VERACITY INSIGHTS

POLITICAL RISK & STRATEGY

AS INDIA EMBARKS ON LANDMARK TAX REFORM, GROWING PAINS ARE ALL BUT GUARANTEED

By Benjamin Weiss

With the Indian Parliament's unanimous approval of a constitutional amendment last month, New Delhi is poised to replace its fractured and complex tax regime with a nationwide goods and services tax (GST). The landmark reform, the passage of which Prime Minister Narendra Modi called a "truly historic occasion," will make it dramatically easier to do business in India and should bring much-needed transparency and predictability to a tax regime long plagued by black money, corruption, and a bewildering patchwork of state and federal duties.

However, businesses operating in India would do well to temper their enthusiasm, at least in the near term, as the GST must first clear a series of political, logistical, and operational hurdles before firms will be able to reap the benefits of the single Indian market the tax is designed to create. In short, the journey from the current system to the proposed GST is certain to be a bumpy one.

POLITICAL WRANGLING

While the government will be pushing for quick enactment of the GST—in part to leave ample time before the 2019 general election to iron out the law's kinks and curb the inflation many economists expect will accompany its implementation—the 1 April 2017 rollout mooted by Revenue Secretary Hasmukh Adhia is likely to be delayed by several months, if not longer.

The wheels of India's democracy tend to turn slowly—the GST has itself been subject to more than a decade of political wrangling—and a number of legislative barriers must still be overcome before the tax will go into effect: at least 15 states must ratify the amendment passed by the Rajya Sabha and Lok Sabha, the upper and lower houses of Parliament (seven states had done so at the time of publication); all 29 states and two union territories must then approve their own GST bills; the central government will need to pass actual GST legislation (the recent votes covered only the constitutional amendment granting the central government authority over interstate commerce); and Parliament will have to approve a separate interstate GST bill, which will allow for collection of the new tax.

TAX RATES TO BE DETERMINED

Even more tortuous than the legislative process will be determining a standard tax rate, which will have a significant effect on state and federal revenues, as well as businesses' profit margins, and is to be hammered out by a powerful GST Council composed of state and central government representatives.

In hopes of curbing inflation, the opposition Congress Party has demanded a cap on the standard GST at 18 percent for most goods and services (essential goods and luxury items will be taxed at lower and higher rates, respectively, while some products, like petroleum and alcohol, will remain outside the

GST). While officials aligned with the ruling Bharatiya Janata Party (BJP) have said they back the 18 percent figure, others in the BJP have signaled that such a rate would not be "revenue neutral"—resulting in a loss in aggregate tax revenue—and that the standard rate would likely be set closer to 20 percent at the outset.

Several states have expressed a preference for an even higher rate to ensure that they will not take too heavy a hit when they lose the ability to collect sales taxes, entry duties, and other fees. As the proposed GST will be a "destination tax"—collected at a good's or service's final point of consumption—large manufacturing states like Tamil Nadu, whose raw materials are often shipped outside the state, stand to lose out considerably on tax receipts. Indeed, Tamil Nadu officials have vehemently opposed the GST, and the state's representatives staged a walkout from Parliament prior to the constitutional amendment vote. While central government lawmakers have agreed to provide compensation for losses incurred over the first five years of the new tax regime, anxious states still intend to bargain hard for higher GST levels, potentially delaying agreement over a suitable standard rate. States and the central government will also need to settle on the details of tax-sharing arrangements.

Businesses will be closely watching—and weighing in on—GST rate negotiations as well. Services today are effectively taxed at 15 percent, so firms in service sectors are likely to see their tax burden increase. Telecommunications and food processing companies, which are currently taxed on the lower end of the spectrum, are expecting a heightened tax bill and are lobbying for lawmakers to rein in the standard rate. Automobile manufacturers and cement companies, meanwhile, are likely to be satisfied with the new rates, as those industries are currently taxed as much as 27 percent.

Which sectors stand to gain or lose under India's GST?

Likely **tax rate decreases** for:

- Automotive
- Cement
- Fast-Moving Consumer Goods

Likely **tax rate increases** for:

- Financial Services
- Food Processing
- Telecommunications

Sectors **outside** of GST**:**

- Alcohol
- Electricity
- Petroleum

COMPLIANCE AND TRAINING

In addition to potentially higher tax bills, firms should expect considerable compliance costs, particularly in the immediate term. While the GST is expected to eventually make tax reporting smoother and ease interstate commerce—time-consuming inspections of goods and documents at state checkpoints should disappear as the GST subsumes most state-imposed duties—a handful of provisions may actually make compliance more tedious: services firms, for example, will reportedly be required to register in each state of operation, as opposed to the current practice of having to secure just one centralized tax registration, while firms in several sectors will see the number of tax returns to be filed jump considerably, owing to the need to file returns in each state of operation multiple times per month.

Companies will need to train employees to adhere to these new requirements and to navigate an intricate system of input tax credits, which is a key element of the GST's value-added approach. As a result, GST is likely to be adopted by firms gradually, rather than at the flick of a switch, which may result in inconsistencies among vendors, suppliers, and other partners until all parties have embraced the new system.

India's government, too, is undertaking a massive education effort. According to plans issued by the revenue secretary, the government plans to train some 60,000 state and federal officers on the rules, systems, and collection processes governing the new tax, which highlights the magnitude of the tax code overhaul.

EXECUTION RISK

The GST will be administered entirely online on the GST Network (GSTN), a US$200 million IT platform under development by tech giant Infosys. The latest in a series of digital initiatives undertaken during Prime Minister Modi's tenure, GSTN is a welcome departure from India's reliance on paper records, and it should enhance auditing and improve transparency.

However, the move online comes with challenges and risks. Employees and government officials will need to learn how to operate the computerized system, which may prove particularly burdensome for firms with staffers who are less comfortable or familiar with online tools.

States have been busy collecting taxpayer data to populate the system, though given the sheer sum of data to be gathered and input, the risk of human error is high and could cause bureaucratic headaches for some unlucky companies. Developers are aiming to test GSTN months before its launch, though the system underpinning India's US$2 trillion economy will surely have its share of bugs; one need look no further than the US transition to online enrollment for health insurance in 2013 for an example of a flawed and costly technology rollout.

GROWING PAINS

Indian lawmakers and industry leaders are right to celebrate the impending reform of the country's tax system. The GST will in many ways simplify business and bring openness to a notoriously challenging market. In the near term, though, firms would do well to practice patience, take steps to prepare for the GST's arrival, and expect more than a few growing pains.