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Converging GST rates: Needed, but not now

The roadmap has always been clear – a 3-rate structure – but it may be better to get there after other reforms are carried out

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A GST Council meeting is due to take place. And the debate about the multiplicity of rates has started yet again. Though discussed many times earlier, it is still important to put in perspective how and why the multiplicity of rates was arrived at when the GST laws were being conceptualised.

As is known, GST had merged the myriad indirect taxation laws – central excise, service tax, and the Value-Added Tax (VAT) laws of the states. While the rates of taxation were common across the country for all manufactured goods (central excise) and services (service tax), the VAT rates differed across states. Hence the weighted average of rates across central excise, service tax and the rates of the various states was taken.

This was necessary because GST being a step into the unknown, revenues had to be protected. It had to be ensured that revenues, as were being generated prior to the launch of GST, were also being generated post the concept of revenue neutrality. The result was inevitable -- a multiplicity of rates -- 0,5,12,18 and 28%. For good measure, there was even a 3% for gold, apart from multiple exemptions. This was obviously not good fiscal policy and drew a lot of flak.

The roadmap was, however, always clear; that the ultimate goal would be a convergence of rates – a merit rate, a standard rate and a demerit rate. In the meantime, for considerations other than fiscal, the rates, especially the 28% slab, kept getting whittled. So, revenue neutrality was compromised very early on.

An RBI report of 2019 estimated that the effective weighted average GST rate had declined from 14.4% as prevailing at the time of introduction of GST to 11.6%. The International Monetary Fund (IMF), which had carried out an analysis at the behest of the Fifteenth Finance Commission (FFC), has arrived at the current effective rate being about 11.8%. The result of these ill-thought-out reduction of rates meant, in effect, that the GST buoyancy during the period 2017-2020 was, as pointed out by the FFC, less than the subsumed taxes during 2011-2017.

Currently, there are about 183 items in the 0% slab, 308 at 5%, 178 in the 12%, 517 in the 18%, from where the bulk of the GST revenue comes, and 28 items in the 28%. GST revenue accounts for nearly 35% of the gross tax revenue of the Centre and about 44% of the states' revenue pool. Any change in the rate structure has ramifications across the Centre and the states. Given the compensation burden which the Centre has taken upon itself, it would possibly mean an additional burden on the Centre.

It is in this background that the issue of merger of rates has to be seen. There is no gainsaying the fact that fewer the

rates, the better, for both the taxpayer and the tax administrator. The earlier studies by the NIPFP and the then CEA had suggested a median Revenue Neutral Rate (RNR) of about 17% and 15-15.5%, respectively. So, when we talk of convergence of rates, it should be remembered that this would mean not only reducing from 18% towards 15-15.5% but also increasing the rates of several commodities from 12% towards 15-15.5%.

Any move towards convergence will also mean an exercise to rectify the consequential inverted duty structure, which has crept in because of the random reduction in rates of final products. This having been done without examining the fallout, the rates of the inputs that go into manufacture have become higher in several cases than the rate of the final product.

An exercise of rate convergence is desirable but that it has serious revenue implications should not be forgotten in the cacophony and rhetoric of armchair columnists. Rather, it is the GST Council that has to be sure that this is the course of action needed at this juncture.

The focus instead should be on other reforms, starting with the long-delayed expansion of the GST base. Finance Minister Nirmala Sitharaman has again gone on record to state that there is no proposal to bring petroleum products within the ambit of GST. Union excise duties have been contributing about 11.8% of the Centre's gross tax revenue – much more than the customs contribution of 5.8%. Around 17%, on average, of the non-GST revenue of the states comes from petroleum products. So, while it is understandable as to why petroleum products will remain out of GST ambit, it is still unfortunate.

Similarly, electricity, which is outside the GST net, needs to be brought in, too. The earlier these commodities are brought within the GST net, the better. Doing so will reduce costs, improve compliance, and have the potential to spur revenue growth. It would mean the integration of the value-added tax system, where all products are taxed, and input credit made available.

The cleaning up of the inverted duty structure is also overdue. All exemptions need to be looked at -- they break the credit chain and distort the GST structure. The indiscriminate levy of cesses – with the Agriculture Infrastructure Development Cess (AIDC) proposed in the recent Union Budget being the latest – militates against the concept of GST.

What also needs to be done is to improve compliance. The FFC has also pointed out that the gap between the potential of GST collections and the actual collection is 2% of GDP. This is huge. This brings us to the troublesome functioning of GSTN. While its functioning has been steadily improving, there is still much to be done. Technology, ultimately, has to facilitate self-assessment; it has to facilitate analysis of data, risk profiling and targeted action against evaders. Tax administration needs strengthening; this also means ensuring speedy dispute resolution.

The GST Council should thus focus on reforms that will have a significant impact on revenues and reduce costs. None of this is going to be easy, but then who said it was?

(The writer is former chairman, Central Board of Indirect Taxes & Customs)