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TIME TO GIVE UP THE BOGEY OF A REVENUE NEUTRAL TAX RATE

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A standard GST rate set at 12% may not be revenue neutral but could spur economic growth

India’s nationwide goods and services tax (GST) was 15 years in the making, if you count the setting up of the VijayKelkar task force on tax reforms as its starting point. That we need a uniform, predictable and stable indirect tax regime across the country has not been in doubt. Indeed, it is axiomatic if we want a common economic market which is frictionless. The GST constitutes a major tax reform since it eliminates the earlier system’s tax-upon-tax cascade, encourages inter-state commerce, provides an inbuilt incentive for compliance, reduces leakages, corrects the earlier skew which favoured imported goods, and is fully electronic. Even though we want GST to be comprehensive and cover a large part of the economy, ideally, its share along with indirect taxes must not exceed 50% of the total tax kitty. A consumption tax such as GST is easier to collect than an income tax, since it is collected on every tiny transaction and leaves an electronic trail that makes evasion difficult. This makes it administratively attractive. But indirect taxes are regressive, since they burden the poor more than the rich in relative terms. The proper way to address income inequality, or achieve redistribution, is through progressive income taxes, not through differential GST rates. It is incorrect to argue that we need a lower rate on milk or *chappals* than a Mercedes because the poor don’t consume the latter. The rate must be the same, for administrative efficiency and simplicity of implementation. A plethora of rates, such as a lower one for salted groundnuts but higher for peanut butter, makes space for discretion on the part of tax inspectors, misclassification, interpretation disputes, litigation, corruption, and worse. Multiple rates defeat the very purpose of shifting to GST. Most countries have opted for one GST rate, or at best three—a standard rate, with a merit rate below and a demerit one above. This was what the Kelkar task force recommended.

Which brings us to the question of what that standard rate should be. It was answered by the task force, and also in a detailed study by a committee chaired by a former chief economic adviser. The study poses the question as follows: if there is a single GST rate, on what basis would we calculate it? That rate is estimated by using the concept of a revenue neutral rate (RNR). Put simply, this is the rate which is the ratio of all excise plus value added (sales) taxes in the numerator, divided by the total taxable gross domestic product (GDP) in the denominator. Since almost half of GDP is excluded (agriculture, health, education, petroleum, electricity), the rate will be higher ab initio. Whatever is padded on to the numerator will make this mythical RNR even higher. This was the contentious issue of discussion between the Centre and states prior to the roll-out of the GST. Since the reform envisaged the end of all indirect taxes, to be finally subsumed into GST, all states were careful to throw in all sorts of their existing taxes into the basket of the numerator. So, in went entry taxes and other state-specific levies. For a state like Maharashtra, a very large item was its octroi tax. Even though Maharashtra was only one of maybe two or three states with sizeable octroi collections, this “padding" did not invite a veto from other states. Of course, Maharashtra is India’s largest industrial state and its revenue concerns could not be ignored. There was also the issue of diminishing the denominator further, by exempting all businesses below a threshold from even filing for GST. The higher the threshold of this exemption, the smaller became the denominator, and, hence, higher the eventual RNR. It was clear that the RNR was the tail wagging the dog of the entire GST design. Not surprisingly, in the initial stages, we ended up with a multiplicity of rates, with its peak rate as high as 44%. Despite this jockeying for getting all state and Central revenues into the numerators, in the final negotiations, the finance minister had to sweeten the deal by promising to reimburse any shortfall in states' revenues after GST was rolled out. This was a three-year insurance scheme, where if the states' revenues did not grow by 14% every year, then the Centre would plug the gap. Never mind that we have had a continuous and now-severe slowdown in economic growth since 2017, and the states would have suffered a big drop in tax collections even without GST. The states' GST shortfall was sought to be made up by one component of inter-state GST collections, as also a special coal cess, rechristened "GST compensation cess". This cess is sizeable, belongs only to the Centre, is not under GST and increases India's energy costs. That aside, it should be clear by now that the original sin was to hang all rate discussions on this useless peg called the RNR. If the Centre was anyway prepared to compensate the states through its own fiscal resources, why not go that route the whole hog? The RNR is anyway an imprecise and elusive concept and a moving target. Replace all GST rates with a standard rate of 12%, as envisaged in the original Kelkar report, and gamble on growth. In a year that is crying out loud for a strong fiscal injection, and when we urgently need relief for consumers, lowering GST levies would be the best booster dose.

We should make the GST net wider and more comprehensive, include petroleum and electricity, and announce fiscal compensation for revenue shortfalls. This will strengthen cooperative federalism, may actually boost growth, and, who knows, with increased tax collections, the states may not even need compensatory transfers.

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