Further reforms are needed for the GST to succeed

The Rs9 trillion booster shot announced at the end of October will not achieve its purpose unless the tangles in the goods and services tax (GST) structure are sorted out, and the systemic bias against small-scale dealers embedded in its present design eliminated. Big business in India relies critically on inputs from small business. Organized sector manufacturers will hesitate to expand if these traditional input channels dry up. If they respond by producing their inputs in-house, we will be going right back to what we were trying to get away from with value-added taxation.

The GST carries design features that have harmed supply chain structures, as I wrote in my *Mint* column on 6 October. Some of them were partially reversed at the meeting of the GST Council held that day, but further changes need to be considered at the next meeting on 9 November in Guwahati.

The alterations made on 6 October included enhancing the turnover limit to Rs1 crore for the voucher-free composition scheme which has quarterly reporting, and making quarterly reporting permissible beyond that up to a limit of Rs1.5 crore. These were certainly moves in the right direction, but both changes benefited only retailers selling business to consumer (B2C).

They did not benefit small business to business (B2B) suppliers to large turnover buyers doing monthly reporting. These cases are very common—some of the biggest manufacturers rely on small suppliers of intermediate inputs like nuts and bolts. The large buyer will have to wait for his input credits to be honoured through voucher matching until the small seller does his quarterly uploading. He will clearly prefer to buy from a supplier who does monthly reporting, which then introduces a clear bias in favour of large suppliers, and an inefficient transfer of production away from low-cost small-scale producers. The small seller can of course opt to stay with monthly reporting, which means the quarterly relaxation is in effect not useful to him. As for B2B composition scheme suppliers who do not issue vouchers, they start with the basic disadvantage of the buyer not being able to claim input tax credits under the voucher matching scheme.

A ministerial panel appointed in October made several proposals to make the composition scheme more attractive, such as reducing the rate of levy on turnover and further raising the turnover qualifying limit. These will again benefit only B2C retailers. No small B2B supplier will opt for the composition scheme as long as there is universal voucher matching.

The whole purpose of value-added taxation was to improve the spatial spread of economic activity both regionally and across the scale dimension. The bias against small industry in the present GST design can only be eliminated by getting rid of voucher matching for all but integrated GST (IGST) transactions. On quarterly reporting, the ministerial panel does seem to have proposed that it be extended to all, but with summary documentation and payments every month. A monthly payment system will release business from the present reporting straitjacket only if it is treated as a monthly advance tax, with documentation needed only once every quarter (like advance payments of income tax).

I still maintain that the principal reason why GST reduced economic activity had to do with the reporting modalities, not the brambly rate structure. But the rate structure was and continues to be a problem. It has undermined the very principles on which the tax reform process was built seamlessly across successive governments at the Centre, the most fundamental of which was simplification.

The fact of a multiple rate structure is quite distinct from the pattern of assignment of products to those rates. Instead of a coherent block-wise mapping of products by type on to rates, products of the same type were assigned to different rates, with no visible rationale. This was then followed by several changes in rate assignment, clearly displaying the lack of any principle underlying the first round of rates assigned.

For example, at the 21st meeting of the GST Council held on 9 September, rate reductions were announced for 40 products. Walnuts, whether whole or shelled, were reduced from 12% to 5%. Were other edible nuts already at 5%? If so, why were walnuts at a higher rate earlier? Or were all nuts earlier at 12%, with walnuts now singled out for a lower rate? Dried tamarind and roasted gram were reduced from 12% to 5%, but *idli/dosa* batter (a similar traditional processed foodstuff) remained at 12% even after reduction.

It gets worse. Cotton quilts came down from 18% to 5% for pieces costing under Rs1,000, but 12% for pieces costing more than that. But, to be fair, there were also some offsetting instances of rate rationalization. Oil cakes, which previously carried different rates by end use, got unified. Brooms got unified too, but could they have not been further unified into a single product category of household goods? With the simplification announced in late October, whereby retailers can issue vouchers to consumers consolidated by rate, it becomes particularly important to group products by type into a single rate.

Rates are technocratic issues. What can be put up to the GST Council is rate policy with respect to a product group, not issues of principle such as rate differentiation by end use or price boundaries. These run contrary to the core attributes of GST as a tax, and should never have been among the options presented to the council in the first place.

Why has it taken so long for the design flaws of the GST to be recognized? I suspect it was because when the GST Council was formed with all state finance ministers as members, it seemed a faultless structure with all interests adequately represented. The incentive error made there was that the compensation formula gave all states a guaranteed 14% growth rate in revenue, instead of a guarantee calibrated in terms of revenue buoyancy to underlying (nominal) GDP growth. That dulled the gaze of all state governments at the growth impact of the structuring of the GST. A pity, because some states have excellent commercial tax departments, with more than 10 years' experience in operating the state-level value-added tax.

Was Parliament watching? Indeed, a number of questions on the GST were tabled in the Lok Sabha's monsoon session which began on 17 July, a few weeks after the 1 July launch of GST.

They were bunched and responded to on three dates during the monsoon session. On 21 July, question number 1,069 on GST, was taken up. The first of its four parts was: "Whether due to implementation of GST the micro, small- and medium-scale traders will suffer huge losses as feared by some economists". The minister responded in a single word: "No". The last part was: "Whether the GST might adversely affect economic growth in the initial part of 2017-18 and if so, the details thereof?" The minister responded with: "The implementation of GST is expected to have a positive impact on the economy." And that was that. As an unstarred question, no further follow-up question was permissible, on whether reality was departing from expectations.

Another question, number 1,101, asked whether the government was tracking the response of the general public to the roll-out of GST. The response was: "The implementation of GST has been smooth with no instances of any major inconveniences faced by the public in general... Further, the government is taking all possible steps to ensure correct information is disseminated to the general public by way of topic-wise, GST-focused advertisements in the electronic media. All this is coupled with regular meetings of the secretaries of all the departments of the government to sort out any issues that may arise."

I don’t know where those who drafted this response were living if they saw no major inconveniences. I was alerted to the design defects in the GST not in professional circles, but from conversations between shopkeepers whenever I ventured out to buy anything. The full-page advertisements in the major newspapers alluded to by the minister did not reveal why traders were shrinking the scale of their activities (the issue addressed in my piece in *Mint* on 6 October).

Question number 3,273, answered on 11 August, the last day of the monsoon session, was on whether there was confusion among traders over GST. To which the good minister responded: “No Sir. There is no major confusion with reference to registrations and exemptions under GST.” In response to question 2,206 answered on 28 July, on whether the GST carried features that were possibly problematic, the minister said: “No sir. It is intended to bring transparency and accountability in business transactions along with the ease of doing business and rationalization in tax rates.” Because it was an unstarred question, the member of parliament could not respond to say that doing business had actually become more difficult.

Moving to the Rajya Sabha, question number 1,065 asked whether rolling out GST in a state of unpreparedness had spawned a large workforce of tax consultants and chartered accountants whose heavy bills would burden small traders, the response once again was a short “No sir”. Question number 2,498 asked whether the common man faced problems after demonetization and GST. The response on 8 August was that the roll-out had been smooth with no blockages or interruptions.

Good questions, but not enough to have shaken the apparent conviction of the government that the GST design was perfect. Any tax reform has to facilitate business in order to secure revenue and willing compliance. Such a configuration for the GST is still possible if the reporting frequency is shifted to quarterly for all, and voucher matching is restricted to IGST transactions.

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Comments are welcome at views@livemint.com

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