GST and Corporate Finance- A note

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The Goods and Services Tax (GST) is the most important indirect tax reform in India. It was debated enough over the past sixteen years and yet when it was launched in India, a common criticism was that the present government hurried its implementation. Experts complained that the IT infrastructure was not robust to handle such large volume of data that would get generated in the GST portal. Better beta testing would have avoided initial technical glitches. Perhaps due to pressure from business community and opposition (some claim that impending election in Gujarat did the trick), the government had to recently announce some major changes in the GST rates and also simplified compliance requirements. The major changes include reduction of GST rate for more than 178 items, composite scheme limit increased to INR 15 million, exemption from GST registration for all service providers with turnover up to INR 2 million, pruned by nearly three-fourths the number of items under highest GST rate, halved the composition tax of 1% on turnover of taxable goods, and provided relief to the e-commerce sellers if total turnover is less than INR 2 million. However, marketplace operators and sellers are still not happy with the recent changes in GST rules. One may note the recent announcement by the GST Council would cost the exchequer.

France was the first country to introduce VAT (somewhat equivalent to GST) in 1954 and now more than 160 countries implemented GST or its equivalent. Brazil has higher peak GST rate (35%) than India (28%). There is a difference between GST and VAT as the former is a destination-based tax. USA does not have single GST as taxation decision lies mostly with the states. Closer home in Singapore, GST was implemented in 1994 with a single rate of 3%. What is interesting is the Singapore government assured the business community at time of GST implementation that the rate would not be raised for first five years. In practice, GST rate was increased to 4% in 2003- after a gap of 9 years. Later the rate further rose to 7% in 2007. Such a clear and categorical signal did help business community migrate to GST regime without much difficulty. Another smart decision of the Singapore government was lowering of direct tax to reduce the burden of GST on business and common citizen. It showed great sincerity on the part of the government to care for its citizens. China also implemented GST in 1994. Initially it had many GST rates. And realising the administrative difficulty in maintaining several rates, China has now (July 2017) moved into three-rate band – 17%, 11% and 6%.

It is said that India had followed the Canada model of GST- the dual tax (state GST and central GST). Let us not forget that introduction of GST in Canada in 1991 was very controversial. The manufacturers had complained that GST had rendered them less competitive in international trade. Canada also did not change the GST rate for initial one and half decade. Unlike Singapore, Canada had lowered GST rate over the years- from 7% (1991) to 6% (2006) and further to 5% (2008). Canada has recently raised the GST rates though and it now ranges between 13% and 15%.

Lessons from Corporate Finance

While framing GST rates, the focus was on 'revenue neutrality'- rates that would not decrease pre-GST revenue of central and state governments. Hence, we end up with four GST rates (excluding the zero rate). It may be mentioned that it is possible to have a single revenue neutral rate (RNR). However, the central government has chosen, and rightly so, to have more than one rate in order not to tax at a higher rate a basket of goods and services which were attracting lower tax in earlier regime. Even after such careful consideration by the GST Council, there was large number of items under the peak rate resulting in protest by traders, and political opponents. The idea of introducing GST with the 'principle of equivalence' was perhaps a mistake. One could use lessons from corporate finance to set the initial GST rates.

Corporate finance literature mentions that when a company wants to raise money through public offer for the first time, it 'underprices' its shares. It is a worldwide phenomenon. A recent example would be IPO (initial public offer) of LinkedIn, which is stated to be underpriced by 100%. Why do companies underprice IPO? One explanation is 'information asymmetry'. When an unlisted company comes to the market for the first time, no analyst would be tracking that stock and hence investors would demand 'premium' for the fear of unknown. Underpricing is generally lower when information about the issuer is more freely available. The GST Council could have drawn from the IPO underpricing literature and introduced lower GST rates initially taking a hit in the indirect tax revenue for the first few years. Actually government had to do it anyway- an estimate shows that recent pruning the list of items under 28% slab would cost the government around INR 200 billion. There were lots of uncertainty and apprehensions surrounding the GST rates and the possible adverse impact that one-nation-one-tax policy would have on the business sentiment. What was required was to 'assuage' the initial 'fear of unknown' through lower GST rates and simple compliance (reporting) requirements. That would have 'earned' the government confidence of business and thus initial technical glitches would be ignored as something common with any large implementation. Anti-profiteering provisions and market competition would ensure that business community pass on benefits of lower tax to end consumers.

The recent changes in GST rates within four months of GST launch further show tentativeness of the Council. Rates were reduced for 178 items from 28% to 18% and for restaurants (with exceptions) from 18% to 5%. One may recall that dining in a restaurant would attract 15% service tax in earlier regime. It was initially revised upwards to 18% in GST and now within a few months lowered significantly to 5%. Let us turn to corporate finance again. Lintner[1], while describing how managers determine dividend payout, observed that managers tend not to make dividend decisions that might have to be reversed in near future. Markets react more negatively to dividend reversal than dividend increase. Hence, knowledge of corporate dividend literature would have helped the GST Council in setting initial GST rates in a way that change in such a short time could be avoided. Examples of Canada and Singapore showed that a stable GST rates for a longer

[1] Lintner, J. (1956) Distribution of Incomes of Corporations among Dividends, Retained Earnings and Taxes, American Economic Review, 2, pp 97-113

duration send a signal of confidence on the part of the government. This would help the business community concentrate more on implementation and compliance issues rather than wasting time in lobbying for reduction of GST rates. The GST Council also, in that case, could have spent more time and energy in fixing the IT glitches and handles issues relating to frequency of return filings. A longer-term GST rates could only be fixed if the rates were lower with fewer slabs in the initial five years, at least. The central and state exchequer would have definitely lost some revenue in such a situation. But smooth transition to the huge transformation is more important than loss of revenue in initial years. There are ways to make good any possible loss. One possibility is that lower GST rates would create favourable buoyancy in the business and hence would offset any shortfall in indirect tax revenue.

Lowering of tax rates has other implications. Corporate finance literature again shows that firms did not use savings due to tax incentives for growth. Rather such savings were passed on to shareholders by way of higher dividend and at times were usurped by managers as costly perquisites. The objective of providing any kind of tax incentive is to help business in early years to grow and face competition. However, literature on ‘agency theory’ amply shows that tax benefits were squandered away. Therefore, benefits of recent downward revision in GST rates for several commodities may not translate to lower invoice value. The administrative machinery has to be very watchful to ensure that ultimate consumers benefit.

Major relaxation is now offered with regard to filing of various GST returns. This would provide comfort to small businesses and release pressure on the GST portal for the time being. Developer of the GST portal will get time to fix the bugs that still remain in the system. It is hoped that GST Council will stay put with the rates for some years and observe the impact of the new law on business. One may justify the decision of lowering GST rates and relaxing compliance as something that quickly address the concerns of the business. This would portray the lawmakers as more proactive. However, the danger is that it may also send signal that such pressure tactics would work in future as well. International investors do not generally like frequent policy changes and hence favour a destination that has stable economic and fiscal policies. India has been making right noises on economic front for the past few years and the global community is watching us with delight. Let us embolden their faith with steady GST policy.