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GST in India: Success comes with new challenges

The Upper House of the Indian Parliament has passed the long-awaited Goods and Services Tax (GST) Constitutional Amendment Bill. This paves the way for the growth of a common market in India with uniform tax rates across the country for various goods and services. This paper discusses the economic implications of the GST. While discouraging tax evasion and removing inefficiencies in the current indirect tax system, the GST must be anti-inflationary and avoid dilution of efforts in moving towards a more progressive tax structure.

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In a rare display of political convergence, national and regional parties came together to vote for the GST in the Upper House of the Indian Parliament (Rajya Sabha) on 3rd August 2016[2] after a debate lasting for more than seven hours. This was a political triumph for the Modi government, which was handicapped by lack of majority in the Upper House. A lot of legislative and procedural work is still left to be done before the GST rolls out. These include the Lower House of the Parliament (Lok Sabha), which had cleared the Bill earlier, re-approving changes introduced by the Rajya Sabha; passage of the Central GST, State GST and the Integrated GST Bills enabling the Centre and States to tax both goods and services with at

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[2] The only exception was the All India Anna DMK (AIADMK), currently in power in Tamil Nadu, whose MPs, while not voting against the Bill, walked out during the vote protesting against some provisions in the Bill.

least fifteen out of twenty-nine states passing state GST Bills; and establishing the GST Council, which would decide a 'revenue neutral rate' (RNR) for the GST, not to exceed the ceiling of 18%.

Greater predictability and less evasion

Indian industry has been demanding the GST for a long time, primarily because of the predictability it will bring in taxes for goods and services across the country. Right now, goods and services in India are imposed a variety of taxes, including Central excise duty, state-level value added tax (VAT), service tax, purchase tax, luxury tax, entertainment tax and entry tax on inter-state movement of goods. All these are expected to coalesce into a single tax rate for each good and service across the country. More predictability is expected from the same tax rate applied to broadly similar categories of goods such as luxuries and necessities.

An important economic implication of the GST is the disincentive it creates for tax evasion. Currently, the plethora of indirect taxes have a cascading effect by adding on to each other and encouraging under-reporting of value of transactions. After GST, at all levels of the value chain, producers would obtain credit for taxes already paid. For example, manufacturers would obtain credit on taxes included in prices of raw materials they bought, while wholesalers would get similar credit on taxes included in prices of final goods bought from manufacturers. Under-reporting of transactions for avoiding taxes would be discouraged, particularly in manufacturing.

Exemptions remain for states

There are items, however, that are being exempted from the purview of the GST. These include crude and refined petroleum products (diesel, petrol, aviation turbine fuel, natural gas), alcohol and liquor for human consumption and electricity services. All these products and services are important items for resource mobilisation for Indian states. It is therefore natural that states would not want to let go of the freedom to tax these revenue sources, particularly when there are still concerns over whether the transition to GST will lead to improvement in state finances, or not. Though the Centre has agreed to compensate revenue losses of states, if any, for five years after the rollout of the GST, the long-term apprehension of states is understandable. It will, however, be eventually left to the GST Council headed by the Union Finance Minister and including Ministers from different states, to decide till when the exempted items would go untaxed. For the time being, state taxes on these would continue to vary leading to differences in their prices across the country.

Challenge of avoiding inflation and tax regression

While the GST would greatly simplify indirect taxes in India, there are a couple of downsides that cannot be overlooked. In the short term, it might have an inflationary impact, particularly for services. The GST council will have the difficult task of choosing a RNR rate that will neither hurt the common man, nor central and state finances. While several manufactured items might become cheaper on the margin post-GST as number of taxes lessen on them, many services might become dearer, particularly if the RNR rate is higher than 15%, the current effective service tax rate.

The GST also does not make the overall tax structure progressive. Progressive tax structures rely on raising more resources from direct taxes, such as income tax, rather than indirect taxes like the GST. Only 3% of India's population pays income taxes. While the effort to introduce the GST is laudable, it should not distract the tax administration and public finance managers of the country from attempts to make the tax structure more progressive by expanding the income tax net. Supporters of GST argue that many wealthy people, currently getting away by paying low income taxes, would get taxed by the GST, as it is a tax on consumption. This argument holds for several segments of luxury consumption, particularly high-end hospitality and entertainment services. Nonetheless, the GST would find it difficult to tax conspicuous consumption across the broad spectrum of economic activities. Such equity can be achieved only by a progressive income tax regime.

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