**CH-11 ONE ECONOMIC INDIA: FOR GOODS AND IN THE EYES OF THE CONSTITUTION**

**Introduction**

- India is on the cusp of implementing transformational reforms to create "One India, One Market, One Tax," via the Goods and Services Tax (GST), it seems appropriate to ask how much *internal* integration India has achieved. To be clear, unless otherwise specified, hereafter, trade will refer to trade between states within India.
- This is done on the basis of a new "Big Data" set available from the Goods and Service Tax Network (GSTN- invoice level data on interstate movement of goods).
- Contrary to perception and to some current estimates, it seems that India is highly integrated internally, with considerable flows of both people and goods. The headline findings are:
    - The first-ever estimates for interstate trade flows indicate that cross-border exchanges between and within firms amount to at least 54 per cent of GDP, implying that interstate trade is 1.7 times larger than international trade.
    - While political borders impede the flow of people, language (Hindi specifically) does not seem to be a demonstrable barrier to the flow of goods.
    - The patterns of flows of goods are broadly consistent with priors but also throw up some surprises:
        - For example, on trade as a per cent of GSDP, smaller states like Uttarakhand, Himachal Pradesh and Goa trade more; the net exporters are the manufacturing powerhouses of Tamil Nadu and Gujarat but otherwise agricultural Haryana and Uttar Pradesh are also powerhouses because of Gurugram and NOIDA, respectively which have become part of the great Delhi urban agglomeration.
    - There is a potential dampener on our finding that trade in goods is high within India. This may be a consequence of the current system of indirect taxes which perversely favours interstate trade over intra-state trade, especially in the cases of final consumption items, exempted goods, or goods that are input tax credit ineligible. If true, the GST by ironing out these oddities may normalise interstate trade.
    - A final finding is that we are able to quantify not just arms-length interstate trade (that is trade between firms), but also intrafirm trade across states. The latter is, surprisingly large (at least 68 per cent of interfirm trade), and is affected by trade costs to a greater extent than interfirm trade. It is also surprising given the constitution favours preserving state sovereignty over one market.

**Section 1 - One India: Internal Trade in Goods**

- While international barriers to trade have been studied extensively, less attention has been devoted to studying the impact of trading networks and other barriers (political and cultural) to trade within countries.
- The estimation of these barriers to intra-national trade for India has hitherto been challenging due to the absence of a comprehensive interstate trade dataset. This chapter

presents the first estimates of internal trade within India using a novel data source – transactions recorded in the process of Central Sales Tax (CST) collection as provided by Tax Information Exchange System (TINXSYS).

**I. Does India Trade More Than Other Countries?**

- India's aggregate interstate trade (54 per cent of GDP) is not as high as that of the United States (78 per cent of GDP) or China (74 per cent of GDP) but substantially greater than provincial trade within Canada and greater than trade between Europe Union (EU) countries (which is governed by the "four freedoms": allowing unfettered movement of goods, services, capital, and people).
- This is all the more striking given that the data here covers mainly manufactured goods, excludes agricultural products, and is therefore an underestimate of total internal trade in goods. A substantial portion (almost half) of trade across states in India occurs as stock transfers within firms. That is, intrafirm trade is high relative to arms-length trade.
- Another way of gauging the magnitude of trade is to compare countries' internal trade with their international trade. India's internal trade is about 1.7 times its international trade of 32 per cent of GDP.
- The intuition from standard gravity models of trade is that large countries trade more within their own borders than beyond them because of the size of their domestic markets.

**II. Relationship between Interstate Trade and Manufacturing**

- There is a strong correlation between a state's manufacturing share of GSDP and its trade volumes (as a per cent of GSDP) along expected lines because our data captures trades in manufacturing items only.
- The other key observation to be made from the figure is the exceptional manufacturing share of Uttarakhand, Himachal Pradesh and Goa relative to other states. This manufacturing prowess in turn is associated with higher interstate trades. The reasons are discussed in the following sections.

**III. Patterns of Interstate Trade: Arms-Length Trade**

**Openness to Interstate Trade (Exports + Imports)**

- The value of domestic trade in Indian states as a per cent of their GSDP is taken as a measure of openness. The most open states by this measure are Uttarakhand, Goa, Himachal Pradesh and Gujarat with Assam, Bihar and Uttar Pradesh bringing up the rear.
- High GSDP states such as Maharashtra and Tamil Nadu are conspicuous in their absence from the top of the list – though their trade to GSDP ratio is still substantial at 33 per cent and 24 per cent, respectively. This is the first of many indications that while India's borders seem porous, this might be because of its complex regulations rather than inspite of it.
- Himachal Pradesh and Uttarakhand, whose exceptional trade volumes might be explained by the exemption from central excise tax for manufacturing in these states. The outlier status of these states is even more apparent when we examine the gravity relationship across states in the later sections – that is, whether smaller states trade more than larger ones.
- The outliers on the under-performing side are Assam (5.3 per cent), Bihar (9.9 per cent) and Kerala (17.9 per cent), who have much lower trade openness than what their size would predict.

- States have small manufacturing share in their GSDP. The other possibility is the exclusion of north-eastern states that may be important trading partners for Assam and Bihar.

**Balance of Interstate Trade: Net exporters and net importers**

- GSTN database shows state-wise trade balances of arms length trade flows. The variation is enormous, from a trade deficit of nearly 45 per cent of GSDP in Uttarakhand and a trade surplus of nearly 25 per cent of GSDP in Haryana.
- The large manufacturing states – Gujarat, Maharashtra and Tamil Nadu have a positive balance of trade highlighting their competitive manufacturing capabilities. This positive balance is also a feature of Delhi (7.4 per cent), Haryana (26.1 per cent) and UP (4.2 per cent), reflecting the large value additions occurring in the manufacturing hubs of the National Capital Region, namely Gurugram and NOIDA. Gurugram and NOIDA, respectively, make otherwise agricultural Haryana and UP manufacturing powerhouses (by Indian standards).
- Uttarakhand, Himachal Pradesh and Goa (seen earlier to possess the highest trade to GSDP ratios) are predominantly trade balance deficient. This may be because we do not observe import side intrafirm trade flows. It is likely that these states' special status (in terms of tax exemptions) would encourage firms to allocate some intermediate stages of their production process there, followed by intrafirm exports.
- Observing the intrafirm net export flows is, however, not possible because even though the export side of this trade data (using the F-forms) exists, the corresponding import side of trade has not been reported for these states.

**IV. Patterns of Interstate Trade: Intrafirm Trade**

- Goa, Gujarat and Maharashtra, relative to other states, are as open to intrafirm trades as they are to arms-length trades. On the lower end of intrafirm trade openness are Uttar Pradesh (8.4 per cent), Rajasthan (11.8 per cent) and West Bengal (15.5 per cent). The fixed cost of setting up companies in these states may potentially be causing frictions in intrafirm trade flows in these states.
- Comparing intrafirm and arms length trade for the same sample of state pairs indicates that there is no discernible correlation between the two types of trades – a state open to arms length trade may not be equally amenable to intrafirm trade.
- Madhya Pradesh stands out as having much higher intrafirm trade than interfirm trade, possibly owing to its central location in the country, making it ideally suited to logistics supply chains.
- These differences in intrafirm trade could also be due to the considerable variation in the underlying commodities represented in the two types of flows. The top 15 commodities by value represented in the intrafirm and arms-length trade imports in Andhra Pradesh and Telangana in FY 2015 (two states which have good quality commodity information). Only five of these 15 product categories (highlighted in green) are common to both types of flows. Thus the types of products produced in each state, their suitability to F-form related transfers and the fixed costs of setting up subsidiaries may jointly determine these flow trends across states.

**V. Is Indian Interstate Trade Unusual? Formal Evidence from a Gravity Model**

- The evidence shown so far suggests that contrary to the received wisdom, India's internal trade does not seem unusually low. But what about the distance cost of trade? Gravity models of trade are one of the most empirically robust relationships and theoretically grounded toolkits used in the analysis of estimating trade costs and their impacts on trade flows. The basic intuition is that trade between two jurisdictions will be greater: the richer they are, the closer together they are, and fewer the policy and other cultural barriers between them.

- All these predictions are borne out by the Indian data. Richer states trade more with each other; states that are closer together trade more; contiguity matters as does the distance between economic agents.
- The results from these models can be interpreted as follows:
    - *Distance* - The most remarkable finding is that India's elasticity of trade flows with respect to distance is much lower than one might have expected – a 10 percentage point increase in distances between economic capitals results in a fall in trade of only 5.65 percentage points[15]. Contrast this with the US, which enjoys a much better freight infrastructure, where a 10 percentage point increase in distance results in trade falling by 9.3 percentage points.
    - *State GDP coefficients* – The elasticity of trade with respect to income is positively correlated with trade flows: a 10 percentage point increase in GDP of an importing or exporting state is associated with an 8.2 and 9.6 percentage points increase in trade, respectively.
    - *Proximity coefficient* – Adjoining states in India tend to trade with each other about 90 per cent[16] more than other states[17]. This effect is lower than the US, where interstate trade patterns are dominated by adjoining state pairs.
    - *Language coefficient* – In the international trade literature, the language dummy has been found to be persistently positive and significant, implying that countries with shared languages tend to trade with each other more than with others.

**VI. Explaining the puzzle: Why Does India Trade so Much?**

- Contrary to priors, it seems that India may be have a pro-trade bias. Why might this be the case? One plausible answer is that the current structure of domestic taxes as well as area-based tax exemptions might actually bias economic activity towards more internal trade.

**Area-based exemptions**

The Central Excise Act exempts manufacturing in certain states from excise duty, including all the North-eastern states, Sikkim, Jammu and Kashmir, Uttarakhand, Himachal Pradesh and Kutch in Gujarat. This exemption creates a strong incentive to shift real or reported production to these areas over what might be dictated by comparative advantage, trade costs and other traditional determinants of trade and firm location.

**The CST and VAT**

- Under the current system, states levy a value-added tax on most goods sold within the state, the centre levies a near VAT able excise tax at the production stage. Sales of goods across states fall outside the VAT system and are subjected to an origin-based non-VAT able tax (the Central Sales Tax, CST). It turns out that the CST – far from acting as a tariff on interstate trade – may actually provide an arbitrage opportunity away from a higher VAT rate on intra-state sales in some cases.
- The crucial determinant of whether the CST acts as a tariff is whether the buyer can receive an input tax credit (ITC) on the purchase if done within state. The input tax credit is the

defining feature of a VAT – without this you are taxed not just on your value addition but on the entire sale value– as with the CST.

- In such cases a buyer would much prefer to pay the lower 2 per cent CST rate than the higher VAT rate. In general, this situation arises whenever the firm is a final consumer, or when the firm is a manufacturer of tax exempt goods. Far from being a rare occurrence, there are some big ticket items that fall into this category, like petrol, diesel, construction material and some machinery.
- In addition, most states provide a "negative list" of commodities that do not receive input tax credits even within state. This negative list of items represents at least 22 per cent of imports in Andhra Pradesh. Within this negative list, automobiles and automobile parts alone constitute 16 per cent of the value of imports into Andhra. ITC non-eligible items constitute at least 30 per cent of imports in Odisha.
- For all other goods, purchasing goods out of state would mean foregoing any input tax credits accrued, thereby raising costs and making it a less attractive proposition. Without a counterfactual, it is not possible to measure to what extent interstate trade in these goods is suppressed by the tax distortion. However, the relatively low elasticity of trade in India with respect to distance and the comparability of India's trade to international norms seems to suggest that the pro-trade bias wins over the disincentives to trade.
- In this case, when the Goods and Service Tax (GST) is implemented, by eliminating these distortions, it will actually lead to a normalisation in internal trade.

**VII. Conclusion**

- Contrary to the caricature, India's internal trade in goods seems surprisingly robust. This is true whether it is compared to India's external trade, internal trade of other countries, or gravity-based trade patterns in the United States. For example, the effect of distance on trade seems lower in India than in the US. Hearteningly, it seems that language is not a serious barrier to trade.
- There is enormous variation across states in their internal trade patterns. Smaller states tend to trade more, while the manufacturing states of Tamil Nadu, Maharashtra and Gujarat tend to have trade surpluses (exporting more than importing). Belying their status as agricultural and/or less developed, Haryana and Uttar Pradesh appear to be manufacturing powerhouses because of their proximity to NCR.
- The analysis does leave open the possibility that some proportion of India's internal trade could be a consequence of current tax distortions, which are likely to be normalised under the GST. One market and greater tax policy integration but less actual trade is an intriguing future prospect.

**Section 2: One India: Before the Law**

**I. Introduction**

- The GST was justly touted as leading to the creation of One Tax, One Market, One India. But it is worth reflecting how far India is from that ideal. Indian states have levied any number of charges on goods that hinder free trade in India—octroi duties, entry taxes, Central Sales Tax (CST) to name a few. The most egregious example of levying charges of services coming from other states is the cross-state power surcharge that raises the cost of manufacturing, fragments the Indian power market and sustains inefficient cross-subsidization of power within states.

- In agriculture, Agriculture Produce Market Committee (APMCs) still proliferate which prevent the easy sales of agricultural produce across states, depriving the farmer of better returns and higher incomes, and reducing agricultural productivity in India. These measures in agriculture, goods, and services make light of claims that there is one economic India.
- It is also worth reflecting on the strength of the Constitutional arrangements in facilitating the creation of an Indian common market. Discussions around the Constitution are inevitably inward focused but in this instance it is worth analysing these arrangements from a cross-country perspective. There is an obvious conceptual commonality of public policy objectives in large federations or supra-national entities: balancing the imperative of creating a common market so that all producers and consumers are treated alike, with the imperative of not undermining the legitimate sovereignty of the sub-federal units.

**II. India's Constitutional Provisions and Jurisprudence**

- 11.39 That comparison requires understanding the constitutional provisions on both achieving and circumscribing the common market. Articles 301-304 provide a layered set of rights and obligations. Article 301 establishes the fundamental principle that India must be a common market:

*301.* **Freedom of trade, commerce and intercourse.** *Subject to the other provisions of this Part, trade, commerce and intercourse throughout the territory of India shall be free.*

Articles 302-304 both qualify and elaborate on that principle.

Article 302 gives Parliament the power to restrict free trade between and within states on grounds of public interest.

*302.* **Power of Parliament to impose restrictions on trade, commerce and intercourse.** *Parliament may by law impose such restrictions on the freedom of trade, commerce or intercourse between one State and another or within any part of the territory of India as may be required in the public interest*

Article 303 (a) then imposes a most-favorednation type obligation on both Parliament and state legislatures; that is no law or regulation by either can favor one state over another.

*303.* **Restrictions on the legislative powers of the Union and of the States with regard to trade and commerce**

*(1) Notwithstanding anything in Article 302, neither Parliament nor the Legislature of a State shall have power to make any law giving, or authorising the giving of, any preference to one State over another, or making, or authorising the making of, any discrimination between one State and another, by virtue of any entry relating to trade and commerce in any of the Lists in the Seventh Schedule*

Article 304 (a) then imposes a national treatment-type obligation on state legislatures (apparently not on Parliament); that is, no taxes can be applied to the goods originating in another state that are also not applied on goods produced within a state. This Article refers only to taxes and not to regulations more broadly.

*304.* **Restrictions on trade, commerce and intercourse among States** *Notwithstanding anything in Article 301 or Article 303, the Legislature of a State may by law (a) impose on goods imported from other States or the Union territories any tax to which similar goods manufactured or produced in that State are subject, so, however, as not to discriminate between goods so imported and goods so manufactured or produced; and*

But then Article 304 (b) allows state legislatures to restrict trade and commerce on grounds of public interest.

*(b) impose such reasonable restrictions on the freedom of trade, commerce or intercourse with or within that State as may be required in the public interest: Provided that no Bill or amendment for the purposes of clause shall be introduced or moved in the Legislature of a State without the previous sanction of the President.*

- The gist of these provisions is that both the Centre and the States have considerable freedom to restrict trade and commerce that hinder the creation of one India.
- Levies in the nature of motor vehicles taxes, taxes at the point of entry of goods into specified local areas, sales tax on manufacturers of goods from outside a particular State, have always existed between States.
- At the same time, many of such levies are constitutionally valid and have been upheld, in principle, by the Supreme Court. For instance, in ***Shree Mahavir Oil Mills v. State of Jammu and Kashmir*****,** the Supreme Court upheld a notification issued under the Jammu and Kashmir General Sales Tax Act, 1962 which exempted the local producers of edible oil from sales tax in order to protect their businesses from facing closure.
- This was not entirely unexpected in looking to achieve free trade while protecting the sovereignty of states to raise revenue would always have led to trade-offs. With nearly seventy years of experience, it is clear that the trade-offs have been such that any hopes of a common market have been effectively crippled.
- In 2016, even though the Supreme Court has rejected the compensatory tax theory, it has upheld the right of States to levy entry taxes. It is submitted that this view of the Court is entirely consonant with the constitutional scheme of Part XIII, which when read as a whole, seeks economic integration while ensuring considerable leeway for states to differentiate their own products from those from other states.

**IV. Comparable WTO Law**

- But there is a third and much weaker standard by which Indian rules should be assessed: the WTO. The WTO has a membership of 164 countries with widely varying income levels and political systems: for example, the ratio of per capita GDP of the richest countries is more than 60 times that of the poorest, while the corresponding ratio within India is less than 5. Also, the WTO has democracies like the US and Europe and non-democracies like China whereas all Indian states are democratic. So, it cannot possibly be argued that the Indian states should have greater freedom than countries in the WTO on the issue of creating a common market.
- If that is reasonable, then the comparison between WTO rules and the provisions of the Constitution is not inappropriate. That is, it is reasonable to compare the common-market/regulatory freedom balance provided for countries in the WTO with the same provided for states in the Constitution.
- What then are the comparable WTO rules? The WTO imposes a most favoured-nation and national treatment requirement just as the Constitution does. But the key difference with the Constitution is the freedom provided to depart from these anti-protectionism requirements. The contrast is really between Articles 302 and 304 (b) of the Constitution and Article XX of the General Agreement on Tariff and Trade (GATT) WTO.

**Article XX - General Exceptions**

- *Subject to the requirement that such measures are not applied in a manner which would constitute a means of arbitrary or unjustifiable discrimination between countries where the same conditions prevail, or a disguised restriction on international trade, nothing in this Agreement shall be construed to prevent the adoption or enforcement by any contracting party of measures:*
    - Necessary to protect public morals;
    - Necessary to protect human, animal or plant life or health;
    - Relating to the importations or exportations of gold or silver;
    - Necessary to secure compliance with laws or regulations which are not inconsistent with the provisions of this Agreement, including those relating to customs enforcement, the enforcement of monopolies operated under paragraph 4 of Article II and Article XVII, the protection of patents, trademarks and copyrights, and the prevention of deceptive practices;
    - Relating to the products of prison labour;
    - Imposed for the protection of national treasures of artistic, historic or archaeological value;
    - Relating to the conservation of exhaustible natural resources if such measures are made effective in conjunction with restrictions on domestic production or consumption;
    - Undertaken in pursuance of obligations under any intergovernmental commodity agreement which conforms to criteria submitted to the CONTRACTING PARTIES and not disapproved by them or which is itself so submitted and not so disapproved;
    - Involving restrictions on exports of domestic materials necessary to ensure essential quantities of such materials to a domestic processing industry during periods when the domestic price of such materials is held below the world price as part of a governmental stabilization plan; Provided that such restrictions shall not operate to increase the exports of or the protection afforded to such domestic industry, and shall not depart from the provisions of this Agreement relating to non-discrimination;
    - Essential to the acquisition or distribution of products in general or local short supply; Provided that any such measures shall be consistent with the principle that all contracting parties are entitled to an equitable share of the international supply of such products, and that any such measures, which are inconsistent with the other provisions of the Agreement shall be discontinued as soon as the conditions giving rise to them have ceased to exist…
- The two striking differences between the two are first that the reasons for invoking departures from free trade/common market principles are more clearly and narrowly specified in the WTO than in the Constitution which instead refers to an open-ended "public interest." Second, and more important are the criteria that have to be met before the departure can be justified. In the WTO, the measure must not constitute arbitrary discrimination; must not be a form of disguised protectionism; and above all must be "necessary."
- WTO jurisprudence has over the years elaborated on all these three criteria and others. For example, the burden of proof is on the party invoking the exception provision (i.e. invoking the right to depart from a common market); measures adopted must be the least restrictive amongst the alternatives available; strict rules must apply to prevent arbitrary and unjustifiable discrimination.

- The key point is that in the WTO the departures from a common market across widely varying countries is quite heavily circumscribed whereas similar departures between states within India is easily condoned by the Constitution and consequent constitutional jurisprudence.
- At a time when India is embracing cooperative federalism, the question to ponder is this: even if India cannot embrace the strong standards of a common market prevalent in the US and EU, should not the law in India at least aspire to the weak standards of a common international market embraced by countries around the world?

**V. Conclusion**

- At the time of the drafting of the Constitution, and given the considerable anxieties of holding together a large and disparate nation, the demands for respecting states' sovereignty were understandably strong. Nearly 70 years on, the sense of nationhood and unity is strong, and anxieties about territorial integrity have faded. Cooperative federalism is becoming an increasingly important governance dynamic. Reflecting this, the country has unanimously passed a landmark Constitutional amendment to implement the GST which should result in a common market for domestic indirect taxes.
- Building on this, the country can go further and extend this principle of one economic India to other spheres. Indeed, in his budget speech of July 24, 2014, the Honorable Finance Minister articulated the principle of extending the principle to agriculture: "the farmers and consumers' interest will be further served by increasing competition and integrating markets across the country…"