

Goods and Services Taxes Regimes: Public Interest, Cascading and Price-Distortions

SYNOPSIS

It is assumed that an economy consists of the flow of the values of goods and services in one direction, and the balancing reverse flow of the money-incomes of the suppliers of the goods and services. It is argued that a self-contained 'State' Policy on the mode of levy of taxes on the flow of values of goods and services supplied through the Market network can be brought to closure only by relating it in the Public Interest to the mode of levy of taxes on the flow of money-incomes of the suppliers and to the mode-(i) of access of the entitled individuals to the supply of subsidized and other public goods and services and/or to cash demo-grants; and (ii) of public procurement of goods and services through the Market network. The argument distinguishes between the implications of Price-Distortions in general and of the Cascading of the Incidence of Indirect Taxes in particular.

'The State' is an institution recognized by the Constitution of India (*vide* Articles 12 and 36) in which all the public authorities are embedded. The set of public interests is elaborated in Part IV of the Constitution and is circumscribed by the provisions relating to Fundamental Rights and to Directive Principles of 'State' Policy enacted respectively in Part III and Part IV. The Government of India has the constitutional responsibility as the *key-stone* authority embedded in 'the State', to invoke the lawful procedure stipulated in Article 263 of the Constitution of India to ensure *coordination of policy and action* focused on any subject of social relevance. Before such procedure is invoked however the Government of India has to make a judgment on whether it would serve *the public interests* for securing which Legislatures are duty-bound constitutionally.

Article 263, however titled, provides as follows:-

263. Provisions with respect to an inter-State Council.—If at any time it appears to the President that the public interests would be served by the establishment of a Council charged with the duty of—

- (a) inquiring into and advising upon disputes which may have arisen between States;
 - (b) investigating and discussing subjects in which some or all of the States, or the Union and one or more of the States, have a common interest; or
 - (c) making recommendations upon any such subject and, in particular, recommendations for the better co-ordination of policy and action with respect to that subject,
- it shall be lawful for the President by order to establish such a Council, and to define the nature of the duties to be performed by it and its organisation and procedure.

Article 263 is the only provision in the Constitution which refers to "policy" (outside Part IV) and to "action". The following provisions in Article 37 relating to the "Directive Principles of 'State' Policy" enacted in Part IV which stipulate fundamental principles of the ***Rule of Law*** with which to guide *lawmaking* and *governance* imply that ***'State' Policy is an integral whole discernible at all times by an accurate interpretation of all the provisions of the law in force:-***

37. Application of the principles contained in this Part.—The provisions contained in this Part (titled "*The Directive Principles of State Policy*") shall not be enforceable by any court, but the principles therein laid down are nevertheless fundamental in the *governance* of the country and it shall be the duty of the State to apply these principles in *making laws*. (words in brackets and italics added).

We infer that the word "reform" denotes the complex constitutional process of *reformulation of 'State' Policy by law-making in accordance with Article 37*. We note that logically mere lawmaking ("*ruling*") has no social use without *action* to solve contemporary social problems by *governance* to implement the 'State' Policy well-focused on every socially relevant *subject* (e.g., a well-recognized problem creating any social disorder) in accordance with the Rule of Law.

It is important to distinguish a "*subject*" of social relevance implied in Article 263 enacted in Chapter II of Part XI of the Constitution from every "*matter*" of legislative competence of the Legislatures referred to in the provisions enacted in Chapter I of that Part, whether any such matter is or is not enumerated in the Lists in the Seventh Schedule. Law relating to any matter may, subject to the provisions enacted in the Constitution, be made *primarily* by any Legislature with the requisite legislative competence it derives from the Constitution, and also by any other authority (e.g., the President; a rural/urban local body) to which power to make law is validly *delegated* in the Constitution or in a statute enacted by a Legislature. Lawmaking may or may not be preceded by the recommendations made by any Council which may be established by invoking Article 263 to serve public interests.

Let us assume that recommendations focused on any subject of social concern are made by a Council after negotiations on behalf of the Union and the States in pursuance of their respective interests in the pursuit of common policy goals between the Government of India and the Governments of the States embedded in 'the State' in accordance with the lawful procedure envisaged in Article 263. Such recommendations would be *treaty-like* and would constrain primary lawmaking relating to any matter not only by every competent State Legislature but also by the Parliament if it invokes its legislative competence otherwise than in accordance with Article 253, in view of the following stipulation in Article 245:-

245. Extent of laws made by Parliament and by the Legislatures of States.—(1) *Subject to the provisions of this Constitution*, Parliament may make laws for the whole or any part of the territory of India, and the Legislature of a State may make laws for the whole or any part of the State. (italics added)

Once reformulated by such procedure, further reformulation of 'State' Policy would have to be subject to the same procedure, without the Courts having to enforce the Directive Principles.

Credible political commitments made on behalf of the competent Legislatures to the collective recommendations of such Council imply that the lawmakers would, in order to fulfill their commitments, have to collectively traverse the political space intervening between every subject of social concern chosen to serve public interests and every relevant matter of legislative competence. Unlike section 135 of the GOI Act 1935 or Article 153 of the 1973 Constitution of Pakistan, **Article 263 enables 'the State' to break free of the pre-Independence rigidities in lawmaking and governance and to evolve as an institution of national life in the Republic.**

We start by stipulating a caveat: Though many arguments in favour of service of public interests in the reformulation of 'State' Policy (a.k.a. "reform") are advanced in this article in the context of the provisions enacted in the Constitution of India, some of them may not apply in case efforts at such reform, in the judgment of the President (i.e., the Government of India), do not *prima facie* relate to public interests to be served by the 'State' Policy on any specific **subject** of social concern *so much as to require* the establishment of a Council-

- 1) to have well-informed expert investigations made into the consequences of adopting any one of the *many possible options* for the **coordination of policy and action** in pursuit of common interest, that is to say, respective interests in the pursuit of a common goal consistent with the Directive Principles;
- 2) to discuss the *projected consequences* of every *candidate option*; and
- 3) to make well-reasoned and binding recommendations based on *credible* political commitments *shared* on behalf of the competent Legislatures to the *second-best* collective-and-transparent-*social choice* of one of the options.

The expert Task-Force on the Implementation of the Fiscal Responsibility and Budget Management Act, 2003 dealing with issues relating to budget-balance noted that the levy of central excises at the "*origin*" of supply had very low buoyancy (0.75). It recommended in 2004 that subject to a Grand Bargain between the Union and the States the indirect taxes regimes ought to transit to regimes for the levy of central and state taxes on the **supplies** of goods and services to be called "**goods and services taxes**" and to be collected at the *destinations* of such supplies. The recommendations are consistent, though only partially, with the easy-to-understand portrayal by R A Musgrave of an economy as consisting of the flow of the values of goods and services in one direction and the complementary reverse flow of the incomes of the suppliers.

Let us now consider the decade-long contemporary efforts by lawmakers which followed *without establishing a Union-States Council by invoking Article 263*. The efforts were initiated by the Ministry of Finance in 2005, in consultation with an "Empowered" Committee of State Finance Ministers *in which the Union is not represented politically*. If so represented the Union and the States would have collectively considered many possible options and the Union would have been able to make credible political commitments to a well-chosen option for reform on behalf of the Parliament in response to political commitments which the States found possible to make. Such commitments would have been focused on a well-chosen socially-relevant subject *in the public interest* and would have been *without the offer and acceptance of any private extra-constitutional inducement*. The efforts have culminated, without clarity on the forthcoming provisions in the tax statutes to be enacted by the Union and the States *even after extensive studies of the tax systems in other countries*, in the introduction of the Constitution (122nd Amendment) Bill, 2014, the *object* of which is to *redefine the respective legislative competences of the Union and the States*, subject to payment of *compensation* (which implies wrong-doing) by the Union to the States and *without any explicit reference to public interest*, for the *reasons* given in the Statement of Objects and Reasons in support of the Bill as extracted below:

The Constitution is proposed to be amended to introduce *the* goods and services tax (i.e., *one set of multiple taxes to be called CGST, IGST and SGSTs*) for conferring concurrent taxing powers on the Union as well as the States including Union territory with Legislature to make laws for levying goods and services tax on *every* transaction of *supply of goods or services or both*. The goods and services tax shall *replace a number of indirect taxes being levied by the Union and the State Governments* and is intended to *remove cascading effect of taxes* and *provide for a common national market for goods and services*. The proposed Central and State goods and services tax will be levied on *all transactions involving supply of goods and services*, except *those which are kept out of the purview of the goods and services tax*.(words in brackets, italics and emphasis in bold added)

The Bill is with a limited reference to the revenue interests of the States mentioned in Article 274 but without reference to any well-chosen prior subject of social concern to be addressed respectively by the Union and the States in the pursuit of common goals to enable 'the State' discharge its constitutional duty stipulated in Article 37 in Part IV. It is ostensibly aimed at enabling removal, at least partly, of the "cascading effect" of many indirect taxes being levied by the Union and the States which is assumed to continue in spite of the series of earlier reforms from 1986 to 2005. In what follows we limit our discussions to this aspect of the Bill and do not consider the aspect of "providing for a common national market for goods and services".

The Bill's aim is contingent on the creation, *without any prior justification as to service of public interests*, of a "Goods and Services Tax Council" which would be obliged to function in accordance with a *new guiding principle of "harmony"* (referred to in section 12 of the Bill). That principle *not being stipulated in Part IV of the Constitution* would not exclude uncertainties owing to the Courts interpreting the recommendations of the Council from time to time since the exclusion by Article 37 of the jurisdiction of Courts would cease to apply . Though every transaction involving "supply of goods and services" is proposed to be subject to the GST levies, some goods are proposed to be kept somehow out of the purview of those levies.

Thus the proposal in the Statement extracted above implies- (i) central and state taxes would eventually be levied on the flow of values of goods and services portrayed by R A Musgrave irrespective of whether or not such goods and services are the subject matters of the *as-yet-undefined* transactions of "*supply of goods and services*"; and (ii) there would be pre-GST regimes of levy of central and state taxes on the flow of the values of *some* goods and services in the economy and post-GST regimes for the levy of central and state taxes on the flow of the values of *other* goods and services in the same economy. Moreover since the proposal is for a "stand-alone", though partial, change in the mode of levy of indirect taxes, the change would not imply any change in the regimes for- (a) the levy of direct taxes on the *incomes* of the entities engaged in businesses and professions which cause such flows in the Market network; (b) the *public procurement* of goods and services supplied through the Market networks which affect such flows; and (c) regulating the access, outside the Market network, of the entitled individuals to the Non-Market supplies of *subsidized and other public goods and services*.

Assuming that there is a *social disorder* to be addressed by reform, there is a significant difference in perceiving the relevant social disorder in general as "*mode-of-governance-induced distortions in the PRICES of goods and services*" and in perceiving such disorder as limited to "*cascading of indirect taxes in transactions involving supplies of some goods and services*" without reference to prices distorted by the regimes of governance of law *other than* the law for the levy of central and state goods and services taxes. Logically, price distortions ought to be measured by comparing prices which would have been agreed to voluntarily by every supplier and every recipient in a *hypothetical* legal regime (which is assumed to levy no direct and indirect taxes and to be otherwise neutral with respect to market-discovered prices of goods and services) on the one hand, with *indirect-tax-inclusive* prices which prevail in the legal regime

under consideration on the other. Typically however prices would be agreed to voluntarily by market participants in a regime of governance enforcing indirect tax law **along with law to levy a set of direct taxes on incomes generated by the units of businesses and professions which cause flow of goods and services in the Market, and to regulate public procurement of goods and services from the Market and the access of the entitled individuals and households to the non-Market supply of subsidized and other public goods and services.**

We proceed to examine the implications of the difference in the foregoing two perceptions. If $a > 0$ is the (*indirect-tax-exclusive*) price that would have been agreed to *in a regime in which no direct and indirect tax is levied, no subsidy can be availed by any entity other than the individual entitled to directly subsidized public goods and services, and there is no tax-exempt public procurement of goods and services from the Market*; $b > 0$ is the *indirect-tax-inclusive* price agreed to by a supplier and a recipient in a regime levying direct and indirect taxes and providing for tax-exempt public procurement and for "indirect" subsidies (including "cross subsidies") in allowing access to public goods and services; and ϵ and t are the mode-of-governance-induced price-distortion and the applicable *ad valorem* rate of indirect tax respectively, it would follow that

$$b = (a + \epsilon)(1 + t).$$

This means $\epsilon = \frac{b}{1+t} - a$. Thus the relationship between price-distortion ϵ and rate of indirect tax t is **non-linear**, inasmuch as ϵ is inversely related to t . The difference between the tax-inclusive and tax-exclusive prices is directly related to t and works out to

$$b - a = (a + \epsilon)t + \epsilon,$$

and such difference, or "incidence" (also referred to as "tax burden"), is **independent of the tax-inclusive price.**

Without reference to any hypothetical no-tax regime or to any regime of public procurement of goods and services from the Market or to the terms of access to public goods and services however, if a is the tax-exclusive price in a regime enforcing indirect taxes and b and b' are the tax-inclusive prices of a given transaction and a *subsequent* transaction and t and t' are the applicable *ad valorem* rates of tax,

$$b = a(1 + t), \text{ and}$$

$$b' = b(1 + t'),$$

leading to the total incidence at the end of the second transaction as a proportion of the original tax-exclusive price viz.,

$$\frac{(b' - a)}{a} = \frac{a(1 + t)(1 + t') - a}{a} = t + t' + tt'$$

The term tt' on the right-hand side represents an addition to $(t + t')$ (which is the sum of the rates of taxes on the two transactions), and such addition is a “tax on tax” contributing to “tax-cascading” *unless addition of taxes and tax on tax can be avoided by enacting and enforcing appropriate provisions in law*. No comparison is possible in every such chain of transactions with any hypothetical “no-tax” regime; and the difference between the tax-inclusive and tax-exclusive prices at any stage is an inverse function of the *reciprocal* of the rate of tax. Thus

$$b - a = b - \frac{b}{(1 + t)} = \frac{bt}{(1 + t)} = \frac{b}{\left(1 + \frac{1}{t}\right)}$$

The difference between the tax-inclusive and tax-exclusive prices, or "incidence" (i.e., "tax burden"), is moreover *a function of the tax-inclusive price payable by the recipient and is not independent of it*.

Let us now apply to each of the two foregoing instances, the following norm suggested by Adam Smith in *Wealth of Nations*, Book V, Chapter II, Part II :

“Every tax ought to be so contrived as both to take out and keep out of the pockets of the people as little as possible over and above what it brings to the public treasury of the state”

The relevant amount of money over and above the tax-exclusive price which would be taken out and kept out of the pocket of the recipient of any supply of goods and services ("incidence" or "tax burden") would be $(b - a)$ in both instances referred to above. The amount of tax accruing to the collecting government according to law would on the other hand be at . If the 'State' Policy envisages that the difference between the incidence (i.e., tax burden) and the amount of tax accruing to the government ought to be minimized, we have the following two results depending on whether the 'State' Policy aims at minimizing price-distortion generally or limits itself to avoid cascading of the incidence only of all indirect taxes :

1) In case price-distortion in general is to be minimized, the norm of Adam Smith would require that the first derivative of

$$(b - a) - at = \epsilon t + \epsilon$$

with respect to t be set to zero and the second derivative be not negative for that t . The first derivative of $(\epsilon t + \epsilon)$ with respect to the variable t would simply be ϵ (i.e., the price-distortion) for *all* t and the second derivative with respect to t would be zero for *all* t .

2) In case only the difference owing to cascading of incidence of indirect tax is to be minimized, the norm of Adam Smith would require that the first derivative with respect to the variable t of

$$(b-a) - at = \frac{b}{1+\frac{1}{t}} - at$$

be set to zero and the second derivative of that function at the relevant value of t be non-negative. However

$$\frac{\partial}{\partial t} \left\{ \frac{b}{1+\frac{1}{t}} - at \right\} = \left\{ \frac{-b}{\left(1+\frac{1}{t}\right)^2} \right\} \times \left(\frac{-1}{t^2} \right) - a = \frac{b}{(1+t)^2} - a,$$

which would be zero only when $t = \sqrt{\frac{b}{a}} - 1$, but

$$\frac{\partial^2}{\partial t^2} \left\{ \frac{b}{1+\frac{1}{t}} - at \right\} = \left\{ \frac{-2b}{(1+t)^3} \right\} < 0,$$

thus leading to the conclusion that the second derivative would be negative and as such the difference between the incidence (i.e., tax burden) and the amount of tax accruing to government cannot be minimized even when t is set equal to $\left(\sqrt{\frac{b}{a}} - 1 \right)$ by all the Legislatures.

In case of the second alternative above, if the tax-inclusive price b is also taken as a variable in addition to t , the first derivative of $f(t, b) = \left(\frac{b}{1+\frac{1}{t}} - at \right)$ would be

$$Df(t, b) = \left[\frac{b}{(1+t)^2} - a, \frac{t}{1+t} \right],$$

leading to critical point (t, b) which ought to satisfy

$$\frac{b}{(1+t)^2} - a = 0 \text{ and } \frac{t}{1+t} = 0.$$

This leads to the critical point $(0, a)$ and the Hessian matrix

$$Hf(t, b) = \begin{bmatrix} \frac{-2b}{(1+t)^3} & \frac{1}{(1+t)^2} \\ \frac{1}{(1+t)^2} & 0 \end{bmatrix}$$

The determinant of the Hessian matrix would take the negative value (-1) at the critical point $(0, a)$, thus ruling out a minimum at that point.

Thus an amendment of the indirect tax law which merely seeks to do away with cascading of the incidence of indirect taxes would not be able to conform to Adam Smith's norm. Conforming to Adam Smith's norm would on the other hand enable 'the State', 'the Bureaucracy' and 'the Market' if they are able to function as *institutions* of *national life*, to create, in the manner described below, a *choice architecture* which would enable every market-participant to experience fairness (which implies *justice*) in the terms of choice of goods and services needed by him/it, and available through the Market network, in the manner envisaged in Article 38 of the Constitution. This would be especially so if the market-participant is the domestic consumer belonging to the set designated "the People of India", even though it would be likely that domestic producers and exporters would also experience fairness.

Article 37 stipulates *inter alia*, the application of the following Directive Principle in lawmaking as a duty of the Welfare State in tackling such social disorders as price-distortions:-

38. State to secure a social order for the promotion of welfare of the people.—(1) The State shall strive to promote the *welfare* of the people by securing and protecting as effectively as it may a social order in which justice, social, economic and political, shall inform all the *institutions* of the *national life*.

(2)...(italics added)

Institutions, as the Noble laureate Douglass North famously theorized, help in minimizing uncertainties in life or converting such uncertainties into risks. The institution of 'the Market', unless it fails to coordinate its acts appropriately, minimizes uncertainties in the discovery of prices for goods and services by realizing an equilibrium *whatever be the law made by 'the State' and whatever be the action taken by 'the Bureaucracy' by its choice and interpretation of the provisions of the applicable law*. Uncertainties in the application and interpretation of the provisions of law to specific facts and circumstances are minimized by *well-coordinated action* of governance in accordance with the Rule of Law by an appropriate Bureaucratic hierarchy and, if need be, by resort to the principle of "*stare decisis*" enforced by the Courts. Such bureaucratic hierarchy would ideally have to be *common to the Union and the States* in implementing 'State' Policy which envisages minimizing price-distortions if such distortions include those caused by "*concurrent*" levy of indirect taxes by the Union and the States. It is for 'the State' to avoid failure in the discharge of its duty as stipulated in Article 37 and to avoid uncoordinated acts of the Entities embedded in it to ensure that the choice architecture implied by the equilibrium prices discovered by the Market secures a fair social order as stipulated in Article 38 by

minimizing *every* mode-of-governance-induced price-distortion instead of limiting its efforts to avoid cascading of the incidence of central and state goods and services taxes only.

Mere avoidance of cascading of the incidence of CGST/IGST/SGSTs does not have any consequence for securing and protecting a just *social* order in the manner stipulated in Article 38 by enabling the institution of the Market to discover prices for goods and services supplied therein without being distorted by the requirements of having to comply with law in general; ***It merely helps design the legal regime of collecting goods and services taxes so as to ensure that the taxes collected are sans incidence of any “CGST/IGST/SGST on CGST/IGST/SGST”***. The design would presumably have to rely on a unique rate of SGST *in common among the States* thus unduly ***constraining the Legislatures of the States without public interests being served***.

We conclude that the *true* contemporary social disorder is the prevalence of distortions in the prices of goods and services which are induced by the requirements of compliance by the suppliers with the uncoordinated protocols of governance of law in general. Such suppliers, in addition to being liable to pay central and state GSTs and other indirect taxes, would also be subject to protocols of tax-exempt public procurement of goods and services from the Market and to regimes for the levy of *direct* taxes on their incomes and for regulating *indirect subsidies* on the supplies of public goods and services with varying degrees of ***risk-aversion in evading taxes on incomes and in misappropriating indirect subsidies***. Stand-alone indirect tax "reform" by partial transit to GST regimes without appropriate linkages of governance to other legal regimes including the regimes of direct taxes on incomes, public procurement of goods and services and regulation of access to subsidized and other public goods and services would not result in compliance with the Directive Principle stipulated in clause (1) of Article 38.

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