GST implementation

Avoid birth defects

Having achieved some unification in tax rates at the state level, increasing the number of slabs is retrograde

M GOVINDA RAO

The problem with multiple rate categories is that it complicates the structure, adds to both administrative and compliance costs, leads to classification disputes and opens up avenues for special interest groups to lobby for lower rates

WITH the impasse over the decision on the rate structure in the GST Council, the euphoria with which GST was touted as a "game changer" and the "reform of the century" is gradually waning. Surely, there are questions on the claims about achieving simplicity, unification in markets, acceleration in the growth rate and increase in exports. The compromises involved in implementation bring in the reality check that the structure that will emerge will fall well short of what is hoped. While it was clear that flawless GST is a mirage, it was fervently hoped that the implementation will not violate the fundamental principles and will at least serve as the next stage of consumption tax reform.

The critical elements of the tax reform are that it should reduce the administration, compliance and distortion costs to the economy. According to the best practice approach, the tax should have a broad base, low rates, less differentiated rates and should be simple and transparent. It was with this objective that the sales tax system with 14-16 tax rates in the mid-1990s was gradually converged into two broad rates in addition to exemption and a low rate on precious metals when the value added tax reform was implemented in 2005.

Reaching consensus of all the states to achieve this is a major landmark. In contrast, the multiplicity of rates in the proposed GST structure, is clearly retrograde as it will increase the administrative complexities and compliance cost. Rather than moving towards neutrality, the reform will increase distortions.

The proposed GST structure entails six rate categories excluding exemptions. Even if the low rate for gold is excluded, there are five rate categories namely, 6%, 12%, 18%, 26% and additional cess on sumptuary items to fund the compensation for revenue loss. The low rate on gold is unavoidable not for reasons of equity but compliance. Indeed, on equity grounds, the general rate should be applied but given the low volume-high value of the commodity and the possibility of informalisation in the production of jewellery, levying the tax at more than 4% could result in large scale tax evasion.

The problem, however, is with the multiplicity of rates proposed. Ideally, like in Canada, there should be a single rate at the central level and one at the state level. Most countries levy the tax at a single rate. However, as I had argued in my previous columns, it would be impossible to think of a flawless GST levied at single rate in India. Although international experience shows that the tax policy has been ineffective in reducing inequalities of income, the political considerations continue to rule. The modern tax literature shows that the focus should be to increase the incomes of the poor rather than reducing the incomes of the rich, and this is better done through appropriate expenditure policy. After conducting a series of incidence studies, Pechman and Okhner conclude that the US tax system is not significantly progressive and the study in Chile found the tax system mildly regressive. However, in Indian context, with only 3% of the population paying income tax, any changes in inequality through the direct tax system leaves out 97% of the population and therefore, having two rates is unavoidable at this juncture to make the system look progressive.

The proposed tax rates of 6% and 26% are clearly avoidable. The 6% rate seems to be due to the fact that almost 300 items are exempt in the Union excise duty and the government does not want to tax them at 12% suddenly. This will however, create a problem as the states are levying the VAT on some of these items at 5%. The Union government could have pruned its exemption list in the last budget itself so that they could have been taxed at the merit rate of 12% when the GST is levied. Even now rather than soft pedalling, the Council should decide to tax these items at 12% and avoid an additional rate category.

There is no rationale for having a super rate of 26% either. This comes from the recommendation of the CEA Committee which seems unsure of its calculations on the revenue neutrality with 18% standard rate and provides an additional rate category. With consumer durables included in this category, it will create a lot of administrative and compliance problems. Perhaps, the better option is to levy the standard rate at 20% and avoid this additional rate. This should adequately take care of revenue considerations. As creating an additional rate category from the prevailing VAT system is clearly retrograde.

There will be more discussions when the list of exempted goods and services and those belonging to the different rate categories is put out. Hopefully, care will be taken to avoid levying lower rate on inputs. Since the basic principle of GST is to provide input tax credit, there is no reason for levying lower rate. Taxing inputs at lower rate provides incentive to evade the tax on the final products by suppressing the value of output. In fact, this is a major shortcoming of the prevailing VAT and GST implementation provides an opportunity to overcome this.

The problem with multiple rate categories is that it complicates the structure, adds to both administrative and compliance costs, leads to classification disputes and opens up avenues for special interest groups to lobby for lower rates. Indeed, with unprocessed food exempted and basic consumer goods subject to lower tax, the low-income households will be adequately insulated from the price escalation on account of GST and there is no reason for having so many rates. As regards, the cess for compensating the states is concerned, it is hoped that seeding the PAN number in the GST registration will improve income tax compliance significantly as it had happened in many developing countries.

As argued by Richard Bird and Pierre Pascal Gendron, some imperfections may even be an essential element of getting GST accepted in the first place in developing countries. However, it is important to ensure that the fundamentals of the reform are not violated. In India, having achieved a measure of unification in tax rates at the state level already, increasing the number of rates is certainly retrograde and hopefully GST Council will avoid this. The developments also have cast serious doubts on the ability to accomplish the reform by April 2017, and rather than forcing the issue, it is desirable to implement the reform after adequate preparations during 2017.

The author is adviser, Deloitte Touche Tohmatsu and chief economic adviser Brickwork Ratings. Views are personal