GST: Disruptive but developmental

The body of work—Constitutional provisions, laws, rules, schedules, procedures and processes—of 30 governments over 15 years which culminated in the introduction of the goods and services tax (GST) has been on the ground now for seven fortnights.

While less than 100 days is very early in the day to pass any judgement on the Indian GST experiment, or make sense of revenue numbers that are coming, a quick list of big wins and losses can be put together.

The big unqualified win is the emergence of the GST Council as India's first federal institution; genuinely federal and fully functional. In the last 70 years, despite repeated efforts, no federal institution has emerged. Be it the Finance Commission, Planning Commission or its new avtaar, the NITI Aayog, or even the Inter-State Council.

Despite their institutional design and mandate within a federal set-up, either these institutions have been dysfunctional or controlled by and leaning towards the centre. Indeed, to borrow a memorable line of S. Guhan, these institutions "bark at the centre and bite the states". They dealt with all the federal issues from a very centric mindset.

The GST Council has changed all that. In the years to come, this Council will not only be the centrepiece of the new federal fiscal architecture, but will also be a role model for future federal institutions that are bound to come up.

Apart from its composition, what has made the Council remarkably federal is the process of decision making. In the 21 meetings so far, hundreds of decisions have been taken, ranging from legislative to operational. Every single decision has been made by building a consensus. Nothing has been put to vote. Of course, there have been strong disagreements, deep divisions on many issues. This decision by consensus has not only set a precedent but has also become the DNA of this institution. For this, credit must go to Union finance minister Arun Jaitley.

Second, the big systemic gain is that somewhere along the way the country has discovered an alternative way of formulating laws. On many occasions, the GST Council converted itself into a drafting committee. The Council discussed draft laws section by section. In fact, line by line, making changes on the fly and in real time. It was redrafting proposed formulation of laws live as it were.

Even in Parliament, this has never been done. Indeed, one can't think of any place in the world where such participative lawmaking has happened. This style and method needs to be showcased and replicated elsewhere in the country.

Finally, at the institutional level, GST in India is a bold experiment of pooling of sovereignty by the centre and the states in matters of taxation. This can have huge implications on the political economy of the nation as also on how our polity can be structured for functional purposes in the years to come.

In the course of its intensive and extensive debates, the GST Council has created a fraternity of finance ministers. At a professional level, the Council is a forum for sharing best practices. At a personal level, it has engendered a rarely seen camaraderie.

Consequently, functioning of the Council has risen above political party lines and ideologies. The party lines may not have been obliterated, but have certainly been blurred. Nothing can be more encouraging for economic policymaking in the country.

The first 100 days haven’t caused as much of a disruption in the basic macro-economic variables as had been expected or as had been the cross-country experience. There hasn’t been a post-GST inflation spiral as has been seen in many countries like Singapore, Australia and New Zealand. Despite many hassles and operational glitches in the information technology (IT) systems, the proportion of registration to returns is a healthy 60%. Also even though the states have got into a liquidity problem and are taking recourse to overdrafts, the revenue loss has not been such that it will cause a fiscal crisis.

In terms of policy framework, the big gain is that for the first time there are uniform rates for commodities across the country. True, there is still a long way to go before the one tax-one nation goal is achieved in letter and spirit. But there is no denying that one tax on one commodity is a reality. Coming from a regime of extreme dispersion of rates, not only across states but within commodity groups, this has been a big move forward. Everyone seems to have already forgotten the nightmarish rate structure, say of the footwear industry, which had more than 19 rates within a state!

Given the fact that GST as a tax regime is still work-in-progress, the multiple rate slabs will converge overtime. It is very likely that the two slabs of 12% and 18% will converge to 14.5% sooner than later. Indeed, the Union finance minster indicated a reduction of tax slabs a couple of days ago. Along with this, the number of commodities attracting 28% tax will have to be trimmed.

It is true that the GST council erred on the side of caution and pitched the rates high. This was driven by revenue considerations as well as compensation financing requirements. It needs to be pointed out that the way the compensation scheme for loss of revenue due to GST is designed, states have virtually got a tax insurance! It effectively covers everything ranging from inefficiency in collection to loss caused by a natural calamity. Such an open-ended compensation could not have been financed by the centre’s receipts alone.

The move away from commodity-specific exemptions, which was the fountainhead of corruption and granting largesse, is also a giant step towards transparency.

Without taking note of any of these systemic changes, an emerging public discourse is making GST out to be not only an unmitigated disaster but also the sole reason for the economic slowdown in the country. This is substantively erroneous and contextually misleading.

The transitional troubles of businesses and adjustment anxieties of the overall macro-economic system are being portrayed as tardy implementation, procedural lapses and systemic failures of the new tax regime.

One often hears that the issue of procedural and compliance matters has become very cumbersome in the new regime. While there is some merit in the argument, especially with regard to small businesses, let us not forget that three months ago businesses were filing multiple returns: separate returns for value-added tax (VAT), excise duty, service tax, and countervailing duty. All these have been replaced by one GST return.

What is causing compliance distress is not the returns per se but the frequency of filing; from a quarterly cycle, businesses have had to move to a monthly cycle.

It should be possible for the GST Council to address this issue based on the emerging revenue patterns. Depending on the size-class frequency distribution of businesses and their revenue contributions, the filing frequency can be calibrated and changed. Indeed, the finance minister recently hinted as much at one of his public functions when he revealed that 400,000 returns account for most of the revenue.

It is, however, important to recognize that the compliance burden is not due to the obsessions of the tax bureaucracy. The compliance framework aids a major structural change: the formalization of the Indian economy. As such these are troubles of transition not to a new tax regime but to a new form of business organization.

Most of the pains that are being faced by the small businesses, the informal, unorganized sector, are in part from the formalization of the Indian economy, which is being advanced by the compulsory filing of returns.

Comparable, though not as glamorous as the liberalization of the 1990s, or globalization of the 2000s, the distinctive push towards formalization of the country's informal economy through GST is the biggest structural gain from implementation of this indirect tax reform. So it must at least be understood if not happily endured!

In terms of the paper work, accounting, business processes, the serious constraints that have emerged and have the potential to cause liquidity stress in small businesses is the reverse charge mechanism.

It is being felt that the small businesses are bearing a disproportionate burden in accounting for transactions from the unregistered segment. While technically the reverse charge mechanism is required, the GST Council can help ease the small businesses into this system over time.

Notwithstanding this, the widespread pangs of transition must be alleviated by relaxing the procedural norms. In small but meaningful ways, GST procedures must incentivise the transitions which will eventually result in growth in output and jobs as the economic units in the informal economy move and get relocated in the formal economy.

The formalization will lead informal workers out of poverty, powerlessness, exclusion and vulnerability. The formalization through GST can also mean that entrepreneurs in the informal segment can more easily access capital and credit, and invest it in their businesses to obtain higher productivity and sustainability.

At present, there are some serious sectoral issues that have surfaced. The main among these being the exporters and handicrafts which need to be resolved. The effective tax burden on exports as well as handicrafts has become very high compared to the previous tax regime. It is not just hurting growth but impairing survival.

From a systemic point of view, there are two issues that the GST Council needs to deliberate on. First is the relevance of a maximum retail price (MRP) system—an anachronism from control raj days—in a GST regime. The MRP system was relevant in a pre-liberalized economy operating with producer taxation. The producers would work out the costs and margins of the distribution chain and allocate that within the MRP. Now it is a consumption tax, with final payment of tax at the last stage. Here, it becomes an anomaly to have an MRP. It over-determines the system. The result in the last three months has been that GST is being charged over and above the MRP!

It is time to examine if it is right or even the mandate of the manufacturer to set the price at which a product will be sold to the end-user. For, in doing so he decides the profit margin of the retailer, which in the current system may end up harming the consumer. Under GST, the MRP is more likely than not to create a retail price collusion as it becomes the de facto uniform price.

Second is an unstated business ethics issue which is coming to the fore under the transition to GST. It is an open secret that businesses in India have been operating different accounts to avoid paying taxes. There is a fear among the business and trading community that after full implementation of GST, tax officials can analyse turnover, other details and arrive at estimates of possible tax evasion over past years.

Not only indirect tax officials, but also direct tax officials can analyse the data to calculate possible incomes of business in the past and compare it with the income tax paid. This fear of possible retrospective tax inspection and survey lies at the heart of the chorus against GST and its implementation.

Most businesses and traders want to come clean by complying with the GST laws. To boost their confidence in doing so, the GST Council could get a clarification issued that cases under the earlier tax regimes will not be reopened due to a change in volume of transactions or turnover or some other parameters under the GST regime. This done, the chorus against the so-called tardy implementation of GST will stop in a day.

It is for these reasons that GST should not be seen only as a tax collecting system but a regime that has huge social and business ethics implications. What we are hearing today on the negativities of GST are in part a resistance to a behavioural, social and the value system change that GST is threatening to bring about and enforce. Therein lies the real pain.

Haseeb A. Drabu is the finance minister of Jammu and Kashmir

END