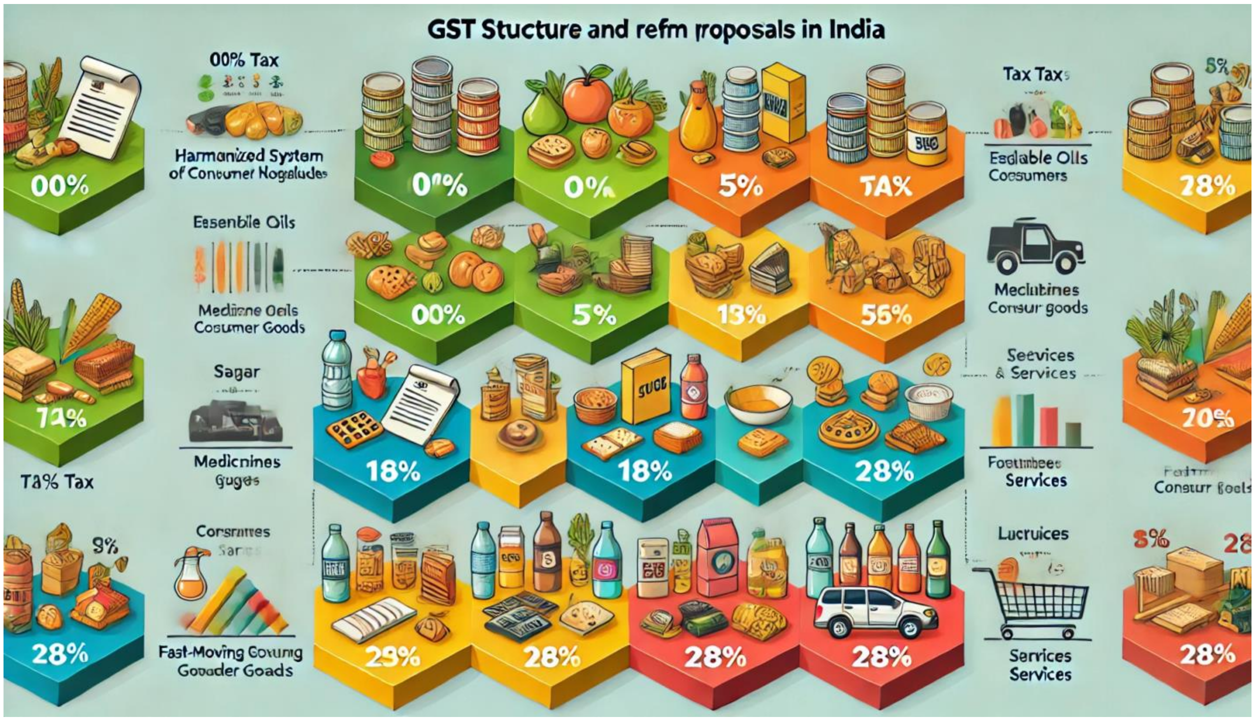
GST TAX RATE STRUCTURE: AN ANALYSIS – PAPER III



The **Goods and Services Tax (GST)**, introduced in July 2017, is one of the most significant reforms in India’s indirect tax regime. Despite the relative success of its implementation, several stakeholders still raise concerns about the complexity of its tax structure and the multiple tax rates applied to various goods and services. As GST authorities look to chart the future of the indirect tax regime, this article explores the key aspects of GST, the challenges posed by multiple tax rates, and various proposals for reform.

GST Tax Rate Structure

At the time of its rollout, the GST replaced a plethora of central and state taxes like excise duty, VAT, service tax, and others. To accommodate the diverse nature of goods and services in India, the GST Council introduced a multi-tier tax rate structure:

- **0% Tax**: Essential goods, like fresh fruits, vegetables, and basic food grains.
- **5% Tax**: Goods and services considered essential but slightly more processed, like edible oils, sugar, and medicines.

- **12% and 18% Tax**: Most consumer goods and services fall under these two slabs. Products like packaged food, clothes, and electronics (12%) or services, consumer goods, and fast-moving consumer goods (18%) are in this bracket.
- **28% Tax**: This is reserved for luxury goods and "sin goods" like tobacco, luxury cars, and premium goods.

The multiplicity of these tax rates was initially designed to ensure equity and fairness. Items of necessity were taxed at lower rates, while non-essential, luxury items were taxed at higher rates.

Classification of Goods - The Harmonised System of Nomenclature (HSN)

One of the critical aspects of GST classification is the **Harmonised System of Nomenclature (HSN)**. This internationally standardized system classifies goods and services to determine the applicable tax rates. The system categorizes products under 99 chapters, which group similar items together.

For example, food products such as biscuits, rusks, and bread fall under different categories in the HSN. Biscuits are taxed at 18%, rusks at 5%, and bread is exempt from tax. Despite being similar food products, their classification under different HSN codes leads to varied tax rates.

While the HSN system ensures global uniformity in product classification, it can sometimes lead to confusion. Minor changes in a product, such as adding cream to a bun, can push it into a higher tax slab. The anecdote of the hotelier from Coimbatore highlights this absurdity — a simple bun has no tax, but adding cream makes it liable for an 18% GST.

Problems of Multiple Rates and Discrepancies

One of the biggest challenges with the current GST structure is the **multiplicity of rates**, which often leads to confusion, disputes, and even legal battles. The different tax rates on similar items can create discrepancies in classification, as seen in the **paratha vs. roti** case. While roti is taxed at 5%, paratha is taxed at 18%, despite their similarities as flatbreads. Such classifications result in confusion for both consumers and manufacturers.

Similarly, there have been instances where tax authorities and manufacturers clashed over whether a product fell under a higher or lower tax slab. For instance, Marico’s **Parachute coconut oil** was argued as both a cosmetic product (taxable at 18%) and a pure coconut oil (taxable at 5%). Other examples include disputes over products like **Nestle’s KitKat** (whether it's a biscuit or chocolate) and **Dabur’s Lal Dant Manjan** (whether it's tooth powder or medicinal).

These discrepancies often lead to prolonged litigation and ambiguity, affecting the ease of doing business and compliance.

Varied Reform Proposals

Several reforms have been proposed to streamline and simplify the GST structure. The primary suggestions revolve around either collapsing tax rates into fewer slabs or adopting a **flat tax rate**.

1. **Flat Rate**: A uniform tax rate with no exemptions or carve-outs has been proposed, similar to countries like Singapore and New Zealand. This would vastly simplify the system and remove classification disputes. However, it was considered impractical for India, a diverse country with numerous essential and luxury items. Former Finance Minister **Arun Jaitley** himself stated that a single tax rate was a flawed idea, questioning whether items like food and luxury cars should be taxed at the same rate.
2. **Collapse of Two Rates**: Another proposal suggests merging the **12% and 18% tax slabs** into a single median rate of around 15%. This approach would reduce classification issues and disputes between tax authorities and businesses. However, the trade-off would be a potential revenue loss for the government, especially since a large portion of GST revenue comes from the 18% slab. Even reducing this slab by 1% could result in a 3.5% decline in revenue, as noted by government officials.
3. **Arun Jaitley’s Idea**: In 2018, Jaitley proposed a standard tax rate between **12% and 18%**, with **luxury and sin goods** as exceptions. He suggested that over time, as revenue increased, the government could consolidate rates further to reach this goal.

4. **Other Proposals**: There have also been ideas to **standardize specific categories**. For instance, all confectionery items could be taxed at a single rate, rather than different rates depending on the composition of the product (e.g., a plain bun vs. a cream-filled bun). These reforms would reduce ambiguity and simplify compliance for manufacturers and retailers.

Problems of Reforms – Revenue Neutrality and Federal Consensus

One of the most significant challenges in implementing these reforms is maintaining **revenue neutrality**. **Revenue neutrality** refers to ensuring that changes in tax structures do not lead to a net loss or gain in revenue for the government. Given that a large portion of GST revenue comes from items taxed at 18%, any major reduction in this slab would lead to a significant drop in revenue.

The **concern over revenue decline** is especially relevant given that GST collections are a major source of income for both the central and state governments. Any reduction in tax rates could lead to shortfalls, impacting government spending on crucial public services.

Additionally, any reforms require **federal consensus** since the GST regime is governed jointly by the states and the center through the GST Council. Some states, particularly in the south, are already demanding a greater share of revenues under the Finance Commission mechanism. Proposals to lower tax rates are, therefore, politically sensitive, as states are reluctant to agree to changes that could reduce their income.

Governance Rationality of Multiple Rates

While a simpler GST structure is desirable, the **multiple rate system** does have its rationale, primarily based on **equity and fairness**. India is a diverse country with vast socio-economic disparities. Essential goods like food items, medicines, and basic necessities are taxed at lower rates, ensuring affordability for the poorer sections of society. On the other hand, luxury goods are taxed at higher rates to ensure that those who can afford to pay more contribute more to the exchequer.

Thus, the **governance rationality** behind maintaining multiple tax rates is rooted in the principle of **progressive taxation**, where the burden is distributed based on the ability to pay. While this makes the system more complex, it ensures that the tax structure is not regressive.

Conclusion

The **GST tax rate structure** in India, though one of the most significant reforms, continues to face challenges due to its complexity. While there are valid concerns about the multiplicity of rates and classification disputes, it is essential to strike a balance between **simplification** and **revenue needs**. Any reform must ensure **revenue neutrality** and garner **federal consensus** to avoid disrupting the financial stability of both the central and state governments.

Going forward, solutions such as collapsing the 12% and 18% slabs into a single rate, or streamlining categories, may offer a middle ground. However, the underlying principle of fairness must remain central, ensuring that essential goods are affordable while luxury items continue to bear a higher tax burden.

Main Practice questions

1.Discuss the challenges posed by the multiplicity of tax rates under the Goods and Services Tax (GST) in India. How do discrepancies in classification of goods and services create complications in the implementation of GST? Illustrate with examples.
(250 words)

2.Examine the key reform proposals aimed at simplifying the GST structure in India. What are the potential challenges to implementing these reforms, particularly with respect to revenue neutrality and federal consensus?
(250 words)

Answer guidelines

Question 1:

Discuss the challenges posed by the multiplicity of tax rates under the Goods and Services Tax (GST) in India. How do discrepancies in classification of goods and services create complications in the implementation of GST? Illustrate with examples.
(250 words)

Answer Guidelines:

1. **Introduction**:
    - Briefly explain the GST tax structure with multiple rates (0%, 5%, 12%, 18%, and 28%). Mention how it was designed to accommodate different types of goods and services in a diverse economy like India.
2. **Challenges of Multiple Tax Rates**:
    - Explain the **confusion** caused by having different rates for similar goods and services (e.g., bread vs. rusk, chapati vs. paratha).
    - Discuss how this leads to **classification disputes** between manufacturers, retailers, and tax authorities (e.g., Marico's Parachute – whether it is coconut oil or a cosmetic).
    - Highlight the **impact on consumers** (e.g., the example of buns and cream).
3. **Complications in Implementation**:
    - Point out how businesses struggle with **compliance** due to these complexities.
    - Describe how **protracted litigation** has arisen because of these disputes, leading to delays and financial burdens on companies.
4. **Examples**:
    - Use specific examples like the Gujarat AAAR ruling on parathas vs. chapati, and disputes over food and beverages served at cinema halls.
5. **Conclusion**:
    - Summarize the importance of streamlining the GST structure to avoid such complications and improve ease of doing business.

Question 2:

Examine the key reform proposals aimed at simplifying the GST structure in India. What are the potential challenges to implementing these reforms, particularly with respect to revenue neutrality and federal consensus?
(250 words)

Answer Guidelines:

1. **Introduction**:
   - Briefly describe the GST structure and the need for reforms aimed at simplifying it.
2. **Key Reform Proposals**:
   - Explain proposals such as introducing a **flat tax rate** (as seen in countries like Singapore), **collapsing tax slabs** (merging 12% and 18% slabs into a single rate).
   - Mention **Arun Jaitley's idea** of reducing slabs to 0%, 5%, and a standard rate for most items, with exceptions for luxury and sin goods.
3. **Challenges in Implementation**:
   - **Revenue Neutrality**:
     - Explain that merging tax slabs could lead to a significant loss of revenue, especially since 70% of GST revenue comes from the 18% slab. A 1% reduction in this rate could lead to a 3.5% drop in revenue.
   - **Federal Consensus**:
     - Mention that any reform must involve the **GST Council**, where the central and state governments must reach an agreement. States, especially those demanding a greater revenue share, are reluctant to accept changes that might reduce their income.
4. **Conclusion**:
   - Emphasize that while reforms are needed, any proposal must balance **simplification** with maintaining **fiscal stability** for both the center and the states.