GST: Once The Rubber Has Hit The Road

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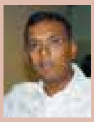

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The GST is India's most striking reform, one that is changing not just taxation, but business and business models themselves. Unlike any previous transformation, what businesses now need to contend with are changes in everything from their IT systems, logistics and warehousing, to how they manage vendors and channel partners. From a retail and consumer point of view, the new tax could well prove to be 'Demonetisation 2.0', pushing more and more of the economy into the formal sector. It also seems to be enthusing foreign investors, with several European and Japanese retail brands recently committing to open 100-200 stores each in India over the next two years. From a broader growth perspective, however, the verdict is not yet out – and it is worrisome that analysts are even expecting a short-term dip because of the GST. This is revealing, because a well-designed VAT/GST system should immediately drive up growth, as it did for South Africa in the 1990s, by improving business decision-making and reducing the cascading effect.

In terms of firm-level impact, it is early days yet, and the transition so far has been bumpy – but at the very least, India's larger businesses seemed to have managed the first phase fairly well. What has helped is all the solid planning and preparation – by industry and government alike – in the run-up to GST implementation. Also encouraging is how firms have managed not only to build strong, internal cross-functional GST teams, but also to reach out to each other for help. Some of the teething issues will doubtless settle down in the coming months, but there are a number of unresolved issues and design problems that may not go away in a hurry. The onus, then, will be squarely on CFOs to turn what is certainly a very challenging situation into a growth opportunity.

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LESS THAN PERFECT...

In several ways, India's GST falls short of its initial, overarching aim: moving away from a system where tax structures drive the market and propel business decisions. In fact, it comes with a number of serious challenges. First off, unlike other VATs the world over, it differentiates between goods and services – whereas, theoretically, such systems work best when all items being consumed as output, whether a good or a service, are treated the same, and when all input taxes get credited. Every item/service then goes

through the supply chain without differentiation, and effectively, it is only the final, consumed item that is taxed. Second, compared even to the initial experience of about 160 other countries introducing the VAT, there are far too many rates. There are so many rates, in fact, that one needs an entire excise-tax-like handbook – and not, as one would have hoped, a 1-page hand-out – to detail them. This will create a compliance nightmare for most traders and dealers. With multiple rates also come multiple classification issues, to the extent that different types of Indian sweetmeats are being taxed at rates of 18 per cent or 28 per cent, depending on whether they contain chocolate. Many such discrepancies will continue to crop up, though encouragingly, the government is making corrections where appropriate.

Challenges in the new system include a plethora of rates, low minimum filing thresholds, the exclusion of key items, and certain legacy issues

Third, and again unlike most countries, the minimum threshold for GST filing has been kept unnecessarily low – just Rs 20 lacs. This will bring millions of taxpayers at the bottom of the pile into the net, potentially subjecting them to audit and assessment by both the Centre and – in many cases – by multiple states. In effect, this reverses a 2006 decision to keep very small taxpayers, who then made up 85 per cent of all taxpayers but accounted for just 5 per cent of revenues, outside the fold. While the Centre had pushed for a higher threshold, ultimately, it had to yield to the states' demands on this score. Fourth, the exclusion of alcohol, petroleum and real estate from the GST are major loopholes. The first two alone make up 40-50 per cent of GDP, which means that those producing or consuming these goods cannot receive input credit, thereby generating a huge cascading effect both upstream and downstream. As the experience of other countries shows, unless all goods and services come into the tax net, value chains get broken.

At the ground level, too, a number of operational and legacy issues remain. The GST Council is yet to take a view on the carry-forward of sales-tax balances linked to pending c-forms. For businesses that must compete with imports, some of the tax structures impact local manufacturing, and are perhaps at odds with the 'Make in India' initiative. The necessary tax-rate mismatches will need to be corrected carefully and incrementally, on a case-by-case basis, so an extended period of 'friction' should be expected. Another very big concern is the anti-profiteering rules – an area where there is still very little clarity. For now, businesses that are seeing cost increases are reluctant, in the absence of clear rules, to pass on these costs to consumers in the form of higher prices. Finally, the rules and mechanisms around input tax credit need to be refined, such as the fact that credits may be disallowed if inputs and outputs are not exactly matched. Given GST rates of 18-28 per cent, the amounts involved are not small.

...BUT ALL SAID, THERE ARE REASONS FOR OPTIMISM

Despite all the GST-related challenges that industry faces, the forward-view is one of cautious optimism. At one level, it remains to be seen if the new tax is truly 'revenue neutral'. If it is, there should theoretically be no up-tick in inflation, and in fact, prices should soften as the general cascading effect becomes less pronounced. On the other hand, if revenues actually go up, there will be a strong impetus to reduce the number of rates, as well the headline rates themselves. Should petrol be included at a later stage – as the Finance Minister has indicated it might – it would only add to the momentum around fewer and lower rates. However, it will require the Centre to push hard against the states to achieve this. An even bigger 'win' – but also less likely in the near term – would be if real estate were brought in. In many countries, property transactions are regarded as a service and covered under the GST. Calculations by the 13th Finance Commission indicate that if stamp duty were included, rates could be slashed to as low as 12 per cent.

What is very positive to see is that policymakers and the tax authorities are showing great sensitivity to taxpayers' needs. For perhaps the first time, the signal from the top is that 'customers' – i.e., taxpayers – do matter. The Prime Minister has emphasised the need to modernise the administration, take away any scope for search-and-seizure operations, and reduce the need for face-to-face interactions. As many as 50,000 tax officers and inspectors have received training on GST-related issues, and countless seminars and workshops have been organised at the chambers level. There is, though, still a long way to go, in terms of administrative efficiency, the quality of the software in use, and the stability of the GST network. The difficulties taxpayers face in correcting mistakes, for instance, are a major impediment, and it would be a pity it scares small taxpayers off from filing returns. The inclusion of so many smaller entities, especially on the services side, has also upset what was a well-established 'equilibrium', and it should be hoped that state administrations do not compound the problem by 'going after' them.

> Encouragingly, the government has indicated a willingness to rationalise rates, bring in petroleum products, and - most crucially - listen to taxpayers' needs

Expectedly, certain industries will face bigger challenges than others in the ongoing transition. Alcohol producers, for one, already had to contend with having their production, distribution and pricing decisions regulated heavily. Their situation is now compounded by the fact that, since alcohol has been left out of the GST, they cannot claim input credit, and will thus see rising margin pressures. In response, Diageo – which operates 70 plants and 100 warehouses across 24 states, holds over 100 brands, and has thousands of distributors and over 60,000 vendors – has embarked on a massive value re-engineering exercise. Working closely with distributors and vendors to better understand their business models, it is streamlining its operations and consolidating its logistics costs. By squeezing out new types of efficiencies, it hopes to stay ahead of the curve in what is clearly a very complex market. Other industries – including retailers like Nike – will have different problems to deal with. On the one hand, with the informal sector coming under pressure in the new regime, they expect problems like counterfeiting, which seriously impacts sales, to ease. On the other hand, its working capital requirements will go up, given expectations of delayed input credit payments; and it will also have to build the cost of new investments – such as integrated warehouses – into its cost of doing business. ■