How will GST affect the Indian economy and consumer experience?

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In about a month, India's new indirect tax system will be rolled out. It has been described as the biggest reform in indirect taxes. India now joins some 160 other countries that already have a Goods and Services Tax (GST). The only large economy exception without a GST is the United States. Most other countries have this consumption tax as a key component of their indirect taxes . In a nutshell, here are the key features of the GST :-
First, it moves the tax system from production to consumption. It covers the gross domestic product (GDP) more comprehensively. Because the tax base is now a much wider set of transactions, hopefully the per capita tax incidence will be lower.

Second, it eliminates a major bane of cascading,i.e. having to pay tax on tax. It will thus increase efficiency of taxation.

Third, the GST has interlocking incentives for compliance, because your tax incidence, and refund, depends on production of proof of tax paid by your supplier. The paperwork, or rather the computer records, is interlinked in a chain. No one person in the chain can evade tax because it hurts either his vendor or customer. In that respect, the GST's interlocked incentives look similar to Grameen Bank's joint liability lending in microfinance. Micro loans are given without any collateral, but if one person defaults, the entire group is blacklisted. This ensures an almost100% repayment rate. Similarly, the GST too has interlinked incentives for the whole value chain.

For these three reasons and many more, the GST is expected to bring many benefits to the economy. These are higher GDP growth, lower inflation , buoyant tax collections, wider coverage and less tax evasion, and, most importantly, a truly common economic market across the country. Indeed the slogan for promoting the GST was "One Country One Tax ".

The origins of the GST go back almost two decades and are also found in the reports of the Kelkar Committee on Tax Reforms. The basic premise of tax reforms then and now were lower rates, simpler code and eliminate exemptions. On all these three goals we have much distance to travel.

First, with five slabs of 0%, 5%,12%, 18%, 28% plus cess, we have increased the chance of classification disputes, discretion and litigation. The high rates encourage tax evasion, distort decisions, and promote wasteful resources into tax avoidance. A rational tax system should have very few rates and low rates. Indeed, before the introduction of this GST, the service tax had just one rate, that was 15%, applicableto all services. We now have multiple rates and the chances of disputes and legal battles have increased.

Multiple rates are attractive politically. Items consumed by the poor are taxed at low rates and luxury goods are taxed at higher rates. But this classification itself is problematic especially in a diverse, fast evolving economy. For instance, perfumed hair oil may be a luxury item in Bihar but not in Tamil Nadu. Rubber slippers are worn by the poor, but also the rich at beach resorts. There is also a quality continuum, and from unbranded to branded.

Furthermore, today’s poor may be tomorrow’s rich, so there is an aspirational class too. It is far too complex to classify goods rigidly as those consumed by the poor and the rich distinctly. But multiple rates increase costand complexity. As the task force also pointed out, the cost of auditing the classiication of exempt,low rate and high rate slabs across every stage of production, distribution and consumption is very high. Single or few rates are easy to comply with and involve muchlower disputes.

Multiple rates have been introduced so as to soften the blow of inflation. By keeping most of the goods consumed by the poor(as identified by their consumption basket), the hope is that inflation will be in check, which leads us to the question, will inflation remain in control? Since almost 60% of India’s GDP is from services, and the rate is moving from 15 to higher, it is quite likely that inflation will inch up. This is especially evident in the financial, telecom, hospitality and trade services. Of course, to the extent that service providers will now get input tax credit, which they might pass on to their customers,inflation may not rise by much. Since the IT systems are not fully in place and refunds are not instantaneous, the benefit of tax credit will be delayed. This cost of delay and consequent cost of working capital too introduces an inflationary element.

It was hoped that not many items would be in the 28% bracket,failing which inlation will be higher. The tax burden on industry is coming down in the GST. This is because currently, excise plus state VAT adds up to more than 25%, which will definitely go down. Since inflation in India is currently moderate — indeed this has been a major achievement of the NDA government — the impact of the GST ,even though inflationary, will still be modest. In the longer term, further price moderation is possible due to the supply side effect of the GST.

Still untouched finally, a large part of the economy is still not covered by the GST. Potable alcohol, crude oil, natural gas,aviation fuel, diesel, petrol, electricity and real estate are currently out, and States will levy their own taxes on these. Taxes paid on these will not be able to be offset against the GST. To that extent it is an inflationary distortion. Hopefully, this lacuna in the GST will be mixed soon.

The ideal of a low, single rate and comprehensive total GDP coverage, with a fully IT-enabled compliance system, is a destination still far away. But as Mr. Kelkar himself has said, the journey of a hundred miles must begin with the first step. To that extent this historic tax reform has come alive.