Moving towards a more effective GST

The overdue transition to the new goods and services tax (GST) has started off on the wrong foot. The three main problems have been the complicated tax structure that can create distortions, onerous compliance procedures that have created working capital stress in many smaller companies, and technical glitches in the GST network.

This newspaper had commented a year ago that India was moving towards a flawed GST. One part of the flawed start can be explained by political realities. The complicated federal bargaining in the GST council led to a system of five tax rates, along with a special rate for gold, as well as cesses that go against the very basic principles of value-added taxation.

Another part of the flawed start can be explained by poor incentive design. As economist Indira Rajaraman pointed out in these pages, state finance ministers were less concerned about the growth impact of a poorly designed GST once New Delhi promised them a guaranteed 14% increase in tax revenue rather than a compensation formula calibrated to the growth in underlying nominal gross domestic product.

The rationalization of tax rates announced by the GST council last week is welcome against this backdrop. This is hopefully the first step towards a neater GST architecture—and the move towards a less flawed system will hopefully be sooner than expected.

Assam finance minister Himanta Biswa Sarma has said in an interview with *The Hindu* that the goal is to do away with the 28% slab. Jammu and Kashmir finance minister Haseeb Drabu tweeted that there would be a standard rate, a rate for merit goods and a rate for demerit goods. These are worthwhile goals.

What now? The task now is to have fewer tax slabs, lower rates and wider coverage.

The move to fewer tax slabs hopefully seems to have begun. The most significant decision taken by the GST council last week is to cut down the number of items at the top tax rates to 50, compared to an original list that was nearly five times bigger. Nearly half the goods and services in the GST net will now be taxed at the modal rate of 18%. And two out of three items will be taxed at either 12% or 18%. The most logical step now is to merge these two rates, with a medium-term goal to see that something like 90% of the taxable goods and services are at the new modal rate. In other words, there will be only a small list of merit goods to be taxed below the new standard rate and a small list of demerit goods to be taxed higher than the new standard rate.

Such rationalization will in effect mean that indirect tax rates are lower than their current level, with higher economic growth ensuring that fiscal accounts do not take a hit.

Indian GST rates are far higher than in most other countries. One reason is the problem of inadequate coverage. Only about half the Indian economy comes under the ambit of GST, so whatever is taxed has to be taxed stiffly. Important items such as petroleum, natural gas, alcohol, electricity, real estate and construction have been kept outside the GST net, mostly for political reasons. The Union government needs to work with the states to bring these items into the GST net. One result would be that wider coverage will create space for more moderate GST rates.

However, it needs to be reiterated that even the messy GST we have now is far superior to the numbing maze of indirect taxes that it has replaced. The fundamental promise of GST is still important. As we have argued earlier, GST will integrate the Indian market, promote economic efficiency by taxing final consumption rather than intermediate goods, encourage voluntary compliance and create a new architecture for cooperative federalism. There is no reason to shed crocodile tears for the indirect tax system it has replaced.

The GST council has its work cut out in the months ahead. It needs to move towards a system of three rates, a moderate standard rate at which most items are taxed, a widening of the GST net to include items such as petroleum and real estate, removal of cesses, and streamlining of compliance procedures so that supply chains do not grind to a halt as a result of working capital stress.

What would be the rate structure of an optimal GST for India? Tell us at views@livemint.com

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