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# Goods and Services Tax (GST): A Paradigm Shift in Indian Tax System

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**Abstract**

*The political and economic case for GST is straight and simple: Income is taxed irrespective of source and use and therefore, consumption should also be taxed on the same principle. India has witnessed many reforms in indirect taxes over the past two decades with the replacement of state sales taxes by Value Added Tax (VAT) in 2005. Prior to VAT implementation, the tax structure was complicated due to the "cascading effect of taxes" whereby an item is taxed more than once from the production to the final retail sales stage. VAT was introduced to avoid this irrational tax system and taxes are paid on the "value added portion" by each producer and the hurdles of the cascading effect are done away with. Due to shortcomings in VAT, government realized the real need for harmonization of Goods and Services Tax (GST). This paper attempts to provide descriptive analysis of GST with reference to India.*

***Keywords***: *GST, Goods and Services Tax, Indirect Tax in India, Direct and indirect taxes*

## 1. What is GST?

Addressing the press media, Honourable Finance Minister Shri Arun Jaitely said on August 8, 2016:

> "Implementation of the Goods and Services Tax (GST) will reduce tax evasion and improve ease of doing business by engendering a common market throughout the country. GST will ensure one tax in the entire country. It will result in seamless transfer of goods and services in the country. This is a major indirect tax reform which in long run will be in interest of the country and Centre has addressed concerns of all the states."

FM Jaitley moved the modified constitution amendment bill in the Lok Sabha while appreciating political parties for showing unanimity in passing the bill in the Upper House and suggesting the modifications as well. The Lok Sabha, which had already passed the GST Constitution Amendment Bill in May 2015, took it up again to approve the modifications made in it by the Rajya Sabha.

The Constitution Amendment Bill for Goods and Services Tax (GST) got approved by The President of India after its acceptance in the Parliament (Rajya Sabha on 3 August

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2016 and Lok Sabha on 8 August 2016) and ratification by more than 50 percent of state legislatures. The Government of India is committed to replace all the indirect taxes levied on goods and services by the Centre and States and implement GST by April 2017.

Thus, the political and economic case for GST is straight and simple: Income is taxed irrespective of source and use and therefore, consumption should also be taxed on the same principle. 'G' – Goods; 'S' – Services; 'T' – Tax. Goods and Service Tax (GST) is broad and a single comprehensive tax levied on goods and services consumed in an economy. It is levied at every stage of the production-distribution chain with applicable set offs in respect of the tax remitted at previous stages. It is basically a tax on final consumption. In simple terms, GST may be defined as a tax on goods and services, which is leviable at each point of sale or provision of service, in which at the time of sale of goods or providing the services the seller or service provider may claim the input credit of tax which he has paid while purchasing the goods or procuring the service. GST will subsume central indirect taxes like excise duty, countervailing duty and service tax, as also state levies like value added tax, octroi, entry tax, luxury tax. The final consumer will bear only the GST charged by the last dealer in the supply chain, with set-off benefits at all the previous stages. It is expected to bring about a 2% incremental GDP growth of the country. The illustration shown below indicates, in terms of a hypothetical example with a manufacturer, one wholesaler and one retailer, how GST will work. The same logic shall hold for services as well.

| Stage of Supply Chain | Purchase Value of Input | Value Addition | Value at Which Supply Goods & Services Made to Next Stage | Rate of GST | GST on Output | Input Tax Credit | Net GST= GST on Output- Input Tax Credit |
|---|---|---|---|---|---|---|---|
| Manufacturer | 100 | 50 | 150 | 10% | 15 | 10 | 15-10=5 |
| Whole Seller | 150 | 30 | 180 | 10% | 18 | 15 | 18-15=3 |
| Retailer | 180 | 20 | 200 | 10% | 20 | 18 | 20-18=2 |

*Source: Referencer on Goods & Servics Tax, published by ICSI, September 2015*

Presently in terms of Article 246 – Schedule VII of the Constitution of India we have got three lists, the Union List, the State List and the Concurrent List. Under the Union list only the Central Government can levy taxes and in the State List only the State Government can levy taxes. And under the Concurrent List both the Centre as well as the State can levy taxes. A look at the Central Taxes reveals a list that includes Customs duty, Central Excise, Service Tax and to top it all we have education cess and secondary higher education cess. We have got product specific cess like automobile cess, research and development cess and the likes. In the State List we have VAT along with Central Sales Tax (CST). This consists of entry levy tax, octroi, entertainment tax, luxury tax, etc. So, we have multiple taxes both at the Central and State Level and GST will bring some simplification, clarification and uniformity in indirect taxes.

## 2. Background of Goods and Services Tax (GST) in India

Goods and Services Tax also known as the Value Added Tax (VAT) or Harmonized Sales Tax (HST) was first devised by a German economist during the 18th century. He envisioned a sales tax on goods that did not affect the cost of manufacture or distribution but was collected on the final price charged to the consumer. Thus it did not matter how many transactions the goods went through, the tax was always a fixed percentage of the final price.

India has witnessed many reforms in indirect taxes over the past two decades with the replacement of state sales taxes by Value Added Tax (VAT) in 2005. The Kelkar Task Force on implementation of the Fiscal Responsibility and Budget Management (FRBM) Act, 2003 had pointed out that although the indirect taxation in India has been steadily progressing in the direction of VAT principle since 1986, the existing system of taxation still suffers from many problems. The tax base is fragmented between the Centre and the States. Services, which make up half of the GDP, are taxed inadequately. Kelkar Task Force in this context had suggested a comprehensive GST based on VAT principle. In May 2007 Empowered Committee (EC) of State Finance Ministers in consultation with the Central Government, constituted a Joint Working Group (JWG), to recommend the GST model. Within 7 months of its constitution, the Committee has sent its recommendations to the Government of India in the form of 'A Model and Roadmap for Goods and Services Tax in India' dated April 30, 2008. It was outline of the proposed GST.

JWG recommendations with regard to GST are:

1. GST should have two components, a Central tax and a single uniform state tax across the country.
2. A tax over and above GST may be levied by the states on tobacco, petroleum and liquor.
3. The GST may not have a dual VAT structure but a quadruple tax structure namely:
    a. a central tax on goods extending up to the retail level
    b. a central service tax
    c. a state-VAT on goods
    d. a state-VAT on services

Given the four-fold structure, there may be at least four-rate categories- one for each of the components given above. In this system the taxpayer may be required to calculate tax liability separately for the different rates of tax.

1. The JWG report suggested that states must tax intra-state services while inter-state services must remain with the Centre. Petroleum products, including crude, high-speed diesel and petrol, may remain outside the ambit of GST. The report had also mooted elimination of the area-based and sectoral excise duty exemptions that are being given by the Centre.
2. Central cess like education and oil cess may be kept outside the dual GST structure to be introduced from April 2010. Besides central cess, the EC of State

Finance Ministers has also recommended to keep purchase tax and octroi, which are collected at state and local levels, outside the GST framework.

3. The working group had suggested including cess and surcharges, which are levied for specific purposes on taxes at central and state levels, and had suggested to meet the specific requirement through budgetary allocation.
4. The report has also recommended keeping stamp duty, which is a good source of revenue for states, out of the purview of the GST. Stamp duty is levied on transfer of assets like houses and land.
5. Suggested to keep levies like the toll tax, environment tax and road tax outside the GST ambit, as these are user charges.
6. Recommended that if the levies are in the nature of user chargers and royalty for use of minerals, and then they must be kept out of the purview of the proposed tax.

The then FM, Mr. P. Chidambaram remarked that there is a large consensus that the country must move towards a national level GST that must be shared between the center and the states. He proposed 1st April 2010 as the date for introducing GST. Subsequently the Empowered Committee of State Finance Ministers agreed to work with the Central Government to prepare a roadmap for introducing a national level GST with effect from 1st April 2010. Finally, The Constitution Amendment Bill for Goods and Services Tax (GST) got approved by The President of India after its acceptance in the both the Parliament. The Government of India is committed to implement GST by April 2017.

## 3. Importance of GST to the economy

A National Council of Applied Economic Research (NCAER) study, commissioned by the Thirteenth Finance Commission has stated:

> "GST across goods and services is expected, *ceteris paribus*, to provide gains to India's GDP somewhere within a range of 0.9 to 1.7 per cent. The corresponding change in absolute values of GDP over 2008-09 is expected to be between Rs. 42,789 crore and Rs. 83,899 crore, respectively. The comparable dollar value increment is estimated to be between $ 18, 550 million, respectively. The additional gain in GDP, originating from the GST reform, would be earned during all years in future over and above the growth in GDP which would have been achieved otherwise. The present value of the GST-reform induced gains in GDP may be computed as the present value of additional income stream based on some discount rate. Assuming a discount rate as the long-term real rate of interest at about 3 per cent, the present value of total gain in GDP has been computed as between Rs 1,469 thousand crores and 2,881 thousand crores. The corresponding dollar values are $325 billion and $637 billion."

Exports shall gain between 3.2 and 6.3 per cent with absolute value of Rs. 24,669 crore to Rs. 48,661 crore. GST would lead to efficient allocation of factors of production with decline in overall price reduction. Real returns to the factors of production would go up. Returns to land between 0.42 and 0.82 per cent; wage between 0.68 and 1.33 per cent; capital would gain somewhere between 0.37 and 0.74 per cent.

When asked as to how GST would help fiscal consolidation, Dr. Vijay L. Kelkar, Ex-Chairman, Thirteenth Finance Commission in his post-evidence replies stated as under:

> "The changeover to GST is designed to be revenue neutral at existing levels of compliance. Given the design of the flawless GST, the producers and distributors will only by-pass through for the GST. Further, given the single and low rate of tax the benefit from evasion will significantly reduce. Therefore, there will be little incentive for the producers and distributors to evade their turnover. Accordingly, this policy initiative should witness a higher compliance and an upsurge in revenue collections. This will also have an indirect positive impact on direct tax collections. Further, given the fact that GST will trigger an increase in the GDP, this in turn would yield higher revenues even at existing levels of compliance. Another important source of gain for the Government would be the savings on account of reduction in the price levels of a large number of goods and services consumed by the Government. However, to the extent, the Central Government will be required to incentivize the States to adopt the GST, there will be an increase in the budgetary outgo. Given the smallness of the size of the compensation, it is expected that there would be a net gain in the tax revenues. This should enable the Central Government to better manage its finances. As regards the State Governments, the design and the road map of the GST recommended by us would lead to substantial gain in revenues. While the revenue neutral rate for the States is estimated to be 6 percent, we have recommended that the states should be allowed to impose GST at the rate of 7 percent. An increase in the RNR of the States by 1 percent implies a revenue gain of Rs. 31381 crores per annum in the base year 2007-08 (i.e., 16.67 percent increase in the revenues). This gain will be further augmented by better compliance. Therefore, overall the implementation of GST should enable the Government at both levels to better meet the challenges of fiscal correction. GST will positively impact the common man in many ways. Firstly, it will add to the overall economic growth by removing economic distortions. It will create new employment opportunities (about 20 million high end jobs over a period of time) thereby increasing the levels of income across a large section of the society. Secondly, it will reduce inflation if GST is levied at the combined rate of 12 percent as recommended by the Thirteenth Finance Commission. Thirdly, it will e-centralize production to areas enjoying comparative advantage so more jobs can be expected to be created in rural areas. This will in turn slow down the pace of migration to urban areas. Fourthly, it will improve governance since the introduction of a comprehensive GST will bring about more transparency and an end to crony capitalism. Finally, GST can create further opportunities for relief under direct taxes over time since it is viewed as a revenue generating machine. Alternately, it will facilitate fiscal consolidation thereby reducing the debt burden of citizens in general."

Responding to the question on the impact of GST on prices, Dr. Vijay L. Kelkar, Ex- Chairman, Thirteenth Finance Commission in his post-evidence reply stated:

> "Prices of agricultural commodities and services are expected to rise. Most of the manufactured goods would be available at relatively low prices especially textiles and readymade garments. There are two opposing forces which determine the changes in price levels. First, increased payments to the primary factors of production, viz. land, labour and capital, increase the cost of production and hence tend to have upward pull on prices. Second, sectors under imperfect competition (manufacturing sectors) get benefits of cost reduction through increasing returns to scale which are not reaped by sectors assumed to be in perfect competition. The relative impact of the force determines the overall price change. It may also be noted that the share of primary inputs (land, labour and capital) in total output is relatively high in agricultural and services sectors. Another factor that impacts the price levels refers to the quantum of intermediate input purchases from sectors under perfect competition versus imperfect competition. Relatively low proportions of intermediate inputs purchased by agriculture and service sectors (i.e., sectors under perfect competition) are sourced from manufacturing sectors and hence these sectors do not reap the benefit of relatively low cost inputs from manufacturing sectors. Therefore fall in prices of manufactured goods should benefit agriculture and services sectors. Further, the terms of trade can also be expected to improve in favour of

agriculture vis-à-vis manufactured goods. The prices of agricultural goods would increase between 0.61 percent and 1.18 percent whereas the overall prices of all manufacturing sector would decline between 1.22 percent and 2.53 percent. Consequently, the terms of trade will move in favour of agriculture between 1.9 percent and 3.8 percent. The increase in agricultural prices would benefit millions of farmers in India. Similarly, the urban poor will also benefit from new employment opportunities. With regard to the food crops the poor would continue to remain secured through the public distribution system. The prices of many other consumer goods are expected to decline. These include sugar; beverages; cotton; textiles; wool, silk and synthetic fibre textiles; and textile products and wearing apparel. Therefore, overall inflationary impact of GST will be negative through lower prices, lower fiscal deficit and higher output."

## 4. Conclusion

The overall macroeconomic effect of reduction in economic distortions due to GST would be to provide an impetus to economic growth. The NCAER study commissioned by the Thirteenth Finance Commission estimates the impact of the introduction of a GST which would eliminate all taxes on production and distribution and rest on final consumption only. It will lead to efficient allocation of factors of production thus leading to gain in GDP and exports. The switch over to GST will be neutral to vertical and horizontal integration and thus will encourage industries to be located in states which enjoy a comparative advantage. Resource rich backward states will also attract natural resources based industries regardless of the fact that the consumer is located elsewhere. In nutshell, GST would generate greater employment as it helps to increase labor intensive sectors and thus, along with growth in GDP, economic welfare will also be enhanced.

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