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India's Goods and Services Tax – A Primer

The Finance Ministry of India placed the One Hundred and Fifteenth Constitutional Amendment Bill in the Lok Sabha on 22nd March, 2011. This Amendment Bill is hugely significant as it introduces the Goods and Service Tax (GST) in the Indian Constitution. Introduction of GST marks the most significant reform in Indian tax system and easily one of the most important economic reforms in India. The Bill still has a long journey to make before it is included in the Constitution as it would now be discussed in upcoming Parliamentary sessions. One expects vigorous debate on this front amidst members. But still for GST to come to this level is itself a feat given the huge challenges with the tax proposal.

The Finance Minister in the FY 2011-12 Union Budget has proposed to introduce GST by April 1, 2012. This is the third such timeline proposed by the Finance Minister after missing two previous dates. It will be interesting to see whether GST is finally introduced in 2012.

This paper is an attempt to understand the impact of GST on Indian economy. The paper will start with a snapshot of the current taxation system in India and how GST will change the taxation system. It then looks at the GST design in India which has been adapted to suit the Indian taxation system. The paper ends with the probable impact of GST on Indian economy and also touches on experience of GST in other international economies.

I. Understanding Taxation System in India

India is a federal country and both Centre and States have their own rights to collect taxes. Each state is independent in levying and collecting taxes. The taxation powers are defined clearly in the Indian Constitution. Centre collects all the direct taxes (income tax, corporate taxes etc) along with the Indirect taxes like Service Tax, Excise duty and Customs duty.

The States collect indirect taxes like VAT on goods, CST and Local Taxes. These revenues states keep with themselves. Earlier instead of VAT, States had sales taxes on various goods. Now states have replaced sales taxes with VAT. Each state has adopted its own structure of VAT with different duties and structure.

A Finance Commission is appointed to look at the transfer of a certain percentage of the taxes collected by the Centre to the State. The Finance Commission defines the rules and conditions for the transfer of resources.

In an earlier taxation system, people paid taxes at various levels. There was no system of getting a rebate on the taxes paid previously while paying the inputs. This is also called as cascading effect. Ideally the taxes should be based on value addition and the producer should pay taxes on whatever value he adds to the product. In the absence of such a system, producers ended up paying much higher taxes. Higher taxes are a barrier for business and discourage business activity. The businesses instead spend time trying to save taxes leading to distortions and a parallel economy. A large number of enterprises prefer to stay out of the taxation system and avoid paying taxes. High taxes also lead to lobbying activities where producers of a certain sector ask the government to lower/waiver taxes for their sector. This also leads to multiple taxation rates for multiple products and further increases inefficiency in the system.

A Value Added Taxation system is seen as a way to negate this cascading effect. VAT taxes goods at each stage and on the value addition done by the enterprise. In a VAT system the idea is also to have a single rate of taxation for all the goods. As this may not be practically possible, the Governments try and minimize the number of taxation rates. The multiple tax rates will take time before they are merged into one rate.

The Centre was the first to adopt VAT with a selected group of commodities in 1986 and was called MODVAT. The number of commodities was increased gradually in form of CENVAT in 2002-03. The Service Tax was also made part of CENVAT in 2004-05.

GST is an extended version of Value Added Tax (VAT) and aims to cover all goods and services. VAT covers mostly goods and GST covers all goods and services. VAT was selectively applied in India (discussed later) and GST is an attempt to get rid of weaknesses in the VAT structure.

With a GST in place, all these indirect taxes should be merged into one tax. Ideally, these taxes will be collected by the Centre which will then be transferred to the States via a rule/formula. This will require changes in the constitution as Centre can only tax goods at production stage and on Services. The States can only tax sale of goods. Hence, States cannot tax services and Centre cannot tax sales of goods. The States cannot also tax imports.

All this needs to be changed with the GST and hence would require amendments in the Indian Constitution. That is the reason why the 115th Constitution Amendment Bill has been introduced (explained in the introduction)

Hence, implementation of GST was always seen as a concern for States as they surrender their powers to tax. This is a very difficult issue and as a result numbers of discussions have followed between the stakeholders (covered later).

Similar issues were seen in implementation of State level VAT as well. However, the problem then was inter-states. As explained above, before VAT States had sales taxes with multiple rates. States were often seen in a sales tax war with other states. In the war states competed with each other offering lower tax rates to certain industries to set units in their states. This resulted in revenue loss for both the states. Hence with State-level VAT attempts were made to make it harmonious starting with asking the states to stop this war. The design of VAT system in each state has also been done in a uniform fashion keeping the distinctive state economy in mind.

The First Discussion Paper on GST reviews the experience of VAT system in States and summarizes it as:

> *As a consequence of all these steps, the States started implementing VAT beginning April 1, 2005. After overcoming the initial difficulties, all the States and Union Territories have now implemented VAT. The Empowered Committee has been monitoring closely the process of implementation of State-level VAT, and deviations from the agreed VAT rates has been contained to less than 3 per cent of the total list of commodities. Responses of industry and also of trade have been indeed encouraging. The rate of growth of tax revenue has nearly doubled from the average annual rate of growth in the pre-VAT five year period after the introduction of VAT.*

Just like GST now, states were worried at the time of VAT on losing revenues. At that time Finance Ministry promised to make up for any losses from transition to the VAT. Even State Finance Ministers understood the transition costs were short-lived and were supportive. However, with GST issues are more complex as States loose their power to tax and all the pressure is on Finance Ministry to justify the need to move to GST. The Centre has proposed to set a Rs 50,000 Cr fund to help states which have a shortfall in tax revenues after GST.

II. Why GST when we have VAT?

GST is similar to VAT in terms of the value-added approach. The question that comes to mind is - India already has VAT then why should someone go for GST? Moreover, it seems to be very complicated and a difficult exercise, then what are the reasons?

- **Limitations in Centre VAT system:** There is CENVAT but several taxes are still out of the ambit like surcharges, additional customs duties etc. In some goods we get input tax and not in others, making the tax filing system complex and cumbersome.

- **Limitations in State VAT system:** The States also have VAT but again story is the same. Many taxes like luxury taxes, entertainment tax etc, are not included. There is no input tax credit in case of CENVAT paid on certain items.

- **Interstate Sales Tax (CST):** Though it is an important source of revenue for states it is seen as very burdensome by businesses. The companies make goods in one state but on distribution inside the country, end up paying taxes in each state. They are supplying goods within the country and should just be taxed at one place.

- **Inclusion of Services in VAT system:** Production of goods is because of both physical production and services. But Services are taxed only by Centre and that too is done selectively. The Services need to be taxed at State level and integrated with the Goods VAT system as shown in the example above.

- **International Standard:** GST is becoming an international standard and it is important India also has one. There are many factors before international companies while choosing a country for its business and taxation system is one very important factor. With other countries having GST and India not having one, the companies are likely to opt for former ahead of India for locating their businesses. Likewise Indian companies may also prefer to increasingly set their bases in other countries where tax system is more efficient.

Dr. Vijay Kelkar, Chairman of the Thirteenth Finance Commission has been one of the most vehement advocates of GST in India. In a speech he cities work of eminent tax economist Prof. Charles MClure. Mclure identifies six characteristics of a well designed GST in a federal system.

- Uniform rate of taxation within a given jurisdiction, ideally at a single rate
- Sales would be taxed under the destination principle.
- Low costs of compliance and administration
- Each level of government to set its own tax rate subject to agreed ceilings and/or floors
- A substantively Common tax base for Central and State governments
- Substantial Co-operation in tax administration between all levels of government

Kelkar added that first two are important for economic reasons; the third for administrative reasons and the fourth for political reasons, the last two come into play in a system of multilevel finance such as we have in our country. These principles should be adopted while designing GST in India as well.

III. GST Design in India

GST was first proposed in India in the Union Budget speech in 2006-07. It has been quite a journey since then. Box 2 summarises the timeline of GST in India.

The Empowered Committee of State Finance Ministers released the first discussion paper on GST in November 2009. This paper has specified the features of GST in India. The highlights are:

- **Dual GST System:** There will be two kinds of GST, for the Centre (CGST) and for the State (SGST). The taxes that are merged into GST is given in the following table

Taxes merged under Centre GST	Taxes under State GST
Central excise Duty, Additional Excise Duties	VAT/Sales Tax
Additional Customs Duty known as Countervailing Customs Duty, Special Additional Customs Duty	Tax on Interstate Sales (CST) – This has to be phased out with introduction of SGST. A new concept called Inter-state GST or IGST
Service Tax	Local Taxes - Entertainment Taxes, Luxury Taxes, Tax on lottery, betting etc
Cesses and Surcharges	Service Tax
	Entry Tax not in Lieu of Octroi
Source: First Discussion Paper on GST	

  As the table shows, GST has made a start be merging the various Centre and State taxes into CGST and SGST respectively. But the idea of a PAN India Tax is still missing. The States also would get to tax services under the GST. Some goods/taxes are kept outside the purview of GST like Purchase Tax, Tax on Alcohol, Tax on Petroleum Products (crude, motor spirit, high speed diesel etc).

- **A separate accounting system for dual GST:** The businesses will need to maintain separate accounts for the two GST.

- **No inter system input tax credit:** As there are separate accounts for the two, a business can get input tax credit paid on CGST can only be utilized for paying Output tax on CGST. Likewise, SGST input tax credit can only be adjusted for output tax SGST. There cannot be cross utilization of Input Tax between CGST and SGST.

- **Inter-state GST**: IGST will be introduced to account for Inter State Sales. The Centre will collect IGST on an interstate sale from the exporting state and transfer it to the importing state. The producer and his customer will be eligible for input tax credit on IGST.

- **Taxation Rates:** There will be two tax rates for SGST– lower rate for necessary and basic importance items and a standard rate for all other goods. Further, there will be a special rate for precious metals and a list of exempted items.
  For CGST also a dual rate structure will be adopted in conformity with the SGST rates. For services, there would be one rate for both CGST and SGST.

  The Governments have still not arrived at GST taxation rates as discussions are still being held amidst members. Finance Commission Task Force estimates the revenue neutral rates (rate at which tax collection will be same in old and new regime) at 12% - 5% for CGST and 7% for SGST.

- **Threshold exemption:** This is built to keep small traders out of tax net. It is always difficult to monitor small traders and costs are high for the same. Hence the tax system sets thresholds under which only business above a certain turnover will be taxed.

  In the VAT system, states have adopted their own threshold limits. Under GST, there is an attempt to harmonize and keep the threshold limits similar across states. The limit being considered is Rs 10 lakh for both goods and services. However, for CGST the limit is being considered as Rs 1.5 crore for goods and for services to be kept at "appropriately high" levels.

- **GST Council and Dispute Settlement Authority:** The 115th amendment bill also mentions setting up two constitutional bodies - GST Council and GST Dispute Settlement Authority. GST Council will make recommendations on all key matters pertaining to GST like taxation rates under both CGST and SGST, exemptions from GST etc. Union Finance Minister will chair the council with Finance Ministers from states as members. The Council members may also elect a Vice-Chairperson of the Council from the members.

  The Dispute Settlement Authority will be responsible for any disputes amidst Union/States/members with respect to GST. The Authority would have one Chairperson and two members. The chairperson should be judge from Supreme Court or Chief Justice from a high court and appointed by President of India on the recommendation of Chief Justice of India. Two other members should be experts from field of law/economics/public affairs on the recommendation of GST Council. This has been done to balance the interests of the parties.

Overall, the GST system is an improvement over the current indirect tax system. It merges the Centre Indirect Taxes under CGST and States Indirect Taxes under SGST. But still there is vast scope of improvement as it is still far from a Pan India Tax system. The taxes remain under both state and centre. Then issues like exemptions, dual rate structure etc remain in the system. It does not meet the design principles suggested by Mclure but is still going to be much better than the current system of taxation.

The proposed GST system is on the lines with the way India has been conducting its reforms. India has followed the gradual approach in most of its reforms where reform is adopted with many of the deficiencies remaining in the system. It is like the skeletal system with just the basics in place. Over a period of time, the flesh is added to the bones to make the reform more comprehensive. The GST is also likely to move in the same direction.

IV. Impact of GST on Economy - International Experiences

Most countries have adopted VAT system and GST is considered similar to a VAT system. It is possible that some economies that have adopted VAT system is actually a GST as well. So we really do not know the broad experiences of most economies and stick to countries which call their tax systems as GST based. GST system has been adopted in a few economies – Canada, Australia, New Zealand and Singapore. Hong Kong proposed to introduce it but had to abandon it amidst stiff opposition.

Tom Bolton and Brian Dollery in a paper compare impact of the GST in Australia, Canada and New Zealand (An Empirical Note on the Comparative Macroeconomic Effects of the GST in Australia, Canada and New Zealand, 2004).

Over a long term there are improvements across the macroeconomic variables but there were short-term glitches. Inflation did seem to rise in the years of introduction but was mainly blamed on the administration for the same. The impact on revenue and current account has been very impressive with sharp gains seen in all the three economies.

In Australia there was a more dramatic impact of GST on the economy. Before GST's implementation, consumers rushed to purchase goods that they perceived would be substantially more expensive post-GST. After the tax, consumer consumption and economic growth declined sharply initially. In Q1 2000, Australian economy recorded negative economic growth for the first time in more than 10 years. Consumption and growth soon returned to normal. There was some negative impact on price of real estate as well but the market rose and property prices and demand increased sharply in 2002-04.

	Australia	**New Zealand**	**Canada**
Introduction year	2000	1986	1991
Price Changes	Short run one off effect,	Short run spike in prices, no longer run increase	Short run spike in prices, no longer run increase, price regulatory body criticized
Economic Growth	Introduced during sustained economic growth period	Introduced at the end of recession, subsequent upswing	Introduced in midst of major recession, criticized as Compounding problems
Revenue Effect	Revenue exceeded expectations	Revenue exceeded Expectations	Revenue exceeded Expectations
Current Account	Slight improvement since introduction	Rapid immediate improvement, longer term stabilization	Dramatic Improvement since introduction of GST, NAFTA
Source: Tom Bolton and Brian Dollery (2004)			

In another study, Hamilton showed that GST increased the real output of the Canadian economy by 1.4% of GDP, principally through an increase in the productivity of capital and total factor productivity. The sectors like transportation, utilities, services and agriculture experienced significant gains.

V. Impact of GST on Indian Economy

The studies assessing impact of GST are limited as the design of GST was not clear till the First Discussion Paper. Thirteenth Finance Commission has undertaken a study with NCAER, a Delhi based think-tank on cost-benefit analysis of GST regime in India. The highlights of the report were:

- **Medium term gains:** GST could to increase India's GDP somewhere within a range of 0.9% to 1.7%. The comparable dollar value increment is estimated to be between \$9.5 billion and \$18.6 billion respectively.

- **Long term gains:** 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. It estimates present value of total gain in GDP between \$325 billion and \$637 billion. This is nearly 30-60% of the size of Indian economy currently!

- **Export gains:** GST will lower the overall tax inputs in supply chain of goods and services leading to lower prices of Indian goods and services. This will increase the competitiveness of Indian goods and services in the international market and give boost to Indian exports. The uniformity in tax rates and procedures across the country will also go a long way in reducing the compliance cost. These gains are expected to vary between 3.2 % - 6.3% with corresponding absolute value range between $5.4 billion - $10.7 billion, respectively. Imports are expected to gain somewhere between 2.4 and 4.7% with corresponding absolute values $6.9 billion and $13.6 billion, respectively.

- **Others:** GST would lead to efficient allocation of factors of production. The overall price level would go down. It is expected that the real returns to the factors of production would go up. NCAER results show gains in real returns to land ranging between 0.42 and 0.82 per cent. Wage rate gains vary between 0.68 and 1.33%. The real returns to capital would gain somewhere between 0.37 and 0.74%. Kelkar adds that GST could help add productive employment of as much as 4 to 5 million. Barring impact on economy, GST could help the consumers as well. The lower taxation will lead to lower prices of goods and services.

NCAER sums up the findings as: *implementation of a comprehensive GST in India is expected to lead to efficient allocation of factors of production thus leading to gains in GDP and exports*. This would translate into enhanced economic welfare and returns to the factors of production, viz. land, labour and capital. They add that as with any other modelling exercise, the results are subject to certain limitations.

However, going by the above international experiences there could be two additional problems.

- **Inflation:** Most of the international case studies show an inflation spurt in initial months of GST implementation. In Australia's case we saw spurt in prices of goods which Australian consumers thought would become expensive after the GST. Much of blame for inflation is accorded to the various regulatory bodies and uncertainty over the new tax regime. The inflation situation stabilizes as implementation gains pace and is understood by consumers and producers.

  In India's case inflation could be critical as unlike developed countries profiled above, India has far more inefficiencies in supply chain in local markets. The Indian GST reform is far larger in scale compared to above economies. These rigid inefficiencies along with higher information asymmetry on probable impact of GST could push inflation higher in initial days of implementation. Indian economy is already plagued with persistent high inflation and this new reform could further test inflation further.

- **Tax Revenue Shortfall:** RBI in the State Finances Report (2010-11) said the revenue implications of GST are likely to vary across states. The Centre and the States are still discussing various aspects of GST like taxation rates, revenue sharing model between Centre and States etc. As there is still uncertainty over the final blueprint of GST, it is difficult to estimate the impact of GST on state finances. Other issues are enhancing the administrative capacity of states and building IT (Information technology) infrastructure to capture the full benefits of GST. The report points that VAT led to improvement in tax revenue for most states.

  However, just like VAT there could be some short-falls in revenues in some states over a short-term. The central government has already proposed a Rs 50,000 Cr fund to help the states which suffer from the short-fall. However, a higher shortfall could lead to both Centre and States to borrow more from the markets. This will be critically watched as it has further ramifications on fiscal deficits, interest rates and inflation.

VI. Conclusion

Goods and Service Tax is easily the biggest taxation reform in the country along with the proposed Direct Tax Code. In terms of macroeconomic reforms too, it will be at tops with the various reforms taken since 1990s. It will also serve as a useful case study for other economies which are contemplating to implement GST. The sheer scale of GST project to bring all indirect taxes in India under one fold is a major achievement and needs to be commended. The proposed GST is not the desired and true form of GST. But a single indirect tax cannot be done as India's federal structure has to be preserved.

GST is also expected to bring many benefits to the Indian economy. Though, all these benefits are based on the assumption that overall taxation structure is less bureaucratic and cumbersome than present. The implementation is going to be crucial so that the promised benefits are realized.

The Government also needs to be weary of inflation spurts in initial implementation phase of GST as pointed by experiences from international economies. Ideally, one should be first easing all these state-wide inefficiencies and then implement GST. However given the challenges in India, the policymakers are hoping GST will help ease these inefficiencies and eliminate them over a period of time.

Box 1: How does GST work?

Suppose there is a biscuit manufacturer. He purchases raw materials and machinery on which he pays certain percentage of tax.

	In Rs lakh	Tax Rate	In Rs Lakh
Raw Material	100	10%	10
Machinery	100	10%	10
Total Input Tax paid			20

Now suppose he produces biscuits worth Rs 450 lakh and adds Rs 50 lakh as profit. He sells the goods to one large all India distributor. The manufacture will have to pay taxes on selling his biscuits. Now in a traditional system, he would pay the tax on the entire Rs 500 Lakh and get no input credit. So he pays a total tax of Rs 70 Lakh – Rs 20 Lakh on Production and Rs 50 Lakh on Sales. This is called cascading effect and a producer pays the tax on each economic transaction. The end result is much higher taxes by the producer leading to lack of incentives by the producer.

However with a VAT/GST system, the producer gets an input tax credit of Rs 20 Lakh. As he had paid Rs 20 Lakh on the inputs, it gets deducted from the tax bill. On net basis, the producer pays Rs 50 Lakh of taxes.

			Without VAT/GST	With VAT/GST
	In Rs lakh	Tax Rate	In Rs Lakh	In Rs Lakh
Sales (Production + Profit)	500			
Total Output Tax		10%	50	50
Less Input Tax			--	20
Tax Paid			50	30
Total Tax paid (Input Tax + Output Tax)			70	50

Now let us see the books of the all India distributor. Let's say he pays Rs 10 lakh to the transport provider for transporting goods from manufacturer to the distributors' godown. He pays service tax on the same. Hence total value of his goods becomes Rs 510 Lakh. His input tax payable is Rs 51 Lakh.

	In Rs lakh	Tax Rate	In Rs Lakh
Goods	500	10%	50
Service Tax	10	10%	1
Total Input Tax paid			51

The Distributor sells the biscuits to the consumers. The same input tax output tax calculation applies here as well. Without a VAT/GST system he pays a total of Rs 111 Lakh as taxes. With a VAT/GST system he pays Rs 60 Lakh as total taxes, a total saving of Rs 51 lakhs.

			Without VAT/GST	With VAT/GST
	In Rs lakh	Tax Rate	In Rs Lakh	In Rs Lakh
Sales (510 + 90 lakhs profit)	600			
Total Output Tax		10%	60	60
Less Input Tax			--	51
Tax Paid			60	9
Total Tax paid (Input Tax + Output Tax)			111	60

Box 2: GST in India – Timeline

The GST proposal has evolved over a period of time. There have been multiple discussions between States and Centre as there are large stakes on hand. It is useful to take a look at the timeline of events.

- February 28, 2006: Finance Minister Mr. P. Chidambaram, in the Union Budget for 2006-07 discussed GST for the first time. He remarked

  It is my sense that there is a large consensus that the country should move towards a national level Goods and Services Tax (GST) that should be shared between the Centre and the States. I propose that we set April 1, 2010 as the date for introducing GST. World over, goods and services attract the same rate of tax. That is the foundation of a GST. People must get used to the idea of a GST. Hence, we must progressively converge the service tax rate and the CENVAT rate.

- February 28, 2007: In 2007-08 Budget speech, Finance Mr. Minister P. Chidambaram initiated working on GST:

  I wish to record my deep appreciation of the spirit of cooperative federalism displayed by State Governments and especially their Finance Ministers. At my request, the Empowered Committee of State Finance Ministers has agreed to work with the Central Government to prepare a roadmap for introducing a national level Goods and Services Tax (GST) with effect from April 1, 2010.

- May 10 2007: This announcement was followed by formation of the Empowered Committee of State Finance Ministers (ECSFM). ECSFM in turn formed a Joint Working Group with key Finance Ministry officials to work on GST.
- November 19 2007: The Joint Working Group first presented its views to ECSFM after discussions with various chambers of commerce and tax experts.
- April 30 2008: ECSFM sent its first report to Government of India
- December 16 2008: ECSFM discussed comments received from the Government. A new committee made to discuss these comments and submit views
- 21 January 2009: The new committee submits its views. Another Working group formed of concerned officials of State Governments with senior officials from Central Government. They also submit a detailed structure of GST
- October 19 2009: Finance Minister Pranab Mukherjee met with ECSFM on related issues of loss of revenues due to phase out of Central Sales Tax.
- November 10, 2009: All the detailed issues on GST as seen by ECSFM are presented in the First Discussion Paper on GST. The discussion paper has helped lay out a path for GST.
- February 26, 2010: In the Budget Speech, Finance Minister Pranab Mukherjee proposed to achieve the roll-out of GST by April 2011. He stressed on the use of Information Technology to achieve the objective and informed that project ACES - Automation of Central Excise & Service Tax, has already been rolled out throughout the country this year. A Mission Mode Project for computerisation of Commercial Taxes in States has been approved recently.
- February 28, 2011: In the Budget Speech, Finance Minister Pranab Mukherjee proposed to achieve the roll-out of GST by April 2012. He said significant progress has been made to improve Information Technology in Tax systems and GST Network (GSTN) is almost ready.
- March 22, 2011: Finance Minister places the constitution amendment in Lok Sabha bill to introduce GST in the constitution

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