Convocation Address at Indira Gandhi Institute of Development Research

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Honourable Governor Dr. D. Subba Rao, distinguished Director of the Indira Gandhi Institute of Development Research Professor D.M. Nachane, Members of the faculty, students, Ladies and Gentlemen,

1. I am honoured by your invitation to give the Convocation address at this globally renowned Institution. I convey my warm congratulations to all successful candidates and extend my best wishes for their new and exciting professional career. You have chosen to work in one of the most valued social sciences and I say to you all **"शुभास्ते पन्थानः सन्तु".**

2. My own professional career has been that of a policy economist. I therefore propose to stick to my comparative advantage and focus on a specific but key economic policy issue – relating to fiscal reform—in the hope that this will illustrate the vast potential that exists for using our professional skills to improve the economic fortunes of India, even as the storm clouds of recession gather. In fact, it is my firm view that the acceleration of reforms including fiscal reforms is the surest way to successfully meet today's profoundly difficult economic challenge.

3. The design and alignment of multiple tax system in large federations like India is perhaps the most important policy challenge for public finance professionals. Across three levels of government, i.e. central, state and local government each with definite but overlapping constitutional mandates, economic agents face a myriad of taxes, levies and user fees. Tax regimes that operate at cross purposes undermine desirable incentive structures and impose added transaction costs on all economic agents. Improving the efficiency of a tax system in a federation can significantly lower the tax burden on all factors of production without the need to lower revenues accruing to government that rate cuts or tax expenditures almost inevitably imply. A unified tax system is also a necessary condition for a common market to exist; this permits free and unimpeded movement of goods and services across a federation thus encouraging efficient regional specialization. This also enables the economy to accrue the benefits of increasing returns particularly in the modern sector of the economy. Finally tax reforms can significantly lower the costs of doing business; firms can decide on the appropriate level of vertical and horizontal integration based on a business case and not as is often the case in India,

for tax planning. For these reasons, it is well worthwhile putting time, effort and resources into improving the design efficiency of the tax system.

4. For personal and corporate income taxes, there is a close relationship between the federal and provincial systems. In India, these taxes are levied and collected by the Centre and their vertical and horizontal distribution is determined by the Finance Commissions in accordance with our Constitution. The same is also true of taxes on international trade. In the Indian context there is the greatest dissonance in the realm of taxes on goods and services. I will today argue the case for a "grand bargain' between different units of the Indian Federation as well as relevant stakeholders like businesses, consumers and suppliers of factors of production, to harmonise the system of indirect taxes on goods and services. This harmonisation will significantly reduce the vertical imbalance between the Centre and the States by enhancing the tax base of the States. This will also bring very significant macroeconomic benefits. The instrument to secure this is the Goods and Services Tax or GST, which is proposed to be introduced in India from April 1, 2010. To my mind, the introduction of GST would be the single biggest measure after the elimination of licensing in 1991. In fact, this could also provide the requisite stimulus to the economy during the present economic slow down.

5. The GST is in essence a simple broad based form of taxation. Businesses are assessed taxes on the total value of their sales but receive credit for the taxes paid by their suppliers. In this way, only the incremental value added at each stage of production is taxed. Consumers pay the tax on final goods and services purchased. In terms of the national economic identity, therefore, a tax is levied on that part of value added which is consumed. Exports are "zero rated' as in competitive international markets you cannot export taxes!

6. As economists, it is important that we carefully understand the theoretical case for a GST. The case is straightforward; Income is taxed irrespective of source and use; if consumption is to be taxed, then the same principle should apply. This minimises the distortions in the economic choices of agents. This is the feasible second-best solution, compared to the unattainable first best distortion-free world of lumpsum taxation. However, there are analytical objections to accepting this breathtakingly simple analytical proposition. Let me give you an example.

7. Critics of the GST often aver that according to the theory of optimal taxation, tax rates should *not* be uniform. They should, rather vary inversely with the elasticity of demand for particular goods and services, and tax rates should be higher on products that are complementary with leisure that cannot be taxed directly. The important thing to remember is that this works in a world where it is possible to implement optimal tax reforms without any residual distortions caused by successful attempts at incidence shifting i.e. when we are in the 'first best' world. But, this is not the world in which we live; in addition, the representative consumer assumption that operates an optimal tax model is not just invalid, but very problematic in the political economy of a democratic polity. Consider this: the demand for the food grains is less elastic than the demand for air-conditioners, but food grains are consumed relatively much more by the poor. In such case, it is clear that the regressive policy implications of implementing the theory of optimal taxation would be unacceptable to our polity. In addition, econometric estimates of relative elasticities differ hugely, leaving the door open for lobbyists and special pleading. Hence, the principle remains valid that all consumption should be taxed uniformly without regard to source and use.

8. In real world, interesting question is what are the principles that a well designed GST should embody? Prof. Charles MClure identifies six characteristics of a well designed GST in the federal system. The first two are important for economic reasons; the third for administrative reasons and the fourth for political reasons, the last two come into play in a system of multilevel finance such as we have in our country. These principles are:

- Uniform rate of taxation within a given jurisdiction, ideally at a single rate
- Sales would be taxed under the destination principle.
- Low costs of compliance and administration
- Each level of government to set its own tax rate subject to agreed ceilings and/or floors
- A substantively Common tax base for Central and State governments
- Substantial Co-operation in tax administration between all levels of government

In India, in designing the GST, we will also need to ensure minimum exemptions, limiting exemptions to goods such as essential food and medicines.

9. With the above principles in place, a flawless GST emerges as a hugely attractive policy option in the Indian context. The present economic crisis portends a huge challenge; the only "gain without pain" will come if we can improve efficiency of the economy and thereby our productivity and international competitiveness. In an open economy, international competitiveness implies improving the efficiency of our domestic industry vis-a-vis imports and of our exports vis-a-vis our international competitors and this the GST will help our economy to achieve.

10. One of the most important factors adversely affecting our competitiveness is the present indirect tax system. High import tariffs, excises and turnover tax on domestic goods and services have enormous cascading effects, leading to a distorted structure of production, consumption and exports. The existing tax system introduces myriad distortions which favour some goods and services at the expense of others. Manufacturing sector, thanks to the levels and cascading of indirect taxes is so highly taxed that India is an outlier in terms of taxation. Conversely, services tend to be significantly under-taxed in India. These distortions yield inefficient resource allocation, and come at the price of inferior GDP growth. This is one of the important reasons why in India the share of manufacturing sector in the total GDP is one of the lowest amongst all the dynamic emerging market economies. Such distortions in our tax system is also affecting adversely in achieving an acceleration of growth of manufacturers particularly labour-intensive manufacturers which are so needed to meet the oncoming challenge of providing productive employment at growing numbers.

11. A well designed destination-based GST on all goods and services is the most elegant method of eliminating distortions and taxing consumption. Under this structure, all different stages of production and distribution can be interpreted as a mere tax pass-through, and the tax essentially 'sticks' on final consumption within the taxing jurisdiction.

12. Introducing GST will do more than simply redistribute the tax burden from one sector or group in the economy to another. The introduction of the GST brings about a macroeconomic dividend as it reduces the overall incidence of indirect taxation and therefore the overall tax burden by removing the many distortionary features of the present sales tax system. There are four important macroeconomic channels through which this happens:

a) ***First***, the failure to tax all goods and services distorts consumption decisions; it weakens the signaling power of relative prices. GST reduces these distortions and enables all economic agents to respond more effectively to price signals

b) ***Second***, the unrefunded taxation of capital goods discourages savings and investment and retards productivity growth. This is perhaps the most important gain through introduction of GST in an emerging economy like India.

c) ***Third***, for a given constellation of exchange rates and price levels, violation of the destination principle places local producers at a competitive disadvantage, relative to producers in other jurisdictions. and

d) ***Fourth***, differences in tax bases of different States and the Central government, greatly increase costs of doing business. This is a league table in which we have long languished at the bottom. The GST based tax reform provides a real policy opportunity to do something about this problem without waiting for prior and sweeping political economy changes.

13. This is a cutting edge policy issue in the present economic context of India. The Report of the Task Force on Implementation of the Fiscal Responsibility and Budget Management Act, 2003 recommended the introduction of a comprehensive dual goods and services tax to be levied on a common base by both the Centre and the State. This levy was intended to subsume all indirect taxes levied by both the Centre and the State. The macroeconomic gains from this reform were to provide the wherewithal for the "grand bargain." This recommendation was accepted by Government and the Union Budget 2006 stipulated that the Central Government will collaborate with the States to introduce a comprehensive Goods and Services Tax on 1st April, 2010. The Empowered Committee of the State Finance Ministers have since then made considerable progress on finalising the design of the GST. The Central Government has also agreed in principle to the design. The Thirteenth Finance Commission is charged with assessing the impact of GST on the fiscal position of all units of the Federation, including the impact on foreign trade. It is already clear that a well designed revenue neutral GST will enhance the revenue buoyancy of the States in future years. This will also be a major structural correction in our country's intergovernmental revenue assignments, thereby reducing vertical imbalance between the Centre and the States. We in India should be grateful to the Empowered Committee of Finance Ministers for this contribution towards strengthening India's federal system. In the coming months, they will finalise the design of the GST. I hope they will ensure –

a. Minimum number of rates and minimum exemptions so as to achieve widest possible tax base; and
b. Removal of distorting state taxes such as entry tax, octroi, high stamp duties etc by subsuming them in the GST.

This will help to achieve reasonably low GST rates ensuring nation-wide acceptability, high compliance and revenue gains to all members of the federation.

14. From a policymaker's perspective, the macroeconomic benefits of GST in the Indian context are clear. GST once introduced will create a common market across the length and breadth of the country, something which has eluded us since long. There will without doubt also be a reduction in the overall tax burden. At present, the combined statutory rate of VAT is close to 30 per cent. This marginal rate is applied to a very narrow base. As a result the effective rate is extremely low. Since economic decisions and compliance behaviour are based on the marginal rate, the higher the rate the greater the distortion and evasion. Our preliminary research indicates that the effective revenue neutral rate at which GST can be implemented will be far lower than 30 per cent, indicating a significant reduction in the effective tax burden on our economic agents. Consequent to alignment with the lower effective rate, we can also expect an upsurge in compliance as has been witnessed in the case of direct taxes.

15. There are also benefits to foreign trade that can be reasonably expected. At present, export of taxes to other countries is sought to be eliminated through the mechanism of duty draw back on the basis of estimated incidence of embedded taxes. This scheme is far from satisfactory. The comprehensive GST will fully eliminate export of taxes and improve international competitiveness. This would considerably help to increase the production and exports of labour-intensive manufacturers as well as employment in our economy.

16. Analyzing the economy wide effects of indirect tax reform requires a model that can quantify the magnitude of the benefits to the macro economy from reducing the distortions I have just listed. The most appropriate approach for this type of analysis is Computable General Equilibrium modeling. As you begin your career as professional economists, I would encourage you to pursue this extremely promising line of research in the area of macroeconomics and public finance in the Indian context. There is a long tradition of such research in Canada. In his CGE model based study of the impact of GST in Canada, Prof. Hamilton showed that a well implemented GST reforms would increase the real output of the Canadian economy by 1.4 per cent of GDP, principally through an increase in the productivity of capital and total factor productivity. The extent of change in real output, of course, varies by sector; in Canada, transportation and utilities, services and agriculture experienced significant gains. There were also substantial gains to provinces that were below average in per capita income but which had a large collective, marginal propensity to consume. The gains were of an order of magnitude that permitted a "grand bargain" – a Pareto efficient outcome, to collectively benefit from the macroeconomic dividend that the introduction of GST provided.

17. Considering the high level of distortions extant in the Indian indirect tax system, one can argue that in India the real output effect of a well designed and properly implemented GST would be at least 1.4 per cent of the GDP that was found in Canada; and this amounts to US $15 billion annually, implying that the economic value of these GST reforms would, at a modest 3 per cent discount rate, be close to half a trillion dollars or 50% of the country's present GDP. More importantly, this means potentially creating an additional productive employment of as much as 4 to 5 million. There are indeed spectacular returns from a policy reform. It is for this reason that I said earlier, that the introduction of GST would be a reform measure whose economic impact would compare with that of the elimination of licensing in 1991. The benefits would accrue to all units of the Federation and also improve vertical balance in our federal finance. By sharing the GST revenues, the finances of the third tier of government can be significantly strengthened and with such strengthened fiscal base, our cities and towns will become much better places to live, work and enjoy.

My fellow economists,

18. I have today tried to give you a flavor of the exciting times you live in as you complete your professional training and put your formidable – and now tested – applied and policy skills to use. I hope my exploration of a specific fiscal reform challenge –indirect tax reform – has shown how important it is that your skills, acuity and professional training be available not just in the marketplace of ideas, but also in the toolroom of policy reforms. It is here that you can make a professional difference to the welfare of the citizens of this country, and I can assure you that there is no more rewarding terrain to forge your professional careers. I look forward to our continued professional association and wish you every success.