The uncertain gains from GST

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The next big reform on the agenda is GST. The single tax has been projected as changing the way in which business is done. And along with the measures taken by the government in easing the business climate, it should make things much easier for India Inc. There are various studies to show how GST will bring in several benefits. The contentious issue today, holding back its acceptance, is the potential loss for some producing states, which need to be compensated when a single rate is applied. It is hoped that, over time, the sharing formula will be arrived at and accepted by all the constituents.

There are, however, some issues relating to GST that merit discussion. The first is that when we have a single tax rate on goods and services which are fixed at, say, 18% or 22% or 27%, someone has to pay for it and it is not possible for all to be gainers from such a tax. The government is talking of a revenue-neutral tax, which is hard to arrive at, given the complexity of the system. If it can be done, then it would be a Pareto optimal solution where no one will be worse off and someone better off.

Second, the inflationary impact cannot be escaped. Today, there are a series of taxes, with a lot many being under VAT, which means that the nominal rate would be applied on the value-added component at each stage. The system is complex and it is hard to add the nominal rates of central excise, central sales, state excise, sales, octroi, customs, countervailing duty, etc, to arrive at the GST rate. Assuming that tax authorities do find such a rate, on an average basis, there will be several goods and services that will be taxed a higher rate, which, in turn, will put pressure on prices. Services, for example, are taxed at 14% by the Centre and any rate that is higher will jack up the prices. For consumer goods, the final impact is uncertain as tax rates vary across states and there will be loser and gainer households. Also, with producing states being allowed to levy 1% special tax, intuitively there will be a price impact that has to ultimately be paid by the consumer.

There could be mitigating factors in terms of cost-savings by companies, which do not have to go to different windows to pay different taxes. The issue is whether they will lower their final prices if there is a net gain at a time when their profitability has been under pressure? Anecdotal experience shows that when taxes are lowered, the same is not fully transmitted to the MRP. Hence, if some goods are effectively taxed at a lower rate or there are savings due to efficiency, it is uncertain if final prices will come down. Therefore, the final impact on inflation will be a matter of conjecture, considering that services are not touched by the WPI and partly by the CPI. Currently, with global commodity prices down and manufactured goods inflation close to zero, the potential inflation impact looks minimal, but a growing economy always carries along a higher core inflation number which needs to be monitored more closely when GST sets in.

Third, the impact on GDP is uncertain. There are studies which show that India's GDP will grow by 1.5-2%, based on different models. Logically, if we look at the output method of calculating GDP, then the question to be posed, whether or not we are producing fewer goods because of high indirect taxes? Have these taxes come in the way of production? The answer would generally be in the negative, which means that production decisions per se may not be influenced by taxes to be a limiting factor. The current system is inefficient for certain and pushes up cost of production and distribution, and hence there would be some front-loading on consumers. But as we have never had a situation where supply has not been able to keep pace with demand—as producers were not producing goods because of high taxes—it stands to reason that production per se will not really increase significantly with this tax, though efficiency would be enhanced. In fact, if we are talking of a revenue-neutral rate, then most certainly the tax incidence should not change and the question would then be if anyone held back production because of too many processes? Therefore, the direct impact on GDP could be limited.

GST would definitely be an efficiency-enhancer as companies will gain by spending less time and money in paying taxes. Their cost will come down for certain, as often trucks spend several hours at the check-posts waiting for clearances and paying taxes. A single point and rate of tax is ideal for anyone in business. Companies will definitely benefit from GST, which should get reflected in their profit lines.

That said, on balance the tax may not really lead to substantial increase in production except at the margin where a producer could not produce because of tax and process encumbrances. But compliance will definitely improve as several producers who hitherto were not paying taxes due to the painful processes would come forward. To this extent, there would be a one-time increase in GDP as their output gets recorded, provided there were no imputations being made for the same by the CSO presently.

Further, while there is impatience in having GST being in operation from April 2016 onwards, a challenge could be in the IT space as to how we manage to integrate the systems to ensure that the tax can be levied. Currently, every state and UT has its own means of collecting the tax and the systems have to be merged, which is a logistical issue. Also, the redundancy of staff would be an issue to be tackled, as there are such departments in every state, given that commodity taxes are the main source of revenue for all state governments.

When analysing the impact of GST, we need to separate efficiency issues from the economic ones, as the latter are more complex with the impact being nebulous. There is no doubt that we need to have a GST and get out of the labyrinth of taxes that exist today at different levels. However, the impact on GDP and inflation is still uncertain. While prima facie it is hoped that prices will come down and GDP may go up, such a win-win situation may not be easily forthcoming.

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(Financial Express)