GST at Home & World

Govind Bhattacharjee

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On August 31, 2017, the CSO released GDP data pertaining to April-June quarter of the current fiscal which showed GDP growth falling to 5.7% - its lowest in three-years. The liberal economists joined the political opposition in painting a bleak picture of imminent collapse of the Indian economy, blaming the fall in growth entirely to the disruptions caused by demonetisation and GST. But the decline of growth only confirmed the continuing downward trend of falling growth since the last quarter of 2015-16, much before demonetization period, while GST was launched only in the July 2017, whose impact would be seen more in the second quarter's results, which I guess won't bring much cheers. Behind the declining growth were factors like a steady deterioration in the export sector, stagnant credit growth and an underperforming banking sector, combined with weakened domestic demand caused by demonetisation.

Launching of GST in India was indeed a bold step fraught with high political risks. A radical economic reform like this can make and unmake governments. The most striking example of this is Canada whose GST has many features in common with the Indian GST.

In January 1991, led by Prime Minister Brian Mulroney, Canada introduced a dual GST like India's, replacing a highly unpopular 13.5% Manufacturers' Sales Tax which was hurting its international trade and export competitiveness, and the Government thought that a harmonized GST was the remedy. Introduction of the GST in Canada was rather messy; inflation soared and growth declined immediately and GST could not raise the tax levels enough to contain the rising fiscal deficits. The economic slump led to widespread public resentment, and GST became the object of public wrath. Mr. Mulrony and his Progressive Conservative Party (PCP) had to pay a steep price for this. In the Parliamentary elections of 1993, PCP's strength in the 295-seat House of Commons got reduced from 169 to only two seats. PCP could never recover from the shock - it finally disbanded itself and merged with the Canadian Alliance to form the Conservative Party of Canada in 2004. The opposition Liberal Party under Jean Chrétien won the 1993 elections on the promise to repeal the GST but instead of repealing, rather strengthened and streamlined it. Chrétien later apologised to the electorate for reneging on his election promise. Canada today administers a federal GST together with either with a provincial sales tax (PST) or a harmonized sales tax (HST) levied by its different provinces. While the federal GST rate has come down from 7% in 1993 to 5% now, the HST attracts a uniform rate of 15%, while the PST rates vary between 6% and 10%.

GST is a disruptive reform and needs to be managed carefully. Managing disruption is never smooth or easy. There are bound to be hiccups which can be very unsettling, both economically and politically. To be sure, GST is not a miracle cure for everything that ails the economy. Prices take time to adjust in a market economy, and the effect of the GST can be seen only over time and not overnight.

Like in India, GST everywhere followed introduction of VAT. France was the first country to introduce VAT way back in 1954. As many as 160 countries today, including all OECD Countries except USA, have some form of VAT or GST. Many countries have introduced GST by harmonising the taxes on goods as well as on services, partially if not wholly, but very few of them have federal structure – and hence the attendant complexities - like ours. Some of the countries which have harmonized the taxes on sales of most goods and services include France and Italy, UK, South Korea, Japan, Singapore, Sweden, Hong Kong/ China, Austria, Malaysia, Canada, Germany, Russia and Australia, the last six being federations.

In Australia, GST was introduced with effect from 1st July 2000. Although the idea had existed since 1975, it was always treated with a great deal of scepticism. The proposal was revived in the 1990s by Liberal Party's leader John Hewson. But after being asked by journalist Mike Willessee to explain the arithmetic of how the price of a birthday cake would be impacted by the proposed GST, it was given up on the assumption of being "too complicated". In that interview, to Willesee's question, "You tell us in what you've published that the cost of cake goes down, the cost of confectionery goes up, there's icing and maybe ice-cream, and then there's candles on top of it", Hewson could only say, " To give you an accurate answer, I need to know exactly what type of cake to give a detailed answer", prompting Willesee to retort, "If the answer to a birthday cake is so complex - you do have an overall problem with the GST, don't you?"

In 1996, the Liberals won the federal elections after promising 'never ever' to introduce a GST. The 'never ever' lasted for only two years, when, under the leadership of John Howard, Liberals fought the 1998 election on the issue of introduction of a GST that would replace all existing sales taxes and apply to all goods and services. Despite a negative vote swing of 4.61%, they formed the next Government and introduced the GST in 1999, replacing the federal wholesale sales tax system. Gradually many State and Territorial Government taxes, duties and levies such as banking taxes and stamp duties were abolished. The consequent budget shortfall were compensated by the revenue earned from GST that was shared with the States. Simultaneously, for greater acceptance, rates of federally levied personal income tax and company tax were reduced to absorb the shocks emanating from the GST. It was understood that GST would take time to stabilise, and its intended consequences like reduced business costs which would spur consumer demands would flow over time, and no miracles could be expected in the short term. In the 2001 federal elections, the opposition Labour party made its rollback a centre-piece of its electoral campaign, describing it as a "bastard tax", but lost the election.

Australian GST has a rate of 10% with a system of input credits, like in India. Like in Canada or France, here also concerns were raised that GST would impact the poor much more than the rich, being a regressive tax, but the likely regressive potential was mitigated by adopting a set of measures like abolition of federal wholesale sales tax as well as some stamp duties and fuel taxes, besides effecting reductions in rates of personal income tax and state banking tax side by side with the launching of GST.

But the reactions and counter-reactions were very much like what we are witnessing in India today. The behaviour of business and consumers were also strikingly similar in the two countries. In the period leading to the introduction of GST, consumption rose sharply as consumers had rushed to purchase goods that they perceived would be more expensive in the post-GST period, and traders and businesses destocked and cleaned up their inventory by offering lucrative discounts, just like in India. Thus immediately after the GST came into effect in July 2000, both consumption and economic growth declined. Inflation soared by as much as 2.8% in the quarter ending September 2000. In the first fiscal quarter of 2001, the Australian economy recorded negative economic growth for the first time in more than 10 years. The opposition, exactly like in India, cried foul and blamed the GST. Like in India, small businesses complained of cumbersome procedures and glitches faced in online submission of quarterly Business Activity Statements to the Australian Taxation Office as required under law; one study in fact estimated that costs of compliance to the new tax system amounted to 3% of annual turnovers of small businesses. But consumption soon returned to normal and growth picked up gradually. In each of the countries that had introduced GST, the economy had underperformed in the year of its introduction, something that was anticipated and in fact, are being witnessed in India today. One study pointed to the negative impact of GST on the real estate market, projecting a steep rise in prices of new homes by 8% and a steeper fall in demand by 12%. But real estate market returned to boom between 2002 and 2004 with prices and demands both soaring, especially in cities like Sydney and Melbourne and elsewhere.

Ten years hence, GST was recognised as a resounding success in Australia that had replaced inefficient taxes that imposed high deadweight costs while raising little revenue. As Professor Sinclair Davidson of RMIT University wrote, "The GST was the last great tax reform that Australia experienced. In the subsequent ten years we have become accustomed to tax cuts, not new taxes."

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Short term inflationary impact has characterised the switchover to GST in almost every country, and governments had intervened appropriately to arrest this, sometimes adopting extraordinary measures and policies for limiting price escalation by businesses like freezing prices and profit margins, price monitoring, publicity campaign, enactment of anti-inflation laws and reduction of other taxes. When VAT was introduced in India from 1 April 2005, no such measure was adopted. As a result, there were either unexplained increases in prices, or businesses refused to reduce the MRPs despite decline in the tax rates of their products, as pointed out by the CAG in 2010. We ought to be more proactive this time, having learnt from the past.

One particular concern in Australia as in India was to ensure that there was no undue profiteering in the implementation phase and that the benefit of reduced costs was passed on to the consumers to mitigate the immediate impact of GST on prices. The anti-profiteering provisions of our GST Act derived some useful ideas from the GST Acts of Australia and Malaysia which have stringent anti-profiteering provisions in their respective GST Acts.

Social acceptance of any new tax is vital for its success, and public criticisms and debates play a significant role in informing and moulding public opinion. The political risks and costs of introducing the GST are always high, but proper management of transition and follow up can always provide insulation to the risks.

Nearer home, Indonesia was the first ASEAN country to implement the GST in 1984. All the eight members have the GST now in place, Malaysia being the latest to join the GST brigade in 2015. Malaysia has been toying with the idea of introducing a GST since long. When a GST Bill was introduced for the first time in 2009 in Malaysian Parliament, it attracted mounting criticism from public and political opposition, and the bill had to be withdrawn. Finally, on 1st April 2015, a uniform 6% GST was launched, replacing the sales-and-service tax regime of indirect taxes. The effect of replacement of the single-stage sales and service taxes to a multi-stage GST was highly disruptive - inflation went up immediately, consumer confidence nosedived and public protests erupted. But the timing of its implementation had coincided with the steep global slump in oil and gas prices between 2014 and 2016, and the successful implementation of the GST had helped the federal treasury to cushion the impact of lower oil revenues; by that time the public protests and opposition had also fizzled out. 12 months later, business confidence was restored and 70% of the businesses surveyed reported growth. As the Malaysian Prime Minister had rightly said, “GST has been our saviour”.

Like in India, Malaysia also had a problem of black economy, with estimates of it ranging from 9%-27% of GDP, and emphasising the need for a more efficient and effective tax enforcement regime. The World Bank has reported that the “hidden or informal economy” constitutes 31% of the Malaysian economy. Just like in India in the post-demonetisation period, the Malaysian post-GST implementation phase had also seen many searches and seizures to unearth black money. The procedural changes necessitated by GST were phenomenal and it shook up the entire gamut of commercial operations in Malaysia. At the end of June 2016, there were over 7,294 GST appeal cases, indicating the extent of taxpayer grievances. But the Government had created a social safety net in the form of monetary assistance to compensate poor households, along with a package of measures to mitigate the impact of the new tax, benefiting about 4.7 million households and 2.7 million single individuals, to address the adverse distributional effect of GST. But the concerns of the small and medium enterprises (SMEs) were not properly addressed; about one-third of the firms audited by the Malaysian Customs during September 2016 were facing problems very similar to those these are facing in India.

GST contributed about 18% to Malaysia’s Federal revenue in 2015, a share that is bound to increase substantially with an expanding economy. Share of GST varies widely from country to country depending upon the structure of their tax systems and expenditure priorities, and the rates as well as threshold amounts also show wide variations. Thus no horizontal comparison among different countries in respect of GST will be valid. About 160 countries have adopted some form of VAT or GST, but most of these would be vastly different from the dual destination-based system that Canada and India are following. Among the OECD countries most of which had switched over to VAT/GST during the 1970s and 1980s, Chile raises as much as 55% of its total tax revenue from GST, followed by and Turkey (44%), Mexico (36%) while Japan raises only 20% percent of their total revenue from GST, as against the OECD average of 33%.

As regards the rate also, it varies from 5% in Canada to 6% in Malaysia to 15% in New Zealand to 19% in Germany, 20% in France and 27% in Hungary. Japan had introduced a consumption tax in 1989 the rate of which was increased from 3% to 5% in 1997. The effect was devastating and Japan went into recession. In 2013, the Shinzo Abe Government increased the rate to 8%, while postponing further proposed increase to 10% till October 2019.

The GST experiences of these and other countries make one thing clear – that GST everywhere has followed more or less the same track and run the same course, causing similar ripples, disruptions and turbulence, but everywhere these distortions have proved to be transitory. Ultimately the new system has found its own equilibrium in every country wherever it was launched, and there is no instance of any country rolling back the new system after having launched it. Everywhere, there was initial spikes in inflation and economic growth took a beating in the immediate aftermath of the launch of the GST. But eventually growth had picked greater momentum than before and inflation could be controlled everywhere.

The Indian experience is a repeat of this universal trend and there is no particular reason for despondency at the developments that we are witnessing again. These are undesirable but not unanticipated outcomes, if we are to relate to the experiences of other countries in our connected world, because behaviour of the consumer and businesses remains identical everywhere. The transition phase we are passing through could be longer and more difficult than one might wish, especially in a complex and diverse country like India. It is crucial that this phase be carefully negotiated, by drawing lessons from countries discussed above. As these experiences show, without exception, GST delivers in the long run, and by long run, I reckon a time horizon of 3-5 years. In the end, GST has been working well in every country.

Global experiences also tell us that our GST design may not be as imperfect as it is made out to be by its critics. In many countries, there are multiples rates and a wide variety of exempted goods and services, and essential supplies needed by the poor often attract a reduced rate. Real estate and petroleum are covered in some countries but excluded in others. There cannot be a one-size-fits-all solution; different countries have different systems at the national and sub-national levels. SMEs have been impacted negatively almost everywhere; apart from their genuine concerns about lack of capacity and technological weaknesses which need to be addressed urgently, a part of their problems also arises from a certain reluctance to comply with the new tax regime which makes tax evasion difficult. Awareness and public education are essential for success of any new system, to make way for its acceptance and voluntary compliance, without which no tax system can ever achieve its objectives. There are many lessons to be learnt from the international experiences and the sooner we learn them, the better it would equip us to avoid the pitfalls.