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Case Study: Introduction of Goods and Services Tax in India

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The Introduction

At the stroke of the midnight hour on the 1st of July, 2017, the national Goods and Services Tax (GST) came into being at a ceremony in the Central Hall of Parliament, thus implementing the most transformative indirect taxation reform in India since Independence in 1947. It had been more than a decade in the making ever since the idea of switching over to a national GST regime was first mooted by the Kelkar Committee on Tax Reform[1] in 2002.

Prior to the introduction of GST, taxation powers were divided between the Centre and the states. The Constitutional scheme of the division of fiscal powers bestowed on the Centre the power to tax the production or manufacture of goods (other than alcohol for human consumption), while the States were conferred powers to levy taxes on the sale of goods as well as the production, sale and distribution of alcohol for human consumption. Since services were not specifically mentioned in either list, the power to levy taxes on services was vested in the Centre by virtue of its exclusive jurisdiction over residuary powers. In addition to these main entries, the States were also given powers to levy profession taxes, entry tax or octroi, electricity duty, and taxes on the sale of newspapers[2] as well as to collect stamp duty.

Pre-GST Reforms - Scope and Limitations

In the decades since Independence, indirect taxes in India had witnessed progressive reforms (especially after the launch of economic reforms in 1991) aimed mainly, to reduce cascading to the extent these were possible within the Constitutional scheme of devolution of powers between the Centre and the States. Most of the time, these reforms were incremental and took place without any grand design. Thus, Central Excise duties levied by the Centre on the manufacture of goods were converted into a Value Added Tax (VAT) - like tax by permitting input tax credit (ITC) of duty paid on inputs in 1986. The scheme was subsequently expanded to include ITC of the duty paid on capital goods too. Service tax was introduced through the Finance Act, 1994 with levy on three services[3], and gradually expanded to include more services within its ambit, until the negative list approach was adopted in 2011, whereby barring a short negative list all services became eligible to service tax. Thereafter, cross-flow of ITC between Central Excise duties and Service tax was permitted. As far as State taxes were concerned, the major change was the replacement of State Sales tax with a Value Added Tax (VAT) starting 2005 such that the rates of VAT were harmonised across States minimising the incidence of "rate wars" amongst States and minimising arbitrage opportunities for businesses. Thus, the implementation of VAT reforms for States had an equally long gestation period, with the then Finance Minister mooting the idea of replacing the State Sales Tax with a Value-Added Tax in 1995 to holding active discussions on the matter in 2000 and Haryana becoming the first state to implement VAT in 2003[4].

[1]Headed by Dr Vijay Kelkar, Advisor to the Minister of Finance and Company Affairs

[2]Article 246 of the Indian Constitution deals with the Seventh Schedule that mentions three lists, viz. Union List, State List and Concurrent List, which specify division of powers between the Union and the States.

[3]Telephone services, non-life insurance services and stock brokers' services.

[4]The decision to implement VAT was left to the State Governments; and the last state to switch to VAT was Uttar Pradesh in January, 2008.

These reforms, however, failed to integrate the multitude of Central and States taxes and merge into a common and comprehensive base which covered both goods and services with a seamless flow of ITC across the value chain of production and distribution. Many economic activities that ought to have been subjected to VAT such as entertainment, generation and distribution/ sale of electricity, and the manufacture and distribution of liquor for human consumption continued to be subjected to stand-alone taxes by the States. Moreover, in a bid to bolster their resources and depending on the nature of economic activity, some States levied entry tax, octroi and/or purchase tax that were widely perceived to be distortionary. However, inter-state sale of goods continued to attract the Central Sales tax (CST), which was levied by the Centre, but collected and appropriated by the States. This situation of a lower CST rate compared to State VAT created an arbitrage, resulting in large-scale tax evasion. This was reported to take place in two ways: firstly, by some firms falsely claiming the concessional rate of 2 per cent applicable to inter-state sales on intra-state sales[5] and secondly, by falsely presenting inter-state sales as consignment or branch transfers - the latter being tax exempt.[6] To prevent evasion, it became necessary to implement a complicated and pernicious administrative system with complex forms and documentation, as well as road-side check posts at state borders.

The economic consequences of such a tax system were unfavourable as the tax base was splintered with different parts of the supply chain of goods and services suffering different taxes at different rates. While some taxes were collected by the Centre, others belonged to the States with incomplete ITC flow resulting in cascading and double taxation (tax on tax). Such a disjointed tax base led to diffusion of responsibility across tax authorities and compromised the efficiency of revenue collections. Because of the difference in the tax rates between goods and services and the rapid growth of the service economy entailing customers being offered goods and services bundled together, such as dining at fancy restaurants, frequent disputes arose about whether a particular activity amounted to a service or not; and whether it would be exigible to Central Service Tax or State VAT. Above all, businesses faced an onerous compliance and administrative burden, owing to the need to deal with multiple tax authorities and comply with different requirements for documentation, account-keeping and return filing. A consequence of such tax cascading was that full zero-rating of taxes on exports (both of goods and services) was not possible, making Indian merchandise less competitive in global markets. Conversely, the extant regime did not allow the Central Government to fully counterbalance domestic taxes leviable on non-excisable goods (such as farm produce or alcohol), when such goods were imported into India in the same manner as it could on excisable goods through the levy of additional custom duties. This created an uneven playing field for domestic producers of such non-excisable goods. As for consumers, embedded taxes meant that they could not discern the actual and full burden of tax placed on any

[5]'Utilisation of declaration forms in inter-State trade- A Study Report'- CAG, October, 2012
[6]'Reform in Central Sales Tax in the context of VAT'- M. Govinda Rao, Economic And Political Weekly, February 15, 2003

goods or services even if they were aware of the nominal rate of either Central Excise duties or VAT. In other words, the tax burden on the common citizen lacked transparency.

Challenges in bringing about transformative reforms

To address these issues effectively, numerous challenges had to be confronted at several levels. The Constitutional scheme of devolution of taxation powers itself needed to be redefined so that the tax base could be integrated through the application of a single tax regime across the national supply chain of goods and services, separately or bundled together, from the primary to last stage of retail consumption. The Centre and the States - the latter being run by Governments of different political hues, ideologies, economic size and fiscal strength - had to agree to choose the most efficacious option out of a bundle of possible solutions. These challenges were further intensified since the Centre and the States would need to share their sovereign taxation powers for this common cause, giving up a fair degree of independence they enjoyed at the state level in determining the tax base, coverage and rates, despite an unwritten obligation of the States to maintain a harmonised rate structure under VAT. This concern was more pronounced among States that had levied taxes peculiar to their circumstances to raise revenues, such as purchase tax on wheat and paddy imposed by Punjab; or entry taxes imposed by several States, since these would need to be abandoned under the new GST regime. Matters were also complicated by a lack of certitude or confidence regarding the impact this new tax system would have on their respective revenue base and consequently the fiscal resources at their command. States were wary of transitioning into a regime where they may need to depend on the Centre to bridge their deficits in case of a shortfall. Their prior experience of receiving compensation during VAT transition and progressive reduction in the CST rates had not been comforting. Further, it was obvious that integration of the national tax base required a liberal spirit of give and take, with no certainty regarding the extent of disruption and the duration of the transition. Economically advanced States were concerned that under GST, revenues could shift in favour of not-so-affluent consuming States, given the destination-based design of GST levy. The smaller or special-status States with a slender economic base did not see much gain in switching over to a new system either. While loss of revenue was less of a concern for the Centre because other avenues for raising revenues such as direct taxes were available to it, this was a big concern for the States for whom domestic indirect taxes were the only source of tax revenues. Having switched over to the State VAT regime recently, many States would perhaps also have experienced some degree of policy fatigue towards adopting yet another transformation on an even bigger scale.

Empowered Committee of State Finance Minister – The Shepherd

However, one of the positive spin-offs of the VAT implementation process was the existence of the forum of the Empowered Committee of State Finance Minister[7] (or the Empowered Committee) to enable discussion and deliberation on the desirability of transitioning towards a full-fledged GST system, the modalities for doing so, and laying out the transition road-map. The Empowered Committee did commendable work in forging consensus among the States and shepherding them towards the new VAT regime in a fairly smooth manner with significant revenue gains. It was endowed with the requisite domain knowledge of indirect taxes levied or collected by States, the legal framework within which they operate and what it would take to move from State VAT to a full-fledged Goods and Services Tax regime. Thus when it came to conducting discussions to preparing states for the transition the Empowered Committee was the natural choice and in his Budget speech of 2007-08, the then Finance Minister announced that it would be the Empowered Committee that would work with the Central Government to prepare a roadmap for the introduction of a national GST with effect from 1st April, 2010.

First Discussion Paper on GST in India – proposing a comprehensive design

In partnership with Central Government representatives, the Empowered Committee began discussing the probable design of a Goods and Services Tax. These deliberations culminated in the release of the 'First Discussion Paper on GST in India'[8] in November, 2009 by the Empowered Committee which spelt out the broad contours of the proposed regime with a view to obtain feedback from stakeholders.

Recognizing some of the inherent challenges of this new system, the first Discussion Paper proposed significant policy choices in the design of GST that were more or less preserved in the final model adopted in 2017. These included:

Adoption of a dual GST wherein the Centre and the States were to enjoy concurrent powers to levy and collect the tax on each supply of goods or services or both (in the case of composite supplies) barring supplies either not eligible to or exempted from GST. Thus, every transaction of a supply of a good or service shall bear two components of GST simultaneously - the Central GST (CGST) and the State GST (SGST). This design choice was unique for a federal country, reflecting pragmatism, given the existing Constitutional scheme of indirect taxes wherein both the Centre and States had been levying and collecting indirect taxes akin to VAT although at different stages of the supply or value chain. In federal countries such as Canada (barring the province of Quebec) and Australia, GST is collected by either the Federal or the Provincial Government with a revenue-sharing arrangement. The Discussion Paper acknowledged that the introduction of GST would require Constitutional amendments to assign States the power of taxing supply of services, while the Centre had the power to tax the supply of goods in the distribution chain beyond manufacture. It was also pointed out

[7] EC was originally set up on 17th July, 2000 with limited State representation; was reconstituted on 12th August, 2004 with Finance Ministers of all States its members; and registered as a Society under the Societies Registration Act.
[8] https://gstcouncil.gov.in/sites/default/files/First%20Discussion%20Paper%20on%20GST.pdf

that there would need to be Central laws for the levy of CGST and IGST and each State would need to promulgate a separate law for the levy and collection of State GST, with key features being common so that the laws were easy for pan-national businesses to comply with.

GST was to be a destination-based tax which meant that the tax revenue was to accrue to the jurisdiction where the final consumption of goods or services takes place. Further, import of goods into the country would be subjected to GST while exports would be zero-rated (to be taxed in their country of consumption). In the same vein, domestically too, revenue collected on Goods or Services supplied from State A to State B would be assigned to State B, the consuming state. This destination-based feature fulfils the principle of tax neutrality, which origin-based taxation does not. Under the destination principle, exports are free of GST and imports are taxed on the same basis and at the same rate as domestic supplies creating a level playing field for domestic and foreign businesses.[9]

There would be seamless flow of Input Tax Credit (ITC) throughout the value chain whether it is intra-State or inter-State, except where any goods or services are exempt (not zero-rated). Further, ITC would flow within the CGST and SGST streams respectively and would not be allowed to intermingle - a safeguard necessary to preserve the purity of the respective revenue streams of the Centre and the States. Another significant feature was the adoption of the Integrated Goods and Services Tax (IGST) model to allow ITC to flow unhindered for inter-State supplies. It may be recalled that the erstwhile CST on inter-State sales did not allow such unhindered flow, which caused 'cascading of taxes' problem. In comparison, IGST promised a superior solution acting as a bridge for the seamless passage of ITC across State boundaries, with no threat of revenue loss. This was also to ensure that IGST rate being equal to the sum of CGST and SGST rates, with no rate arbitrage that prevailed under the CST, which were much lower than the applicable VAT rates. Besides the full ITC of IGST paid in the exporting State would be available to the dealer in the importing State and SGST credit could be used for payment of IGST on outward supplies in the exporting State. This would enable the easy settlement of accounts between the Centre and the States so that SGST component of IGST paid in the exporting State eventually accrued to the importing State. Thus, a major shortcoming of the existing tax regime had been effectively resolved by IGST; and despite prolonged deliberations on this aspect (including on some alternative models proposed) prior to the introduction of GST, this feature was retained in the final design.

The Empowered Committee enumerated eight Central taxes[10], including cesses and surcharges and six State taxes[11] that were to be subsumed within GST making its coverage quite comprehensive. Among the major exclusions was State excise on alcohol for human consumption. Purchase tax levied by some of the agricultural States was proposed

[9]Please see Chapter 2 of International VAT/GST Guidelines: OECD

[10] Namely: (i) Central Excise Duty, (ii) Additional Excise Duties, (iii) The Excise Duty levied under the Medicinal and Toiletries Preparation Act, (iv) Service Tax, (v) Additional Customs Duty, commonly known as Countervailing Duty (CVD), (vi) Special Additional Duty of Customs - 4% (SAD), (vii) Surcharges, and (viii) Cesses.

[11]Namely, (i) VAT / Sales tax, (ii) Entertainment tax (unless it is levied by the local bodies),. (iii) Luxury tax, (iv) Taxes on lottery, betting and gambling, (v) State Cesses and Surcharges in so far as they relate to supply of goods and services, and (vi) Entry tax not in lieu of Octroi.

to be subsumed, with a guarantee of revenue compensation by the Centre. In terms of coverage of goods, the Empowered Committee proposed that five petroleum products[12] would continue to be subjected to Sales tax by the States and need not be subsumed. This stance was driven primarily by the States' perceived fear of loss of revenue since sales tax/ VAT on petroleum products contributed about 25-35% on their Own Tax Revenues. This proposal, however, was at variance with the international practice whereby petroleum products are commonly subjected to VAT or GST like other goods. However, owing to their negative externalities, huge revenue potential and inelastic demand, they are mostly charged to additional non-VAT taxes, such as sumptuary excise taxes. In fact, the Empowered Committee had proposed a similar formulation for tobacco and tobacco products, which were to be brought under GST, but could also be levied to excise duties by the Centre. It has not been possible to rectify this 'anomaly' in respect of petroleum products till date. This conflict between theoretical purity (which in the case of petroleum fuels dictates their coverage under GST) and pragmatism (which argues against) confronts policy makers constantly and does not lend itself to any straitjacketed solution.

The Paper strongly advocated in favour of deploying Information Technology (IT) systems for the implementation of GST and placed responsibility on the Centre to enable the creation of requisite infrastructure, both for the Central and State administrations. This was a daunting task owing to its sheer scale and ambition. But according primacy to taxpayers' interests, ease of compliance, and ensuring efficiency and transparency in operations of the new system, is what finally sets the Indian GST regime apart.

Finally, one of the most significant issues discussed was that of assured revenue compensation by the Centre to the States, at least for a period of five years after the implementation of GST, through a neutral and automatic mechanism. In the run up to GST, considerable negotiating capital was spent on working out the compensation modalities, such as the sources for the Centre to raise resources for this purpose and the nature of guarantees that would be inviolable and ensured the determination and disbursement of compensation would not be left to the caprices of any Central authority. There were also prolonged discussions on how long the compensation should last, the formula on the basis of which the respective amounts would be determined and the rate of growth of revenue that would be assured. Eventually, the successful resolution of this issue through means such as a legislative guarantee for compensation, the levy of a Compensation Cess to provide for the compensation kitty and projection of a generous rate of revenue growth of 14% over the pre-GST base year of 2015-16 (perceived as a normal year) for assured compensation to the states, paved the way for consensus on implementation of GST.

[12]Namely, (i) crude, (ii) motor spirit, (iii) Aviation turbine fuel, (iv) high speed diesel, and (v) natural gas

Completion of the tasks left incomplete in the Discussion Paper

While the Discussion Paper outlined a blueprint that made it possible to envisage what the proposed GST would look like in its key aspects, several critical issues remained unaddressed including-

The rate structure of GST - While acknowledging that it would be best to have a two-tier rate structure for goods and a single rate for services. It was perhaps too early for the Committee to comment on this aspect with any certainty unless there was agreement about the taxes to be subsumed and the coverage of the base in terms of goods and services to be included. Unless these terms were clearly defined, a revenue neutral rate could not have been computed. It was also linked to several other parameters such as the level of threshold exemption for small taxpayers, the threshold for compounding of taxes and the list of exemptions. This turned out to be one of the most prolonged and difficult area of discussion with several Committees, including one appointed by the Thirteenth Finance Commission, recommending a rate structure at substantial variance with each other. Once again, the discussions were peppered by rival contentions between the purists proposing a single rate structure with a unified rate for all goods and services and pragmatists holding that a developing country like India could not afford to tax items of mass consumption and luxuries at the same rate. Eventually, a three-tier structure with rates of 5%, 12% and 18% and a demerit rate of 28% found favour. In addition, a compensation cess was imposed on 'demerit' goods. These rates were decided by the GST Council at its 14th meeting held on 18th May, 2017 at Srinagar.

The list of exemptions - whether the exemptions prevailing under Central Excise, Service Tax and State VAT should continue as such or be pruned to enable a simpler structure with moderate rates.

Administrative issues such as how the taxpayer base would be shared between the Centre and the States so that every taxpayer does not have to deal with two authorities viz. the Central and State, on a daily basis. These administrative issues were left to the end for the GST Council to decide just weeks before the introduction of GST. These are discussed in later section.

Process of Constitutional Amendment

Constitution 115th Amendment Bill proposing insertion of fresh articles and changes to the relevant entries in the Union and State List was introduced in the Lok Sabha on 16th March, 2011, which, however, lapsed owing to the dissolution of the fifteenth Lok Sabha. The key features of this Bill, such as levy of IGST on inter-State supply and creation of a GST Council, were retained in the final Constitutional Amendment Bill. However, provisions relating to creation of an autonomous Dispute Settlement Authority to resolve disputes among Governments that were party to GST were dropped based on the recommendations of the Standing Committee on Finance in its 73rd Report.

A new Constitution 122nd Amendment Bill was introduced by the newly elected Government on 18th December, 2014. The Bill was referred to the Select Committee of Rajya Sabha, which held wide-ranging consultations with Ministries/ Departments of the Central

Government, State Governments, think-tanks, and trade and industry associations. It did not propose any significant changes, except relating to the period of revenue compensation. In specific terms, it recommended that compensation be mandated “for” a period of five years instead of “may extend to five years”. The Constitution (101st) Amendment Act, 2016, enacted on 8th September, 2016 finally ushered in the GST, carried this change. In this Amendment Act, the provision for the levy of an additional (non-VATable) tax of 1% on supplies made in the course of inter-State trade for a period of two years, with proceeds assigned to the originating (or exporting, mainly industrialised) States, was also dropped.

As for the rate structure under GST, the Select Committee of the Rajya Sabha did not accept a suggestion to incorporate a ceiling of 18% ad valorem in the Constitution itself. However, its report did deliberate upon the likely rate structure and, drawing on the experience of several countries that have adopted GST, emphasised the benefits of moderate rates of GST (perhaps not exceeding 20%) to minimise its inflationary impact.

Likewise, on the administrative aspects of GST, the Select Committee acknowledged the process initiated for setting up of the Goods and Services Tax Network (GSTN), a not-for-profit, non-Government company, which would bolster a strong IT framework and infrastructure to support the working of GST. It, however, also stressed the need for GSTN to bring all the States up to speed in this regard and to sufficiently train both officers and taxpayers in the use of IT systems to enable the smooth implementation of GST.

Sprint to implementation post the Constitutional Amendment

The period between the passage of Constitution Amendment Act on 8th September 2016 and the launch of GST on 1st July 2017 was marked by very intense activity with 18 GST Council meetings, interspersed with wide-ranging consultations with trade and industry bodies and other stakeholders, in addition to drafting of laws and procedures at the officers’ level. Simultaneously, steps for the establishment of a comprehensive IT infrastructure as mandated were being taken. The contours laid out through the Constitutional Amendment now required to be infused with flesh and blood, complete to the last detail, within an ambitious time frame of nine months.

The issues being discussed were no longer theoretical but real in terms of erosion of sovereignty, revenue loss or the special interests of each Zone, area or State. Going through the minutes of the GST Council meetings, it is evident that a fair amount of thought and statesmanship went into determining the sequence in which issues were discussed for ease of navigation. The highlights of this stage are discussed in the next section.

Pragmatism and Statesmanship of the GST Council

In order to achieve speedy consensus, the issues causing grave concern to the State governments such as the likely loss of revenue and how the gap in collections would be bridged were front-loaded and resolved early. Likewise, the rate structure (of significant interest to trade and industry concerned about the likely hike in tax burden) was also addressed promptly.

Appropriate sequencing appears to be the first reason that enabled steady progress with no major roadblocks experienced. Also, the results achieved were fairly balanced in meeting the expectations of State governments and the tax payers. Interestingly, the Chair did not force the conclusion of issues or impose his views on members, preferring to discuss threadbare the contentious issues having divergent views. Secondly, if agreement could not be reached, they were parked or deferred giving participants the time to ruminate over different positions and hold informal discussions behind the scenes to obtain consensus. Inter-sessional discussions among officials also helped ease and hasten the process. This gentle approach of 'nudging' the Council members to converge to a common position lent ownership and durability to the consensual decisions. The third, of course, was the Chair's readiness to make meaningful concessions for achieving consensus. These are very critical lessons in public policy-making as also in 'negotiations' involving large groups.

Compensation Conundrum

Based on their previous experiences of delays in CST and GST compensation, several States had grave misgivings about the adequacy and automaticity of compensation even in the first round of GST discussions pre-2014. This continued to be a cause of concern, since the States felt that while the Centre had non-GST avenues for revenue augmentation and retaining 'sovereignty' in those spheres, the States were being made to give up their freedom to levy and collect taxes almost completely. There was a fear that the switch to GST would cause a loss of revenue in the initial years when compliance would not be satisfactory. Another argument was that owing to its destination-based nature, the advanced, industrial States were apprehensive that revenues would shift away from them in favour of the consuming States. These net exporting States were major voices in the GST Council debates who carried enough weight to thwart consensus, if not resolved to their satisfaction. As such, the issue of compensation was taken up in the 1st meeting of the GST Council held on 22-23rd September, 2016. It was agreed that the base year for computing compensation would be 2015-16 - a 'normal' year; all taxes and cesses levied by the States and subsumed in GST should be included in the base year kitty; and that compensation would be released quarterly against actual collection figures reported by the Central accounting authority. However, the projected rate of growth to be used for computing the compensation amount could not be agreed upon and was left undecided.

These threads were picked up at the 3rd Council meeting on 18-19th October, 2016 along with some of the more difficult issues surrounding compensation. The States had been demanding that for calculating the base year revenue, CST revenue should be calculated notionally at 4% (the operative rate before its reduction to 2% in preparation of GST). While, this request was finally not agreed to, there were other balancing factors. So, it was decided that for the base year revenue calculation, Special Category States would be allowed to include revenue foregone owing to area-based exemptions and octroi revenue would also be included as requested by Maharashtra. But what really sealed the compensation deal was the Central Government offer, at this meeting,

of a very generous nominal rate of growth of 14%, a good 2-3 percentage points above the nominal GDP growth rate for FY 2017. It was also higher than the 12% rate suggested by some of the States, in the midst of expectation of deceleration in GDP growth in the coming years. Against this background, the offer of 14% assured revenue growth for five years was a deal-clinching proposition, soothing the nerves of anxious State governments. It also helped to pave the way for future discussions.

Of course, when the draft Compensation law was discussed in the 7th Council meeting held on 22-23rd December, 2016, there was a spirited debate about whether the revenue for compensation should be raised through a cess or borne by the Centre out of its own resources from corporate tax, personal income tax, etc., with the former being approved. Among other issues discussed, selection of goods or services for imposition of cess, the principles guiding this selection, and rate of Cess that would be sufficient to bridge the anticipated gap without imposing too heavy a burden on consumers, were important.

It was agreed that Cess would be levied on a narrow basket of 'luxury' and 'demerit' goods (pan masala, aerated drinks, luxury cars, coal, peat and lignite and tobacco), making it least burdensome for consumers. In addition, these were items that attracted pre-GST rates of tax higher than the demerit rate of GST of 26% proposed at that time. Cess collected would be parked in Public Account rather than the Consolidated Fund of India; and compensation would be paid on a monthly basis (instead of quarterly as earlier proposed) to the States that experience a shortfall. States had also expressed concerns about a possibility that the cess revenue collection may, at times, fall short of the amount required to fully bridge the revenue gap of the States. After detailed deliberations, it was decided that it was best left to the wisdom of the GST Council to take an appropriate decision, if and when such an eventuality arose.

Detailing of the Rate structure

Another significant feature that attracted significant debate was deciding the rate structure, which, commenced at the 3rd Council meeting held on 18-19th October, 2016. Based on computations by the National Institute of Public Finance and Policy (NIPFP), the Chief Economic Advisor, the Thirteenth Finance Commission as well as international comparisons, the Council recognised that the standard rate of GST would have to settle between 15-18%. Another important question was the number of rates that would be optimal. At the 4th Council meeting it was agreed that having a single or dual rate structure would not be feasible in the Indian context, as it would mean either a very sharp reduction or increase in rates to ensure revenue neutrality. It was for this reason that linking the rate structure to the pre-GST incidence of taxes was preferred. Taking into account the taxes subsumed into GST and the fact that Central revenues of Rs 4.42 lakh crore and State revenues of Rs 4.40 lakh crore needed to be protected, it was proposed and agreed that the standard rate(s) for goods could be 12% and 18%, with a merit rate of 6% and a demerit rate of 26%. All services, it was proposed, would be taxed at a uniform rate of 18%.

In proposing these rates, the major considerations were the incidence of taxes

(combined for Central Excise, Service Tax & Value-Added Tax, as also the impact of cascading) on goods and services pre-GST, the likely inflationary impact of revised rates and the need to raise resources for compensation. It was also a concern that the rate structure should not be regressive, with items of mass consumption attracting a moderate tax burden. Two important concerns raised by the States were that the GST should not have an inflationary impact; and that in case the tax incidence on some items (such as luxury or demerit goods for which the highest rate of 26% was being proposed in lieu of much higher pre-GST rates) was lowered, trade and industry may not pass on the benefit to consumers, a concern that resulted in incorporation of stringent anti-profiteering provisions in the GST law). In this context, the debate also involved the question of whether it may be better to have a higher rate of GST rather than a cess for such goods. Doubts were also raised about the Constitutional feasibility of levying Cess on GST after the recent amendments. This debate was resolved by acknowledging that the imposition of a higher rate of GST, instead of a Cess, would require much greater tax effort for collecting the same amount needed for compensating the States. This is because collections from a higher rate of GST would need to be shared between the Centre and the States, while Cess collections could be used exclusively for compensation purposes, thereby placing a lighter burden on the consumers. At the 3rd meeting, the Council approved the proposal of having a three-tier rate structure (with two standard rates of 12% and 18%) but discussion on categorization of items under the two rates was left to be decided in future on the basis of the recommendations of the Fitment Committee of officers already tasked with the job.

The work of the Fitment Committee was taken up at the 4th Council meeting held on 3-4th November, 2016. The logic of the proposed rate structure was explained thus: rate of 6% ad valorem was being proposed for items that attracted a pre-GST incidence of 3-9%; the first standard rate of 12% for items having a pre-GST incidence of 9-15%; the second standard rate of 18% for items with an incidence ranging from 15 to 21%; and the highest band of 26% for those with incidence exceeding 21%. Some members suggested that a formulaic approach to fixing of rates was not desirable. In response to this, the Council directed the Fitment Committee of officers to keep in mind the social and economic realities when slotting items that attracted a pre-GST incidence exceeding 21%. Some States questioned the wisdom of enhancing the VAT rate of 5% applicable to many items (that were exempt from Central Excise duty) to 6% and the simultaneous lowering of incidence on demerit or luxury goods clearly attracting an incidence of 28% or more (Central Excise duty of 14.5% and VAT of 12.5%) to 26%. They also proposed that there should be another slab of 40% for the latter.

It was their proposal that compensation cess could apply to luxury cars, aerated drinks, pan masala and tobacco products over and above the rate of 40%. The Council accepted the suggestion to maintain the lower slab at 5% (instead of the proposed 6%) and enhance the demerit rate from 26% to 28%. However, the idea of having another demerit rate of

40% was not accepted on account of poor optics assessment that such a structure, with extremely high tax incidence, would encourage tax evasion. There was near unanimity that some sensitive items of mass consumption such as food grains that were fully exempt from VAT and also not chargeable to Central Excise, should continue to be exempt. While the rate structure was approved, the Council directed the Fitment Committee to carry out the exercise of actually slotting individual items into these slabs and to revert with their recommendations in this regard. The Council deferred a decision on the rate of tax applicable to gold.

Putting in place the legal and IT infrastructure

In the run up to its introduction, draft model GST law comprising the Central GST law, State GST law, UT GST law, Integrated GST law, and Compensation Cess law needed to be approved by the Council. To ensure that the IT infrastructure, including software and hardware, needed to operationalise the working of GST for the Central and State Governments, were ready as an interface for trade , some of the key business processes had to be finalised. As such, draft rules on registration, payment, returns, refunds and invoices were approved at the 2nd meeting in September, 2016 itself. The discussions on model laws had to await their drafting by officer level Committees. Most of the provisions were approved by the 7th meeting in December, 2016, but final approval for these laws and salient rules relating to registration, returns, payments, input tax credit, valuation, transitional provisions, composition etc. was given only by March 2017.

This left little time for finalisation of the software for the originally planned implementation by 1st April, 2017. In addition, the Council had to regularly review the IT preparedness for the launch, a task assigned to the GSTN. While business process modules in the IT system had to await the finalisation of law, rules and procedures, GSTN had already begun work on the migration of existing Central Excise, Service Tax and VAT taxpayers onto the GSTN platform. Further, it had to open its system for registration for new taxpayers well before the revised implementation date of 1st July, 2017. The front loading of approvals for registration, return filing, payments, and refunds by the Council helped in timely completion of these arrangements

Conclusions and prevailing challenges

GST was not an incremental but a transformative reform, which was paved through the tax reforms in the preceding decade, which went a long way towards preparing the technical and cultural soil for its introduction. Characterised as a Good and Simple Tax by the Prime Minister at the time of its launch, it has delivered on several of its perceived objectives, especially the unification of the national market and establishment of a seamless ITC mechanism with minimal cascading. By doing so, it has improved the competitiveness of Indian goods and services in global markets through more complete neutralisation of domestic taxes on exports. One of its biggest achievements has been its positive impact on domestic logistics and the seamless movement of goods across State borders. By minimising the physical interface

between the taxpayer and tax officials through robust IT-based business processes and clearly assigning jurisdiction to a single tax authority, this new tax regime has ushered in an era of considerable Ease of Doing Business.

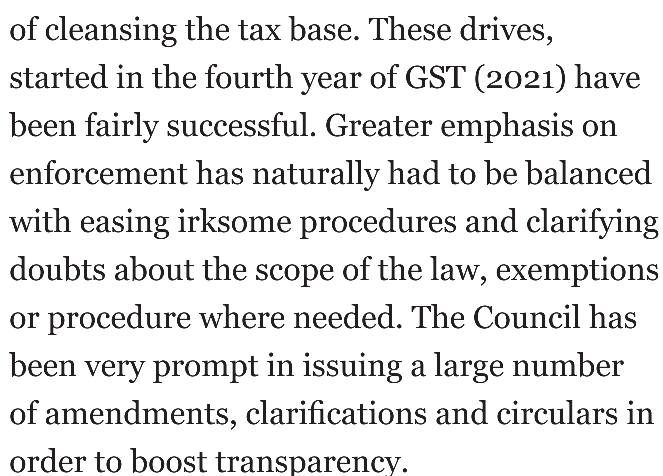
These factors appear to have contributed to some degree of formalisation of the Indian economy and a concomitant expansion of taxpayer population over the last five to six years. Starting with a taxpayer base of approximately 45 lakh taxpayers, the base has now grown to 1.40 crore.

However, as with any transformative reform of this magnitude, the initial period of GST implementation faced a fair amount of turbulence owing to technology glitches (basically inadequate load-bearing capacity of IT infrastructure causing frequent outages), complicated return formats and lack of clarity on the rate/ exemption applicable to certain categories of goods and services. Taxpayers also faced difficulties in obtaining registrations and subsequently in claiming both ITC and export refunds. In many cases, taxpayers could not file claims of transitional ITC in a timely manner. This called for a fair amount of alacrity on the part of GST Council in resolving these difficulties through timely and urgent clarifications, circulars and amendments.

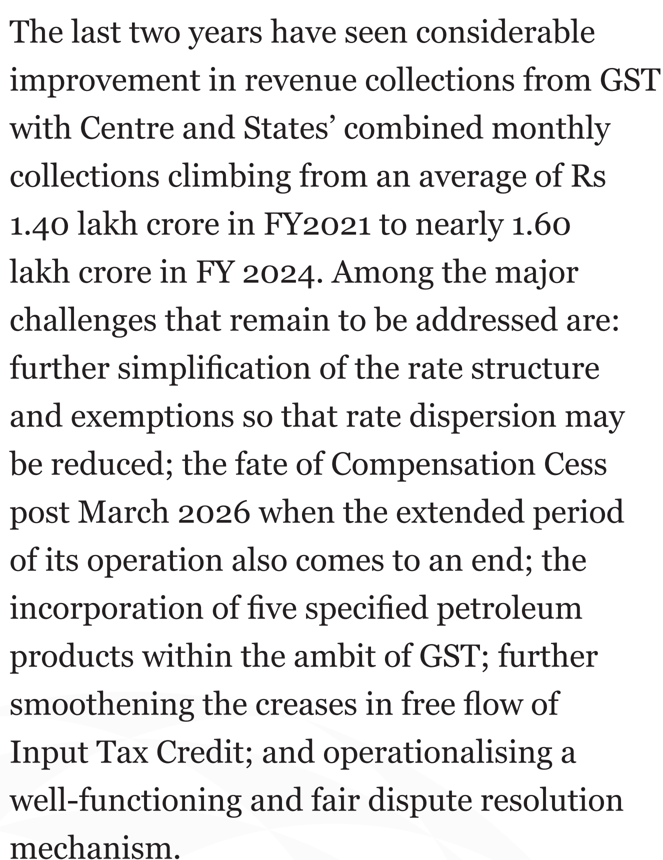
Apart from operational issues, the Council had to reset rates of tax so as to moderate them on a large number of items in two rounds in 2018 and 2019 in the wake of a large number of representations from several industry segments. Low revenue productivity of GST in the initial years also contributed to this negativity. In the interest of speedy decision-making, the Council not only met frequently during this phase but also set up a GST Implementation Committee of officers from the Central and State Governments to take decisions in any exigency in between meetings of the Council which could then be placed before the Council for approval. This contributed immensely in improving the responsiveness of the system in tackling operational concerns/ problems raised by the trade, industry as well as State or Central tax administrations.

The initial period also saw a weak compliance and growing menace of fake billing or fake ITC through the creation of bogus, non-existent entities. This was an expected fallout due to the way the system was designed to keep the barriers to entry for new taxpayers to GST at a very low level, as an Ease of Doing Business initiative. In this phase, registration of new taxpayers was time-bound with minimal interventionist checks, especially physical verification of premises often resorted to by tax administrations in risky cases. The injection of bogus ITC into the chain obviously compromised the revenue efficiency through inflation of ITC claims and even its monetisation through the refund mechanism-the latter especially in the case of exports.

Over the years attempts have been made to tighten legal provisions pertaining to misuse of ITC scheme, verification procedures for new registrants (or even existing ones) and checks to be carried out before granting refunds in high-risk cases with the approval of the Council to identify and flush out bogus entities from the system as also to prevent the entry of new ones. These changes were supplemented by specific enforcement drives undertaken by the two tiers of Government, sometimes in unison and often independently to fulfil the objective



of cleansing the tax base. These drives, started in the fourth year of GST (2021) have been fairly successful. Greater emphasis on enforcement has naturally had to be balanced with easing irksome procedures and clarifying doubts about the scope of the law, exemptions or procedure where needed. The Council has been very prompt in issuing a large number of amendments, clarifications and circulars in order to boost transparency.



The last two years have seen considerable improvement in revenue collections from GST with Centre and States' combined monthly collections climbing from an average of Rs 1.40 lakh crore in FY2021 to nearly 1.60 lakh crore in FY 2024. Among the major challenges that remain to be addressed are: further simplification of the rate structure and exemptions so that rate dispersion may be reduced; the fate of Compensation Cess post March 2026 when the extended period of its operation also comes to an end; the incorporation of five specified petroleum products within the ambit of GST; further smoothening the creases in free flow of Input Tax Credit; and operationalising a well-functioning and fair dispute resolution mechanism.

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