GST and Governance: Unintended Implications on the Poor and MSMEs

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1. Introduction: GST as a Tax Structure

Goods and Service Tax (GST) or Value Added Tax (VAT) was first introduced in France in 1954 and now more than 160 countries around the world have the system. Any type of tax on goods and services is an indirect tax and is by nature a regressive tax. Palil and Ibrahim (2011) found that rates of GST in high-income or developed countries range from 7% (Singapore) to 42.58% (Argentina). The average rate of GST in developing and developed countries is 12% and 21% respectively. Table 1, shows the GST rates for some countries.

Table 1: GST rates and their inception across a selection of countries around the world

<table>
<thead>
<tr>
<th>Country</th>
<th>GST Rate</th>
<th>Year of Introduction</th>
</tr>
</thead>
<tbody>
<tr>
<td>Australia</td>
<td>10</td>
<td>2000</td>
</tr>
<tr>
<td>Brazil</td>
<td>10</td>
<td>1984</td>
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<tr>
<td>Canada</td>
<td>5</td>
<td>1991</td>
</tr>
<tr>
<td>China</td>
<td>17</td>
<td>1980</td>
</tr>
<tr>
<td>France</td>
<td>20</td>
<td>1954</td>
</tr>
<tr>
<td>India</td>
<td>18**</td>
<td>2005</td>
</tr>
<tr>
<td>Indonesia</td>
<td>10</td>
<td>1985</td>
</tr>
<tr>
<td>Japan</td>
<td>8</td>
<td>2014</td>
</tr>
<tr>
<td>Malaysia</td>
<td>6</td>
<td>2015</td>
</tr>
<tr>
<td>New Zealand</td>
<td>15</td>
<td>1985</td>
</tr>
<tr>
<td>Pakistan</td>
<td>17</td>
<td>1990</td>
</tr>
<tr>
<td>Singapore</td>
<td>7</td>
<td>1994</td>
</tr>
<tr>
<td>Thailand</td>
<td>7</td>
<td>1991</td>
</tr>
<tr>
<td>United Kingdom</td>
<td>20</td>
<td>1994</td>
</tr>
</tbody>
</table>

Sources and Notes: Collect by authors from multiple sources.

**India has multiple tax rates and two tiers of taxation.
Though GST has been implemented in several countries, its success has been mixed and restricted predominantly to developed countries. Gober and Burns (1997) and Gold (1991) have found that changing even one of the components of the tax structure of a country has a very varied impact on the economic growth of that nation. It is, therefore, important for a country to predict and find the optimum rate of each tax when designing and before implementing a new tax structure, to avoid burdening the consumption as well as economic growth of the country. Palil and Ibrahim (2011) study the short-term effects of the implementation of GST in Australia in 2000. They find that GST had a significant impact on inflation only in the period just after the implementation. Further, the anticipation of GST increased consumption just prior to implementation and reduced it in the quarter after implementation, indicating the inflationary impact was due to pre-GST hoarding and not GST itself. Hakim et al. (2016) concluded that though GST was implemented in more than 140 countries, it had a positive impact only in developed countries. Given the mixed experiences that countries have had with GST implementation, a developing country deciding to shift to this particular regime has to have pertinent reasons, and yet, is a change that intrigues academic curiosity.

2. GST in India

2.1 The Need for GST

Tax policies are critical for a country’s progress and has a direct impact on the economy. An effective tax policy has often been thought of as a regime that cares for the entire income distribution in the economy and does not cause any market distortions or failures, while generating higher tax revenues for the Government (Nayyar and Singh, 2018). Designing and implementing a new tax regime is, therefore, a colossal task and a country needs pertinent reasons to embark on such a task.

In the particular case of India, the current indirect tax structure has had many issues such as complexity, tax cascading, definitional issues with respect to manufacturing, the inclusion of services, etc. Thus, there are many reasons why India would change its tax regime.

There were three predominant reasons stated when the Indian Government decided to shift from a broad-based CENVAT-Service Tax-VAT structure to a new GST regime. All of these reasons viewed the GST regime as a governance mechanism aimed at improving tax revenue and reducing collection cost. The first is the simplification of the indirect tax system. Poddar and Ahmad (2009) in their exploration of GST reforms highlights the need for a simpler regime. Most countries that have adopted GST have a single tax rate and thus, this is simpler to implement. This would also help increase the tax base. Secondly, this system by its nature was intended to improve tax compliance, as the linked chain-like process highlights missing links (i.e.,
the tax evader) and so reduces tax evasion. This would also disincentivize businesses from transacting with the informal economy and would help, reduce the size of the informal economy. Finally, the GST regime was expected to kickstart the digitization of indirect tax filing and would hence, improve efficiency in tax collection.

All of these reasons viewed the GST regime as a governance mechanism aimed at improving tax revenue and reducing collection cost. It was also aimed at formalizing the informal economy. A simple tax regime would be an incentive to formalize while the digital linked processes would dis-incentivize businesses from transacting with the informal economy. These would reduce the size of the informal economy.

The rollout of GST in India happened with a lot of anticipation and expectation about these potential positive effects. Vasanthagopal (2011) and Dash (2017) expected the new regime to improve the economic outcome of the country.

2.2 The Indian GST Structure

In 2017, GST was implemented in India, replacing 17 different indirect taxes with six different tax slabs and a dual-GST structure for the state and federal governments. The Indian GST has a dual structure (like Canada and Brazil) that gives both the Centre and State equal stakes. The tax to be levied falls under three heads – Central GST (CGST), State GST (SGST) and Integrated GST (IGST). CGST and SGST are for all taxable intra-State goods and services supply. IGST is for inter-State taxable supplies. Largely, four GST rates have been implemented, 5%, 12%, 18% and 28%. The tax reform primarily altered the tax collection mechanism. Prior to GST, the indirect taxes were levied as a combination of VAT and other indirect taxes. Post GST, all taxes were subsumed under GST. VAT was applicable only on goods while GST is applicable on goods and services (Agarwal et al., 2020). Also, GST had to be paid monthly or quarterly, rather than the annual tax earlier and it had to be paid online whereas VAT was paid offline.

2.3 Expected Impact of GST

The primary idea with the implementation of GST was to simplify the tax structure. Most countries that have done so, have used only a single tax slab and have exempted certain goods entirely. The secondary idea behind its implementation was that since tax compliance is vertically linked, there is less tax evasion in the GST system as it is easier to identify missing or incorrect links (i.e., tax evaders or someone paying incorrect taxes).
Further, by reducing the complications in filing taxes the system was supposed to encourage more business activity. This would imply that in the first few years of GST implementation there would be a sharp rise in tax collections as the individuals and firms who were evading taxes will not be able to do so (including the informal economy). Further, there will be a boost in economic activity, and consequently an increase in GST collection.

In the case of India, the GST structure with multiple slabs and dual structure did not make the new tax regime easier and many filing deadlines required extensions. Even three years after the introduction of GST, many businesses had not been able to file the returns even for 2017, the first year.  

It was also hoped that an easier regime would encourage business activity, formalize the informal economy, and boost the overall economy. If this is the case, then we would expect a positive association between GST collection and economic activity, i.e., GST collection would increase with increased (and formal) economic activity. However, Figure 1 reveals otherwise. We find an increasing GST collection trend, even though economic activity is volatile. The post-GST period for India has been hit by the COVID pandemic and this has been a period of slow economic progress and even shrinking of GDP, as is reflected in Figure 1. This period should see a fall in GST collection, since the size of the pie (the country’s GDP) shrank. However, as is evident from Figure 1, there is no growth of per capita income but GST collection has continued to increase during the whole pandemic. One alternate explanation for the continuous increase in GST filing even during the economic downturn could be that there has been increased compliance. However, there has been enough evidence and reporting about the loopholes in GST implementation, for us to reliably say that evasion continues in India. Unearth of the Manpasand Beverages tax fraud is a prime example of how the new GST regime’s loopholes can and have been exploited.  

This is only one of many such examples and the fraud cases continue to increase in number and value. Tax authorities have detected GST evasion of ₹40,000 crore across 5,700 evasion cases in just over a year (2020-21), mostly on account of fake invoices and fraud input tax credit claims. Therefore, there appears to be no economic boost or reduction in evasion due to GST. Yet, we see an increase in GST collection.

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Further, there has been significant downside to the introduction of GST. First, using multiple slabs and a multi-tier structure with a state and federal tax have complicated the process significantly. This has implied that small businesses have found it harder to understand the tax they owe the government and the tax credit that they have to claim. If we were to compare the system in India with that of Singapore (one of the successful cases of GST implementation) we will see some stark difference. First, Singapore has one flat rate of 7% which is much lower than the level in India, as most commodities in India have a rate above 10% and going up to even 28% for certain commodities. There are very few commodities that come in the 5% bracket which is the lowest possible tax rate. Further, India has a dual-GST due to the federal nature of the country. This causes two issues, first the burden on the consumer is high and secondly, the onus on the tax payer, to file both taxes and get the appropriate input credit increases their paper work manifold.

If we take into account the structure of the Indian economy the challenges that a GST type of tax regime would face are even more severe. India has a thriving informal economy with about 40% of value added being done
by the informal economy.\textsuperscript{24} If this is the case, then in an tax filling system that needs to be vertically linked to all your suppliers, they there will be many firms that are buying or selling to firms that are actually not registered and so this creates loopholes in the system and compliance to GST is then hampered. Apart from these fundamental issues, Kour et al. (2016) have identified 12 barriers to GST implementation including the lack of skilled manpower, lack of clarity of GST provisions, political unwillingness, and lack of policy for proper division of tax.

Small and medium size manufacturing are an important part of the Indian Economy. India has more than 93 lakh registered MSMEs and 63 lakh unincorporated non-agriculture MSMEs in the country engaged in different economic activities in 2015-16, and this number has only been growing. They contributed approximately 30\% to India’s GDP in 2018-2020. Also, the sector contributes to employment significantly. According to the 73rd Round of NSS, the estimated number of workers employed in the MSME sector was 11.10 crore in 2015-16.\textsuperscript{25} Given the importance of the sector to the economy, it is challenging when the sector faces difficulty due to the new tax regime. The first issue was that since firms with less than 1.5 crore turnover were exempt from GST, their downstream supply chain could not claim input tax credit and so, preferred GST registered supply chain partners. This negatively affected these MSMEs\textsuperscript{26}, creating more pressure on small businesses. Further, since taxes are filed digitally, the MSMEs have had to invest in learning how to use and adopt technology. This has increased costs further and put immense pressure on the sector. Yet, we see an increase in GST collection.

3. Discussion

The collection of taxes is one of the main sources of revenue generation for any government. There are two ways that this can be done. The first is direct taxation, where individual and corporations pay a direct tax on their income and profit to the government. The second is the indirect taxes that are levied by the governments on all economic activity, including the tax of consumables, that is, goods and services and also tax on imports and export. Most countries have a progressive direct tax policy, in that people who earn more, pay more. They also exempt people with low incomes from paying taxes. This ensures that the tax burden is greater on people

\textsuperscript{24} https://www.imf.org/-/media/Files/Conferences/2019/7th-statistics-forum/session-ii-murthy.ashx
\textsuperscript{26} https://economictimes.indiatimes.com/small-biz/gst/five-years-of-gst-is-it-a-gamechanger-for-msmes/articleshow/92587574.cms
with lower marginal cost of paying the tax. However, indirect taxes, by their nature are implemented irrespective of the capacity to pay of the consumer, which makes these taxes regressive.

In developing countries, where there is a significant section of poor and lower middle class populations, the reliance of governments on indirect taxes can have major negative welfare implications. However, developing countries, also have the challenge of high level informalization of the economy and so the base of individuals and corporations that can pay direct taxes is lower. This implies that it is easier for governments in developing countries to levy indirect taxes. This is a difficult situation for most countries to balance. Further, direct taxes take away income from the segment of the population that has the surplus to invest and so growth may be affected by having high direct tax rates.

The Indian experience so far points out that there has been a governance failure with respect to the primary reasons for implementing this tax regime: that it would simplify the tax filing process and there would be increased economic activity since there is less pressure on direct taxes and so, there can be more investment. Also, GST would increase compliance. However, this has not happened. There is still tax evasion and the process is complicated with a dual system with multiple slabs. While formalization of the informal economy has added to GST collections, it has also created large-scale disruptions to supply chains, increased compliance costs, and muted business growth. Can the increase in GST collections then be associated with regressive indirect taxation of the lower and middle income echelons of the Indian economy?

Alternatives to GST for India

In India, due to the pressure of revenue generation and the limited increase in the income tax base, since 2017 the government has been under constant pressure to revise the GST rates upwards and to bring additional goods and services under the GST system. This has resulted in the average level of GST paid being high in India, which has resulted in increased inflation. Further with the governance failure in curbing tax evasion after the GST as well, the anticipated increase in income due to this tax has been lesser. Finally the Dual-GST structure with multiple slabs has made tax in India even more complicated, negatively affecting the country’s attractiveness as a destination for business. There has thus, been a continuous demand by all stakeholders to revise the regime (Mukherjee, 2021).

27 The formalization of the Indian economy has also been possible due to multiple efforts like the formalization of the EPFO report, emergence of the gig economy, large-scale digitization, creation of the e-Shram portal, etc.
A regressive tax is always more harmful for the poor, since the marginal effect of one dollar of additional tax is felt more by them than is felt by the rich. This implies that the use of indirect taxation creates additional burden on the poor and therefore, should be used with caution in the context of developing countries like India. Using direct taxation would imply that one can target the people who have higher capacity to pay. However, the argument put against this is that they are also the segment that can invest in future growth, and therefore keeping direct taxes lower is beneficial for growth. However, with a great degree of informalization of the economy and a large vulnerable population, the burden of the indirect tax in on this segment. Looking at the current situation in India, the downside to using direct taxes seems to be low, and the government should focus on increasing the tax base and reducing the complications in filing taxes and should refrain from over-reliance on GST as a source of revenue or as a governance mechanism.

While a lot has been written about GST, the analysis has been only piecemeal. Despite large-scale digitization, there continues to be lack of data and clarity. It is imperative to undertake extensive assessments of the impact GST is having on a) the functioning of the informal and MSME sectors in India and b) the consumption of lower and middle income segments of the population.

References:


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