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THE UNFULFILLED PROMISE OF THE GOODS AND SERVICES TAX

Relevant for: Indian Economy | Topic: Issues relating to Growth & Development - Public Finance, Taxation & Black Money incl. Government Budgeting

Three years on, the tax is still hobbled by problems that need to be addressed without delay

The rollout of the goods and services tax (GST) in 2017 was supposed to be a landmark reform, promising riches of higher economic growth, better tax collections, efficiency and competitiveness. It was 12 years in the making, so a supposedly well-cooked design and policy. The legislation's passage was also a victory of herculean proportions for having secured a political consensus across states. It was passed in Parliament with a unanimous vote. But on the third anniversary of its passage, its promise is mostly unfulfilled. Was something wrong in the original design, or has it failed in its implementation? It is a bit of both.

Firstly, large parts of the economy remain outside the GST net, belying the concept of "one nation, one tax". Secondly, its relatively high rates have made both industry and services less competitive, especially in comparison with their international peers. India's dismal export performance in the past few years can be largely attributed to the burden of delayed GST refunds and an overvalued exchange rate. Thirdly, the convergence to a low median rate remains a distant dream, and we still have a multiplicity of tax slabs. The tendency for bureaucratic tinkering with rates and classifications persists. The most recent example is that of packaged parotta being levied 18% GST, whereas its north Indian cousin, the parantha, is taxed at 5%. There are many such instances of differential tax rates. There are differences between hair oil and coconut oil, or biscuit and chocolate. Such arbitrariness has resulted in confusion, uncertainty and litigation. This may keep revenue officials busy, but that is not what the reform had promised. The element of discretion needs to be done away with.

Fourthly, there is the spectre of the anti-profiteering authority, which can pounce on anyone, any time. It was set up to prevent undue profiteering (conveniently left undefined) by producers that did not pass on the benefit of lower taxes to consumers. Many companies have been fined under this clause. It was supposed to end within two years. But it still lives on, and without any indication of a sunset.

Fifth is the issue of inverted duties applicable to some industries. Due to non-uniform GST rates in a value chain, an upstream player is often left with unutilized input tax credit, which becomes a deadweight for the whole system, affecting pricing and competitiveness. This problem has plagued many service sector businesses too, since costs like electricity and fuel are not included in the GST net, and hence are not eligible for tax credits. The country thus also has a problem of incomplete GST coverage across the economy.

Sixth, and most importantly, we have not seen higher growth, nor tax buoyancy, nor much lower prices for products and services, which was a key GST promise. Of course, it is debatable whether one can solely blame the tax for this.

It's not just the imperfect indirect tax system, but also other factors such as the banking sector woes, stagnant investment and business confidence that have caused the downturn.

The early phase of GST implementation suffered from glitches mainly due to its network. The ambition of matching every invoice with every transaction in real-time proved to be too heroic.

This was in the earlier design, which faced the ugly reality of poor network connectivity in the country. The GSTR-3B form is a makeshift arrangement for reconciliation, but a more robust long-term solution is needed. The E-way bill, that magic bullet for frictionless inter-state commerce, is still far from functioning smoothly. There is too large a discrepancy between GST filing and final returns, pointing to systemic flaws. The fact that a large number of businesses below a threshold turnover have been exempted exacerbates the problem of a fractured tax system.

One of the original fatal design flaws was to base everything on a mythical “revenue neutral rate", or RNR. (See my Mint column of 18 November 2019, ‘Time to give up the bogey of a revenue-neutral tax rate’). Since everything was pegged to this rate, the entire GST system drifted far above the 12% rate envisaged in the original tax reform reports of 2001-02. Another fatal design flaw was in the compensation promised to states. To bring them on board, the Centre dangled the carrot of reimbursing any revenue shortfall. What was the base case? A uniform and rosy rate of 14% growth in GST revenues for the first five years. This assumption was a serious error, as described in a paper of Vijay Kelkar and V. Bhaskar of Pune International Centre. A blanket five-year guarantee gives states no incentive to make tax efforts of their own. Nor does it make an allowance for an economic downturn, such as the one caused by covid. And the GST compensation cess is almost completely gobbled up by the Centre. So, compensation to states is inadequate, or delayed, or both. This is especially problematic, coming at a time of increased fiscal needs to fight the pandemic.

To be fair, the GST Council functions quite democratically, meets often, and takes reasonably fair and quick decisions. But it cannot undertake drastic and fundamental reforms to correct some of the birth defects of GST (such as RNR). At a time when the economy needs a massive fiscal stimulus, it would be advisable to cut the median GST rate to 12%, widen the tax net to include petrol, diesel and electricity, correct the inverted duties, and remove the multiplicity of slabs. This would be the best way to celebrate three years of GST.

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