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GOVERNMENT OF INDIA

Committee headed by the Chief Economic Adviser Dr. Arvind Subramanian on Possible Tax rates under GST submits its Report to the Finance Minister; On the Revenue Neutral Rate (RNR), the Committee recommends the same in the range between 15 percent and 15.5 percent (Centre and states combined) with a preference for the lower end of that range based on the analysis made in the Report

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Committee headed by the Chief Economic Adviser Dr. Arvind Subramanian on Possible Tax rates under GST submitted its Report to the Finance Minister here today. The Committee in its concluding observations has stated that this is a historic opportunity for India to implement a game-changing tax reform. Domestically, it will help improve governance, strengthen tax institutions, facilitate "Make in India by Making One India," and impart buoyancy to the tax base. It will also set the global standard for a value-added tax (VAT) in large federal systems in the years to come.

Following are the highlights of the Executive Summary of the Report submitted today:

The GST has been an initiative that has commanded broad consensus across the political spectrum. It has also been a model of cooperative federalism in practice with the Centre and states coming together as partners in embracing growth and employment-enhancing reforms. It is a reform that is long awaited and its implementation will validate expectations of important government actions and effective political will that have, to some extent, already been "priced in."

Getting the design of the GST right is, therefore, critical. Specifically, the GST should aim at tax rates that protect revenue, simplify administration, encourage compliance, avoid adding to inflationary pressures, and keep India in the range of countries with reasonable levels of indirect taxes.

There is first a need to clarify terminology. The term revenue neutral rate (RNR) will refer to that single rate, which preserves revenue at desired (current) levels. In practice, there will be a structure of rates, but for the sake of analytical clarity and precision it is appropriate to think of the RNR as a single rate. It is a given single rate that gets converted into a whole rate structure, depending on policy choices about exemptions, what commodities to charge at a lower rate (if at all), and what to charge at a very high rate. The RNR should be distinguished from the "standard" rate defined as that rate in a GST regime which is applied to all goods and services whose taxation is not explicitly specified. Typically, the majority of the base (i.e., majority of goods and services) will be taxed at the standard rate, although this is not always true, and indeed it is not true for the states under the current regime.

Against this background, the Committee drew a few important conclusions.

- Because identifying the exact RNR depends on a number of assumptions and imponderables; because, therefore, this task is as much soft judgement as hard science; and finally also because the prerogative of deciding the precise numbers will be that of the future GST Council, this

Committee has chosen to recommend a range for the RNR rather than a specific rate. For the same reason, the Committee has decided to recommend not one but a few conditional rate structures that depend on policy choices made on exemptions, and the taxation of certain commodities such as precious metals.

The summary of recommended options is provided in the table below.

Summary of Recommended Rate Options (in percent)

RNR	**Rate on precious metals**	**"Low" rate (goods)**		**"Standard" rate (goods and services)**	**"High/Demerit" rateor Non-GST excise (goods)**
Preferred	15	6	12	16.9	40
		4		17.3	
		2		17.7	
Alternative	15.5	6	12	18.0	40
		4		18.4	
		2		18.9	

All rates are the sum of rates at center and states

- On the RNR, the Committee's view is that the range should between 15 percent and 15.5 percent (Centre and states combined) but with a preference for the lower end of that range based on the analysis in this report.
- On structure, in line with growing international practice and with a view to facilitating compliance and administration, India should strive toward a one-rate structure as the medium-term goal.
- Meanwhile, the Committee recommends a two-rate structure. In order to ensure that the standard rate is kept close to the RNR, the maximum possible tax base should be taxed at the standard rate. The Committee would recommend that lower rates be kept around 12 per cent (Centre plus states) with standard rates varying between 17 and 18 per cent.
- It is now growing international practice to levy sin/demerit rates—in the form of excises outside the scope of the GST--on goods and services that create negative externalities for the economy. As currently envisaged, such demerit rates—other than for alcohol and petroleum (for the states) and tobacco and petroleum (for the Centre)—will have to be provided for within the structure of the GST. The foregone flexibility for the center and the states is balanced by the greater scrutiny that will be required because such taxes have to be done within the GST context and hence subject to discussions in the GST Council. Accordingly, the Committee recommends that this sin/demerit rate be fixed at about 40 percent (Centre plus states) and apply to luxury cars, aerated beverages, paan masala, and tobacco and tobacco products (for the states).
- This historic opportunity of cleaning up the tax system is necessary in itself but also to support GST rates that facilitate rather than burden compliance. Choices that the GST Council makes regarding exemptions/low taxation (for example, on gold and precious metals, and area-based exemptions) will be critical. The more the exemptions that are retained the higher will be the standard rate. There is no getting away from a simple and powerful reality: the broader the scope

of exemptions, the less effective the GST will be. For example, if precious metals continues to enjoy highly concessional rates, the rest of the economy will have to pay in the form of higher rates on other goods, including essential ones. As the table shows, very low rates on precious metals would lead to a high standard rate closer to 20 percent, distorting the economy and adding to inflationary pressures. On the other hand, moderately higher taxes on precious metals, which would be consistent with the government's efforts to wean consumers away from gold, could lead to a standard rate closer to 17 percent. This example illustrates that the design of the GST cannot afford to cherry pick—for example, keeping a low RNR while not limiting exemptions--because that will risk undermining the objectives of the GST.

- The GST also represents a historic opportunity to rationalize the tax system that is complicated in terms of rates and structures and has become an "Exemptions Raj," rife with opportunities for selectivity and discretion. Tax policy cannot be overly burdened with achieving industrial, regional, and social policy goals; more targeted instruments should be found to meet such goals, for example, easing the costs of doing business, public investment, and direct benefit transfers, respectively; cesses should be reduced and sparingly used. Another problem with exemptions is that, by breaking up the value-added chain, they lead in practice to a multiplicity of rates that is unpredictable, obscured, and distortionary. A rationalization of exemptions under the GST will complement a similar effort already announced for corporate taxes, making for a much cleaner overall tax system.
- The rationalization of exemptions is especially salient for the center, where exemptions have proliferated. Indeed, revenue neutrality for the center can only be achieved if the base for the center is similar to that of the states (which have fewer exemptions—90 products versus 300 for the center). If policy objectives have to be met, instruments other than tax exemptions such as direct transfers could be deployed.
- The Committee's recommendations on rates summarized in the table above are all national rates, comprising the sum of central and state GST rates. How these combined rates are allocated between the center and states will be determined by the GST Council. This allocation must reflect the revenue requirements of the Centre and states so that revenues are protected. For example, a standard rate of 17% would lead to rates at the Centre and states of say 8 percent and 9 percent, respectively. The Committee considers that there are sound reasons not to provide for an administration-complicating "band" of rates, especially given the considerable flexibility and autonomy that states will preserve under the GST (including the ability to tax petroleum, alcohol, and other goods and services).
- Implementing the GST will lead to some uncharted waters, especially in relation to services taxation by the states. Preliminary analysis in this report indicates that there should not be large shifts in the tax base in moving to the GST, implying that overall compensation may not be large. Nevertheless, fair, transparent, and credible compensation will create the conditions for effective implementation by the states and for engendering trust between the Centre and states; The GST also represents a historic opportunity to Make in India by Making One India. Eliminating all taxes on inter-state trade (including the 1 percent additional duty) and replacing them by one GST will be critical to achieving this objective;
- Analysis in the report suggests that the proposed structure of tax rates will have minimal inflationary consequences. But careful monitoring and review will be necessary to ensure that implementing the GST does not create the conditions for anti-competitive behavior;
- Complexity and lags in GST implementation require that any evaluation of the GST—and any consequential decisions—should not be undertaken over short horizons (say months) but over longer periods say 1–2 years. For example, if six months into implementation, revenues are seen to be falling a little short, there should not be a hasty decision to raise rates until such time as it becomes clear that the shortfall is not due to implementation issues. Facilitating easy implementation and taxpayer compliance at an early stage—via low rates and without adding to

inflationary pressures--will be critical. In the early stages, if that requires raising other taxes or countenancing a slightly higher deficit--that would be worth considering.

- Finally, the report has presented detailed evidence on effective tax burdens on different commodities which highlights that in some cases they are inconsistent with policy objectives. It would be advisable at an early stage in the future, and taking account of the experience of the GST, to consider bringing fully into the scope of the GST commodities that are proposed to be kept outside, either constitutionally or otherwise. Bringing alcohol and real estate within the scope of the GST would further the government's objectives of improving governance and reducing black money generation without compromising on states' fiscal autonomy. Bringing electricity and petroleum within the scope of the GST could make Indian manufacturing more competitive; and eliminating the exemptions on health and education would make tax policy more consistent with social policy objectives.

There is a legitimate concern that policy should not be changed easily to suit short term ends. But there are enough checks and balances in the parliamentary system and enough pressures of democratic accountability to ensure that. Moreover, since tax design is profoundly political and contingent, it would be unwise to encumber the Constitution with the minutiae of policy that limits the freedom of the political process in the future: the process must retain the choice on what to include in/exclude from the GST (for example, alcohol) and what rates to levy. The credibility of the macroeconomic system as a whole is undermined by constitutionalising a tax rate or a tax exemption. Setting a tax rate or an exemptions policy in stone for all time, regardless of the circumstances that will arise in future, of the macroeconomic conditions, and of national priorities may not be credible or effective in the medium term. This is the reason India—and most credible polities around the world--do not constitutionalise the specifics of tax policy. The GST should be no different.

The nation is on the cusp of executing one of the most ambitious and remarkable tax reforms in its independent history. Implementing a new tax, encompassing both goods and services, to be implemented by the Centre, 29 States And 2 Union Territories, in a large and complex federal system, via a constitutional amendment requiring broad political consensus, affecting potentially 2-2.5 million tax entities, and marshalling the latest technology to use and improve tax implementation capability, is perhaps unprecedented in modern global tax history. The time is ripe to collectively seize this historic opportunity.

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