What the new GST should look like

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- Given stagnant revenues, it is clear urgent reforms are needed in the value-added tax. Here's a template
- There is no 'one size fits all' GST. Often, the reform is carried out with some bad features to get it accepted, but getting rid of them can pose formidable challenges

The implementation of the goods and services tax (GST) in a large and diverse federal country ruled by different political parties is a remarkable achievement. Almost all the 166 countries that have implemented GST in one form or the other have taken considerable time to stabilize the value-added tax that has been seen as a money machine and an appropriate instrument to offset revenue losses from reducing tariffs.

In India, the tax has been evolving over the last 27 months. This is a good time to analyse the revenue implications and economic impact of GST, as well as identify the reform areas to increase revenue productivity and minimize administrative, compliance and distortion costs.

There is no "one size fits all" GST; each country has to adopt the system that it finds feasible. Often, the reform is carried out with some bad features to get it accepted, but getting rid of them can pose formidable challenges. Since the roll-out of the tax, there have been 37 meetings of the GST Council addressing changes in the structure and operations.

The overall experience shows that GST is here to stay and it will continue to evolve as the governments gain in confidence. The experience has also led to the moderation in expectations. It is now clear that significant additional reforms are needed to ensure better compliance and to minimize economic distortions.

The gains

The most important gain is from the abolition of interstate check-posts erected to enforce taxes on cross-border transactions. This has reduced the impediments to the interstate movement of goods, and helps to create a national common market. It is estimated that the long-distance travel time for goods transportation has reduced by almost 20%.

The reform has also improved supply- chain management and it is no longer necessary to create branch offices merely to avoid interstate sales tax. The abolition of interstate sales tax has made the tax destination-based and reduced inequitable interstate tax exportation. Equally important is the compliance gain due to linkage and exchange of information between income-tax and GST departments.

A major gain is the reduced cascading due to more comprehensive mechanism to credit input taxes against taxes on outputs. Earlier, the central excise duty was levied at the manufacturing stage and it cascaded into the final retail value. Also, the state value-added tax was levied on excise duty paid value. Besides, there was no systematic mechanism for providing input tax credit between excise duty and service taxes.

The inclusion of taxes like central sales tax, octroi, purchase taxes and luxury taxes on hotels in GST too has substantially reduced the tax on tax; mark-up on taxes; and tax on the mark-ups.

Finally, the creation of GST Council is an important innovation in cooperative federalism. This has helped to minimize the transaction cost of reforming the calibration of domestic consumption taxes of the Centre and states. However, it remains to be seen how the institution will eventually shape up.

The ground reality

While these gains are real, the full potential of reforms will depend upon further simplification and rationalization. The most important constraint, however, is stagnant revenues and unless immediate measures are taken to raise revenue productivity, the euphoria will wane.

For 2017-18, the Comptroller and Auditor General (CAG) of India's report estimates that the central government part of GST actually declined by 10% for the subsumed taxes as compared to the previous year. The Budget Estimate for 2018-19 for the Central government was Rs. 7.43 trillion—the actual collection was 22% lower at Rs. 5.81 trillion. In 2019-20, while the estimated monthly collection of GST is Rs. 1.18 trillion, the average monthly collection during the last seven months has been less than Rs. 1 trillion. The government is thus staring at a shortfall of Rs. 2 trillion for the whole year.

GST implemented in India has a number of shortcomings. The problem includes large list of exemptions, multiplicity of rates and exclusion of several items of consumption from the base. All this has resulted in erosion of the base and continued distortions. The decision to exempt almost 50% of the items in the Consumer Price Index basket has narrowed the base.

The tax is levied at four different rates (at 5%, 12%, 18% and 28%) in addition to the special rates on precious metals (0.25%), gold (3%) and job work in diamond industry (1.5%). A special cess is also levied at varying rates on items under 28% category and, in the case of some class of automobiles there's a cess of 22%, resulting in the total incidence of 50%.

Multiplicity of tax rates enhances administration and compliance costs, enables misclassification and in some cases causes inverted duty structure. Moreover, high tax rates on automobiles, and building and construction material at a time when demand conditions are compressed has caused further slowdown in these sectors.

There are infirmities arising from the rate variations according to use of the product, value of the product and lower rates on items considered as inputs as compared to those judged as outputs. These cause distortions as well as compliance problems.

By excluding petroleum products, real estate and electricity, 40% of the internal indirect taxes at the Centre as well as states are not in the net. In addition, large-scale exemptions and low-compliance composition scheme up to Rs. 1.5 crore turnover has added to cascading.

The reforms

Further reform in GST requires the GST Council to gain confidence in revenue performance and that requires stabilizing the technology platform. The originally proposed three forms, GSTR-1, GSTR-2 and GSTR-3B, could not be operationalized. The summary form, GSTR-3B, does not provide the information required for invoice matching.

As the filing of the annual returns too is being repeatedly postponed, there is no viable means to match invoices and this has given rise to a fake invoice industry. So far, 9,385 cases of tax fraud by this means have been detected involving an amount of Rs. 45,682 crore. The undetected amount would be much larger. In addition, the dysfunctional technology platform has resulted in integrated GST allocation in ad hoc and arbitrary ways, and has caused delays in the refunds to exporters.

Firming up the IT platform will be greatly helped if a number of steps are taken. First, the threshold for registration is kept at a reasonably high level. The international experience recommends the threshold at about $100,000, and in India Rs. 50 lakh could be a reasonable threshold.

The data from Karnataka for 2017-18 shows that 93% of taxpayers had less than Rs. 50 lakh turnover and they accounted for 6.5% of the turnover and 12% of the tax paid. It is important to focus on the “whales" rather than the “minnows".

Second, 100% invoice matching is not followed anywhere. As Professor Richard Kerver of the University of Western Australia shows, Korea tried it but gave it up . Perhaps, it is desirable to match invoices above a certain value—say Rs. 10,000.

Reducing the tax rates

Once, a measure of stability is brought into revenues, it is easy to undertake reforms in the structure and operational details. Reducing the number of tax rates is important and it should begin by getting rid of the 28% category altogether and transferring them to the 18% slab. The revenue from this category, including the cess, is reported to be 22% of the total.

At a lower rate, the turnover would be higher due to increased demand and the loss of revenue will be lower.

Simultaneously, it is desirable to prune the list of exempted goods and services. Michael Keen and Jack Mintz (The Optimal Threshold for a Value-Added Tax, Journal of Public Economics) show that having a reasonably high threshold helps the cause of equity. More importantly, equity is better served through targeted cash transfers and not by differentiating tax rates.

Besides, calibrating tax rates based on consumption pattern alone ignores the employment potential from these sectors. Only those that are difficult to tax for administrative reasons should be exempted and many of the items under 5% should be moved to 12%.

In the next stage, the 12% and 18% categories can also be merged at 15%. This will simplify the tax system into two rates. It is also important to rectify the infirmities such as rate differentiation for the same group of commodities. Services based on price differences or use should be eliminated, as should rate differences based on the stage of production.

Another major reform needed is to include the petroleum products and electricity in the GST base. Petroleum products contribute about 42% of the revenue from domestic indirect taxes and in the interest of ensuring competitiveness, their inclusion in the tax base is essential. However, given the large contribution to revenues, this becomes feasible only when the revenue from the tax stabilizes. All these reforms should be sequenced and calibrated over a period of two-three years.

There are some “demerit goods" such as tobacco and its products in the 28% category. At present, the supply of tobacco products is taxed at 28%, but there are very high rates of compensation cess. In the case of cigarettes, the rate of cess varies depending on the length of cigarettes. It is important to levy high tax rates on such items for sumptuary reason, but the proper method is to levy GST at the standard rate and have a separate excise on them.

In conclusion

It is important to have a strong technical secretariat comprising administrators, economists, accountants and lawyers to advise the GST Council based on rigorous research. The team should have the capability to estimate the effects of changes in the base and rates, administrative and legal implications of various measures, and present the options to the GST Council to take informed decisions.

At present, the GST Council relies on the analysis done by the “fitment committee", which consists of the nominated officials of the Tax Research Unit in Central Board of Indirect Taxes and Customs (CBIC), and officials of the commercial taxes department from some states.

Equally important is the need to make all data, which is not sensitive to enforcement, available in public domain. Reluctance to share the data is a major constraint for undertaking independent research. Even the report of CAG is unequivocal in stating, “after much pursuance, CBIC has shared only the MIS reports which give aggregate statistics at

Commissionerate level (for Central data) and State level (for State data)" and opined "…Unhindered and full access to pan-India data is crucial for meaningful audit and to draw required assurances needed…"

When a constitutional body like CAG itself has difficulties, it is not surprising that independent researchers find it impossible to get the data to undertake quality analysis. Hopefully, the GST Council will facilitate independent research; it does not help to shoot the messenger when the objective is to improve the tax system.

M. Govinda Rao is former director of the National Institute of Public Finance and Policy, and member of the Fourteenth Finance Commission.This is an abridged version of the paper presented by him at the Indian Economic Summit organized by Deepak and Neera Raj Center on Indian Economic Policies, School of International and Public Affairs at Columbia University.