

GOODS AND SERVICES TAX (GST)

How IMF sees

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The IMF has been so closely associated with the GST. Recommended as early as 1990 in the Tax Commission Report, the GST has been long in the making. All along, the IMF has been involved. In 1992 we fielded the first specialist technical assistance mission. It drafted a report that outlined and made recommendations on all the conceptual issues. The report has proven very helpful to the government in designing the GST. Subsequently we have helped when it came to translating these designs into concrete and detailed legislation. For this purpose technical assistance missions came to Sri Lanka in 1996 and 1997. Currently, in the person of Peter Bruges whom you will hear shortly, backed up by the staff at IMF headquarters, we are providing hands-on assistance with the implementation. The IMF has been able to provide this technical assistance because it could draw on a wealth of international expertise and experience.

With the decision to implement the GST as of April, a long preparation process has finally come to fruition. We recommend the government. In the end, despite the long deliberation, it was still a bold step that required political courage. Unlike new spending programs, for which there is always a specific constituency and often a general sympathy among the electorate, new taxes, even if they replace existing ones, are generally resisted, and particularly forcefully by special interests. The decision to introduce the GST proves the government's commitment to strengthening

the structure of the country's fiscal accounts. Naturally, we hope that this initiative on the revenue side will be followed by equally bold initiatives on the expenditure side.

Your main interest, no doubt, is in trying to understand the workings of the GST and being able to put questions to the experts on the panel. You will be less interested in my economists's perspective on the GST, and I will therefore be brief. Nonetheless, a refresher of why the GST is important to Sri Lanka may help you deal with some of the frustrations you will surely encounter once it is implemented.

As you know, the GST is a so called value added tax or VAT (henceforth, I will speak about GST and VAT interchangeably). There is no precedent in tax history for the success the VAT has had. Theoretically conceived in the US early in this century, but practically pioneered in France in the 1950s, it has taken the world by storm. By now it has been introduced in almost all industrial countries - the US and Australia being the most significant exemptions - and to many if not mostly developing countries. All in all some 80 countries now have VATs. The reason for this phenomenal success is the VAT's superiority over alternative taxes in raising revenue, neutrality and efficiency. Allow me a few words on each.

The VAT has proven to be a good revenue raiser, contributing in most countries between 12 and 30 per cent of revenue, which represents about 5-10 per cent of GDP. This reliable revenue creates a valuable alternative tax source,

especially in countries that have a limited income tax base or that must rely on volatile revenues from primary commodities.

The main advantage of a VAT compared to other forms of taxation is that taxing consumption can be less distortionary than taxing labour and income. If the tax is designed with few exemptions and little zero rating that further helps reduce distortions. With the VAT on investment fully credited, they are an improvement over taxes that do tax capital goods. Similarly the fact that the VAT on an export can be fully identified and rebated should ensure that exports compete on an equal footing.

The efficiency gains of the VAT stem mainly from the fact that it usually replaces inefficient, distortionary and badly administered taxes. Most relevant for Sri Lanka is that the GST eliminates the cascading effect of the turnover tax, permits lower and fewer rates, and is administratively more suitable because of its self-enforcing and cross-checking features. The administrative burden associated with the VAT can be relieved by more widespread use of computers. The government's decision to stick with the single rate of its original design, despite many requests for multiple rates, will also critically facilitate the administration of the GST.

In the last Budget Speech Minister G L Peiris referred to concerns about the cost of living in connection with the introduction of the VAT. I understand

that such concerns have also played a big role in setting the GST rate at a relatively low level. Concerns about the cost of living or rather the inflationary impact are understandable. Let's distinguish between two possibilities: one, an increase in the rate of inflation, that is, a sustained increase in the rate of change in the price level; and two, a one-time increase in the price level. The possibility of an increase in the rate of inflation we can discard on conceptual grounds. Such an increase can only result from an expansionary monetary policy. A one-time effect on the price level is, however, possible, although it is unlikely to be large.

The conventional conclusion is that a VAT introduced in a revenue neutral manner — which is what the GST is intended to be — would have no impact on the aggregate price level, since the aggregate demand in this case is unchanged. Similarly reasoned, a revenue-enhancing VAT would lead to a decline in the price level because it is fiscally contractionary; and a revenue-losing VAT, because it is expansionary, would cause the price level to rise. To this there are a couple of qualifications.

First, this reasoning excludes any supply response. If, however, the GST entails a lower degree of distortion in production, which is the main reason it is being introduced, than it would lead to an expansion of supply and therewith exert a downward pressure on the price level.

Second, there is the problem of the price index. The GST will bring about many relative price changes that will induce changes in expenditure patterns as a result of which the aggregate price level should remain the same. However, the policy focus is always on inflation as measured with a specific price index, usually the Consumer Price Index, as is the case in Sri Lanka, and this index has historically fixed weights. Hence, the adjustment in expenditure patterns will not be captured and the CCPI will be affected. It is hard to say beforehand whether the impact on the price level would be plus or minus.

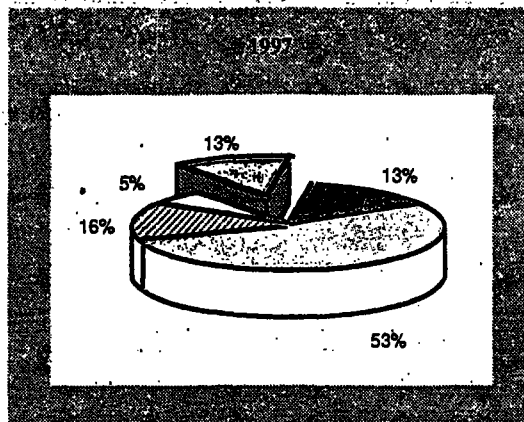
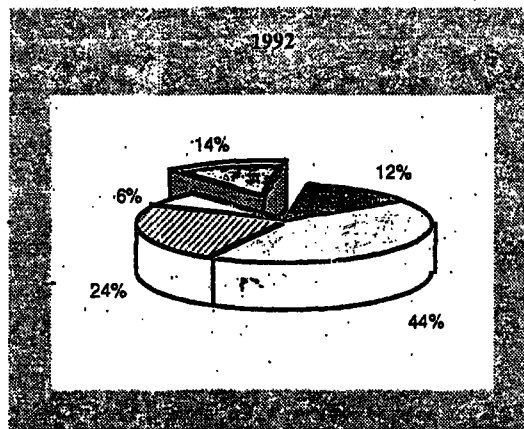
Thirdly, any economy counts monopolistic and monopsonistic elements. The introduction of a new tax

with all the attendant confusion could be exploited by them as an opportunity to raise prices. It is therefore, important that the public be optimally informed about the GST, especially about the fact that it replaces other taxes and is designed to be revenue neutral. This will maximize competitive pressure and limit the scope for monopolistic price rises.

The big question that remains is whether the GST rate of 12.5 per cent will prove to be appropriate. A lot of effort has gone into trying to compute the rate at which the GST would be revenue neutral, that is, bring in as much money — no more and no less — as the current BTT. Inevitably those calculations are surrounded by a great degree of uncertainty. Moreover, the Government is rightly still very concerned

about the size of the fiscal deficit, which it wants to bring down from 7.6 per cent of GDP last year to 4 per cent in 2000. It should also be noted that due to the erosion of the various tax bases, the revenue performance of the economy has deteriorated in recent years. Measured as a share of GDP, government revenues have decreased from 20.4 per cent in 1995, to 19 per cent in 1996 and 1997, and now to a projected 18.6 per cent in 1998. In other words, in the aggregate, taxation in Sri Lanka has been declining. In the light, therefore, of the uncertainty surrounding the revenue neutral rate, the still large fiscal deficit, and the recent revenue performance, the Government, I am sure, will be watching very closely whether the GST is producing the desired revenue at the current rate.

Composition of Revenue



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