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The GST: Light at the end of the tunnel?

As the Goods and Services Tax is inching towards implementation, a major overhaul of the Indian tax system has also been in progress. This article discusses three key strengths of the ongoing process, and highlights the merits of introducing GST as early as possible.

We are used to highlighting the shortcomings of economic reform in India, both in process and outcomes. These shortcomings are particularly apparent now, when the economy is struggling on several fronts: growth, inflation, and the external balance. In this context, it is good to revisit an ongoing success story of Indian economic reform: its tax system.

Indian tax reform

In the last two decades, India has made tremendous strides in terms of reforming income taxes and consumption taxes. These reforms have included improvements in tax policy as well as in administration. The former has helped the latter: rationalising tax policy has made tax administration easier to conduct effectively, but there have been direct improvements as well in the technology of tax administration.

Better tax policy has meant cutting inefficiently high rates, whether in the income tax structure or in areas such as import tariffs. In the case of consumption taxes, it has meant replacing a complicated tangle of sales taxes and duties, often piled on each other, with a simpler, more transparent Value Added Tax (VAT). As the VAT nomenclature implies, taxing only value added avoids the problem of taxes being applied to quantities that already include other taxes – a cascading effect that can create unintentionally high rates, and multiple inefficiencies. Better tax administration has been built on the foundation of new Information Technology (IT) systems, which support mechanisms such as deducting income taxes at source for those who are required to pay them, and the tracking of purchases and sales required for VAT credits along the value chain.

GST: An important new step

The Goods and Services Tax (GST), which is inching toward implementation, represents an important new step in the process of Indian tax reform. The sooner it is put in place, the better for the economy. In particular, there is some reason for thinking that the GST will give the central as well as state governments a firmer, broader revenue base, which is less subject to political distortions than is the income tax: the GST is a VAT, better coordinated than the present system, and applied more broadly and consistently. The current VAT structure includes state-level as well as central-level taxes. The GST will retain this dual structure, with state and central components, but strives for more coordination of which goods and services are exempt, which are taxed, and at what rates. The GST will also bring more firms into the tax collection system, reducing the thresholds for exemption from collecting taxes. Increasing the number of goods and services that are taxed as well as the number of firms that collect the tax increases the effective tax base.

A key institution in the process of introducing the GST, as it was earlier for introducing the VAT and for managing state sales tax incentives, has been the Empowered Committee of State Finance Ministers (EC). This EC met in May 2013, and then, on June 7, its chairmen met with representatives of industry associations and consulting firms, where an EC paper (Empowered Committee, 2013) formed the basis for discussion. This discussion paper is a model of clarity, and illustrates how this complicated process of introducing a **major overhaul of the tax system** is proceeding. There are several facets of the process worth noting.

Technical policy formulation: There is a clear understanding of the technical issues involved in government, trade-offs involved in specifying tax bases in different ways (based on turnover introducing the GST, including changes in revenue receipts at different levels of levels)[1], and mechanisms for administration (especially across different levels of government). One might expect this clarity, given the time it has taken to get where we are, although length of time taken has not been a guarantee of quality in other cases of policy formulation. There is also a clear use of technical inputs from the main national source of such expertise, the National Institute for Public Finance and Policy (NIPFP).

Political management: There is a clear understanding of the constitutional issues involved in introducing the GST, of course, but also a polite and pragmatic statement of the needs of the states in terms of some protection against revenue uncertainties that might come with the reform, as tax rates and tax bases change. In this context, the previous national government appears to have been somewhat lax in its political management of a complex Centre-state issue – the compensation being requested by the states seems to be quite small relative to central tax receipts, or even as a percentage of the fiscal deficit. This bodes well for reaching agreement under the new government, which has a better political equation with many states, and with the business people who will have to pay and help implement the GST. The new finance minister has already reached out to the states for their support of the GST. The states, in turn, have reiterated their desire for some assured compensation for the central sales tax revenue and other tax revenue forgone with the shift to the GST – a similar deal was key to the implementation of the VAT over a decade ago. The NIPFP expert team has calculated different scenarios for rates and revenue, based on different assumptions about the phase-in of the new system.

Institutional innovation: The central government has created a

GST Network (GSTN), which is a non-profit company with ownership shares of the Centre, states, National Securities Depository Limited, and three selected financial institutions. The GSTN will provide a common IT infrastructure to support the introduction and implementation of the GST. As the EC discussion paper elucidates, issues of monitoring and control versus costs of compliance, can all be dealt with effectively with a combination of the right policy framework and a solid information infrastructure.

Way forward

The EC discussion paper of June 2013, which distils many years of discussion and analysis, perhaps marked the end of the process of agreeing on the details of the GST, and the beginning of serious efforts to make it happen. The GST will be a major milestone in Indian economic reform, and it seems likely that a grand bargain between the Centre and the states will soon be reached. Tax reform has not been perfect. There is much left to do. For example, the GST, in coordinating taxes on the same bases (in this case, business sales) may provide a model for reform of the income tax system, allowing states along with the Centre to tax personal incomes (which would require another constitutional amendment, but would give the states much needed revenue autonomy). The GST use of information infrastructure might point the way to methods for strengthening property tax systems across India's creaking, bursting cities, as well as other aspects of local tax systems. Hence, the GST and the conceptual and real infrastructure it has engendered may have positive spillovers to other, equally important areas for ongoing tax reform.

This is an extended and updated version of an article that appeared in the Financial Express.

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[1] In particular, setting lower threshold turnover levels for firms to be in the tax system may lead to small increases in revenue that can be outweighed by greater costs of monitoring and enforcement. Including large numbers of small firms might also increase the scope for corruption and collusion among firms and tax enforcers.