

## The Challenges of the Goods and Service Tax (GST) implementation in India

### Executive Summary

A Goods and Services Tax in a federal structure by very nature is complex. The GST system in India tries to minimize the complexity by applying a common base and rate across the country. However, the multiple rate structure and an enforcement framework using onerous reporting requirements for businesses places a huge compliance burden on businesses especially SMEs and is having a negative impact on the economy. The government could reduce the compliance burden on SMEs by providing a longer transition period for them to be part of the full GST requirements. Exporters are facing significant shrinkage in their working capital under the new system which is restricting their ability to take in new orders. Reducing the cash flow burden on exporters and reducing cases of refunds would require immediate policy interventions. The economic impact of the new system will last for at least a few months until businesses can comply with the new system. The additional cost of compliance and the higher tax compliance is likely to render some marginal businesses unviable which would have real economic impact on investment and jobs. However, over time, the benefits of the implementation in the form of positive economic benefits such the removal of tax restrictions on free movement of goods across the country and higher tax collection will over time make up the temporary slowdown. In the interim, the government would need to take additional measures to address these issues of potential slowdown to the economy and minimize any additional compliance burdens on businesses especially SMEs.

#### ➤ **Why was the GST brought in?**

The new GST system was introduced, after more than a decade of efforts, on the 1<sup>st</sup> of July to replace multiple central and state Value Added Taxes on the same base that existed earlier. Prior to July, 2017, the Center and each State levied its own VAT resulting in a fragmented tax system with different rates being applied for similar sales of goods. Further, the State VAT was levied over a Central quasi-VAT and an inter State Sales Tax resulted in cascading of taxes as these taxes were not allowed to be credited against each other. To collect more revenue some States levied egregious 'entry taxes' that caused restrictions on the free movement of goods around the country. The new GST was designed to bring about a common policy and administrative framework for taxation across the entire country and causing minimum tax based restrictions on trade.

#### ➤ **Brief Outline of the new GST system**

The new GST system replaces many central and state taxes on the same base with a country-wide common framework and minimizes the complexity by applying a common base and rates across the entire country. The system largely uses four rates of taxation (5%, 12%, 18%, 28% and additionally 0.25% for precious stones and 3% for gold) along with several exemptions. The new GST system removes any taxation that is applied when goods cross state borders allowing for minimum tax based restrictions on trade. The new system also seeks to improve tax compliance by applying strong data reporting requirements electronically and cross-matching of the reported data.

#### ➤ **Issues faced in GST implementation**

These include onerous requirements on businesses on collecting and reporting transaction-wise data onto the electronic portal for all businesses with turnover over 7.5 million rupees a year. Issues also arise due to identification of the goods and services with a HSN code to arrive at the correct tax rate to apply. Exporters who earlier had benefited from tax exemptions on their inputs are now required to pay taxes on inputs up front and claim their refunds after filing of tax returns. Exporters are required to also collect tax on exports as it were a domestic sale if they do not have a Letter of Undertaking or Bond. This is putting pressure on the working capital of small exporters. Informal businesses are under severe pressure having to now pay taxes (and the additional cost of compliance) and marginal businesses are likely to close thus having a real economic

impact which could spread down the value chain. Some of these issues such as classification and uploading of returns are transitory, however structural issues on multiple rates and treatment of exporters and marginal businesses will continue.

➤ **How are the issues in the implementation of the GST being addressed?**

The Government has been attempting to address the issues faced by businesses. A Committee of Ministers headed by the Deputy Chief Minister of Bihar has been constituted to look at online filing system performance issues and a Committee headed by the Revenue Secretary, Government of India on resolving problems faced by exporters. Additional time is being given to businesses to file tax returns.

➤ **Performance of the GST – Compliance and Revenue collection:**

Based on the collection from the first two months, the collection from the GST is largely on track. There has been a shortfall on the number of returns filed which may be because of transition issues.

➤ **Potential issue with the e-waybills:** The e-way-bill is a system whereby every transport of goods requires the creation of an electronic way bill from the tax administration system giving details of the parties to the transaction and of the goods being transported. The e-way-bill system is expected to start in October. It is likely that this will add to the burden of the businesses as well as transporters during the transition period.

➤ **Political Economy of the implementation of the GST**

The government had a limited window to implement the GST before the political cycle kicked in. This may have played into the hurried implementation without full preparation. The government hoped that by the time the next elections campaigning begins at the end of 2018 the issues in the GST would have settled and the benefits of the implementation in the form of positive economic benefits such as the removal of tax restrictions on trading and higher tax collection.

**Potential ways to address the issues faced by businesses on the implementation of the GST:**

- Allow longer period for filing of tax returns such as quarterly filing
- Support taxpayer assistance like the Tax Return Preparer Scheme for Income Tax
- Introduce a GST suspension regime for small exporters
- Allow automatic refunds for certain categories of exporters using a risk based approach
- Move to fewer tax rates to address the issue of classification and refunds
- Postpone the introduction of the e-way bill until the system stabilizes
- Clarify to taxpayers the administration of the GST by the dual Central and State Tax Administrations

## 1. Introduction

There has been a lot of press coverage on the issues in the implementation of the new Goods and Services Tax (GST) rolled out on July 1, 2017 replacing multiple National and State Taxes. This note elaborates the issues and suggests possible solutions highlighting solution that are already under implementation.

The new GST system was introduced in the 1<sup>st</sup> of July to replace many central and state taxes on the same base with a country-wide common framework. As each State levied its own VAT, the tax system was fragmented with different rates being applied for similar sales of goods. Another complication was the result of Services being taxes exclusively by the Center while goods were taxes both by the Center and the States. As the Sate VAT on goods was a separate tax as compared to the Center this resulted in cascading of taxes as these taxes were not allowed to be credited against each other. To collect more revenue some States levied egregious 'entry taxes' that caused bottlenecks on the free movement of goods around the country. The new GST was designed to bring about a common policy and administrative framework for taxation of consumption across the entire country and causing minimum tax based restrictions on trade.

## 2. Brief Outline of the new GST system

**2.1 Legal Framework:** The new GST 'system' (system because it is not one law) includes four Central laws, the Central Goods and Services Tax (CGST) Act. and the Integrated Goods and Services Tax (IGST) Act. and the Union Territories Goods and Services Tax (UTGST) Act. along with twenty-four state laws, the relevant State Goods and Services Tax (SGST) Act. which are nearly identical.<sup>1</sup> In combination with these laws the GST system includes another Central law, the Goods and Services (Compensation to States) Act. which provides the taxation of certain sales<sup>2</sup> (mainly luxury and demerit goods) called the compensation cess to compensate the States for any loss of revenue that the new tax system may cause. As the GST system requires a coordinated action between the Center and the States, any changes to the GST system are brought through the GST Council comprising of the finance ministers of all the State government and the Central government. Simplification is also achieved through a common policy and administrative framework as outlined below.

**2.2 Policy Framework:** The GST system is based on a system of multiple rates to various categories of sales (0%, 5%, 12%, 18%, 28% and additionally 0.25% for precious stones and 3% for gold). On all within-State sales, the GST rate is applied on a common base by the Center and States, with each levying half of the rate as applicable to the sale, the relevant nearly identical laws being applied being the CGST Act and the relevant SGST Act. In the case of sales where the buyer and seller are in different States or in the case of exports, the entire rate is applied on the sale and the relevant law applied is the IGST Act. Further, there are several exempted sales and finally exports are zero rated. The identification of sales that are exempt or under the various rates are done through the Harmonized System Nomenclature (HSN) Code for goods and Services Accounting Code (SAC) for services which identifies all goods and services. The HSN/SAC Code are mostly required to be identified up to the 4 digit level, however there is also the requirement to identify certain sales up to the 8 digit level. Taxpayers with turnover of 7.5 million<sup>3</sup> (US\$114,500) or more charge GST on sales at the prescribed rates and can deduct any taxes paid on their purchases. All taxpayers who have turnover from Rupees 2 million<sup>4</sup> to 7.5<sup>5</sup> million fall under a 'composition scheme' whereby they pay tax on turnover instead on value added. The rate of tax is 5% of turnover for restaurant services, 2% of the turnover in the of

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<sup>1</sup> These state laws differ on specific issues such as, for example, the threshold for registration in the case of special category States.

<sup>2</sup> The technically correct usage is 'Supply' rather than 'Sale'

<sup>3</sup> 5 million for certain special category states

<sup>4</sup> 1 million for certain special category states

<sup>5</sup> See 1 above

manufacturers and 1% of turnover in other cases. Such taxpayers are not allowed to charge any tax on their sales.

**2.3 Tax Administrative Framework:** The administration of the GST is done in parallel by the Central and the State GST administrations with the powers to audit and administer shared.<sup>6</sup> To support the administration of the taxpayers, a common nation-wide IT backbone called the GST Network (GSTN) has been put in place through which all tax returns are required to be filed. The GSTN would also aid in the selection of taxpayers for audit through a risk based selection mechanism and would support the other main tax administration functions of the Central and State Tax Administrations.

**2.4 Enforcement framework through matching invoices:** The enforcement framework comes naturally through the nature of the GST/VAT as the two sides of B2B transactions (sales and purchases) are reported in their respective tax returns ensuring compliance. In most other countries, this is usually enforced during audit through the matching of the invoices in selected audit cases. In the Indian GST on the other hand, compliance is enforced during the filing process through 100% matching of all the invoices on all B2B transactions in the case businesses with turnover of Rupees 7.5 million and more. All matching of invoices is done through the GSTN at the time when businesses file their tax returns. Any mismatches are then flagged, and taxpayers are required to file a corrected tax return (see Table1). To capture taxes due from sales by unregistered taxpayers, the GST tax due is collected from the purchaser through a reverse charge mechanism.<sup>7</sup>

**2.5 Treatment of exporters and refund mechanism:** Prior to the GST, exporters did not pay VAT on their inputs that were imported. Under the new GST, exporters are required to pay GST taxes on all inputs including imported inputs and these taxes can be credited and as exports are zero rated the entire tax is refunded to the exporter. However, a refund will be available only if all the input taxes are deposited by the suppliers of these inputs. Further, under the new GST, exporters are required to also collect tax on exports as it were a domestic sale if they do not have a Letter of Undertaking or Bond.

### **3. Issues faced in GST implementation**

There has been a lot of press coverage (mostly negative) on the issues in the difficulties faced by businesses in complying with the new Goods and Services Tax regime rolled out from July 1, 2017. The complaints as reported in the press range over a clutch of issues ranging from poor availability of the GSTN system, non-availability of certain forms and formats (Letter of Undertaking and Bank Guarantees for exporters), delay in refunds of GST paid, transitional issues in carrying over of input tax credit from the old VAT and CENVAT systems, inability to complete fill out outward sale invoices in the GSTN system, GST rate issues and the difficulties faced by the informal sectors and sectors such as textiles that operate in cash with little documentation. Many of the issues are genuine and transitory in nature and are being addressed by the GST Council and Government.

**3.1 Issues in collecting taxes on sales:** Issues arise due the multiple rates and classification. For example, it has been reported just in the case of the business of selling paper, pamphlets are taxed at 5%, letterheads at 12%, files at 18% and hardbound registers at 28%. In the case of businesses with total sales above Rupees 75 million, four digit HSN code is required to be reported for each sale and in the case of imports and exports, 8 digit HSN Code is required to report all sales. This creates difficulties for businesses some of whom are risk

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<sup>6</sup> The State Tax Administration administers 90% of taxpayers with turnover less (over) than Rs. 15 million to be administered by the State Tax Administration and the Central Tax Administration the remaining 10%. For taxpayers with turnover over 15 million 50% of them are administered by the Central Tax Administration and 50% by the States.

<sup>7</sup> The reverse charge changes who pays the tax. Normally, the supplier of items taxable for GST is the taxpayer. If the reverse charge applies (in this case, because the supplier is unregistered) the tax is to be paid by the purchaser.

averse and charge at the highest rate applicable to avoid problems during audit. However, it is hoped that over time this issue gets resolved as businesses are likely to get clarity on the correct HSN Code over time and the applicable rate for their sale. However, issues of classification could crop up during audit which may result in further problems for businesses.

**Issues in preparing the tax returns:** This again arises due to the onerous information requirements in the tax form including the transaction level data of all sales, requirement to match the purchases data as well as detailed information on the HSN code for goods and Service Accounting Code (SAC) for Services for each sale to arrive at the correct rate to apply. Further, the tax return also requires details of all inter-state B2C sales of value above 0.25 million. All this information requirement in a format requires the services of an accountant as well as the software to prepare them. For businesses not used to such detailed data collection as part of their business the cost of compliance increases considerably over the previous years. Under GST, the majority of dealers will need to adopt two-, four-, or eight-digit HSN/SAC codes for their commodities, depending on their turnover the year prior.

- Dealers with turnover of less than Rs 1.5 crores will not be required to adopt HSN codes for their commodities.
- Dealers with turnover between Rs 1.5 crores and Rs 5 crores shall be required to use two-digit HSN codes for their commodities.
- Dealers with turnover equal to Rs 5 crores and above shall be required to use four-digit HSN codes for their commodities.
- In the case of imports/exports, HSN codes of eight digits shall be compulsory, as GST has to be compatible with international standards and practices

### **3.2 Issues in uploading of tax returns:**

The onerous information requirements in the tax return are placing further heavy demands on businesses as well as the GSTN on uploading them to the server. Tax returns are required to be filed every month requiring the need for additional accounting support. The additional cost on accountants especially for SMEs are non-trivial. There are reports that due to the paucity of qualified accountants available, the additional cost of accountant is on average Rs.10,000-15,000 (US\$ 150-230) per month per SME.

**3.3 Issues in the return filing process:** The return filing process requires matching of B2B invoices on both sides of the transaction and a second return is generated for any mismatches in the invoices. When these mismatches are corrected, the final return is filed. However, businesses face problems when both sides of the transaction do not complete the transaction with the month creating mismatches. It is common for some buyers to confirm the sale after more than a month at which time the buyer may not agree on the agreed transaction value after delivery. Business are facing such practical issues with the filing process as there is little tolerance for errors in the return filing process. Businesses worry that mismatched invoices would lead to further scrutiny of those transactions by different tax administration raising the cost of compliance with GST.

**3.4 Issue in refunds for exporters and others:** Ideally refunds should arise mainly in the case of exporters and in the case of long gestation projects where items are delivered long after inputs were purchased. However, refunds may also arise due to the design of the GST with multiple rates. If businesses are making sales at a lower rate but pay tax on inputs at a higher rate then refunds may result in the natural course of business. Exporters have been badly hit by the requirement to pay tax on imports up front resulting in cash flow issues unlike in the past they have been benefiting from tax exemptions on their inputs. This has put a lot of pressure on their working capital requirements. Further, refunds are not yet being issued expeditiously as the system is designed to be risk averse to any fraud that may arise on refunds. Other transition issues include delays in providing formats for Letter of Undertaking and Bond for exporters to export without paying

taxes on export sales. According to Federation of Indian Export Organisation (FIEO), exporters have stopped taking orders with least or no working capital at their disposal due to blockage of funds under GST and uncertainties looming large on refunds for the months of July to October, 2017.

**3.5 Impact of slowing economy on GST implementation:** The introduction of GST has become conflated with other factors slowing growth including demonetization. While some impact on higher inflation has been expected from international experience, it is still too early to judge the impact of GST on the macroeconomy. But also, other problems are bubbling up to the surface such as lack of adequate bank credit for small businesses, interest rates and cash flow problems as the input credit system requires that some amount of working capital is blocked until it is adjusted on sale (some businesses claim that this could be up to 5% of their working capital). Another factor is the impact of higher tax compliance under the new GST on informal businesses whose margin was entirely the tax they were not paying. When one includes the additional tax being paid, the additional cost of compliance for preparing and filing tax returns and the blockage of working capital, marginal businesses are likely to close thus having a real economic impact which could spread down the value chain.

**3.6 Potential issue in introduction of the e-way bills:** The government had postponed the implementation of the e-way bill system (to October) whereby every transport of goods required the creation of an electronic way bill from the GSTN giving details of the parties to the transaction and of the goods being transported. It is likely that this will add to the burden of the businesses as well as transporters. Transporters have been reporting reduced time on the road because of the introduction of the GST which may get undermined by the e-way bill requirement.

#### **4. How are the issues in the implementation of the GST being addressed or may be addressed:**

**4.1 System to address issues in a timely manner:** The government has been attempting to address the issues faced by businesses. A Committee of Ministers headed by the Deputy Chief Minister of Bihar has been constituted to look at GSTN system performance issues and a Committee headed by the Revenue Secretary, Government of India on resolving problems faced by exporters.

**4.2 Reducing the burden of return filing:** The timelines for filing detailed monthly returns for July has been extended to compensate for system related delay and lack of preparedness amongst businesses:

**Table 1: Tax Return Forms to be filed under the GST**

<b>Form</b>	<b>Initial Deadline</b>	<b>Revised Deadline</b>
GSTR1 (outward sales)	September 10	October 10
GSTR2(inward sales)	September 25	October 31
GSTR3 (consolidated return)	September 30	Novemebr 10

There is indeed a need to further simplify the compliance requirement for small businesses and the Government is examining the simplification of return filing requirement.

**4.3 Addressing the issue of Refunds to exporters:** Reports indicate that Rs. 650 billion has been claimed as transitional credit from the VAT/CENVAT system to GST. While the genuineness of the claim will need to be assessed (the government is examining every claim over INR 10 million from 162 businesses) this must be done in a timely manner for the system's credibility. Otherwise, demand is bound to arise for exemptions, alternate regimes etc. which defeat compliance. As a relief to businesses, transitional credit can now be claimed for up to six months after GST's introduction.

Reducing the delays on issuing refunds could be done by providing them on a risk basis whereby refunds are provided automatically at the end of the return filing process in cases where the business has a good track record of compliance reserving additional scrutiny only for high risk cases where refunds are demanded.

In the medium to long term two additional steps could be contemplated to address this issue:

- Allow suspension of VAT for exporters who source their inputs from exports. This reduces the burden on exporters as otherwise tax is paid to the treasury on imports only to reclaim it on exports. Such a system addresses their cash flow problems that the current system has created.
- Move to a single rate of VAT which addresses multiple issues including refunds as well as difficulties in classification of sales under the various rates mentioned above.

**4.4 Longer period to file tax returns:** The monthly filing requirement of tax returns may be replaced by a quarterly filing for some businesses. While this creates a problem in implementation because, the filing process requires matching of invoices and requires that all tax returns are available for the matching to happen, a longer period for the matching process may be allowed. While this is not ideal, it may be tried during the early stages of implementation to move to monthly filing only after the system stabilizes. Checks may be put in place so as encourage business to upload most of their invoices within a month of the sale occurring but allowing the final process to be completed at the end of the quarter. Further to maintain cash flow for the government, the quarterly filing requirement may be staggered by asking one third of business to file each month. This ensures that the system also does not get overloaded at the end of each quarter.

**4.5 Potential issue in introduction of the e-way bills:** The requirement of an e-way bill for transportation of goods may be postponed further to allow the system to stabilize.

**4.6 Taxpayer education and assistance:** The government is putting in considerable resources to educate taxpayers however reports indicate that many SMEs are facing practical difficulties in complying with the new laws. Businesses are mainly using the assistance of accountants in the private sector. The government could help further help businesses by supporting the number as well as quality of accountants through a project like the CBDT's Taxpayer Return Preparer Scheme for Income Tax.

## 5. Performance of the GST – Compliance and Revenue collection:

### 5.1 GST revenue collection

Total GST collections in July and August 2017 (up to September 25, 2017) was INR 940 billion and INR 907 billion respectively. These figures do not include the GST to be paid by dealers who opted for the composition scheme which is about 1.02 million dealers. The break-up of the collection is as follows:

**Table 2: Revenue collection under GST July and August**

	July (for INR 923 billion)	August
Central GST	149 billion	144 billion
State GST	227 billion	211 billion
Integrated GST	475 billion	474 billion
Compensation Cess	72 billion	78 billion

Based on this data it appears that the government will meet their revenue target for indirect taxes when one includes tax collected on fuel which is outside the GST.

**5.2 GST Registration:** A total of 5.85 million dealers had registered under GST system as against an estimated population of dealers of 7.23 million expected to migrate from State VAT, CENVAT and Service Tax to the GST. The registration of dealers had improved in August to 6.82 million. Of the 6.82 million registrants, 1.9 million were new registrants. Therefore, it is estimated that the migration from the earlier systems to GST is of the order of 70 percent. These figures are from official press release. Other sources cite that 8.5 million businesses have registered (6.3 million from the pre-existing regime and 2.3 million new businesses). While the migration may not be fully complete, it is also expected to result in some base clean-up of dealers who are no longer operative or have dropped below the registration threshold of Rupees 2 million and Rupees 1 million respectively for regular and special category states. In the same vein the new registrants could represent formalization of previously unregistered businesses as well as new registrations in GST taken by business after dropping out of their pre-existing registrations. This provides an opportunity for states and the center to analyze the migration of businesses from their jurisdictions and take closure and tax recovery actions against those businesses that have dropped out without formally notifying tax authorities and following legal procedures for de-registration.

**5.3 GST Returns filing data:** In July, 5.96 million registrants were required to file their GST returns (Summary return 3B applicable for the months from July to December 2017) of which 4.4 million filed their returns (74%). The total number of registrants required to file their returns for August was 6.8 million of which 3.76 million returns were filed (55%). It appears that there is some slippage in the filing of tax returns based on expectation. It may be useful to understand why some have not filed their GST returns as expected.

**Conclusion:** The GST system in a federal structure by very nature is complex. The GST system in India tries to minimize the complexity by applying a common base and rate across the country. However, the enforcement framework through onerous reporting requirements for businesses places a huge compliance burden on businesses especially SMEs. The government could reduce the burden by providing a longer transition period for businesses. Further, reducing the cash flow burden on exporters and reducing cases of refunds would require policy changes.



## Appendix: Medium to Longer Term issues with VAT/GST and World Bank support

1. Risks and challenges in the implementation of a new VAT relate to:

- Complex rate structures
- Exemptions
- Broadening the VAT base to additional sectors/areas of the economy
- Modernizing tax administration, including changes in the organizational structure and IT
- Taxpayer segmentation
- Inter-jurisdictional aspects in federal systems
- Political economy aspects
- Risk of fraud, especially in the context of exports

International experience also suggests that the introduction of a new tax system is the start of a process of reforms, rather than the end, and will require strong accompanying measures with continuous adjustments and improvements during implementation.

2. **In India, the key challenge GST implementation could face is proper control, of fraud-prone refunds particularly.** Since the GST is a self-assessed tax that is collected throughout the entire production chain involving a long paper trail of invoices, robust control mechanisms are critical. This is particularly the case for refunds, which can be highly vulnerable to fraud. In the European Union, removal of intra-EU borders linked to VAT refund mechanisms led to widespread fraud (missing trader, carousel fraud) that impacted on revenues. This could also be the greatest risk that India will face during GST implementation if control and risk-based tax audits are fragmented among states rather than centralized.

3. **Other main areas for GST implementation are modernization of the tax administration, tax audits and sound measurement of GST impact.** GST provides an opportunity to modernize overall tax administration in terms of functional organization and technology. There is a need to develop a strong tax audit system using a risk-based approach, particularly at the state level. Finally, a robust measurement of potential GST losses could help establish effective and targeted countermeasures, given that the central government has committed to cover states' revenue losses for the first five years. Moreover, in a federal system like India, inter-jurisdictional aspects and cross-state transactions, including the increasing importance of trade in services and electronic commerce, require particular attention.

4. **The World Bank has extensive experience in supporting governments in implementing tax reforms and strengthening tax administration.** Recent engagement supported Governments in Kuwait (design and implementation of a new VAT system); Pakistan (comprehensive TA on Tax Policy and Tax Administration); and Indonesia (ICT road map and institutional transformation). The Bank has models to conduct functional reviews of both Central and State tax administrations, including IT and HR management analysis. It also has experience in mapping and reengineering core processes of tax administration and on international taxation issues (transfer pricing, general anti-avoidance rules and exchange of information) and on tax audit through training and the development of a risk-based audit program. In the case of India GST, the Bank could offer support for tax audit, a functional review of tax administration followed by process mapping and business process engineering assessment and training curricula development in GST administration. A Human Resource and IT assessment could be considered at a later stage. Some of these are already being implemented in select states where the World Bank has a public financial management lending engagement. These could be expanded to cover more states in partnership with the center. Specific knowledge exchange programs can also be set up with the Central Board for Indirect Taxes and the GSTN in areas of special interest.