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VAT and GST in India – A Note

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Abstract

One of the most widely debated issues in Indian Public Finances in current times is undoubtedly the proposed Goods and Services Tax (GST). Perceived as the ‘biggest tax overhaul since independence’ GST promises to fuel overall economic growth and increase tax revenue of the government to a great extent by removing all the impediments that the financial system had been hitherto subject to. This short note starts off by providing a somewhat candid analysis of the present system of VAT which has been in effect since 2005 and then goes to explore certain critical issues related to GST, its prospects and problems and how it can usher in a new era of government finances of the country.

# I am indebted to Professor Shyama Nair of Gulati Institute of Finance and Taxation, Kerala for many helpful discussions.

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Background

“All [state] activities depend first on the Treasury. Therefore, a King shall devote his best attention to it.”

_{Kautiliya: The Arthashastra [2. 8. 1, 2]}_

Optimization of equity and efficiency in the system of taxation is a pre-requisite of social and financial growth. Models of taxation should aim, on one hand, at preventing adverse effects of taxes and on the other hand, enhancing the rate of growth of tax revenue by promoting natural compliance and making taxation system broad based.

However, the model of taxation of goods and services followed in India for more than 50 years post independence was characterised by cascading and distortionary tax on production that lead to misallocation of resources and hampered impetus to economic growth. Voluntary compliance is also inhibited by this system. Such cascading effects ultimately have a negative effect on the size of tax base thereby dampening the process of revenue generation and resource mobilisation of the government. To address these major pitfalls of the prevailing taxation-system, Central Value Added Tax (CENVAT) was introduced in early years of the new millennium\(^1\). It was held that VAT would address the problems of the existing system of taxes and was seen as an important break through in the sphere of indirect tax reform in India.

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\(^1\) Although in India VAT was introduced in terms of MODVAT (Modified VAT) in 1986, however it included only some commodities. It was only in 2002-03, with the introduction of CENVAT (Central VAT) that all commodities were brought into the purview of this tax system.
VAT – Basic Issues

Prior to the introduction of VAT in the centre and in the states, there was a burden of multiple taxation in the pre-existing Central excise duty and State Sales Tax. Multiple taxation implied final product that taxes had to be paid on inputs used in the final product as well as on the. For instance, in the existing structure, before a commodity is produced, inputs are taxed first, and then after the commodity is produced with input tax load, output is taxed again (A White Paper On State-Level Value Added Tax). The “tax on tax” system lead to a negative effect on production and distribution activities. This was causing a burden of multiple taxation with a “cascading” effect. In case of VAT, a deduction on taxes – input tax credit (ITC) - is made on the inputs used on which taxes have already been made thus removing the problem of double taxation (Figure 1 briefly illustrates the concept of ‘input-tax credit’ – the main basis of VAT). Also with rationalised tax rate under VAT system, prices of goods are expected to fall (CAG Report on VAT implementation). Moreover since set offs are given only if taxes on inputs are paid, VAT essentially ensures a built-in check in tax compliance in Centre as well as in the States. Moreover, since VAT pre-supposes a uniform floor rate of tax, differential rates of taxation across states get eliminated which in turn prevents ‘rate war’ among different states.

With these objectives in mind, The Government of India set up an Empowered Committee of State Finance Ministers (referred as Empowered Committee) in 1999 to formulate the basic design of VAT through consensus. Deliberations over six years bore fruit in a White Paper In January 2005. While laying down the basic design, the White Paper provided space for “federal flexibility” by permitting State Governments to adopt appropriate variations.
Haryana was the first of the States to introduce VAT in April 2003 and the remaining states gradually started implementing VAT from 2005.

**Figure 1: Flow Chart of Input Tax Credit**

- **Manufacturer A**
  - Sale Price Rs. 100
  - VAT payable (at 10%) = Rs. 10

- **Manufacturer B**
  - Sale Price Rs. 150
  - VAT payable (at 10%) = Rs. 15
  - Set off Input Tax Credit (paid to A) = Rs. 10
  - Tax payable = Rs. 5

- **Wholeseller**
  - Sale Price Rs. 180
  - VAT payable (at 10%) = Rs. 18
  - Set off Input Tax Credit (paid to B) = Rs. 15
  - Tax payable = Rs. 3

- **Retailer**
  - Sale Price = Rs. 200
  - VAT payable (at 10%) = Rs. 20
  - Set off Input Tax Credit (paid to Wholeseller) = Rs. 18
  - Tax payable = Rs. 2

*Source: Implementation of Value Added Tax in India, Comptroller and Auditor General of India (2010)*
With now VAT being in place in all states across the country for more than six years, the system of taxation has not only become more transparent, tax compliance has also increased to a great deal. Increase in Central Tax Revenue also was substantially with implantation of VAT. However, implantation of VAT in States was a difficult task in a federal structure like India where States enjoy a considerable autonomy over taxation—in levying and deciding rates of sales taxes etc. State VAT implementation required a harmonious rate at which all states would agree hence ending the rate war. Steps were taken to prevent unhealthy competition among states and at the same time preventing the states from losing their autonomy. As a consequence, States started implementing VAT from 2005. Responses of Industry and Trade to Central and State VAT have been very encouraging ever since the full fledged implementation of VAT. The rate of growth of Tax Revenue has nearly doubled from the average annual rate of growth the pre-VAT five year period after the introduction of VAT.

‘Fractured’ VAT?

Despite VAT’s success in mobilizing greater tax revenue, the first discussion paper of Empowered Committee of State Finance Ministers point out that there are there are certain shortcomings of the Central as well as State VAT. In context of CENVAT, it has been pointed out that CENVAT has not been extended to include chain of value addition in the distributive trade below the stage of production. Moreover, CENVAT also does not include many Central Taxes like Additional Excise Duty, Additional Customs Duty, Surcharges, etc. The non-inclusion of these taxes keeps the benefits of comprehensive input tax and service tax set-off out of reach for manufacturers and dealers. Like CENVAT, several aspects of incompleteness of State VAT has also been pointed out by the Empowered Committee.
There are, for instance, even now, several taxes which are in the nature of indirect tax on goods and services, such as luxury tax, entertainment tax, etc., and yet not subsumed in the VAT. Moreover, in the present State-level VAT scheme, CENVAT load on the goods remains included in the value of goods to be taxed under State VAT, and contributing to that extent a cascading effect on account of CENVAT element. This CENVAT load needs to be removed. Furthermore, any commodity, in general, is produced on the basis of physical inputs as well as services, and there should be integration of VAT on goods with tax on services at the State level as well, and at the same time there should also be removal of cascading effect of service tax. Such integration is missing in case of State VAT. Thus, contrary to expectations, VAT although could solve some problems of the existing system of taxes and increase tax buoyancy by a certain extent, it could not be regarded as a panacea of all ills associated with indirect taxation (see Poddar and Ahmed, 2009).

**Objectives of GST**

Perceived as the ‘biggest tax overhaul since independence’, introduction of GST at the Central level is expected not only to include comprehensively more indirect Central taxes and integrate goods and service taxes for the purpose of set-off relief, but also lead to revenue gain for the Centre through widening of the dealer base by capturing value addition in the distributive trade and increased compliance. Apart from this, in the GST, both the cascading effects of CENVAT and service tax are removed with set-off, and a continuous chain of set-off from the original producer’s point and service provider’s point up to the retailer’s level is established which reduces the burden of all cascading effects (First Discussion Paper on GST, 2009). *This is the essence of GST, and this is why GST is not simply VAT plus service tax but an improvement over the previous system of VAT.* GST at the State-level is
also expected to improve the overall revenue scenario as it gives additional power of levy of taxation of services for the States, encourage a system of comprehensive set-off relief, including set-off for cascading burden of CENVAT and service taxes and also remove the burden of Central Sales Tax. Because of the removal of cascading effect, the burden of tax under GST on goods will, in general, fall (see CII-KPMG survey 2010, Report of the Task Force on GST 2009 etc.).

According to the Report of the Task Force on Goods and Services Tax (2009), the present system of indirect taxation results in misallocation of resources and lowers productivity and economic growth. Therefore, it is claimed that there is an urgent need of replacing the existing tax system by a new regime of taxation of goods and services which would foster the achievement of the following objectives:

[1] The incidence of tax falls only on domestic consumption

[2] The efficiency and equity of the system is optimized

[3] There should be no export of taxes across taxing jurisdiction

[4] The Indian market should be integrated into a single common market


These are the primary objectives which are to be achieved by moving from the present system of VAT to a better orchestrated GST regime. Kelkar (2009) succinctly summarizes the expected benefits of GST:

“...It will bring about a phase change on the tax firmament by redistributing the burden of taxation equitably between manufacturing and services. It will lower the tax rate by broadening the tax base and minimizing expectations. It
will reduce distortions...[and] foster a common market across the country and reduce compliance costs... It will promote exports...Perhaps more importantly, it will spur growth.”

**Critical Issues**

**Dual GST**

The most important issue regarding the structure of proposed GST is whether conventional GST is at all feasible in federal country like India where both the Centre and State has concurrent powers to tax domestic trade in goods and services. By conventional GST we mean GST which is levied and collected by the Central Government. However, such centralized system of GST implementation would imply states’ to lose their fiscal autonomy in levying and collection of taxes. In fact, this was one of the main reasons behind the States’ initial vehement opposition against the introduction of GST. Therefore, the Task Force has recommended that the GST to be implemented in India would be ‘dual’ in nature. It would be a dual levy independently imposed concurrently by the Centre and the States. It would consist of two components: one levied by the Centre (CGST) and another levied by the States and Union Territories (SGST). However, the base of tax levy would be identical. International experience shows that such models of dual value added taxes have been successful.

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2 Revenues from State VAT account for substantial proportion of State’s Revenue. For instance, in case of West Bengal, State VAT accounts for a substantial proportion of total revenue (Roychowdhury, 2011). In this context, Bagchi and Poddar (2007) advance a somewhat philosophical argument against centralized VAT which hampers State’s autonomy. They argue “the [state’s] power to levy sales tax is a ‘power’ in itself and not just a revenue power.”

3 Canada has a federal level GST since 1991 while provinces have their own sales tax. Quebec has its own VAT on a base that consists of both goods and services which is largely harmonized with federal GST. Both taxes are administered by revenue authorities of Quebec with audit returns being undertaken in close collaboration.
Consumption type GST

According to the Task Force Report, the Centre and State should adopt a consumption type GST\(^4\), i.e. there should be no distinction between raw materials and capital goods in allowing GST credit. Using consumption as the tax base, it is argued, will be favourable both from perspectives of economic neutrality and ease of administration. It is also the only value added tax (in essence GST is also a value added tax) that is equivalent to retail sales tax\(^5\), which it is supposed to replace. The report also mentions that tax base of both CGST and SGST should cover all goods and services until it reaches the final consumer. As such, no distinction needs to be made between goods and services. A registered dealer will be required to collect taxes on every invoice irrespective of whether the supply is for goods or services. The Task Force also recommends since CGST and SGST will be levied on all goods and services, all present taxes levied by the Centre and the State must be subsumed in these taxes. Table 1 lists the taxes which are subsumed in GST.

However, the report claims, taxes on SIN goods should not be subsumed in GST. Also any amount which is collected as tax/fee which is essentially in the nature of a user charge for supply of goods and services not be subsumed either in CGST or SGST.

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\(^4\) There are three possible variants of value added/ goods and services tax: product type VAT, income type VAT and consumption type VAT.

\(^5\) In effect, the tax is only on the pure value added within the production stage in question.
### Table 1: Taxes to be subsumed in GST

<table>
<thead>
<tr>
<th>Central taxes subsumed in CGST</th>
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<tbody>
<tr>
<td>1. Central Excise Duty (including Additional Excise Duties)</td>
</tr>
<tr>
<td>2. Service Tax</td>
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<tr>
<td>3. Additional Customs Duty</td>
</tr>
<tr>
<td>4. Surcharges and all cess</td>
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</tbody>
</table>

<table>
<thead>
<tr>
<th>State Level taxes to be subsumed in SGST</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. VAT/Sales Tax</td>
</tr>
<tr>
<td>2. Entertainment Tax</td>
</tr>
<tr>
<td>3. Entry tax not in lieu of Octroi</td>
</tr>
<tr>
<td>4. Other Taxes and Duties (Luxury Tax, Taxes on lottery, etc.)</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Taxes levied by the States on goods and services to subsumed in GST</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Stamp duty</td>
</tr>
<tr>
<td>2. Taxes on Vehicles</td>
</tr>
<tr>
<td>3. Taxes on Goods and Passengers</td>
</tr>
<tr>
<td>4. Taxes and duties on electricity</td>
</tr>
</tbody>
</table>

Source: Report of Task Force on Goods and Services Tax In India (2009)

### GST on ‘Destination Principle’

Considerable debate has taken on the issue of whether GST should be implemented under the origin principle or destination principle. Because GST in India is aimed to improve competitiveness, the Report proposes that GST should be structured on the destination principle.

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6 In GST under origin principle, the tax is imposed on value added of all taxable products that are produced domestically whereas under the destination principle, GST is imposed on the value added of all taxable products that are consumed domestically. In a closed economy, the two principles are equivalent.
principle. Consequently, tax base will shift to consumption from production activities whereby imports will be taxed and exports will not be taxed. As such, the state in which consumption takes place will earn the tax revenue. In case of international trade, exports should be zero rated, it is proposed and imports should be subjected to CGST and SGST.

**Taxing inter-State sales**

Another issue that requires careful examination before full-fledged GST implementation takes place is taxation of inter-state sales. According to Kelkar (2009), it would be necessary to guard against tax arbitrage where local sales which will be taxed could be shown as inter state sales which will not. Kelkar also points out that there could also be serious problem in taxing services supplied from one state, consumed in another and paid for in the third state. The discussion paper of the Empowered Committee addresses such concerns by proposing a model of Integrated GST (IGST). The IGST model would work as follows. The Centre would levy IGST (CGST plus SGST) on all inter-state transactions of taxable goods and services. The inter-state seller will pay IGST on value addition after adjusting available credit if IGST, CGST and SGST on his input purchases. The Exporting State will transfer to the Centre the credit of SGST used in the payment of IGST. The importing dealer can claim credit of IGST while discharging his output tax liability in his own state. The Centre will transfer to the importing state the credit of IGST used in the payment of SGST. This is the essence of proposed IGST model. This model would ensure that the SGST amount will be transferred to the destination state.
GST Exemption

Ideally there should not be any exemption from CGST and SGST since exemption increases the amount of tax finally paid on intermediate goods. As such exemption will result in undesired results. However, if at all the government needs to provide exemptions, the Task Force report recommends that that they should be restricted to only items listed in Table 2.

**Table 2: List of items exempted from GST**

<table>
<thead>
<tr>
<th>1. All public services of Government (excluding Railways, Post and Telegraph, public sector enterprises, banks and insurance, health and education services).</th>
</tr>
</thead>
<tbody>
<tr>
<td>2. Any service transactions between the employer and employee either as a service provider, recipient or vice-versa</td>
</tr>
<tr>
<td>3. Any unprocessed food article covered under PDS</td>
</tr>
<tr>
<td>4. Education services provided by non-Government schools and colleges</td>
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<tr>
<td>5. Health services provided by non-Governmental agencies</td>
</tr>
</tbody>
</table>


Road Ahead

The GST at the Central and at the State level when introduced – is clear from the discussion above – will thus give more relief to producers and consumers through a more comprehensive and wider coverage of input tax set-off and service tax setoff, subsuming of several taxes in the GST. With the GST being properly formulated, it is expected that there will be revenue/resource gain for both the Centre and the States, primarily through widening of tax base and possibility of a significant improvement in tax-compliance. However, as the KPMG-CII (2010) survey mentions proper implementation of GST

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7 Exemption relieves the exempted trader’s value added from the tax, but all his purchases are taxed.
requires concerted efforts on parts of all stakeholders, namely, Central Government, State Governments and trade and industry. Of course, it is the Central Government which needs to take the initial step. Tax payer education or public awareness campaigns needs to be provisioned. Public workshops, seminars and training on GST also must be conducted in all states. States must also work out their revenue neutral rates, revenue implications as well as compensation packages. These issues must be resolved at the earliest so as to ensure smooth transition from the existing system of VAT to the new GST regime.

References


