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PUNE INTERNATIONAL CENTRE

MAKING GST ACHIEVE ITS TRUE POTENTIAL

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In Memoriam

This Policy Paper is dedicated to our distinguished colleague, Late Shri V Bhaskar, a 1981 batch IAS officer who we lost to Covid-19 last year. He retired as a Special Chief Secretary, Finance in the Andhra Pradesh Government. He was a policy analyst par excellence and he handled several important assignments in his distinguished career. Shri Bhaskar played a stellar role in the 13th Finance Commission which recommended the GST reforms. He co-authored numerous policy papers for the Pune International Centre ('PIC') and actively participated in debates and discussions and thus helped in the shaping of the GST in India. He remained an untiring advocate of tax reforms all his life and we at PIC miss him very dearly.

1. Introduction

The Goods and Services Tax ('GST') completed a tumultuous 4-year journey recently in India. The monthly GST collections hover around the INR 1 trillion mark. It remains to be seen how long the negative effect on the economy and the GST revenue collections would stay put.

It has been time and again noted that the GST implemented by India, though simple as compared to the erstwhile indirect taxes' regime, is unnecessarily a complex one. While the initial idea was to implement one national GST, given the federal structure of our country and the demands raised by various states, a grand bargain was arrived at where a dual GST was adopted. The Centre and the State Governments now have equal tax jurisdiction across the goods and services and have equal right to levy GST on supply of taxable goods and / or services on intra-State transactions i.e., on consumption of the goods and services in the destination state rather than the producing state. Unlike in the previous indirect tax regime where the tax base for levying excise duty and for levying state VAT was different, in the GST regime it is levied on a common base both by the Centre and the States. Further, with regards to the inter-State transactions and transactions involving imports, an IGST is levied by the Central Government, proceeds of which are equally shared between the Centre and the States. While this looks very simple as a concept, it is being implemented in the same old structure where a taxpayer having pan India presence still needs to obtain as many SGST / UTGST registrations and track all of them separately besides the one CGST and IGST. This was the case in the erstwhile VAT regime as well where the same taxpayer was required to follow as many States VAT laws. However, important silver lining being that the SGST laws and procedures are uniform across the country unlike the case with the State VAT laws. Indeed, this has made life easier for the taxpayers and has reduced the anxieties and uncertainties surrounding the tax compliance procedures. However, payment of GST, filing of returns etc. remains to be undertaken State-wise and not at one go, which has a shadow of complexity overhanging from the erstwhile VAT era.

Realising the necessity to further simplify the GST, the GST Council has very recently set up 2 Group of Ministers ('GoMs'), one for GST rate rationlisation and the other for GST System reforms.

This paper suggests a number of proposals that can make the India GST a simple one, paving the way for reducing the compliance burden on the taxpayers and enhancing the tax buoyancy of the overall revenues by simplifying the GST structure and procedures. By adopting the suggested best international practices, India can play a pivotal role in becoming a dominant player in the global value chain and accelerate economic growth as the refined GST will attract new investments and make our economy a counter magnet to China. There is a tremendous potential for increasing India's share in the global value chain with enhanced investment flows. These investments will generate greater employment opportunities in India and enhance the GDP growth and will also provide resiliency to the global economic system. This Policy paper proposes reforms related to the following six key areas:

1. Widening of the GST net, 2. Re-looking at the GST rate structure, 3. Easing the GST compliance 4. Bringing uniformity in interpretation of GST law and procedures ,5. Setting up of an independent National GST Secretariat and 6. Extending the levy of compensation cess up to 2025. With these reforms our GST system will achieve its true potential.

2. Towards making the GST comprehensive

While introducing the GST in 2017, the GST Council took many decisions to arrive at a consensus; one such set of decisions was to keep certain products / services out of the GST net. Thus, petroleum products *(crude oil, natural gas, petrol, diesel, and aviation turbine fuel)*, electricity, alcohol for human consumption, real estate have been kept outside the ambit of the GST net. There have been umpteen number of representations and arguments all these years to bring these sectors under the GST net. Keeping the end products out of the GST net and levying GST on the inputs, input services and capital goods in manufacture of these products results in a huge cascading effect leading to increased costs and loss for the manufacturers and hence increased price for the end consumers. Petrol, diesel, electricity are the glaring examples of such high input costs being recovered from the end consumers. Further, these are making our exports non-competitive as the costs cannot be passed onto the international buyers unlike the domestic consumers.

Petroleum products hitherto have been one of the largest sources of revenue for both, the Centre and the States. In the long-drawn deliberations for introducing the GST, the Centre and the States agreed to keep the petroleum products out from the GST ambit for initial “few” years solely driven by the revenue implications. While one would have expected that the five petroleum products viz. crude oil, natural gas, petrol, diesel, and aviation turbine fuel (ATF) kept outside the purview of the GST would be brought under the GST ambit once the GST revenue stabilizes, it is important to note that the GST revenues have been unstable since the introduction and the Covid-19 pandemic has made them even more un-predictive. As the State Governments have been constitutionally assured of making good their possible loss on account of introduction of GST in the first five years from the date of implementation, they should not hesitate in agreeing to tax structural decisions in this period. The GST paid on inputs, input services and capital goods is not available to be set-off against the output excise / VAT levied on petroleum products resulting in a significant cascade of taxes and increase in costs. The petroleum products form a very large percentage of the consumption basket, both for the businesses as well households. Lack of dependable public transport and infrastructure in many parts of the country has further increased the consumption of these products.

In the last couple of years, though the international prices of crude oil have been stabilized on the lower side, the Centre and almost all the States have resorted to hiking their respective levies and have mopped up significant revenue. From a high price of around $110 per barrel in 2012, the price of crude has been on a slide and is currently fluctuating between $70 - $80 per barrel. It is interesting to note that in the last five years while the international price of crude has been more or less stable barring the exception in 2020, the tax revenues for the Central and State Governments has been steadily rising. The Central Government’s revenue from taxation of petroleum products has increased over the last few years. In the FY 2016-17 it was around INR 2,732 billion which increased up to INR 3,343 billion in FY 19-20 and shot up to INR 4,538 billion (Provisional Estimate) in FY 20-21. Similarly, the State Governments' revenues increased from INR 1,896 billion to INR 2,211 billion during FY 19-20 and reduced to INR 2,177 billion (Provisional Estimate) during FY 20-21[1].

The Centre should continue to play the important role of ensuring that co-operative federalism is functional at its best. Petroleum products should be brought under the GST net. To protect the revenue concerns of the Centre and the States, a non-vatable cess can be levied over and above the GST which can be divided amongst the Centre and the States. These levies will also play the role of "carbon tax" and promote de-carbonisation, thus help our country achieve the Paris Agreement commitments. A suitable non-vatable cess also needs to be levied on coal to promote de-carbonisation[2]. The biggest beneficiaries of this change would be the businesses who use these petroleum products as inputs for their business activities (e.g., Aviation Turbine Fuel used by the airlines, petroleum products used by petrochemicals and pharmaceutical sectors etc). They should be allowed to claim input tax credits of the GST paid thereby reducing the cost of operations. Furthermore, revenue loss if any incurred by the States from the inclusion of the petroleum products in the GST net can be met by the Centre with the proposed continuation of the compensation cess. Once this is done, electricity, real estate and finally alcohol for human consumption also should be brought under the purview of GST so that the inefficiencies and cost escalations due to exclusion of these sectors from GST can be put to rest, once and for all. The inclusion of electricity in the GST ambit would also be extremely beneficial to the trade and industry. The Task Force on Goods and Services Tax, Thirteenth Finance Commission observed that the impact of the embedded taxes in power generation and distribution could account for as high as 30 per cent of the cost of power production and distribution[3]. If electricity is brought under GST, it will substantially enhance the cost efficiency as electricity is an input to almost all the trade and industry. This particularly can have a positive impact on

[1] Petroleum Planning and Analysis Cell (PPAC), Ministry of Petroleum and Natural Gas, Government of India
[2] Discussion Paper on Carbon Tax Structure for India – EY LLP and Shakti Sustainable Energy Foundation, 2018
[3] Report of the Task Force on Goods and Services Tax, Thirteenth Finance Commission, 15th December 2009

labour intensive textiles sector and other such sectors, boosting exports especially in those sectors where China is vacating its presence.

The GST revenues for the States have come under pressure during the pandemic and it is imperative that the States have a few additional sources of revenue other than GST revenues in order to sustain their developmental agenda and provide resources for extended support during natural calamities. Bringing real estate fully into the GST fold will also uplift the tax revenues significantly. The real estate sector is notorious for large unaccounted money transactions. While the Real Estate Regulatory Authority ('RERA') regulations have been introduced a couple of years ago with an objective to provide a transparency in the real estate sector, an end-to-end tracking of the money involved, right from the land owner to the sand supplier to the interior decorator is necessary to unplug rampant tax leakage. The state level stamp duty needs to be subsumed in the GST. These measures will boost the housing sector thereby providing employment to the large number of skilled and unskilled workers. These reforms will enable the urban local bodies to mobilize higher amount of property taxes.

The other assured way of widening the GST tax base of the States and that of the Centre is to completely do away with the GST exemptions. Exemptions prove to be a double-edged sword; one they force tremendous cascading of input taxes in the economy as they become costs and thus adversely affecting Indian manufacturing competitiveness in domestic as well as international markets. Secondly, they promote large scale "cash" transactions as nothing gets tracked through the value chain. More than 400 GST exemptions (goods and services put together) exist currently and this list needs to be pruned drastically in order to make the overall GST structure simpler and efficient. Ironically, the current GST exemption policy hurts small and micro enterprises much more as they do not receive input credits. This could be one of the main reasons adversely affecting the recovery of the Small & Medium enterprises ('SMEs').

3. Simplifying the GST rate structure

The GST rate structure designed 4 years back was largely with the objective to keep the effective rate of taxes in the same range. The then prevalent cumulative tax rate (Excise duty + VAT) largely influenced the finalisation of the GST rate structure. As a result, we have a GST rate structure which has 5 different rates besides the compensation cess on certain goods. This plethora of rates has made the India GST a complex one.

Analytically, for arriving at the appropriate GST rate, budget neutral rate (BNR) would have been better criterion than the one that was adopted i.e., revenue neutral rate (RNR). As far as the government budget is concerned the GST affects both the revenues as well as the expenditure. Yet another relevant issue is the choice of the time horizon. The major structural reforms like GST are really like capital expenditures that have upfront costs but yield results over a longer period. Hence in arriving an appropriate GST rate the requirement of achieving budget neutrality in the first year itself is not useful. The burden on the budget due to GST reforms in the initial years should be treated as an investment made by the Government to introduce major structural reforms with long term gains. In most of the developed and emerging market economies as well, there is a single GST or VAT rate on all the goods and services. The countries having a single rate and simple GST or VAT laws have been successful in optimizing the tax revenue and minimizing tax disputes. Out of the total countries who have implemented a GST or VAT, around 80 percent of those countries have chosen to have a single rate. A single GST rate for India has been an unmet goal, all along the discussions done before implementation. In fact, very early on in the GST debate, a single rate of 12 percent was recommended by the 13th Finance commission. The ages old tax policy of having a differential tax rate for “must have” and “nice to have” goods and services should be done away with. The revolutionary reform of introduction of a single GST rate with additional non-vatable taxes on few demerit goods is now required. This will simplify the GST design to a very large extent, putting to rest almost all the classification issues. A lower rate of GST would also mean less incentive for fraudsters to evade taxes. The genesis of the current GST frauds lies in the very structure of the GST rates as high rates of GST make it lucrative for the fraudsters to evade taxes. We have examples of successful standard single rate GST / VAT regimes; Singapore, New Zealand, UAE, Japan, are the ones, to name a few. A single GST rate of 12 percent (6 percent for the Centre and 6 percent for the States / Union Territories) should be introduced at the earliest.

Reformed GST system can play yet another important role in our public finance. Currently, the vertical imbalance in the revenues accruing to the Centre and the States is even sharper in the case of the third tier consisting of elected local bodies and panchayats. This imbalance is having deleterious effect on India's urbanization, the quality of local public goods and thus further aggravating the negative externalities for the environment and climate change.[4]

Post the introduction of GST, the Local Bodies who earlier had an independent tax revenue source in the form of octroi duty / entry tax on consumption of goods, today have to fully depend on the States for getting their share in the pie. Property tax is the main tax revenue for the local bodies now. The lack of funds with the local bodies has been one of the key reasons for slow development in the projects undertaken by them in their jurisdictions. A steady source of income, *ab initio* from the consumption of goods and services needs to be carved out for them without introducing any additional tax. This can be achieved by strengthening the State Finance Commissions in terms of their mandate and their recommendations should receive acceptance similar to the Central Finance Commission. This can be achieved by amending (1) Article 266 of the Constitution to include a consolidated fund for Municipalities and Panchayats and (2) Articles 243H and 243X to ensure that revenue allocated by the Central and State Finance Commissions to Municipalities and Panchayats do not form part of the consolidated fund of the State and instead the funds flow directly to the consolidated fund thus created.[4] Once the constitution is amended, the GST rate distribution can be 5 percent to the Centre, 5 percent to the States / Union Territories and 2 percent to the Local Bodies. After a period of say 3 years i.e., after introducing the

[4] Vijay Kelkar – Towards India's New Fiscal Federalism – Prof Sukhamoy Chakravarty Memorial Lecture - Journal of Quantitative Economics, Jan 2019

suggested GST reforms, the GST rate can be increased to 14 percent (6 percent to the Centre, 6 percent to the States / Union Territories and 2 percent to the Local Bodies) to address the long term resource needs of the Centre, States and Local Governments as well. This can be supplemented by increasing the exemption threshold limit for levy of direct taxes which will protect the vulnerable sections of the society.

4. Easing GST Compliance

The current GST compliance requirement is to a large extent digitized and the introduction of e-invoicing in a phased manner is good step in the right direction. However, the Input Tax Credit (ITC) mechanism needs to be simplified to a large extent. The key highlight of any value added tax system is ability of the tax payers to claim ITC of almost all the goods and services procured for supplying taxable goods and / or services. The tax paid on the input side ought to be available as a set-off against the liability on the output side. Such is the simple theory which works wonders in other tax jurisdictions. A simple provision allowing input tax credits of almost everything (with a small negative list) that the businesses procure and the expense of which is debited to P&L account needs to be introduced replacing the existing complex ITC mechanism.

The e-invoicing mechanism is now mandatory for taxpayers who have more than INR 50 crore turnover. The plan is to make it compulsory for every taxpayer eventually. Most of the high value transactions are now covered by the e-invoicing mechanism. It is therefore suggested that the generation of e-way bill for those who are covered by the e-invoicing mechanism be done away with. This will ease the burden of compliance for the taxpayers resulting in quicker turnaround of transport vehicles.

The India GST has been hailed as “one nation, one tax” since its inception. Indeed, the current GST is “one nation, one tax” concept as in there are no other taxes levied on supply of goods and services which are under the purview of GST and the State GST rates are now uniform across all the States and Union Territories (U/Ts). However, businesses operating in more than one State / Union Territories have to obtain GSTIN for each of the States / U/Ts and file State / U/T wise GST returns on the GSTN portal using as many number of usernames and passwords as the number of States / U/Ts they operate in. This has resulted in cumbersome compliance. This has also not helped in reducing GST compliance costs and in fact in some cases it has gone up substantially given the sheer number of state wise reconciliations that are required to be performed, month on month and annually too.

Time is now opportune to design a single GST login and password without the need for businesses to use statewise login and password for GST compliances on the GST portal. A taxpayer having pan India operations should be able to access the GSTN portal with a single click for all the states. This one change itself will provide huge relief for making GST compliance more user friendly.

Currently, GST audits can be undertaken by both, the Central GST authorities as well as the State GST authorities. There has to be a mechanism in place to ensure that there are no 'Dual audits' undertaken for the same taxpayer which may lead to unnecessary burden on the taxpayers. Either the current bifurcation of the taxpayers done between the Central GST Authority and the State GST Authorities should be followed for conducting GST audits as well or a turnover threshold-based system may be designed to divide the GST audit activity between the Central GST Authority and the State GST Authorities e.g. All taxpayers having turnover above say INR 5 crore can be audited by the Central GST Authority and below INR 5 crore by the State GST Authorities. Further, the audit program should be consistent across the country and a National Audit GST Manual should be designed which can be followed by audit officers from the Central as well as from the States. The GST Council has already formed a Committee of Officers ('CoO') to have a joint & collaborative approach for GST Audit as well as capacity building for audit. The CoO (Committee of Officers) will ensure that their uniform practices followed for GST Audit by the Centre and State Tax administrations. The Terms of Reference ('ToR') for this CoO should be extended to include GST enforcement / intelligence initiatives as well.

5. Bringing uniformity in interpretation of GST law and procedures

Since the introduction of GST, there have been numerous advance rulings pronounced in each of the States and at times there are conflicting views taken by various State GST Authorities on interpretation of the GST law. There was an announcement of setting up of a National Appellate Authority for Advance

Rulings which will roll out the procedures for filing of appeals and rectification of orders; there is an urgent need for having a National Authority for Advance Ruling in the first place which will ensure uniform interpretation of the GST law. It is too much of a task for a taxpayer to first obtain the Advance Ruling from various States on the same issue and then approach the National Appellate Authority for getting the relief, in the event of any adverse order.

6. Setting up of an Independent National GST Secretariat

The setting up of an independent National GST Secretariat which is represented by officials from the Central Government as well as from the State Governments will go a long way to ensure that there is uniformity in the interpretation of the GST law across the country and there are no conflicting views taken by the State GST Authorities. The National GST Secretariat should be headed by a Secretary General at the same level of a Secretary to the Government of India. The Secretary General should be appointed on a full-time basis. S/He can be from the All-India Services or a distinguished professional from the academia or industry. The tenure of the Secretary General can be for a fixed period of say 3 to 5 years. The National GST Secretariat should function as independent arm of the GST Council headed by the Secretary General and aided by subject matter experts. It can be further supported by specific consumption related inputs from state economic intelligent units. This will enhance the analytical basis for decision making regarding the GST policy matters. The Centre and the States can share the expenses of the National GST Secretariat in the same proportion as the voting share in the GST Council meetings.

7. Extension to Levy of Compensation Cess

After 4 years of the implementation of the GST, it now appears that agreeing to compensate the States for any GST revenue shortfall, that too at a 14 percent compounded growth rate for five years, was a tall order. With no linkage to the GDP growth rate during the same period and keeping petroleum products, electricity, alcohol (fully) and real estate (partially) out of the GST ambit, it was but expected that there would be a shortfall in the GST revenues. Adding to the woes was the blow from the Covid-19 pandemic which took away the little hope of revival and now we are staring at an extension of the period for the levy of compensation cess. The economy was showing high growth during the years 2015 and 2016, hence there was tinge of optimism in proposing a blanket 14 percent rate across the board for all the States. There were many States then for whom the tax revenues from those taxes subsumed into the GST were hardly growing at a single digit. 14 percent guaranteed increase in revenues that too at a compounding rate for five years was like a windfall for these States who never objected then. The Central Government perhaps should have adopted a differential approach depending upon the pre-GST tax revenues of the States and devised a band of compensation slabs. The current levy of the compensation cess will come to an end in June 2022 (completion of 5 years from the GST implementation date).

Beyond June 2022, the levy of the compensation cess should be restricted only to make good the additional loss suffered during the Covid-19 pandemic and the revenue losses incurred for undertaking the proposed GST simplification / rationalization. The extension of the compensation cess can be restricted to a period of three years i.e., upto 2025 post which the GST rate can be increased from 12 percent to 14 percent to address the revenue needs of the Centre, States / Union Territories and the Local Bodies. The formula for the quantum of the compensation cess should be linked to the overall annual growth rate in the economy. The fiscal relations between the Centre and the States have been strenuous in the last couple of years owing to many factors. Agreeing to the revised formula for extension of the levy of compensation cess is a good opportunity for both the Centre and the States to show case to the world the true spirit of co-operative federalism. Moreover, the States are required to be incentivized for making good the revenue losses on account of the Covid-19 pandemic and to continue to be committed to tax reforms leading to improvement in the tax administration mechanism.

8. Summing up: Policy Initiatives for Consideration

Based on the above discussion, the following policy initiatives are suggested to make the GST structure simple which will enable realization of its true potential:

- **Bring petroleum products, electricity, potable alcohol, real estate fully under the GST net**

Petroleum products, electricity, potable alcohol, real estate should be brought under the GST net immediately without any further delay. Wider the net, lesser the cascading of taxes which are otherwise levied on these products.

- **Simplify the GST rate structure**

Scrap the current multiple GST rate structure and bring in a simple, easy to understand single GST rate structure for almost all goods and services with exception for de-merit goods and services.

- **Ease GST compliance**

Make PAN as the single GST identification number and do away with the State based GST registration requirement.

- **Set up an independent National GST Secretariat**

In order to have a uniform and consistent application of GST throughout the country, set up an independent National GST secretariat headed by a Secretary General represented by the Centre and the State Government officials. A Tax Policy Advisory Committee co-opting external economists / tax experts can also be formed to assist the national GST Secretariat in formulating Tax Policies.

- **Extend levy of compensation cess**

Work out a new formula based on overall growth in the economy for compensating the States for recouping the additional tax losses on account of the Covid-19 pandemic and for making good the revenue losses incurred for undertaking proposed GST simplification / rationalization measures for a fixed period of time.