

## **GST REFORM NEEDS A NEW GRAND BARGAIN**

**The GST compensation issue strengthens the necessity for a new system between sovereign and sub-sovereign entities**

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

### **Abdication of responsibility**

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

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

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

### **The onus is on the Centre**

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

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

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

### **The Australian example**

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

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

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

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

### Third tier of government

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

### Other changes

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

### Meanings of Difficult Words:

- ❖ **bargain** (noun) – agreement, arrangement, understanding, deal.
- ❖ **compensation** (noun) – payment, repayment, settlement (for loss/damage).
- ❖ **GST compensation** (noun) – Under the GST law (In India), state governments are guaranteed full compensation for any revenue loss for the first five years after the introduction of the goods and services tax (GST) in July 2017. The compensation is a gap between actual revenue collected and projected revenue.
- ❖ **strengthen** (verb) – increase, intensify, heighten.
- ❖ **necessity** (noun) – (essential) requirement, prerequisite, indispensable thing.
- ❖ **sovereign entity** (noun) – central government.
- ❖ **sub-sovereign entity** (noun) – state/regional government.
- ❖ **strike** (verb) – reach, arrive at; agree on, come to an agreement on, settle on.
- ❖ **result in** (verb) – cause, bring on, bring about, give rise to.
- ❖ **give up** (phrasal verb) – abandon, forgo, renounce, relinquish.
- ❖ **sundry** (adjective) – several, various, diverse.
- ❖ **frictionless** (noun) – smooth, steady, uninterrupted.
- ❖ **commerce** (noun) – business, trade.
- ❖ **buoyant** (adjective) – optimistic, confident, hopeful; lively, high-spirited.

- ❖ **leakproof** (adjective) – closely sealed.
- ❖ **tax compliance** (noun) – the degree to which a taxpayer complies (or fails to comply) with the tax rules of his or her country, for example by declaring income, filing a return, and paying the tax due in a timely manner. It simply refers to taxpayers’ decision to comply with tax laws and regulations by paying tax timely and accurately.
- ❖ **cascade** (noun) – a large number of things happening at the same time.
- ❖ **painstaking** (adjective) – careful, thorough, meticulous.
- ❖ **consensus** (noun) – an idea or opinion that is shared by all the people in a group, agreement, concurrence.
- ❖ **inter alia** (adverb) – Latin for “among other things”.
- ❖ **address** (verb) – tackle, deal with, attend to, try to sort out.
- ❖ **apprehension** (noun) – worry, concern, misgiving, disquiet.
- ❖ **abdication** (noun) – disowning, rejection, refusal/avoidance, abandonment.
- ❖ **consent** (noun) – agreement, assent, permission/approval.
- ❖ **secure** (verb) – obtain, acquire, gain, get.
- ❖ **reimburse** (verb) – compensate, repay, refund, settle up with.
- ❖ **shortfall** (noun) – deficit, inadequacy, deficiency, shortage.
- ❖ **reimbursement** (noun) – money paid back/compensated for the money spent/lost.
- ❖ **year on year** (adjective) – year over year (for comparison).
- ❖ **generous** (adjective) – kind, good-natured, soft-hearted.
- ❖ **generous to a fault** (phrase) – to be extremely /overly generous.
- ❖ **aggregate** (noun) – total, sum, whole amount.
- ❖ **design** (noun) – intention, aim, purpose, objective, plan, proposal.
- ❖ **harmonise** (verb) – coordinate, integrate, make compatible/ bring in line with.
- ❖ **decade** (noun) – a period of ten years.
- ❖ **precursor** (noun) – a similar thing that existed before; antecedent, predecessor.
- ❖ **inbuilt** (adjective) – built-in, integral, incorporated.
- ❖ **taper** (verb) – decrease, lessen, dwindle, diminish, reduce.
- ❖ **make room** (phrase) – to clear a space to allow for something.
- ❖ **incentive** (noun) – stimulus, impetus; concession, payment.
- ❖ **have skin in the game** (phrase) – to have incurred risk by being involved in achieving a goal.
- ❖ **pandemic** (noun) – the worldwide spread of a new disease; The illness spreads around the world and typically affects a large number of people across a wide area.
- ❖ **recession** (noun) – economic decline, downturn, slump.
- ❖ **significantly** (adverb) – notably, importantly, seriously, crucially.
- ❖ **the frontline** (noun) – the front and most important position.
- ❖ **on one’s own** (phrase) – alone, all alone, by oneself, all by oneself.
- ❖ **Force Majeure** (noun) – A force majeure (event) refers to the occurrence of an event which is outside the reasonable control of a party and which prevents that party from performing its obligations under a contract.
- ❖ **abdicate** (verb) – reject, disown, turn down, give up, abandon (a responsibility).
- ❖ **make up for** (phrase) – atone for, make amends for, compensate for.
- ❖ **onus** (noun) – responsibility, duty.
- ❖ **count** (noun) – a point (for discussion or consideration).
- ❖ **recourse to** (noun) – resort to, make use of, use, utilize.
- ❖ **sovereign bond** (noun) – sovereign bonds issued by the government. They can be either local-currency-denominated or denominated in a foreign currency. They are generally with a promise to pay periodic interest payments and to repay the face value on the maturity date.
- ❖ **command** (verb) – receive, be given, get/gain, obtain.
- ❖ **in terms of** (phrase) – with regard to, as regards, in respect of, with reference to.
- ❖ **aggregate** (adjective) – total, combined, whole.
- ❖ **debt/bond market** (noun) – debt market; the market where debt instruments (like bonds (government or corporate) and mortgages) are traded.
- ❖ **credit rating agency** (CRA) (noun) – a credit rating agency is an entity which assesses the ability and willingness of the issuer company for timely payment of interest and principal on a debt instrument. (Courtesy: [www.sebi.gov.in](http://www.sebi.gov.in))
- ❖ **fiscal stimulus** (noun) – Government measures, normally involving increased public spending and lower taxation, aimed at giving a positive jolt to economic activity.

- ❖ **indebtedness** (noun) – owing someone a debt of gratitude; obligation, liability.
- ❖ **macroeconomic** (adjective) – relating to the branch of economics concerned with large-scale factors (interest rates/national productivity).
- ❖ **macroeconomic stability** (noun) – it describes a national economy that has minimized vulnerability to external shocks, which in turn increases its prospects for sustained growth.
- ❖ **domain** (noun) – area/sphere of activity.
- ❖ **break** (verb) – contravene, violate, fail to comply with, disobey.
- ❖ **alibi** (noun) – excuse.
- ❖ **dent** (noun) – blow, damage.
- ❖ **built up** (noun) – set-up, establishment, formation.
- ❖ **federalism/federal framework/system** (noun) – a system of government in which establishments such as states or provinces share power with a national government.
- ❖ **repeated game** (noun) – it refers to a situation in which the same stage game (strategic form game) is played at each time.
- ❖ **consequence** (noun) – outcome, ramification, repercussion.
- ❖ **renege** (verb) – fail to honour, go back on, default on, break one's word/promise (a commitment/contract).
- ❖ **bailout** (noun) – an act of providing financial help/support by the outside investors to a bank/institution/organisation which faces serious financial difficulty.
- ❖ **obligation** (noun) – duty, responsibility, commitment, requirement, necessity.
- ❖ **bumpy** (adjective) – fluctuating, irregular, inconsistent.
- ❖ **radical** (adjective) – thoroughgoing, thorough, comprehensive, complete/total.
- ❖ **overhaul** (noun) – reorganization, restructuring, rearrangement.
- ❖ **tinker with** (verb) – try to repair, try to improve, play with (aimlessly or unskillfully).
- ❖ **mechanism** (noun) – procedure, process, method/technique.
- ❖ **sin tax** (noun) – tax levied on certain goods considered harmful to society and individuals, for example alcohol and tobacco & etc.,
- ❖ **the way forward** (phrase) – something (a plan/action) that leads to success in the future.
- ❖ **coincidentally** (adverb) – simultaneously; at the same time.
- ❖ **apt** (adjective) – relevant, suitable, fitting, appropriate.
- ❖ **elbow room** (noun) – scope, room to manoeuvre, leeway/margin, latitude.
- ❖ **compliance** (noun) – observation, adherence, conformity.
- ❖ **arbitrary** (adjective) – random, casual, erratic, unpredictable, inconsistent.
- ❖ **discretion** (noun) – choice, option, preference, disposition.
- ❖ **litigation** (noun) – legal process, legal dispute, legal action.
- ❖ **buoyancy** (noun) – vigour/strength, high level of activity, growth.
- ❖ **incidentally** (adverb) – by the way, by the bye, coincidentally; by chance, accidentally.
- ❖ **scrupulously** (adverb) – religiously, consistently, constantly/regularly.
- ❖ **bogey** (noun) – nightmare/anathema, curse, bane.
- ❖ **elusive** (adjective) – difficult to find, difficult to achieve; indistinct/intangible.
- ❖ **revenue neutral rate** (noun) – put simply, this is the rate which is the ratio of all excise plus value added (sales) taxes in the numerator, divided by the total taxable gross domestic product (GDP) in the denominator.
- ❖ **anticipate** (verb) – expect, foresee, predict.
- ❖ **à la** (preposition) – in the manner of.
- ❖ **harmonisation** (noun) – an act of bringing into harmony/agreement.
- ❖ **tier** (noun) – grade, level, step, echelon.
- ❖ **functionary** (noun) – official, administrator, office-holder.
- ❖ **in view of** (phrase) – in the light of, owing to, considering.
- ❖ **urbanisation** (noun) – a process of creating urban areas. It is a result of population migration from rural areas in addition to natural urban demographic growth.
- ❖ **decentralisation** (noun) – the process of distributing or dispersing functions, powers, people or things away from a central location or authority.
- ❖ **earmark** (verb) – designate, reserve, set aside.
- ❖ **exclusively** (adverb) – specially, particularly, only.
- ❖ **call for** (phrasal verb) – require, publicly ask/necessitate, demand.
- ❖ **interstate** (adjective) – existing between states.
- ❖ **burdensome** (adjective) – taxing, inconvenient, troublesome, worrisome.
- ❖ **fiscal** (adjective) – financial.
- ❖ **strike a balance** (phrase) – find a fair & reasonable line of action between two contrasting things.