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From GST to RGST: A Raucous Ride

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The transition from General Sales Tax (GST) to Reformed General Sales Tax (RGST) has become an intricate and controversial topic for no particular reason. Let me start the discussion by acknowledging that RGST is not a new tax as generally perceived, rather it is the old GST which when fully implemented would be a sufficiently broadened and extended version of the existing GST. The changes in the existing GST would include withdrawal of many of the exemptions and concessions that have been granted over time, gradual abolition of the zero-rating of domestic sales while maintaining zero-rating of the export sector, and extension of the existing GST to services that are currently outside the tax net. Thus, those who are opposing RGST believing it to be a new tax are required to be properly educated by the Sales Tax and the Taxpayers' Education and Facilitation wings of the Federal Board of Revenue (FBR).

In order to understand the possible challenges and opportunities that could be encountered while implementing RGST let us go back in history and remind ourselves that the transition from sales tax (ST) to GST in early 1990s was not smooth and trouble-free and we should not expect anything different when progressing from GST to RGST. Despite initial hiccups due to operational difficulties and resistance from the business community we know that sanity did prevail and the first phase of GST was levied. The policy decision that there will be substitutability between indirect taxes was one of the motivational factors for the acceptance of GST. The stakeholders were informed that the new tax called GST would replace most of the existing excise duties along with substantial reduction and rationalisation of customs duties. Thus, the additional burden of the tax will be substantially less than what was being anticipated at that time. However, despite this assurance, the speed of implementation of GST was unfortunately fairly slow as compared to the speed at which tariffs were reduced and rationalised and excise duties were removed. Consequently, there was a revenue loss for the revenue authority equivalent to one and a half to two percent of GDP while the benefits were not passed on to the final consumers. This clearly indicates that without due care there is an initial cost of reform initiative in fiscal domain.

It is also relevant to discuss at the outset the rate structure of GST. As we all know that the experimentation of sales tax rate started with the adoption of 12.5 percent rate that was quickly raised to 18 percent in subsequent years. It was reverted back to 15 percent only to be increased again to 16 and then to 17 percent. Higher and multiple rates also prevailed for the non-documented sectors. Realise that all these changes were

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introduced within a short span of 15 to 20 years which is an obvious indication of inconsistency and indecisiveness. While the revenue authority did gain in terms of tax collection, there was an obvious cost of this topsy-turvy behaviour for the taxpayers. The transition from GST to RGST has been analysed within this backdrop while acknowledging the fact that now we are moving from easy to tax, i.e., taxation of commodities, to relatively difficult to tax areas, i.e., taxation of services, while gaining some of the turf that was lost to powerful players in the shape of concessions and exemptions.

What could have been the challenges and gains if the Government decides to levy RGST from January 2011? To answer this critical question, let me concentrate on four areas. The first one naturally relates to possible revenue gains from RGST. One needs to have fair idea of how much additional revenue could be collected when the tax base is broadened by bringing additional services into the tax net.[1] The second and third issues concern with macroeconomic and distributional consequences of GST. Finally GST has serious issues with regard to tax administration, especially related to tax fraud and the operational readiness of FBR. One has to evaluate whether or not the tax administration is ready for this ambitious undertaking.

Using Sales Tax Forecasting model, an initial exercise was undertaken to determine the revenue gains of bringing additional services in the tax net. The assumptions to start calculations included use of 15 percent rate for such services as construction and land development, wholesale and retail trade, banking and insurance, real estate, ownership of dwellings, personal and household services, social and cultural services, and business services. To start with health and education services are assumed to have been exempted from tax on the grounds that the country is already deficient as far as human capital development is concerned. A very low compliance rate of 20 percent has been assumed for the simple reason that the overall compliance rate, especially at the wholesale and retail level, was quite low before the introduction of e-filing in GST.

Using this information, it was found that RGST could fetch an additional sum of Rs 35 billion on account of new services. As of today when half of the year has already passed, if the tax is levied from January 1st, we should expect no more than Rs 17 to 18 billion of additional revenue in the remaining six months. On the other hand, learning from international experience, if we start with a lower tax rate of 10 percent rather than 15 percent then the amount of additional taxation will reduce to Rs 10-12 billion only. Simultaneously, since the tax authorities are contemplating on reducing the existing standard tax rate by at least one percentage point and are also planning to do away with higher tax rates, we expect that the cost of these measures would be around 10 to 12 billion rupees. Thus, taken together, it essentially reduces to a zero sum game. Under these circumstances when initial revenue gains are negligible, the natural question is should the authorities pursue an extended version of GST which would be much closer to VAT? Notwithstanding this less than optimistic scenario, I strongly favour reformed GST over the existing GST for the simple reason that a broad-based tax on consumption (GST or RGST or VAT, the name really does not matter) is a money machine. There is enough evidence in the literature to prove that countries which have opted for a comprehensive

[1]It is important to point out that some of the services having significant tax contribution, like telecom and financial services, are already in the tax net, albeit indirectly.

VAT have generated so much of revenue that they were able to increase the size of the government on the one hand and spare enough resources for productive investment leading to employment and growth on the other.[2] Since Pakistan is in dire need of additional resources, we need to revamp GST as early as possible.

It is unfortunate that the tax has been made controversial without analysing the macroeconomic and distributional consequences of a broad-based GST. There is a widespread fear that RGST will be highly inflationary. In this regard it is important to note that to the extent that certain exemptions will be withdrawn and additional services will be liable to taxation there will be a difference in producer and consumer prices. Hence some prices would go up. On the other hand, since the standard rate will be reduced and higher rate structure will be abolished, this should result in lowering of prices of a large number of commodities. It is anticipated that the net effect will be only a marginal increase in prices not because of additional taxation rather due to downward rigidity of prices as businesses seldom reduce their prices. Besides this, inflationary consequences would also depend on how monetary policy is coordinated with the fiscal policy. An accommodating monetary policy would mean that prices will rise by the amount of tax, whereas a tight monetary stance would imply reduction in factor payments and therefore there will be limited consequences for inflation. Regarding trade balance and investment, the impact of tax on trade balance is expected to be neutral. While imports will be discouraged because of tax and exports are already zero-rated, we should not expect trade balance to deteriorate. Similarly, the tax will not be anti-investment as such provisions as input adjustment and refund on input tax will continue to be available on raw material and machinery and equipment.

Regarding distributional consequences, contrary to available evidence it is quite common to hear that the burden of tax is going to be shifted to lower segments of the society and hence it will regressive. At least three recent studies are available in the literature where incidence of GST has been quantified using Household Income and Expenditure Survey (HIES) data. All of them have concluded that GST tax is mildly progressive. If indeed this outcome is true then we should actually be looking forward to this tax rather than blocking it. Another critical factor to be considered is what is the alternative to GST? Historically the alternatives to GST are customs and excise duties, which incidentally are more regressive than GST.

Let me make my final comment on matters pertaining to tax administration. The two issues that are of immediate concern are: possibility of tax fraud and operational readiness of tax authority in extending the tax base to hard-to-tax areas. The tax fraud originates from zero-rating of exports, allowance for input adjustment, carry forward, refund claim on inputs and similar provisions. Many developed economies, where systems and procedures are firmly in place, are continuously being haunted by the menace of tax fraud. The developing countries are relatively more vulnerable to this. Pakistan too has serious problem with authenticity of refund claims and their timely disbursement. The authorities tackled the issue by zero-rating of five export-oriented industries and later on the concession was extended to some other industries. It was well understood that zero-rating would seriously jeopardise VAT spirit, but there was limited

[2]In Pakistan also GST is a leading revenue spinner—the contribution of GST in federal tax receipts is nearly 40 percent.

choice. Technology through computerisation of taxpayer records was supposed to help in finding out the true extent of refunds and rebates while squashing the use of flying and fake invoices, but it has failed FBR for one reason or the other. How to get around this problem so that the true spirit of VAT is preserved and tax fraud is minimised remains a critical concern. Even though some progress has been made in this regard, but the problem is expected to aggravate when an extended version of GST will be in operation.

Similar is my concern on operational readiness before embarking upon RGST. Currently the tax base is very narrow both in terms of commodities as well as taxpayers. There are only five commodities that generate nearly 80 percent of domestic sales tax receipts and less than 1500 taxpayers contribute nearly 90 percent of domestic sales tax in this country. We are all aware of the fact there are large number of cities in all provinces producing specialist goods but unfortunately the tax collection is very low because the business activities are largely un-documented.[3] Has the tax department prepared itself to exploit the tax potential of this largely informal sector? Has the process of business registration and documentation started? If the answer to these questions is no, then obviously or we have already given up the hope. We have, therefore, indirectly accepted that the possibility of broadening the base is very limited in the informal sector? In this case the implementation of RGST is too far off from reality and we should forget about deadlines. Thank you very much.

[3]For example Sialkot is producing sports goods, Wazirabad cutlery, Gujrat fans, Okara furniture, Kasur leather goods and so on.