. This is less of a concern for the Centre, which still retains the right to impose most direct taxes. But that does not hold for the states. So, to win state support the constitutional amendment introducing GST provides for the possibility of the Centre compensating the states for any revenue shortfall resulting from the transition for a period of five years. How that shortfall will be calculated is, however, unclear. But in the long run, if the transition is to be revenue neutral for the states, it would be necessary to adjust the VAT rate upwards and find sharing mechanisms that make states confident that they would not be losers. That has given rise to the question as to how high a revenue neutral VAT rate would be, with some estimates placed so high that it has triggered a debate on whether, in the interest of the consumer, there should be a ceiling level set for the VAT rate in the Constitution.

Thus, what we would get in the end is a poor cousin of VAT, with much of its proclaimed benefits diluted. There is also uncertainty that surrounds the transition, especially in a quasi-federal country like India, with some elements of revenue sharing, such as that generated by the one per cent special cess to compensate producing states for a period of two years, left undefined. Given all this, the keenness of the government to push ahead with this reform is unclear. Claims that it would increase revenues mobilized and raise GDP growth by 1 per cent or more are based on models that are by no means robust. The answer seems to lie in another feature of VAT that is missed in the Indian discussion. Historically, though first introduced for manufactured products in France in 1954, the VAT system gained ground in Western Europe (and to some extent Latin America) in the 1960s and 1970s. The spread in Europe was the result of the requirement set for membership in the EEC in the late sixties of adopting a harmonized VAT, with a minimum floor level. But the real explosion in VAT's popularity occurred after the late 1980s when it was adopted by industrialized countries outside the EU such as Australia, Japan and Canada and by developing economies in Africa and Asia.

Interestingly, the United States had a role to play in the spread of VAT. The Shoup mission to occupied Japan after World War II argued for its introduction. Subsequently the USAID promoted VAT and sought to popularize the system through financial and technical assistance to developing countries. All through that period, the US government was unwilling to implement the system at home. Later the World Bank and the IMF played a role in pushing the system. More than half the countries that introduced VAT in the 20 years starting 1991 did so, on the basis of advice and assistance from the IMF's Fiscal Affairs Department. Thus, its early history notwithstanding, the spread of VAT does seem to have a lot to do with the transition to market fundamentalism and market-friendly polices starting in the 1980s.

This is understandable. A neoliberal strategy substantially reduces taxes on trade. It also requires incentivizing the private sector with light touch taxation of higher incomes and corporate and financial profits. It also emphasizes the need for financial consolidation and reining in public debt. All of this necessitates reliance on forms of indirect taxation other than taxes on trade to sustain expenditure, however much curtailed. The nature of VAT helps in such a context. As an indirect tax, VAT is not directly levied on the buyer and the legal liability is that of the producer. So, it is less visible. Moreover, since VAT is imposed at each stage of the production process, it gets incorporated into costs so that the final consumer would only note the tax paid on value added at the final stage. This helps to legitimize a shift from progressive direct taxation, especially corporate and income taxes, to regressive indirect taxation. Moreover, since there are a few slabs of VAT each of which applies on a host of goods, raising rates by a small percentage in each slab mobilizes large revenues from a broad tax base and delivers much by way of revenues. All of this favours a shift to VAT under neoliberal regimes, which partly explains its history. It implicitly serves as one more instrument to redistribute incomes from ordinary citizens, including the poor, to the very rich.

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