ADB
ALLIANCE FOR DIGITAL BHARAT

GOODS AND SERVICES TAX:

Recommendations from Industry

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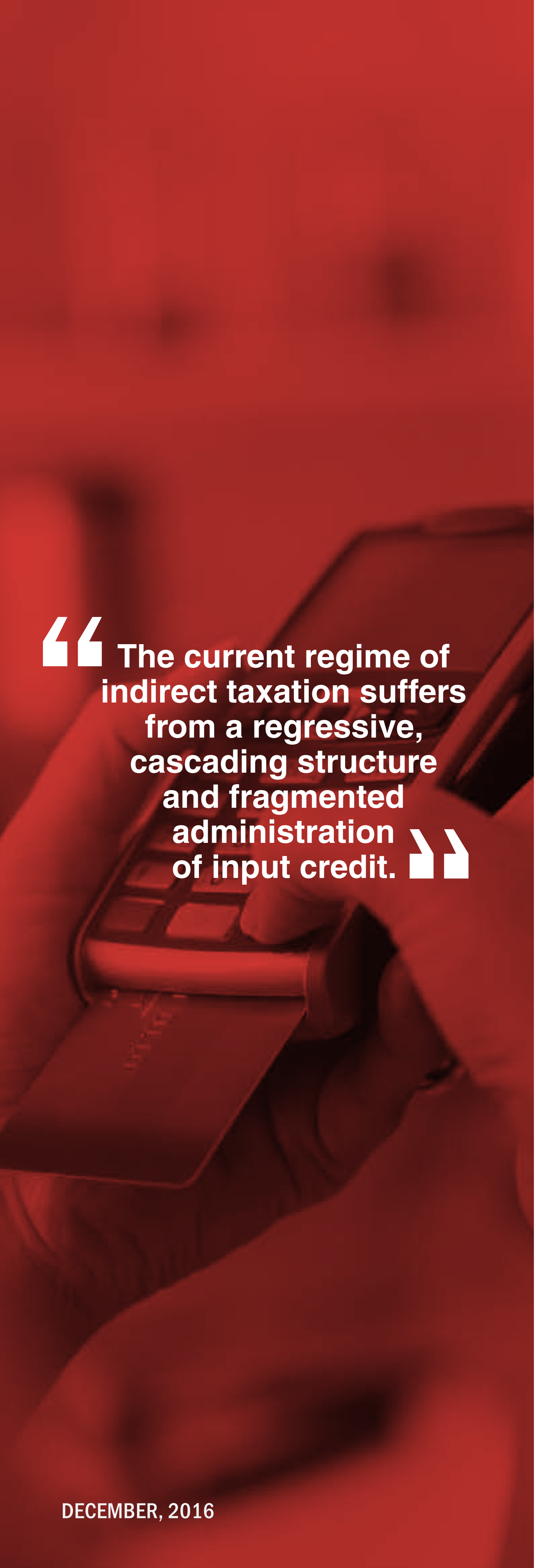


> "The current regime of indirect taxation suffers from a regressive, cascading structure and fragmented administration of input credit."

Executive Summary

In 2005, India switched to a value-added tax, marking a significant step forward in the reform of trade taxation. The logical way forward for tax reforms, is to harmonise and rationalize indirect taxes into a comprehensive indirect tax regime.

It must be kept in mind that the original promise of the GST was the creation of an indirect tax code with a low unified tax rate and minimum exemptions. The inefficient nature of indirect taxation gave impetus to this ambition. However, the extant GST structure is not as harmonized as initially hoped. The GST will need to onboard merchants and retailers across the country, to create a single seamless market to succeed, given the insufficient uniformity of taxation.

Some measures to ensure a seamless market, which are elaborated upon further in this paper are outlined below:

- It is necessary for the Government to significantly decrease the cost of doing business by providing physical Suvidha Kendras and longer payment cycles under the GST, given that compliance costs of the same have proven to be regressive in international experience
- Ensuring easier inter-state movement of goods by removing the check-post regime that causes delays in inter-state transport
- Extensive consultations must be undertaken to avoid market distortions around the eligibility threshold
- The harmonization of tax rates towards fewer slabs without cesses should be on the cards for the GST Council, while ensuring that accumulated tax credits are refunded effectively
- The Government should focus on enabling the compliance capacity of merchants via educational drives and comprehensive consultations with merchant bodies
- Lastly, enabling of tax payments through the maximum number of digital gateways complemented with a push in the same direction by payment portals will enhance the creation of an interoperable system

While the GST is certainly a step in the right direction, there is much to be desired going forward. There is renewed need for government to actively work towards reform of the Direct Tax Code as a complement to indirect tax reform. Direct taxes are progressive in nature, but India still bears the burden of achieving only slightly over 50 percent of fiscal revenues from direct taxes. Reforming the direct tax code to increase direct tax collection will reduce the burden of collection from indirect taxes, enabling the realization of a lower and more unified indirect tax code. To highlight related opportunities and challenges as perceived by Indian MSMEs, the Confederation of All India traders (CAIT) organized a panel discussion through the Alliance for Digital Bharat (ADB) on 6th October, 2016 on the GST. This paper build on the discussions that ensued.

Structural Challenges of the Existing Tax Regime

The replacement of State-level Sales Taxes by the Value-Added Tax in 2005 marked a significant step forward in the reform of trade taxes in India.

The state VAT design was largely based on the blueprint recommended in a 1994 report by the National Institute of Public Finance and Policy, prepared by a team led by the late Dr. Amaresh Bagchi. In the report, it was acknowledged that VAT was not the best solution to the problems of the domestic tax regime in a multi-government setup. The "perfect solution" alluded to in the Bagchi report formed the logical next step for tax reforms in the country – the Goods and Services Tax (GST). The GST's express purpose is to subsume all indirect taxes levied by both the Centre and the States, thereby knitting the country into a unified internal market.

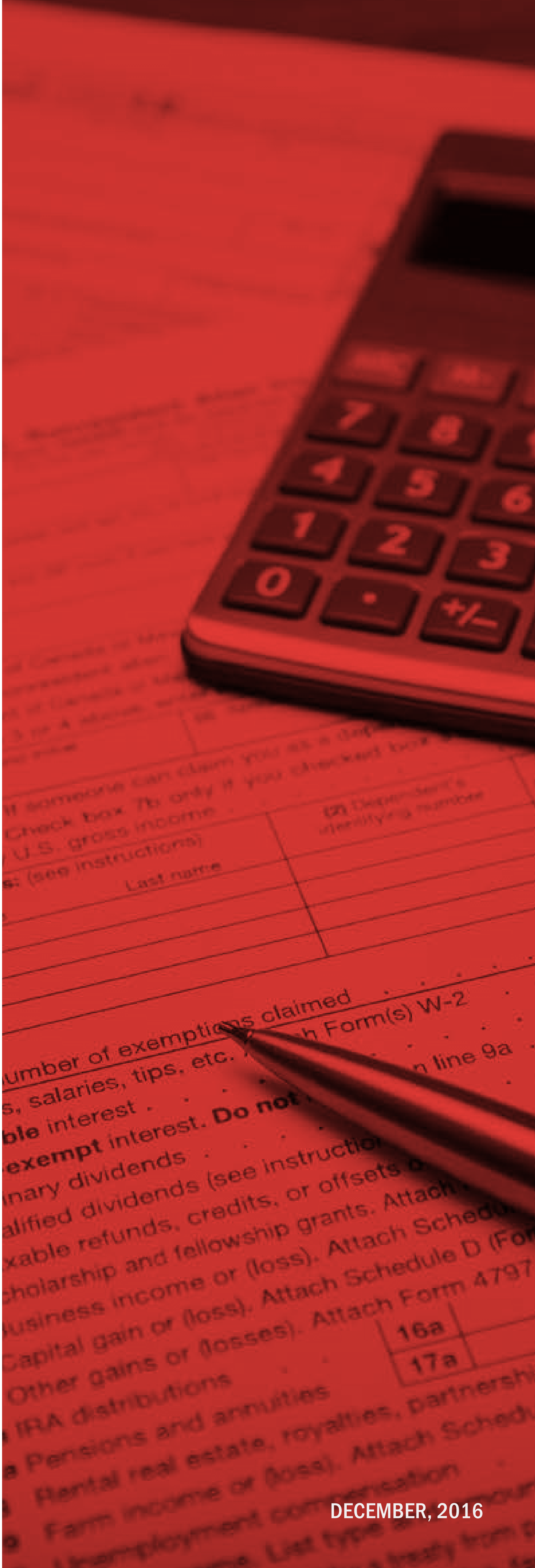
The GST aims to replace the complex system of indirect taxes faced by the domestic market with a more rationalized system of indirect taxation. Under the present tax regime, there exist two major inefficiencies – multiplicity of taxes and cascading of taxes. These make the tax base narrow, the process of paying taxes expensive and the system cumbersome.

Firstly, the Constitution of India, prior to the 122nd amendment bringing into force the GST architecture, restricted the rights of the Centre and States to exclusively taxing certain goods and services. This gave rise to a complex tax system with high costs of compliance. Despite improvements made over the past few years, the systems at both the State and Centre remain complex, with administration suffering from significant gaps. There are frequent disputes and court challenges, and the process for dispute resolution is slow and inefficient. At the same time, the system suffers from significant compliance gaps, except for by highly-organized sectors of the market.
Secondly, the system of indirect taxation suffers from cascading due to the partial coverage of central and state taxes. The Centre levies both CENVAT (Central Value Added Tax) and Service Tax on the manufacturing sector. The taxable activity under the former is "manufacturing" and under the latter is "provision of a service", and in the current scenario, both these terms are hard to define exclusively. Businesses also face a patchy tax credit system which forces them to pay embedded taxes on their inputs – contrary to the principle of taxing only the "value added" component upon which VAT is based. While there are no recent estimates available for the extent of tax cascading under the Indian tax system, it is likely to be significant, judging by the experience of other countries with a similar tax structure. For example, in Canada, under the manufacturer's sales tax, which was like the CENVAT, the non-creditable tax on business inputs, machinery and equipment accounted for approximately a third of the total revenue collected from this tax. Considering that the number of cascading taxes is higher in India, this proportion serves at best as a conservative estimate.

The GST is thus a proposed solution. Under the GST regime, every firm with a turnover of more than INR 20 lakhs per annum, roughly INR 6000 per day, will be subject to a uniform tax to be levied concurrently by both the Centre and the State. Thus, except the smallest of businesses, many enterprises will fall under the taxable umbrella. The entire supply chain thus stands to be taxed, and will be able to claim input tax credits. Interstate transport of goods will be taxed by the Centre as the IGST (Integrated Goods and Services Tax), which is proposed to be equal to the sum of the Central GST (CGST) and State GST (SGST). Thus, multiple taxes that businesses must currently pay are expected to be subsumed under two heads - the CGST and the SGST.

Tax cascading on the other hand will be tackled by a comprehensive, IT-backed input tax credit system, where tax credits for goods and services are treated at par. However, CGST and SGST input credits will not be treated at par and cannot be offset against each other. Since the entire supply chain is to be taxed at the same rate (ideally), businesses will pay tax only on the value they add to a good/service. The final incidence of the tax will rest on the consumer. This credit system, along with the registration and returns system to be supported by the Goods and Services Tax Network (GSTN), should provide the underlying architecture for enabling better tax compliance.

The success of the GST is thus heavily dependent on the successful expansion of the tax base – ideally creating an ecosystem of tax-paying businesses which are seamlessly connected to each other in a single market. Compliance costs on businesses for a value-added tax have been found to be regressive in the experience of other countries (New Zealand, Australia), which implies that the cost of registering for and paying the GST becomes a larger share of the firm's costs as firm size reduces. Thus, providing incentives for MSMEs to comply with the GST are necessary to ensure that envisaged economic benefits accrue from this comprehensive tax reform.



Towards a Compliance Friendly Ecosystem

This vision of a "One Tax One Market" with an expanded tax base will require transformative change in the way taxes are viewed by taxpayers. Currently, the attitude towards excise is one of fear and antagonism amongst traders – taxes are viewed as leakages from the supply chain and a source for harassment by authorities. Therefore, complying with the GST regime needs to be demonstrated as personally beneficial to the tax payer. Reporting earnings and paying tax shall be beneficial to small businesses as they will be able to claim input credits on goods and services as well as on imports, which were earlier outside the purview of the State VAT regime. Traders also need to be assured that firm-level data acquired during the collection of GST will not become a means for harassment in future. Thus, the following issues must be considered before rolling out the GST, to ensure merchant friendliness of the GST:

Increasing the ease of doing business

This should be a priority under the envisaged GST regime. The compliance costs of GST have proven to be regressive in international regimes. In the case of New Zealand, a 2014 report by its Inland Revenue department stated that GST compliance costs were found to be amounting to INR 80,000 for firms with INR 24,80,000 - 61,38,000 turnover; INR 1,64,000 for firms with more than INR 8 crore turnover. Further, firms in New Zealand are required to file GST quarterly. In India, proportionate compliance costs are expected to be higher, as filing is mandated monthly. GST filing is proposed to be undertaken via third-party applications – a "GST Suvidha Provider" – which will administer a Government-to-Business interface to upload invoices, sales registers etc. via mobile phones and personal computers. However, given the quantum of data that firms may have to upload, mobile applications are grossly underpowered and cumbersome to provide adequate support. It is thus suggested that physical Suvidha Kendras be set up under the GSTN to provide IT-support to firms which may otherwise find GST compliance technically challenging and costly. It may be worthwhile to locate these GST Suvidha Kendras in markets from where traders conduct business. Furthermore, the frequency of filing GST may similarly be reduced to a quarterly cycle.

Ensuring easier inter-state movement of goods:

Logistics in the country are severely crippled by the web of check-posts that dot state borders. These increase the cost of transporting goods across states, effectively constraining firms to operate within limited markets. For ease of interstate trading, businesses are inadvertently forced to set up warehousing capacity in each state. The "One Market" principle aims to seamlessly weave these disparate markets into a cohesive whole, ideally removing the necessity of building firm-level warehouse infrastructure across states, reducing transport costs and creating flexible warehousing structures. However, the Model GST Law states:

> **"The Central or a State Government may require the person in charge of a conveyance carrying any consignment of goods of value exceeding fifty thousand rupees to carry with him such documents as may be prescribed in this behalf."**

> **"Where any vehicle referred to in sub-section (1) is intercepted by the proper officer at any place, he may require the person in charge of the said vehicle to produce such documents for verification and the said person shall be liable to produce the documents.- (Section 61)"**

This effectively retains the check-post system and negates any benefits that the levying of the IGST may have on logistics and transport systems. While increasing the threshold limit for required registration of goods via "way-bills" is a positive under the GST, the vague and arbitrary wording of the section leaves space for the creation of unequal permit-based regimes which will continue to fragment markets. It is suggested that inter-state transport be treated at par with intra-state transport, obeying the spirit of the law. This will further enable the reduction of corruption and inefficiencies that plague the logistics sector in the country, and enable smoother transition to a competitive manufacturing economy.

The importance of good physical infrastructure to catalyse trade cannot be under-emphasized. The GST regime, by focusing less on incentives, can use the additional fiscal space to spend on infrastructure upgradation.

Market distortions around eligibility threshold:

The GST taxes any firm that has a turnover above INR 20 lakhs per annum. While the setting of a threshold provides competitive benefits to micro enterprises, threshold limits have been observed to cause market distortions. When the Japanese “Consumption Tax” was first levied, it was seen that there was a surge in big firms masquerading as multiple small firms. A study conducted for a sample consisting of 14,800 thousand corporations, and a comparison of the size distribution of firms in 1988 and 1990, showed an increase in the density below the size threshold attributable to this consumption tax reform of 1989. Statistical tests indicate that the difference was significant, implying that the tax threshold exerted a strong influence on firm size. Further examination shows that much of the behavioral response occurred within a year and a half after the implementation of this law. Eligibility thresholds can also cause micro firms to hold off expansion to remain below the purview of tax compliance. It may therefore be prudent to examine whether the eligibility threshold of INR 20 lakhs is optimal or not – which can be internally assessed by CAIT through a questionnaire circulated to its members.

Harmonization of tax rates:

While the GST removes the myriad tax rates that firms currently face with just three taxes – the CGST, the SGST and the IGST – the application of the same remains subject to the GST Council. As of 9th November, 2016, the GST Council has finalized a tax structure with four tax slabs – nil for items of mass consumption, 5% for other necessities, a standard rate of 12% & 18% for other goods and 28% for luxury and demerit goods, with additional cess levied where necessary. The power to levy cesses creates uncertainties in the taxation system. On the other hand, the multiple tax slabs, while necessary, can lead to inefficiencies. Appropriate definition of slabs has caused disputes in the past and the current structure retains this tendency. It is necessary to resort to a “negative list” approach instead of a slab structure. Secondly, slabs can lead to inverted duty structures where the tax paid on inputs is greater than that on outputs. This can lead to an accumulation of tax credits, as is the case under the CENVAT presently. The assurance that the refund of such accumulated input tax credit will be handled promptly is a must if the proposed slab structures are deployed under the GST.

Enabling compliance capacity of merchants:

It is widely recognized that small merchants lack capacity to adequately tabulate and pay tax. The administrative burden is perceived as too high, both in terms of time and money spent on compliance. Registration and regular and manifold returns submissions are in themselves burdensome. While there is promise of easier compliance through a robust underlying GSTN, there remain challenges to be addressed. Most small merchants lack technological savvy to efficiently utilize electronic filing. Linguistics challenges will also make themselves felt. It is thus incumbent on the government to incentivize Suvidha Providers to rapidly onboard merchant businesses, providing services starting from generation of GSTN registration numbers to ensuring timely submission of taxes through IT solutions. The costs of compliance should be subsidized by the government to achieve the objective of rapidly expanding the tax base. The recent MOU signed between CAIT and Tally Solutions, India's largest accounting software firm, to train the non-corporate sector on maintaining books and filing GST is a step in the right direction. These efforts need to be multiplied manifold, on an accelerated basis. Educating merchants on the benefits of the GST, as well as building e-compliance capacity at the level of small merchants which have not yet fully computerized their accounting practices is key to ensuring success of the GST.

GST and digital payments:

Another important step is the enabling of tax payments through debit and credit cards, recently allowed by the Ministry of Finance. This needs to be complemented through a push by cards payments firms for greater adoption of credit and debit cards – achieved by partnering with a greater number of banks, and by ensuring that banking compliances such as KYC requirements are taken care of while adding to the card user base. The Government can further consider allowing GST payments through digital wallets, besides pushing for the adoption of UPI on smartphones to expand payment options. The digital wallets ecosystem has grown rapidly, and may benefit micro merchants the most, whose earnings are exclusively in cash. In fact, enabling the UPI platform to accept all electronic payment options will further accelerate the push towards a "less-cash" ecosystem. Pushing a “less-cash” ecosystem through emergent technologies and merchants will complement the expansion of the tax base, fulfilling the aim of an open, interlinked tax collection and refunds structure.

Endnotes

http://eprints.lse.ac.uk/38346/1/ARCWP26-AhmadPoddar.pdf
Ibid
A cascade tax is a type of turnover tax with each successive transfer being taxed inclusive of any previous cascade taxes being levied. Because each successive turnover includes the taxes of all previous turnovers, the end tax collected is be greater than the nominal tax rate.
Ibid

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