Removing Cascading Effect of Taxes

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What is GST: Based on who pays and how it is collected, taxes are divided into two categories – Direct Tax and Indirect Tax. Generally levied on Income, Profit or Wealth, some examples of direct taxes are Income Tax, Corporation Tax, Wealth Tax and Property tax. In contrast, Indirect taxes are levied on the transactions of goods or services and can be borne either by the seller or by the buyer. However, the sellers can and in most cases do, pass it on to the buyers. Some examples of indirect taxes are – custom duty on foreign import of goods, service tax on the service provided by a commercial entity, excise duty on the manufacturing of goods, sales tax on the goods being sold and so on. Goods and Services Tax (GST) is an indirect tax which will replace almost all other indirect taxes levied by central and state governments.

Applicable in India from July 1, 2017, two main features of GST are that each good/service will attract only one tax, which will be the same across all states of the country. However, it is noteworthy that there are a few sectors, such as petroleum, alcohol and real estate, which have been kept outside GST and will continue under the previous taxation framework. Custom duties have been continued but integrated in GST, while taxes imposed by local bodies like municipalities, gram panchayats have also been excluded. Barring such exemptions, all indirect taxes in India that were applicable earlier are going to be replaced by GST. Some of the major indirect taxes being subsumed under GST are – Excise duty, Service tax, Special additional duty of customs, State VAT, State sales tax, Entertainment tax, Entry tax, Luxury tax.

There are three main stakeholders who would be affected with the coming in of GST – the Consumers, the Governments and the Businesses. This article tries to analyse how GST is different in comparison to the earlier tax regime and the resultant impacts it can have on the consumers.

How is GST Different from the Previous Tax Regime

Before a particular good/service is finally bought by a customer for his/her personal use, it passes through a number of stages in the production and supply-chain, such that it used to attract one or more indirect taxes at different stages, some levied by the Central government and others by respective State governments. For example – A TV set manufactured in India had to pay excise duty when leaving the factory. If it had used some imported components then custom duties on those items had to be paid, in the next leg of its journey from the manufacturer to the wholesaler there were sales tax, and finally from the

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Secondly, an indirect impact of GST, which is likely to be visible only in the medium to long term, can come through changes in production and supply chain processes.
wholesaler to the retailer there could have been VAT. The situation was more complex when goods moved between the states as not only did they attract a Central sales tax, also the rate for it varied across the states, for example – before GST, value added tax (VAT) was 12.5 per cent in Maharashtra while the same tax in Gujarat was 15 per cent. Many a times, taxes were also levied to promote or dis-incentivise certain products/services, like Luxury taxes or Sin tax. This multiplicity of taxes and complex incidence on multiple stages created two problems – first, it made tax compliance harder for tax payers and also provided opportunities for tax evasion. Secondly, since each new tax was applied on the selling price that also includes tax paid in the previous stage, it basically meant a tax on the amount of tax paid at the previous stage, a phenomenon known as the cascading effect of taxes.

In the picture -1, A is a wholesaler, B is a retailer and C is a consumer. When C pays 20 per cent tax on the price of Rs. 130, which includes the taxes paid by B when buying from A; C effectively not only pays the tax on the actual cost of the good (Rs. 100 + Rs. 20), but he/she also pays tax on the tax paid by B (Rs. 10 and 20 per cent on Rs. 10). Such tax on tax incidences ultimately increases the final price paid by the consumer.

Under the new GST regime, a particular good/service will attract only one tax rate, and it will be same in all the states. Also, each manufacturer/seller/business entity will be able to avail the benefits of a scheme known as ‘Input Tax Credit’ (ITC). To elaborate from the previous picture – when B buys input worth Rs 110, it includes tax payment of Rs 10. When A deposits this amount with the government along with details of buyer (B in this case); B will receive a ‘Tax Input Credit’ of Rs 10. When B sells that good finally to C at price Rs. 130, the amount of tax that B needs to deposit with government is Rs. 13 (uniform GST at 10 per cent now). However, since B already has a tax credit of Rs. 10, it will need to pay only Rs. 3 extra. Thus, while GST makes indirect tax simpler and uniform across states, the ITC mechanism reduces the total tax incidence and hence overall cost for business.

**Potential Benefits/side-effects for the Consumer**

There are two different ways in which GST can have impact on the consumers. Firstly, the direct and immediate impact of GST will be a new ‘effective’ tax rate on each of the goods and services. Depending on how different the new ‘effective’ tax rates are as compared to the pre-GST period, prices will increase or decrease accordingly. Secondly, an indirect impact of GST, which is likely to be visible only in the medium to long term, can come through changes in production and supply chain processes. Both of these potential impacts are discussed in greater details in the following sections.

Under GST, each good or service will be subjected to one of the four prescribed tax rate slabs – 5 per cent, 12 per cent, 18 per cent and 28 per cent or it could be exempted from tax meaning it would have a 0 per cent tax rate. A difference in the ‘effective’ tax rate as compared to pre GST period could arise due to the good/service being placed in different slab. For example – let’s say there is product X which is manufactured and directly sold to the consumer. Under the previous regime, the taxes levied before final sale were Excise duty, State Vat, Entry tax, etc. Let’s assume that the sum total of all such taxes amounted to 15 per cent. If under GST this product is placed in the 18 per cent slab then it becomes
costlier, however if it is put in the 12 per cent or 5 per cent slab then it will become cheaper. It should be noted that due to erstwhile difference in rates across states, there is possibility that a particular good/service becomes cheaper in one state while it gets costlier in another state.

Under GST, agriculture and food products, like food grains, pulses, fruits, vegetable and milk have been exempted along with education and health care. All of these combined together contribute close to 40-45 per cent of expenses of an average household, as measured in the consumer price index. While other necessary items like coal, sugar, edible oil, coffee are placed at 5 per cent. However, the standard rate for services has been kept at 18 per cent which is higher than the pre-GST rate of 14-15 per cent. Due to the multiplicity of taxes and incidences of taxes in multiple stages in the pre GST period, calculating the exact change in effective tax rate for individual goods/service is rather difficult. However, there are estimates by some economists that broadly, tax incidence on 50 per cent of items will remain same, 30 per cent can come down while another 20 per cent may actually see an increase.

Another way in which the effective tax rate can change, is through the Input Tax Credit scheme. As explained previously, this process, by reducing the effective total tax incidence, reduces the overall cost for manufacturers/sellers. This reduction in cost is expected to ultimately bring down the final price paid by consumers. To deal with firms not passing on the benefits of reduced cost to the consumers, Government has introduced a clause in the GST bill known as ‘Anti-Profitereing Rules’ which mandates the firms/businesses that any reduction in cost due to Input Tax Credit has to be passed on to the consumer by way of commensurate reduction in prices. However, it remains to be seen if the prices will actually fall, which can be difficult, at-least immediately, due to reasons like logistic challenges of existing MRPs on the products.

Notwithstanding the potentially lower or same effective tax rates, there are a number of economists and commentators who foresee an increase in inflation in the immediate future. There can be two possible reasons behind this prediction. Experiences from other countries, such as Japan, Australia, Canada, and others show that there was an increase in inflation post GST implementation, and the same situation can arise in India as well. The other potential increase in prices is possible due to increased compliance cost, especially for small and medium enterprises, which brings us to the next part that how GST can affect consumers through its impact on production, businesses and supply chain processes.

One widely discussed aspect of GST is its impact on small and medium enterprises. Currently, a disproportionately large number of business entities in India operate
under the informal economy, which basically means that they escape regulatory and taxation obligations. This escape or evasion, though, also helps in keeping the overall costs down for such entities. Under the Input Tax Credit system, however, one entity can avail its benefit only if it buys from an entity that is registered with the GST network and also has paid taxes accordingly. Due to this provision, there is a strong likelihood that a buyer will buy only from a GST compliant seller, and this can lead to a large part of business entities previously operating outside regulations to register, and hence bear the appropriate regulatory and taxation cost. Even for those enterprises already complying with the existing regulations, shifting to GST network may increase cost, at-least in the initial phase. While on the upside, this has a significant potential to enhance the tax base and overall tax revenue for the government, depending on how it affects the overall cost structure associated, it can also increase prices accordingly.

Lastly, another major impact of GST is likely to be on the transportation of goods, especially inter-state transportation. A long line of trucks at the state border check posts waiting for clearance was a common phenomenon to be seen. However, with GST making the tax rates uniform across states, these queues are expected to disappear. Most of the states have already abolished the check posts. This uninterrupted movement of goods across the country is likely to have a significant reduction in terms of transportation cost as well in terms of time requirement, thereby bringing the overall cost down.

Concluding Observations

GST is being touted as one of the biggest tax reforms in independent India, and there are good reasons to expect that it will have far reaching consequences. From a consumer’s perspective, there are some uncertainties as to how GST will change the overall price level, as there are factors acting on both the sides, to reduce it as well as increase it. Lower effective tax rates for a large basket of goods, Input Tax Credit and improvements in the supply-chain are those factors that should reduce price level. On the contrary, increase in effective tax rates for services and increased compliance cost, especially for small and medium enterprises, have the potential to increase prices. The presence of factors on the conflicting sides makes the task of predicting the price level in the immediate future difficult. And while it is tempting to compare with other countries who have implemented GST before, none of them are as diverse and multi-layered as India, not to mention the complexity of system being replaced by GST. Against this background, it remains to be seen as to how the interaction of all these factors pans out and how does the GST ultimately affect the consumers.

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