

Chapter 1

INTRODUCTION

1. The basic framework for the tax system in independent India has been provided in the chapter I of the part XII of the Constitution. The important feature of the tax assignment is adoption of the principle of separation in tax powers between the Central and State Governments as provided in the article 245 of the Constitution. The Central government has the power to levy taxes on nonagricultural incomes and wealth, corporate income taxes, customs duties, and excise duties on manufactured products, etc which are generally known as broad-based and buoyant in nature. The major tax powers assigned to the States include taxes on agricultural incomes and wealth, sales taxes, excises on alcoholic products, taxes on motor vehicles, transport of passengers and goods, stamp duties, registration fees on transfers of property, etc. States also have powers to levy taxes on entertainment and on income earned by engaging in a profession, trade or employment¹. Some states have retained these powers for themselves, while others have assigned them to local bodies. Although the State list also includes property taxes and taxes on the entry of goods into a local area for consumption, use or sale, these have been assigned to local bodies. It is generally seen that the taxes collected by the State governments are not broad-based and are less buoyant.

2. Due to broad-based nature and buoyancy of the taxes assigned to the Centre, the amount of taxes collected by it was much more than the combined collection of taxes of the states. This could be attributed due to the fact that the framers of the Constitution of India wanted stronger Centre with the dependent States in the Federal nature of governance. The diversity of the country and its vastness

¹ Constitution of India

could be another factor in making a case for strong Centre. At the same time, the Indian Constitution has cast major welfare activities upon the State governments. All this makes the State governments dependent upon the Centre for transfer of funds to them. The Indian Constitution provides for setting up of Financial Commissions which decides the criteria of devolution fund from the Centre to States.

3. The Indian economy is a developing economy having its unique characteristics like low income, less productivity, less profit, illiteracy, poverty, high unemployment rate, lack of expertise and professionalism, insignificant role of private sector, undeveloped service sector, etc. All these factors have forced the government to mobilize resources through indirect taxes and borrowings for carrying out developmental activities. In fact, at some point of time about 90 per cent of total revenue of the government was coming from the indirect taxes. However, over the period of time liberalization process was initiated with the aim of reforming the economy whereby the productivity was sought to be increased, thrust was placed on professionalism, the role of private sector was increased by removing checks and controls, boost was given to the service sector, attracting investment in all segment of the economy, etc. This process of economic reforms started in 1991 has shown results. This has the effect of reducing the dependence upon the indirect taxes, which is known as regressive taxes and are perceived to act as the hurdles in the growth path of the economy. One can see the percentage of direct taxes going up since 2000 and there has been a corresponding decrease in percentage of the indirect taxes collection as compared to the direct tax collection. In 1996-97, the revenue collected from the direct and indirect taxes were Rs 38895 crs and Rs 89593 crs respectively, whereas the collection of direct and indirect taxes in 2006-07 have become Rs 230091 crs and Rs 241908 crs. In fact, the direct tax/GDP ratio has increased from 1.93% in 1990-91 to 5.58%

4. Indirect taxes is being imposed separately by the Centre and State and had the effect of cascading of taxes, whereby, Citizen's are paying taxes on taxes in the supply chain. This was making goods expensive to the consumer and the Indian goods were losing its competitiveness in the international market. A first step in reducing the cascading effect was made in 1986, when Central government introduced MODVAT scheme on the central excise side, which permitted credit of certain duty paid on certain inputs to be utilized for payment of duty on the finished goods. This scheme was further extended to all inputs and rechristen as CENVAT. However, this scheme does not permit credit of some other duties, surcharge, cess, etc and hence the cascading effect of taxes still persists.

5. While reforms were taking place at the Central level, yet not significant reform was witnessed in the State financial sector. However, a Resolution was passed in CM's conference in 1999 for constituting an Empowered Committee of State Finance Ministers to examine the state level VAT to replace sales tax. By now VAT was found to be the most effective method of taxation due to its simplicity, neutrality and ease of administration; and more than hundred countries have implemented the same. The Empowered Committee had issued a white paper on the subject, which is a collective attempt of the States to strike a balance between needed commonality and the desired federal tax ability in the VAT structure³. It is found that the state level VAT will have certain distinct advantage over the existing sales tax structure. The VAT will not only provide full set off for input tax as well as the tax on the previous purchase but it will also abolish the burden of several of the existing taxes, such as turnover tax, surcharge on sales tax,

² Ministry of Finance, Annual Report, 2007-08

³ White Paper on the State Level Value Added Tax (2005)

additional surcharge, special additional tax etcⁱ. The VAT system in the State has been introduced in terms of Entry 54 of the State List of Constitution from 2005 onwards.ⁱⁱ

6. The share of service sector in the overall GDP of the country has been rising significantly and it was contributing to more than 50%. However, before 1994, the service sector was not charged to any tax which restricted the revenue base and its productivity. Therefore the tax planners were forced to increase the tax rates, particularly of union excise duties to maintain the tax/GDP ratio and the fiscal balance. It has been found that richer section of the society consume disproportionately higher proportion of their incomes on services as compared to the poor. Therefore extending the tax of service sector was considered to be desirable from equity point of view. It was also noted that burden of taxation was being borne by the consumer goods and not by the consumer of services. It was noticed that the distinction between the goods and the services were getting blurred and there were attempts by many manufacturers to pass off the cost towards service (post manufacturing expenses, dealer's sales, etc) of the product thereby resorting to the evasion of duties. The Tax Reform Committee⁴ in 1991 recommended levy of tax on the services which the Government of India introduced through the Finance Act, 1994 with 5% levy on three services only. At that time the facility of input credit on the line of MODVAT was not available on the service sector. However, from 2004 onwards the credit of duty paid on services was allowed for payment of duty. It may be said that the integration of goods and services at the centre level was achieved partially. Now around 100 services are being taxed.

⁴ Tax Reform Committee Report(1991)

7. Now, around 160 countries in the world have VAT system of taxation, whereby the tax is charged on the value addition of every stage in the supply chain. It is considered to be self policing with transparency and simplicity in its nature⁵. The system was suggested by Professor Thomas A Adam of USA but, surprisingly USA does not follow VAT system. (USA follows last point taxation system). In 1954, France became the first country in the world to impose VAT for industrial sector. The commonly adopted VAT system is destination based working through tax credit or invoice method. If both Goods and Service are covered under the VAT, the same is known as Goods and Service Tax (GST), which will permit tax credit of duty paid on both goods and service. This could be utilized for payment of duty of output goods or service. The experience in the other country in the implementation of GST indicates that the system is simple to operate and impart neutrality / equity provided single or two rates are prescribed. The system does not suffer from litigation on account of classification, interpretation of law, statute, etc. Though VAT system is in operation in India at Union and State level, yet, the cascading effect of taxes continue to persist due to complete separation of state VAT and central VAT. The Empowered Committee of State Finance Minister, on the request of the Union Finance Minister, had submitted a report for comprehensive introduction of GST in the country, which may reduce the cascading effect of the taxation. The success of the GST would greatly dependent upon the functioning of huge information technology infrastructure of banking, Union and States governments, and its departments. There would be need to provide an effective Risk Management System to thwart any misuse of GST scheme. The success would also be dependent upon the coordination and harmonization between the States and Union and also, uniform enforcement in all the states. Any laxity in any of the state is likely to be misused by unscrupulous elements which could cause huge loss to the Exchequer.

⁵Purohit(2006)

Statement of the problem:

8. All the states have switched to VAT system of taxation from 2005 onwards and they are encouraged with the collection of taxes under the new system. Now, there is a general consensus amongst Centre and State governments to work toward implementation of GST from 2010. The report given by the Empowered Committee of the State Finance Ministers provides for dual system of GST, namely, central GST and state GST. It has also recommended that the State Governments should be permitted to levy and collect duties from the services also. However, the exact modalities to be adopted to achieve the implementation of recommendations have not been spelt out as yet.

Purpose or objectives:

9. The purpose of the dissertation is to go deeper into some of the recommendations of the Group of Empowered Committee and make an attempt to suggest or arrive at system of implementation of these recommendations. The Group of Empowered Committee has suggested for dual GST for the country with certain broad recommendations. However, implementing them would require a detailed analysis of existing data on many subjects. The proposed recommendations would require the Indian Constitution to be amended to enable states to levy taxes on services. As the recommendations are likely to have a far-reaching consequences, including the taxing power and the collection of the Central government, it is imperative that the same is analyzed keeping into consideration the responsibility cast upon the centre for maintaining the integrity and sovereignty. Though the Indian Constitution is considered to be federal in nature yet it has unitary characteristics and powers which keep the country united despite its diversity due to different culture, ethnicity, religions, languages and geography. Any step towards weakening of the financial position of the centre may have a very serious and long-lasting impact on the country.

Research questions or hypothesis:

10. The research questions which may arise on the subject with the reasons are summarized below:

- The Empowered Committee has recommended for dual GST- Central GST and State GST to be implemented separately by the Central and State governments. This would increase the administrative cost, compliance risk, burden on the taxpayer's. Whether committee could have gone for single GST or the recommendations are just window dressing without any impact upon the taxation system, whereby the cascading effect and tax hassles would continue to persist?

- How Inter-state sales of services and Goods to be administered and monitored? How the harmonization in the GST administration is achieved? Whether there would be only increase in the cases and amount of taxes paid after the introduction of the GST due to lack of harmonization? Also, the success of GST would be greatly dependent upon the existence of IT infrastructure, which appear to be grossly inadequate in the country. Whether it is feasible to go ahead for GST implementation 2010 without putting in place the harmonization and IT infrastructure?

- Today Centre plays a very important role in the overall development of the country especially of the special category states, weaker states (BIMARU) by providing significant financial assistance by way of loans, grants. Also, centre is implementing a significant number of Centrally Sponsored Schemes in almost all work of the life of an individual: be education, poverty alleviation, power, road and transports, old-age, women and child development, etc. Whether by implementation of the recommendations of the Empowered Committee, the resources available with the Central government would be restricted thereby making it difficult to discharge the role

played till now? Further, whether Central government ability to handle the preparedness of defense and paramilitary forces would be affected because of perceived lack of financial crunch in meeting the hostile countries in the neighborhood and also rising terrorism in the country because of various groups including naxalism?

Scope/limitations/Delimitations

11. The Empowered Committee has submitted its recommendation and is in deliberation with other departments and States. It is not known what shape these recommendation will take on the finalization? Secondly, introduction of GST will hit upon taxation basis of the Indian Constitution, which will have a far reaching impact upon Central and State's financial sector. In this era of political uncertainties and coalition governments with powerful regional parties, clamoring for powers to the state at the expense of the Centre cannot be ruled out. Implementation of these recommendations would be dependent upon the outcome of the general election in 2009 and the extent to which the central government is influenced by the regional parties.

12. Chapterisation of dissertation:

a. Chapter 1 describes in brief the need for taxation and its importance in any economy. This chapter will also cover in brief evolution of tax system in the country, reforms undertaken, etc.

b. Chapter 2 has discussed put in brief review of literature undertaken on the subject. It has discussed various theories, ideologies and postulates governing indirect taxation and its impact upon the economic growth of the country. Taxation has been one of the most discussed and debated subject since very long. The quest for the best taxation system has been continuing from the time immemorial, and would continue in future also. Thinking on what constitute the best tax system and its implementation strategy has

undergone considerable change over the years, mainly because of changing role of the state in development. The experience of other countries in this regard has been discussed in the chapter. The experience has shown that higher taxes do not necessarily contribute to higher revenues to fuel the development as it will have a very narrow base with high incidence of avoidance and leakage. It has been found that having a moderate tax rate will broaden the tax base, contributing to higher tax revenues. Indian taxation system has been characterized as high tariff, low base with complicated tax laws and procedures, inefficient, lack of transparency, corruption, etc. This has contributed to lower tax revenues with many litigations and revenue remaining locked in the court cases. Further, despite service sector contributing more than 50% to the GDP, yet the taxation on this sector was insignificant which overburdened the manufacturing sector.

c. Chapter 3 deals with the history, problems and reforms in the indirect taxation in India. Before 1990, the Indian economy was characterized as highly controlled economy with high tariffs on imports and manufacturing. The state was controlling a significant number of activities on manufacturing and imports by placing quantitative restrictions. This compounded with a very high tax rates stifled economic growth. At some point of the income tax was as high as 97% and Customs duties were as high a 360%. There was no incentive to be productive or show excellence to be producing the goods at the cheapest cost and also to make the goods competitive in the international market. During this period, the economy of the other countries has already started reforms and restructuring of taxation system. These factors contributed to a situation when the country was about to default on fulfilling the obligations to the IMF due to foreign exchange crisis. We could avoid the defaulting payment by pledging our gold, but, it forced the government to initiate major changes in the financial sector. This included rationalization of tariff

by striving to align with the tariff in the neighboring and South-East Asian countries, simplification of tax laws and procedures, abolition of many restrictive practices and quota regime, decentralization of many activities and decision taking power, delegation, automatic approval routes of investment, etc. During this course of reforms and the restructuring of the financial sector, it was felt that changes in taxation system are call of the day to make it efficient. The experience of VAT system of Centre and State has been found to be very encouraging as it has given impetus to the economy in achieving growth as it has abolished cascading effect of taxes. Though, the VAT system was already in operation at centre, however, some discrepancy still existed, mainly on service sector, which was not letting the economy free from the shackles. It was felt that having a uniform Goods and Service Tax on the whole of the country would be much more beneficial to give stimulus to the growth of economy. The Finance Minister in its budget of 2005-06, has requested, the Empowered Committee of State Finance Ministers to prepare a road map for introduction of GST 2010.

d. Chapter 4 describes principles governing VAT system of taxation with its advantages and disadvantages. This chapter also deals as to how the VAT system was adopted in 1986 on the Central Excise matters and how it had changed over a period of time. Efforts of the State governments to improve the tax compliance and there resolve to implement the VAT taxation in pursuant to the recommendations of Empowered Committee of State Finance Ministers and the success achieved therein had been discussed in this chapter.

e. Chapter 5 discusses international experience in implementation of VAT / GST of Canada and Brazil, which have a similar type of government that we have in India, namely, Union government and State governments. Canada has imposed GST w.e.f. Jan., 1991 at the federal level, after a great deal of discussion. At the provincial level

sales tax is levied by all provinces except Alberta. There are three different models – Quebec levies VAT (Known as Quebec Sales Tax QST). Three other provinces levy Harmonized Sales Tax (HST). Rest of provinces levies Retail Sales Tax. Brazil has a three tier system of commodity taxation: Federal VAT on manufacturing called IPI (Imposto Sobre Produtos Industrializados), State VAT on consumption called ICMS (Imposto Sobre Operacoes Relativas A Circulacos De Mercadorias E Servicos), and ; municipality tax on services- ISS (Imposto Sobre Servicos) . This chapter also contain outcome of various studies conducted upon the operation of VAT/GST in different countries to fully appreciate the strengths and weaknesses of this method of taxation.

f. Chapter 6 deals with consensus of the Union and the State governments on the uniform Goods and Service Tax and constitution of Empowered Committee of State Finance Ministers to suggest roadmap for introduction of this tax in this country from 2010. This chapter contains the terms and conditions of the Empowered Committee and the recommendations given by them which could be made applicable in India for implementing GST from 2010. The Empowered Committee has given certain recommendations for introduction of dual GST,

g. Chapter 7 of the dissertation analyses some of the major recommendations of the Empowered Group, which is yet to be implemented. These includes: Dual GST- whether whole exercise is just window dressing?, Implementation of interstate transactions and likely evasion of taxes, and; collection of GST by State on behalf of Centre- vulnerability of Centre and the country as a whole! These issues are important because they are likely to have impact upon Centre-State financial powers on taxation as well as relationship, likely impact upon funds availability with the Central government, and, inability of Central government to assist weaker states to meet

the requirement of funds for the development of these states. Whether there was an alternative to the dual GST, which is likely to increase the compliance cost besides, bringing in a large number of coordination issues within the Central and State governments?. One of the preconditions of successful implementation of unified GST is existence of credible and reliable IT network. Though, VAT is in operation in centre for last 20 years, yet we have not been able to put in place an effective IT network and the states have not put any such a network in last three years of VAT operation. It is very much debatable whether the country would be able to put in place such an elaborate IT network before 2010. Absence of such network would be an open invitation for all tax evaders to make merry.

h. Chapter 8 concludes the dissertation by analyzing the nature and scope of GST and whether we can start GST by 2010. Political, constitutional and economical condition of the country may force us to go for dual GST system. Some of the recommendations made by the Committee will have far-reaching consequences upon the Central Government capability to mobilize revenue, impacting its role enshrined in the Constitution of India. These recommendations may have to be revisited. The committee has also felt that the success of the GST would be greatly dependent upon a reliable IT network, which is completely lacking at the moment. Issues relating to credit mechanism, which does entail delay but the same time not prone to be misused for evasion, need to be effectively addressed. Devising and designing such a network would require a lot of groundwork and understanding of volume of dealers/Manufacturers etc. In the backdrop of this, it may not be advisable to go for implementation of GST without resolving these crucial issues. This chapter also discusses some of the recommendations which need to be taken before implementation of GST in the country.
