GST as an instrument

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ABOUT 70 per cent of the world's population now lives in countries with a GST-type tax, generally referred to as a Value Added Tax (VAT). The acceptance of this tax as a revenue instrument is largely based on the fact that it has raised more revenue than the sales/turnover tax that it replaced. It is also justified on the theoretical ground that it is a neutral tax; it removes cascading (a tax on tax); and enables a zero rating of exports.

GST is a multi-point sales tax which allows a set-off for tax paid on purchases, since only the value added at each stage of manufacturing or sale is taxed at 15 per cent, compared to a pure sales tax under which the taxation of inputs also leads to vertical integration of firms, militating against ancillary industries and encouraging them to produce more and more of the inputs needed rather than purchase them from ancillary industries.

Pakistan has a highly centralized tax structure, partly owing to the constitutional division of taxation powers, partly because of the taxation system established under the IMF diktat and partly because of Islamabad's bizarre interpretations of the constitutional provisions regarding what taxes the provinces can levy. This state of affairs has made the provinces perpetually dependent on transfers from the federal government.

The tax is collected in instalments on each transaction in the production-distribution process. There is no cascading because of the system of deduction or credit for taxes paid. The tax is levied on consumption and, therefore, the final and total burden of the tax is fully and exclusively borne by he domestic consumers. No GST is charged on exported goods and services. This briefly is the arguments in support of GST.

The counter arguments run somewhat along the following lines. If VAT is successful somewhere there is no reason to assume that it will also succeed in Pakistan. To begin with, GST is not a neutral tax when it comes to making a choice between labour and capital because it does not tax capital and labour equally. It gives credit for tax paid on capital but not on labour-related expenses. Many would, therefore, argue that a tax policy should not be neutral but proactive in promoting development of regions or industries through appropriate incentives and disincentives, until the economy is strong enough to rely purely on free market signals.

At present our economy is characterized by administered prices (wheat, irrigation, electricity and gas), huge subsidies for irrigation, manufacture of fertilizer, scarcity of resources (credit, infrastructure), and a host of exemptions. Efficiency in resource allocation, and, by extension, the advantage of GST neutrality, cannot be exploited if many prices continue to be controlled by the government. Therefore, our markets are not really ideal for a neutral tax.

The argument that the government has generated more revenue from GST than from the earlier sales tax, conveniently ignores the rather high rate (15 per cent) that is applied as GST (and which largely explains the extent of its evasion), the reluctance of the government to process GST refund applications on a timely basis and the high rates of penalties levied on short or delayed payments.

The argument that GST provides a better audit trail than a single-stage sales tax assumes that someone is going to follow the trail or has the capability of doing so. With millions of credits being taken, it is becoming impossible to follow them. Fraudulent transactions and fake invoices ("flying invoices" having become a common feature) have made tax administration a nightmare. The problems of exaggerated refund claims through the use of bogus invoices, non-accounting of cash sales or purchases, under-reporting of sales through multiple books of account, claims based on purchases from unregistered businesses or those that exist only on paper, input tax credit claimed on exempted goods, GST collected on imported goods with the tax revenue being pocketed, false export claims, barter arrangements (exchange of goods against goods), etc., will continue to be faced by the revenue authorities. For the revenue collectors the cost of administration and monitoring refunds is high (extensive administrative capabilities are required to operate the tax) and the potential for evasion is huge.

The experience in Pakistan shows that problems of costs of compliance are high because of the somewhat cozy relationship between some taxpayers and the revenue staff, the frequent audits (commonly more than one per year) of those registered for GST purposes and the endemic, and never likely to be resolved, problem of exporters being unable to get their refunds of GST paid on inputs on a timely basis.

Finally, GST requires a fairly high level of literacy and understanding among taxpayers, coupled with the need for a long period of up-front taxpayer education and for societal acceptance and successful implementation of such a tax.

It is perhaps for a combination of these reasons, and because it is a federation with highly autonomous units, that the US, the biggest and most powerful economy, has not instituted a GST-type tax and relies on a sales/ turnover tax levied by each state with its own rates of sales tax for different goods and services.

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However, unfortunately, it is perhaps now too late to withdraw GST and replace it with a different taxation instrument. Therefore, the only pragmatic solution that would be feasible from the point of view of both revenue generation and empowering fiscally stressed provinces with an instrument that would generate much needed additional revenues without unduly taxing weak administrative capacities, would be a dual GST, with a GST-type tax at 10 per cent or 12.5 per cent imposed by the federal government and a destination-based consumption-type retail-stage non-adjustable sales tax at 2.5 per cent or five per cent levied by the provincial governments.

Moreover, although the share of the services sector in the national income has increased, its contribution to tax revenues has not risen commensurately. Resultantly, the commodity-producing and organized sectors have had to bear a disproportionate burden of GST. This violates the principle of neutrality in taxation between goods and services.

The assignment of taxation powers in Pakistan is done according to the principle of separation. The Constitution assigns the powers to levy a sales tax on goods to the federal government and on services to the provincial governments.

The contribution to GDP of the services sector, excluding public administration and defence, is almost 33 per cent of GDP but the GST collected from this sector is less than one per cent of GDP, less than three per cent of total tax revenues and less than four per cent of revenues from GST. The services sector is the largest and fastest growing source of income and its continued absence in the sales tax system has narrowed the tax base and made it difficult to raise the tax to GDP ratio.

The artificial distinction between goods and services has given sustenance to an uncoordinated system for GST, opening up opportunities for avoidance and evasion of taxes, and in collusion with traders the sale value of post-manufacturing services can be inflated in respect of transportation, installation, after-sale service, warranty, especially since services enter into the production of goods and vice versa and developing a non-cascading system for taxing consumption will only be possible when all services are taxed.

Relieving tax on inputs and zero-rating of taxes on exports is also not fully possible unless all the services are taxed. Therefore, for establishing a modern and rational tax system the selective approach to taxing services will have to be abandoned immediately.

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