India's worsening fiscal math

In November 2017, according to the Accounts released by the Controller General of Accounts, the fiscal deficit was at 112% of the target of 3.2% given in Budget 2017. This has aroused huge concerns about the fiscal performance of the current Government which has made development and good governance its election plank. With the double hit of DeMo and GST, the situation was not rosy in any case.

The gazette notification for the Budget came on March 31, 2017 this year – earlier by nearly 2 months as compared to the previous years. This meant that the Government had permission from April 1, 2017 (as compared to June 1 in earlier years). Hence comparing the expenditure over the past period is slightly misleading. Furthermore, the first big chunk of revenue for the Government comes only by mid-September. Hence, while the expenditure period is not comparable, the revenue period is commensurate to the last year. Even in these terms, the revenues have been worse off as compared to expectations.

The major reason on the revenue portion of the Government has been the extremely less dividend from PSUs and RBI. This source of revenue is down nearly by a 1/3rd of expectations. Furthermore, the revenue expenditure of the Government has been higher by nearly 5% as compared to the target. In addition to all the fiscal math, there is also the matter of the slowing revenue from GST which are down to Rs 80,000 crores in November.

This raises major questions –

1) Was it a mistake to project 13% growth in tax revenues for the full year when the finance ministry knew that the GST would be rolled out during the year?

2) What gave the govt the confidence that it would be able to rein in its revenue expenditure growth to only 6%, when the growth under this head in 2016-17 was about 13%?

A keen reading of the Central Accounts show that the rise of oil prices has started hurting the current regime as the oil subsidies have gone up. This is also in addition to the growing concerns globally as to the closing down of the economy by the USA (US levies heavy import duties). In addition to this, Germany has entered into political turmoil – extension of which might cause financial tightening in Europe. Hence global cues are not very good for the economy.

However, there is some pleasant news pointed out by the purists in all the hullabaloo. The pie of direct taxes in the revenue share of the Government has gone up as compared to the indirect taxes. This might be the first signs that the revered direct tax to GDP ratio might be finally going up. However, the government needs to continue on the warpath of fiscal discipline.

With the states announcing debt waivers for farm loans, the general deficit is bound to go up. Hence any fiscal slippage by the Central Government is bound to cause major jitters in the economy. As the Budget 2018 grows closer, we must hold with bated breath as to whether this Government adopts pragmatism or populism in its last full budget.

Learn the basics of the deficits → Investopedia – Budget Deficit

Read a working paper to understand the effects of fiscal deficit on an open economy → Working Paper

Read business news about the situation in the fiscal path of India:

Mint – September, 2017 Mint – November, 2017 Business Today – Borrowing Up

Follow all the updates leading up to the Budget 2018 here → Mint Countdown to Budget 2018

January, 2018

Blockchain – Not all about Bitcoin!

Today, we rely entirely on big intermediaries like banks, government, big social media companies, and credit card companies and so on -- to establish trust in our economy. In addition, these intermediaries perform all the business and transaction logic of every kind of commerce, from authentication, identification of people, through to clearing, settling and record keeping. Overall, they do a good job.

However, there are growing problems.

- To begin, they are centralized. That means they can be hacked, and increasingly are -- JP Morgan, the US Federal Government, LinkedIn, UIDAI and others found that out the hard way.
- They slow things down. It can take a second for an email to go around the world, but it can take days or weeks for money to move through the banking system across a city.
- They take a big piece of the transaction - 10 to 20 percent just to send money to another country.
- They capture our data, and that means we cannot monetize it or use it to better manage our lives. Our privacy is being undermined.

So what if there were some kind of vast, global, distributed ledger running on millions of computers and available to everybody. And where every kind of asset, from money to music, could be stored, moved, transacted, exchanged and managed, all without powerful intermediaries? Assets -- digital assets like money to music and everything in between -- are not stored in a central place, but are distributed across a global ledger, using the highest level of cryptography. And when a transaction is conducted, it's posted globally, across millions and millions of computers.

And out there, around the world, is a group of people called "miners." They have massive computing power at their fingertips -- These miners do a lot of work. And every 10 minutes, a block gets created that has all the transactions. Then the miners get to work, trying to solve some tough problems. And they compete: the first miner to find out the truth and to validate the block, is rewarded.

Then that block is linked to the previous block and the previous block to create a chain of blocks. Moreover, everyone is time-stamped kind of like with a digital waxed seal. So, if someone wanted to go and hack a block and, they would have to hack that block, plus all the preceding blocks, the entire history of commerce on that blockchain, not just on one computer but across millions of computers, simultaneously, all using the highest levels of encryption

Blockchain themes:

- Usually contains financial transactions.
- Replicated across a number of systems in almost real-time.
- Usually exists over a peer-to-peer network.
- Uses cryptography and digital signatures to prove identity, authenticity and enforce read/write access rights.
- Can be written by certain participants.
- Can be read by certain participants, a wider audience.
- Has mechanisms to make it hard to change historical records, or at least make it easy to detect when someone is trying to do so.

GST

Although I agree most of the readers of this article are well aware of GST is, it never really hurts to brush up a few basics.. To start with, GST is a value added destination-based tax on a comprehensive base of goods and services across the value chain. It will serve as a common and consistent tax structure across India, and proposes seamless credit regime, eliminating the cascading effect of tax. It would ease the compliance mechanism with online filing and elimination of physical interaction, and widen the tax base of our country.

Some of the taxes subsumed under GST are-

Center- CENVAT, additional excise duty, service tax, countervailing duty, customs, surcharges and cess.

States- VAT, Central sales tax, entertainment tax, purchase tax, octroi, entry tax, luxury tax, state surcharges, taxes on lottery, betting, and gambling.

Tax Slabs	Goods	Services
Exempted	Basic food items such as fresh meat, eggs, milk, bread, salt, etc.	Hotel and lodges with tariff <Rs1000, education, healthcare etc.
3%	Gold, silver, diamonds, precious stones and other precious metals etc.	
5%	Skimmed milk, frozen veg, tea, spices, coal, medicines, coffee, etc.	Transport, small restaurants
12%	Processed food, cell phones, sewing machines, etc	Non AC hotels, fertilizers, air tickets, work contracts
18%	Capital goods, intermediate and industrial items and processed food	AC hotels, telecom, IT, financial services, branded garments
28%	Luxury items, sin and demerit goods such as aerated water, pan masala, automobiles, etc	Cinema, betting clubs
Cess	15% cess on cars (mid-size to SUVs and hybrids), Rs400 per tonne on coal lignite and peat, 60% to 290% on tobacco products	

WHAT TO EXPECT FROM GST

1. Shift to the organised sector

India has significant presence of the unorganized sector. A report estimates that in 2005, out of the 485m persons employed in India, 86% or 395m worked in the unorganized sector, generating 50.6% of the country's GDP.

Measures that will lead to shift from the unorganised to the organised sector:

- Reduction in threshold limits
- Through technology enabled platform
- Through availability of input credit
- Reduction in overall effective tax rate

2. Efficiency in supply chain management

The current legal framework exempts CST if interstate movement of goods is for stock transfer and not for sale. Consequently, in several sectors, companies open various depots and appoint C&F agents to avail this exemption and incur additional costs. Under GST, since CST is subsumed, it will lead to reduction in operational cost on the one hand and lower inventory carrying cost on the other.

Benefits for the industry: Pruning of distribution network, reduction in inventory carrying cost

Play on logistics: Consolidation in industry, slight negative impact on CV manufacturers

MACRO-ECONOMIC IMPACT OF GST

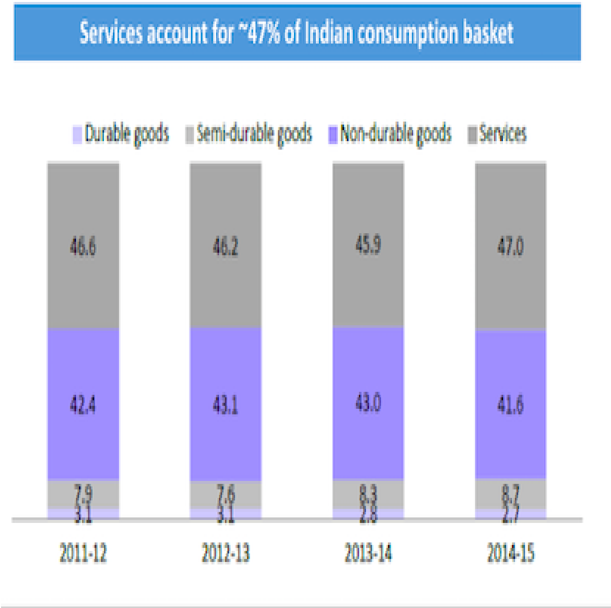
1. Moderate inflation impact

Out of 300 items in CPI basket, ~164 items will see no change in tax rate post GST. 67% of CPI basket taxed at zero rate under GST, similar to previous tax system. Food, rent and fuel have high weight in CPI.

Short-term impact: There could be upward pressures on account of higher compliance cost and partial pass-through

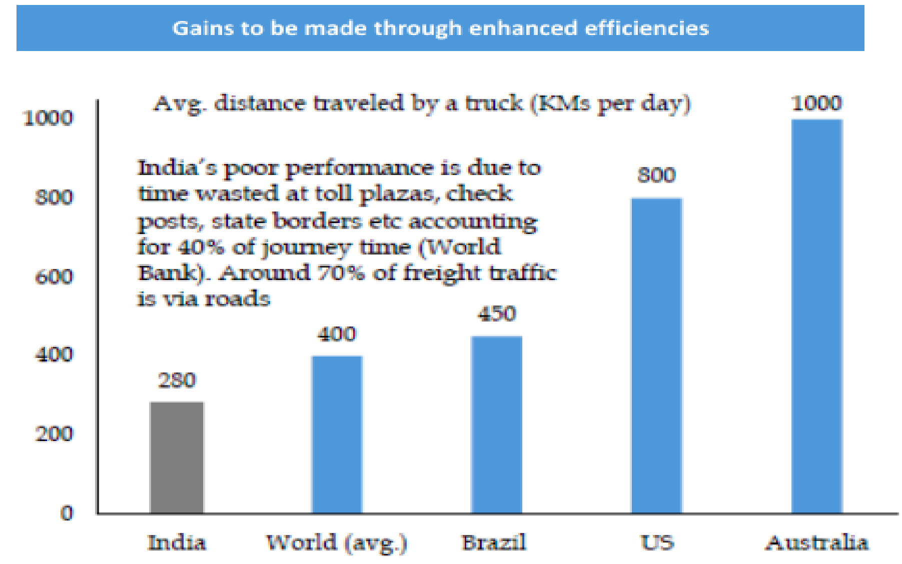
Medium-term impact: CPI inflation is likely to move lower by ~25 bps due to GST, over the medium term.

Customers are likely to feel the pinch- Services comprise a very small share in CPI. However, they account for ~ 50% of the total consumption basket in the economy. While the impact of GST may not be visible in the official inflation measures, it will certainly pinch Indian consumers, as the share of services has been rising.



Net change in tax rate of items in CPI basket	
No Change	**164**
Decline	**72**
Less than 5%	47
Greater than 5%	25
Increase	**61**
Less than 5%	40
Greater than 5% but less than 8%	13
Greater than 8%	8

2. GDP impact will accrue in the long term



3. GDP impact to accrue in the medium term

Growth impact: Various studies estimate impact of GST on India's GDP growth between 0.5-4%, over the medium to long term.

Unified market: Under GST the entry barriers between states will be removed (such as Octroi, entry tax, CST), removal of tax cascading and reduction in transportation cost

Expansion of formal economy: The wider tax base under GST and inbuilt compliance promoting mechanism of input tax credit.

Providing level playing field for domestic manufacturing: CVD /SAD exemptions which make imported products cheaper will be addressed under GST.

Boosting investments: Under GST capital goods are expected to become cheaper as input tax credit are available for all taxes paid.

4. Fiscal impact- Overall revenue neutral

GST is expected to result in some redistribution between Centre and States. In the medium-term it is expected to improve tax buoyancy by promoting tax compliance and widening tax base. Only a part of State's Own-tax revenues will be subsumed under GST ranging from 40-75%, as certain taxes will be kept out of GST : petroleum, alcohol, stamp duty etc. Compensation cess to raise Rs500bn over 9 months in FY18, to meet revenue shortfall. GST being a destination based tax will benefit consumption based states more than manufacturing states. However, manufacturing states also have strong presence of service sector and will stand to benefit under GST.

CHALLENGES AND PROGRESS SO FAR

1. **GST to result in a moderately higher tax to GDP ratio** (New Zealand 27%, European countries 24%)

Widening of tax base – A higher set of goods and services will be taxed in the GST system (both, VAT, excise, service tax)

Higher compliance and better reporting – Mapping of GST through the value chain, with accurate representation of revenue and profit figures (Out of 80 lakhs indirect tax assesses, 72 lakh have already registered, while 13 lakh new tax payers have signed up under the new system)

Change in effective tax rates – Mostly to be revenue neutral given increase in some sectors and decrease in some

2. **GST- Impact on economic growth**

Government expenditure (G) – Expected to go moderately higher given the other elements of fiscal balance allow higher spending

Corporate investment (C) – Short term impact in the near future due to inventory loss, and need for higher working capital; help optimise investments in supply chain and result in higher capital productivity; shift to the organised sector would benefit the organised sector as they could enjoy economies of scale and expand; anti-profiteering mechanism to avoid windfall gains from reduction in taxes, especially in capital goods; providing level playing playing field for domestic manufacturing given CVD/ SAD exemptions which make imported products cheaper are being addressed under GST

Individuals consumption (I) – Given service account accounts for 50% of the consumption basket in the economy, a higher service rate can pinch the normal man consumption

Net exports (X) – Exports to reduce in the short term due to hassles by exporters, however, in the long run, more foreign companies are expected to set up shop in India thereby helping reduce imports

3. **GST- Impact on other countries**

There were important key difference between India and Malaysia GST objective

	India	Malaysia
Objective for GST implementation	Ease of Business	Higher revenues
Principal for formulating GST rate	Revenue neutrality	Improved tax collections
New items taxed under GST	No	Yes
GST rate	Multiple slabs	6% flat rate
Inflation impact	Unlikely	Increased
Sales impact	Likely lower before GST	Higher before GST

The learnings from implementation of GST in other countries are-

Protests are a part and parcel of this change

Higher compliance is certain

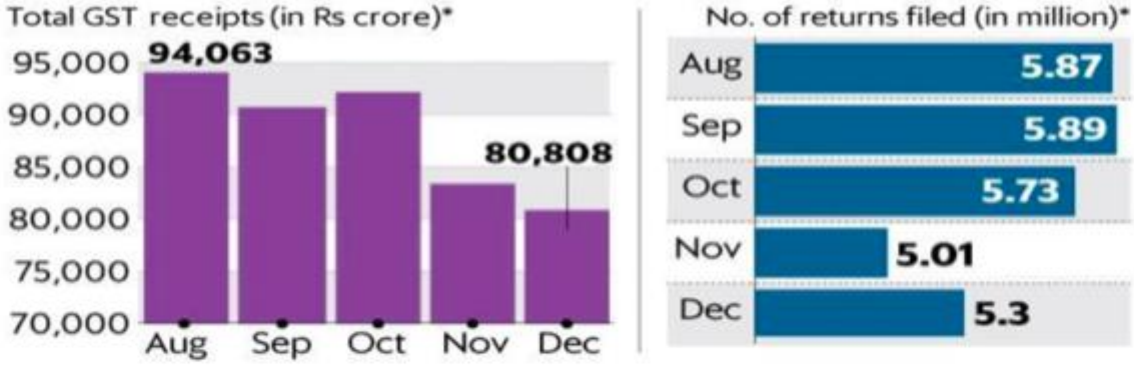
Government to be proactive to bring more clarity

4. GST- Investor's perspective

Support from foreign investors continues to be robust

Higher availability of credit for SME's to grow

GST COLLECTIONS



Reasons for fall in November:

- On November 10, Finance minister Arun Jaitley announced a 10% cut in tax on over 200 goods: chocolates to cosmetics to artificial fur coats and wrist watches
- As many as 50.1 lakh Goods and Services Tax (GST) returns were filed for October
- Drop in collections due to rates on several commodities being cut and tax administration being based on self-declaration as matching of returns, electronic transit permit system or e-way bill and reverse charging being postponed
- By February, when tax collections for the transactions in January will be available, most of the transition issues would have faded and revenue receipts will stabilize

GST- IMPACT ON THE UNORGANISED SECTOR

A 30% increase in tax base has been created. GSTN has created a centralized database containing all transaction data that forces informalities in commodity supply chains to formalize

Financial Impact

Higher cost of compliance has taken a toll on the financial health of small and medium-sized firms

Sharp rise in working capital requirements seen

As they shift to the formal economy, surge in tax revenues expected.

Impact on the organized sector: Near-term impact Mixed; Long-term positive for all

Sector	Product	Earlier Tax[1]	GST	Near-term Impact
FMCG	Edible oil	5%	5%	Neutral
	Toothpaste, soaps, hair oil	24%	18%	Positive
	Detergents	24%	28%	Negative
Consumer Durables	AC	26%	28%	Neutral
	Paints	26%	28%	Neutral
	Electrical fittings/fixtures	24%	12%	Positive
	Furniture	28%	28%	Neutral
	Wires/switches	18%	28%	Negative
Construction Material	Cement	26%	28%	Neutral
	Steel	18%	18%	Neutral
	Tiles	28%	28%	Neutral
Healthcare	Pharmaceuticals	11%	12%	Neutral
	Hospitals	5%	0%	Neutral
Auto	2-wheeler	28%	28%	Neutral
	Small Car	28%	28%	Neutral
	Sedan	43%	43%	Neutral
	SUV	53%	43%	Positive
	CV	28%	28%	Neutral
Services	Finance/Insurance	15%	18%	Negative
	Luxury hotels	24%	28%	Negative
	Air travel-economy class	6%	5%	Positive
	Logistics	5%	5%	Neutral
	EPC/ Construction	18%	20%	Positive

Issues faced

Issues faced by firms- Delay in payment of refund for exports, resulting in working capital blockage

Issues faced by exporters- Procedural issues on identification of jurisdictional officers, quantum of bank guarantee to be given with the bond. Lack of awareness among service providers that they need to submit a bond or a letter of undertaking

Issues faced in compliances- Issues with the GSTN system (slow response rate, taxpayers unable to access the system)

Issues faced in interpretation of rules- Rules for claiming transaction credits, lack of clarity of tax rates for credit notes pertaining to transactions under previous regime vague

Higher rates- Tax rate on services increased from 15% to 18% on transactions like credit card payment, insurance premium payment

Branch registration- Expansion by companies through opening more branches becomes more complex

Increase in compliance cost- High increase in filings will require intensive resource upscaling, including training employees

Increasing digital transactions to make measurement more complicated

The way forward

It is expected **more items to be shifted to 18 percent from 28 percent** slab in the next meeting

Bihar's Deputy Chief Minister Sushil Modi, who is also a part of the GST Council has hinted that there's a consensus in the GST Council on **reducing the number of GST slabs to three**, that is five, fourteen and twenty eight percent respectively

Modi, who was speaking to the media on the sidelines of FICCI's 90th AGM also said that a call on **inducting petroleum products, real estate and electricity** in the GST regime can be taken once GST revenues stabilize

West Bengal Finance Minister Amit Mitra lashed out at the Centre for hasty implementation of GST saying that though the states had **estimated losses of Rs 55,000 crore in the full fiscal on account of GST, the losses incurred have already crossed Rs 39,000 crore in the first four months of the indirect tax regime**