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EXECUTIVE BRIEFINGS
BUSINESS AND ECONOMY: TAXATION

Adit Jain, IMA India
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Goods and Services Tax

The timing for a session on Goods and Services Tax (GST), held in Bombay on the 4th August, was impeccable. India's Upper House of Parliament had only the previous day approved legislation and therefore, it seemed fitting that Dr Parthasarathi Shome should share his views at IMA India's CFO Forum. Dr Shome previously served as Adviser to the Finance Minister, worked extensively on the structure of GST and is acknowledged as one of the world's leading thinkers on tax policy. Whilst a more exhaustive conclusions paper will be prepared in due course, this note offers a brief perspective.

The GST initiative essentially began 16 years ago under the Vajpayee administration. It was subsequently tossed around North Block and Parliament and only became a serious issue five years later. It went through an Empowered Committee of State Finance Ministers and the Thirteenth Finance Commission. By 2011, a draft of a Constitutional Amendment Bill was prepared and referred to a Standing Committee of Parliament. After years of dithering, it was finally passed by the Rajya Sabha and should in a matter of a few weeks become an Act. As a Constitutional Amendment, the bill will necessitate the ratification of 50% of the state Assemblies before it comes into force. The Bill requires the setting up of a GST Council, containing representation from both the federal and provincial Governments. The Council will approve the GST rate, administrative protocols, dispute resolution and flexibility conditions. This whole process, we suspect, could take many months.

In an article published in the Business Standard in September 2015, Dr Shome expressed five misgivings with the GST structure as it stood then. Firstly, he highlighted the lack of clarity in the nitty-gritty including transitional arrangements and administrative procedures. Second, he was anxious that the Government would be tempted to distinguish between goods and services and that would be improper. Third, the states were to be allowed a band for determining the GST rate complicating administrative procedures and compliance requirements, besides undermining the basic integrity of a uniform tax. Fourth, the lack of input tax credit on petroleum would be disruptive and effectively result in cascading taxation. Moreover, input tax credit for capital goods was to be extended over two years rather than one. Finally, a 1% inter-state trade tax was to be levied where exporting states retain revenues without providing input tax credit. Whilst some of these misgivings have been addressed in the final draft of the Bill, others remain.

Dr Shome rightfully contended that an appropriate tax structure needs an understanding of both tax policy and macroeconomic considerations. He alluded to the challenge of dealing with sensitive tax issues between the central Government and states and also among states. The GST Bill, in its present form, is really a political compromise. However, given India's complicated federal structure, it is nevertheless a decent start. An ideal tax structure is one where there is consistency between the rates of growth of GDP and that of tax collections. In the early 2000s, taxes grew much faster than GDP as corporate profits flourished; however, between 2006 and 2007, following the institution of several exemptions, buoyancy in tax fell. Going forward, the issue is whether GST will address this volatility.

Dr Shome cited the example of the shift to VAT many years ago, which led to an increase in the growth of tax collections from 17.5% to 22%. This was on account of higher levels of compliance and more exhaustive coverage. If implemented well, he believes that the GST will lead to comparable results and therefore, the concerns of states on the count of compensation of revenue losses may turn out to be unfounded.

On the matter of the GST rate, Dr Shome suggested that the ideal figure would be around 18%. Anything higher may be inflationary and could even encourage evasion. The tax regime in Romania for instance, which has a GST rate of 25%, has an evasion ratio of 50%. Some economists believe the revenue-neutral-rate is closer to 14-15% and therefore a 4% mark-up ought to be reassuring enough for greater buoyancy without stoking inflation. What is really more important is good administration. An effectively implemented GST environment creates higher tax collections and more investment even at a moderate rate. For instance, New Zealand and Australia collect taxes to the extent of 7% and 3.4% of GDP at a GST rate of 15% and 10% respectively.

Dr Shome was concerned that the legislation in its current form allows states to implement a band for the GST rate, which would be counter-productive. Even when VAT was implemented many years ago, a similar demand for flexibility was debated and subsequently disallowed. Hopefully the same logic would prevail when rules and guidelines for GST are drafted by the Council. The intent of GST is to have *one* indirect tax in which all others are subsumed. Whilst the current dispensation is nearly there, some exemptions remain. But a more worrying question is whether, subsequent to the implementation of GST, local authorities or provincial Governments can create 'new taxes' that currently do not exist. If so, that would defeat the very purpose of the reform.

All things considered, the passing of the GST Bill is a milestone and the most significant tax reform of our time. If properly implemented it should create additional revenues of between 1% and 3% of GDP. Undeniably there will be uncertainties to grapple with, service sector businesses obliged to pay more in tax and contend with compliance issues, but hopefully the system will eventually function efficiently both for assessees and the government.