

## Indirect Tax Reform in India: from VAT to GST

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**Abstract:** The introduction of Goods and Services Tax in India is part of long process of tax reform in India. It has been brought through a constitutional amendment act. The issue of tax cascading was a serious impediment in the realisation of a rationalised tax regime while the need on an integrated indirect tax system was an all time necessity. These concerns led to a step by step movement in the direction of tax reform. Initially the VAT regime was established which recently got replaced with the GST. The GST in India is of a particular type with certain important aspects of it. This paper attempts to discuss the entire shift in the taxation system with the introduction of Goods and Services Tax.

**Keywords:** Goods and Services Tax; VAT; CENVAT

### Introduction:

The indirect tax reforms in India has been a long process in a multi stage manner. It all started with the introduction of VAT in 2005 and in 2017 saw the formulation of GST i.e. the Goods and Services Tax. The aberrations in the excise and sales tax in India necessitated the introduction of Value added Tax. The introduction of VAT had been considered a pioneering step towards tax reform in India. At the global level the major thrust has been towards introduction of VAT in a seamless manner across goods and services with no distinction made between goods and services. This is known as the goods and services tax or GST. It needs to be clarified that the introduction of VAT in India was seen as an intermediate step towards indirect tax reform. It's role in this direction can never be underestimated, however few of the unrealised dreams necessitated the urgent take off towards the next landmark that is the goods and services tax. The discussion over the years involved constant engagement of the centre and states which ultimately led to its introduction across India. The introduction of the GST has not been an easy task owing to it's unique federal arrangement. Following paragraphs will discuss the major steps towards the introduction of GST in India.

### Goods and Services Tax (GST):

GST is a value added tax levied on most goods and services sold for domestic consumption. It is a comprehensive, multi-stage, destination based tax levied on every value addition. It is a tax on goods and services with comprehensive and continuous chain of set-off benefits

from the producer's point and service provider's point up-to the retailer's level [1]. This tax is paid by the consumers, is collected by the government and is remitted to the businesses selling the goods and services. In some countries it is also called as Value Added Tax, as it is a Value Added Tax. The process involved in the collection and distribution of the tax serves as the gamut of this tax, whereby the business adds GST to the price of the product which includes either goods or services or both; a customer buying the product pays GST added to the sales price; and the GST portion is collected by the business or seller and forwarded to the government. It was only in 1954 that GST was for the first time introduced and implemented in France. It stood as an example for as many as 150 countries to adopt this tax system in their desired forms. In most of the countries a single unified GST system has been adopted with a single rate throughout the country. In all these countries almost all products are taxed at a single rate and almost all the central and state taxes have been merged. Only a handful of countries like Canada and Brazil have adopted a dual system where the tax is collected both at the central level and the state level paying heed to the autonomy of the composite governments and their tax administration. Bird, R.M. has described the GST/HST regime of Canada that very nicely explains its role in tax governance [2]. Undoubtedly these examples have served important for the design of GST in India.

### **The CENVAT and the State VAT in India: the improvements they initiated**

In India reforms in the older excise and sales tax regime led to the introduction of CENVAT collected and levied at the central level, the service tax levied at the centre over few services and state VAT collected and levied by states. All of these were multi staged value added tax. As taxation of services was not mentioned in any of the entries, the central government effectuated the power of taxing through the residual entry and went about taxing few services. These service taxes were added to the CENVAT in 2004-05. Article 92C of the constitution limited the power of levying service tax to the union. At the inter-state level the Central Sales Tax or CST was levied by the centre but collected by the states. It was collected at the origin at the reduced rate of 2 percent from the earlier 4 percent. The reduction of this rate from 4 to 2 percent was a step towards rationalisation of the CST regime in a phased manner. The structure of these taxes had been much better than the system that prevailed a few years ago, which was described in the Bagchi Report as "archaic, irrational and complex- according to knowledgeable experts, the most complex in the world" [3]. The Bagchi Report was a blueprint of state VAT design recommended in a 1994 by the NIPFP. In all the years with the introduction of VAT at the central and state level a significant progress has been witnessed towards the improvement of indirect tax structure, widening of base and rationalization of rates. Notable improvements that have been made are-

- 1) Replacement of single point state sales taxes by multi staged VAT across the country.
- 2) Rationalization of the CST rate from 4 to 2 percent towards its removal in a phased manner.
- 3) Bringing the services in the tax regime and expanding its base gradually.

- 4) Rationalization of the CENVAT rates by reducing their multiplicity and replacing many of the specific rates by ad valorem rates based on the maximum retail price of the products.

Hence, these reforms contributed towards enhanced economic efficiency with the resultant increment in revenues.

At the same time it served as a solution to the problem of 'rate war' amongst states whereby the states determined the rates in a highly unhealthy competitive environment proving detrimental to each other's resource generation. It also added to administrative complexities of taxation. The introduction of VAT led to the introduction of rate categories whereby the states could park their goods. Hence, the states put their goods into these rate categories. The introduction of VAT achieved success in terms of harmonisation of sales tax structure through implementation of uniform floor rates of sales tax for different categories of commodities. Hence in this manner rates were harmonised in the VAT regime at the same time the issue of sovereignty of states regarding state tax sources was protected. Also, CENVAT reduced tax cascading through credit payments while the introduction of service tax broadened the tax base.

#### **Deficiencies of the VAT system in India:**

Despite the introduction of VAT at the central and state level in India there remained several unresolved issues. All of these issues necessitated next level reforms in indirect tax regime of India. Some of these issues can be explained as follows;

**Definitional issues:** CENVAT was levied over produced goods. However it gave rise to issues revolving around the definition of manufacturing and issues of valuation as to levy tax on what value. It was recognised that limiting the tax to the point of manufacturing was a severe impediment to an efficient and neutral application of tax, as manufacturing itself forms a narrow base [4].

- a) **Issues in the design of CENVAT and state VAT:** the design of the CENVAT and state VATs was dedicated by the constraints imposed by the constitution, which allowed neither the centre nor the states to levy taxes on a comprehensive base by all goods and services at all points in their supply chain. It was nowhere conducive for evolving a seamless common market for goods and services. In this structure the centre could not tax goods beyond the point of production and the states could not tax services. Somewhere the clear demarcation of tax powers made the nature and application of CENVAT and state VAT partial in nature contributing to further exclusions and inefficiency.
- b) **Exclusion of services:** while the centre taxed selective services, the states could not. In the era of globalization with the expansion in number of services in the supply of goods, denying states to tax services was being seen as a major hurdle towards greater revenue generation. It also created administrative complexities. One can very well imagine why the constitution originally did not include a broad based consumption type VAT at the state level, as it excluded services. Entry 54 in the state list considered the states to levy tax only on the sale of goods and not services. The

expression 'services' was left out of the entry when the constitution was adopted probably because saleable services were not important enough to command a separate identity [5]. However, in the era of globalisation the traditional dichotomy between goods and services became irrelevant, a reason was the advancement in information technology which made this distinction misty. In markets today, goods, services and other types of supplies are being packed as composite bundles and offered for sale to consumers under a variety of supply chain arrangements. Under the prevalent division of taxation powers, neither the centre nor the states could apply the tax to such bundles in a seamless manner with each able to tax only parts of the bundle, creating the possibility of gaps and overlaps in taxation [6]. Hence this exclusion of services from the ambit of sales taxation was proving to be a major flaw of the Indian economy.

- c) **Issue of tax cascading:** tax cascading was not removed completely in the previous reform measures when CENVAT and State VAT were introduced in the country. It occurred under both centre and state taxes. There was a mixture of factors leading to cascading. A very important factor was partial coverage of central and state taxes within the VAT regime. The CENVAT suffered from the same shortcomings as did MODVAT- its structure did not reflect the exact principles of general VAT as practiced in other countries on account of concessions, exemptions and reintroduction of deemed credit scheme (which was withdrawn in the budget of 2003-04) in textile industry [7]. A range of goods and services remained outside the ambit of CENVAT and service tax levied by the centre. This prevented the exempt sectors to receive invoice credit as setoff for the CENVAT and service tax paid on inputs. The geographical location of a factory was another factor leading to exemption. The exemptions were granted to several goods manufactured in the north east, J&K, Uttaranchal, Himachal Pradesh, Sikkim and Kutch (Gujarat). On certain conditions even several small scale industries were exempted. There was extreme populism involved in geographical exemptions [8]. Such exemptions were granted for purposes like packing, labelling etc. which are activities of production with less role of investment, however exemptions based on geographical locations were provided in the name of enhancement in investment and resultant employment generation. There were on this account, three good suggestions in the ParthasarathiShomeCommittee report, that raw materials and capital goods should not be distinguished for giving credit and all goods should be declared eligible for CENVAT, except those in a negative list.

When talking about state VAT inputs of exempt sectors like the real estate, service sector, agriculture, oil and gas production and mining were not paid with setoff credit. This contributed to tax cascading. Cascading even happened at the inter-state level where CST was an origin based tax with no credit given by any level of government. One would expect the magnitude of cascading under the CENVAT, service tax and state VAT to be even higher, given the more restricted input credits and wider exemptions under these taxes [9].

- d) **Issue of complexity:** the administrative structure of CENVAT, state VAT and CST involved a lot of complexity which can be attributed to several factors. Policy related factor was the most important with states having their own policies related to indirect taxes. There were the issues of unnecessary exemptions, multiplicity in tax rates and irrational structure of levies. In the VAT regime individual taxes were highly differentiated in the states which further had negative impacts on tax administration. A typical example was of how few states taxed selectively taxed agricultural products while others did not. Differentiated rates further led to leakages and distortions. Hence, multiple VAT rates owing to differences in tax administration served as a major source of complexity. The prevalent indirect taxation system not only provided unequal tax base between the centre and state governments but also distorted the consumer choice by differential taxation of goods and services[10]. When talking about CST one cannot deny the fact that it was an added cost on manufacturers and dealers who acquired goods from other states. Many times inter-state movement of goods were given the definition of consignment or branch transfers by the dealers which made transfer of input tax credit impossible. This added to complexities and could be seen as a type of evasion.
- e) **The origin based Central Sales Tax and issues inherent:** though the Central Sales Tax over time was reduced from 4 to 2 percent, it was still not a destination based tax. When the goods were sold from the origin state to the final consumers, the origin state levied state VAT while the destination state did not receive any tax over the transaction. It served to the detriment of the finances of destination states.

### **Justification for GST:**

One could not underestimate the fact that both CENVAT and state VAT were suffering from multiple deficiencies and the ultimate realisation of tax reforms needed urgent action. A major limitation was that both were under-utilised. CENVAT could not include a range of central taxes within its structure for example additional customs duty, surcharges etc and resultantly a number of dealers could not avail the credit set off. Also, inputs were not credited at the level of state VAT. In the era of Globalization, businesses involved a combination of manufacturing, sale as well as provision of services, where the same business could not avail credit for excise paid on the manufacture, as credit was only provided at the value added to the product. Hence, what we understand is that there were breakages in chain, despite introduction of VAT. In the state level VAT scheme the CENVAT load on the goods remained in the value of goods, which were not paid set off, adding to the cascading element. Another problem at the state level that was prominent was that a range of indirect taxes, for example, Luxury tax, entertainment tax etc existed and functioned outside the VAT. Also, at the state level services were not taxed and hence further added to the cascading element. The introduction of GST at the central level would lead to several benefits. It would not only incorporate comprehensively more indirect central taxes and integrate goods and services taxes for the purposes of set off relief, but will also cause buoyancy in revenues for the centre through widening of the dealer base by capturing value

addition in the distributive trade and increased compliance. GST will provide for credit payments at all levels from the production stage to service provider's stage and finally to the retailers stage and hence would remove the cascading effect of CENVAT, state VAT and service tax. The main feature of VAT/GST is their neutrality, irrespective of the nature of product and services, the structure of the distribution chain and the technical means used for its delivery[11]. Even before the introduction of VAT, notable economists like MG Rao had suggested that "it would perhaps be more practical to enable both the centre and states to levy VAT at the retail level. As Cnossen also concludes that GST would be significant in the indirect tax reform and the realisation of a single common market in India [12]. Also, with the introduction of GST, burden of central sales tax will also be removed as GST would be a destination based tax. The GST at the state level has been justified on certain grounds like; additional power of levy of taxation of services for the states, system of comprehensive set off relief, subsuming of several taxes in GST, removal of burden of CST[13].

Beyond all these benefits the GST would bring with its introduction, its significance towards forming a single common market remains the most remarkable. One of the important arguments that drove the reform towards a comprehensive GST in India was to remove all impediments to forming a single common market covering all the states [14]. The aberrations in the prevalent structure of VAT at the state level with improper input tax credit and origin based inter-state tax had injured this idea of a single common market. As MG Rao in a popular article mentions "the reasons for the popularity of the tax have to be found in the fact that it has been a revenue spinner, a well designed GST has much lower distortions than both the tariffs and any other broad based consumption tax, and as the tax is supposed to be self assessed it minimises the compliance cost as well" [15]. It becomes important to clarify that, GST is just an improvement over the prevailing consumption tax system functioning at the centre and states. Thus, GST is not a new tax, but simply a more comprehensive VAT on goods and services[16]. The gradual move from sales tax towards VAT has been the groundwork for eventual move towards a comprehensive nationwide GST.

### **Preparation for introduction of GST: The Legal Moves:**

Buoyed by the success of VAT and mindful of the need for further improvement, the Government of India indicated in Feb 2007 that a roadmap for introduction of destination based GST in the country by 1 April 2010 would be prepared in consultation with the Empowered Committee (EC) of state finance ministers[17]. The then Finance Minister made this declaration in the Union Budget 2006-07. The EC prepared 'A Model and Roadmap for Goods and Services Tax in India' in April 2008 which culminated into the 'First Discussion Paper on Goods and Services Tax in India' in November 2009 [18]. The paper dealt with the issue of taxes to be subsumed and at the same time the implementation of the GST. It was in the year 2011 that regarding GST the 115<sup>TH</sup> Amendment Act was introduced in the parliament. The Standing Committee (2012-13) on Finance under the chairmanship of YashwantSinha sent its seventy third report on this amendment act in August 2013. Regarding introduction of GST again in the year 2015, the 122<sup>nd</sup> Amendment Act was brought in the parliament. The Lok Sabha Passed the bill on 6 May 2015 and passed it to



RajyaSabhafor consideration. It was then referred to the Select Committee of RajyaSabha which submitted its report on the bill on 22<sup>nd</sup> July 2015. It recommended a few changes to the amendment act. The bill could not be taken up for voting in the monsoon session of the parliament (21 July-31 August 2015). The Bill was finally passed by the RajyaSabha on 3 August 2016 and the amended bill was then passed by the LokSabha on 8 August 2016. The Goods and Services Tax in India came into effect from July 1, 2017 through the implementation of One Hundred and First Amendment of the Constitution of India by the NDA government.

### **From VAT to GST- choices with states and the key oppositions:**

The states took several years to reform their indirect taxes by replacing the cascading sales tax regime with an intra state VAT. The VAT was implemented in April 2005 with some states like Tamil Nadu and Uttar Pradesh joining the league and implementing it only later. Even, when the idea of GST was mooted and the bill for it was presented, for the first time in 2011; it was opposed by states like Gujarat, Madhya Pradesh, Tamil Nadu West Bengal etc. Unlike the VAT reform in which the states which did not want to join could be left out, GST reform required that all the states should with a consensus join together in implementing the reform. Hence, the concurrence of all the state governments was necessitated. Gujarat and Madhya Pradesh had initially many reservations with the bill when introduced in 2011. Both were in the forefront opposing it initially. In the standing committee report on GST it was mentioned that Gujarat would face revenue loss of Rs. Nine Thousand Crore with expected loss due to removal of cascading effect, inability to achieve revenue neutral rates, loss of CST revenues and the suboptimal collections from service sector [19]. Similarly Madhya Pradesh initially highlighted the issues of state's fiscal health with revenue loss, no autonomy to make changes to the rate structure and meagre compensation to poor backward states due to less consumption of taxable services. However, the reservations had diluted with subsequent changes made to the bill by 2015. Shri A. Navaneethakrishnan, an MP in RajyaSabha representing Tamil Nadu said, "earlier, the hon. Prime Minister, when he was the Chief Minister of Gujarat, was dead against this bill, but now he is supporting this bill, which is a political stand" [20]. On the other hand, states like Tamil Nadu, West Bengal opposed the bill even in 2015. West Bengal Chief Minister Mamta Banerjee announced that her government opposed the GST in the form it was introduced by the government as it did not help the unorganised sector [21]. On the other hand, the main issue for Tamil Nadu was that being a destination based tax GST had revenue loss to it as it was a manufacturing state. In the state assembly of Jammu and Kashmir the opposition opposed the GST as being at the cost of fiscal autonomy and special status of the state, as the state Congress President claimed, "adequate safeguards should be incorporated in the GST regime as was proposed by the NC-Congress cabinet in 2012-13, keeping in view the special constitutional status given to the state" [22].

**Salient features of GST in India:**

The goods and services tax propounded and introduced in India after several discussions was characterised by certain key features which can be discussed as follows:

- The GST in India is a dual in nature comprising two components. It will be a concurrent tax levied by both centre and states. The component levied by centre is referred to as CGST (Central Goods and Services Tax while that levied by the state is referred as SGST (State Goods and Services Tax). The CGST and the SGST are to be paid to the accounts of the centre and the states separately.
- Accordingly, article 246A was inserted in the constitution, through which, both the parliament and the state legislatures are empowered to make laws with respect to goods and services tax imposed by the union or by the state which imposes the tax within its boundary. At the same time, in case of inter-state sale of goods and services only the parliament has power to make laws [23].
- The Central Taxes subsumed in GST are:
  - Central Excise Duty
  - Additional Excise Duty
  - Excise duty levied under the Medicinal and Toilet Preparations (Excise Duties) Act, 1955
  - Service tax
  - Additional Customs Duty (countervailing duty)
  - Special Additional Duty of Customs
  - Central surcharges and cesses (related to supply of goods and services)
 While the state taxes subsumed are:
  - State value added tax/sales tax
  - Entertainment tax (other than tax levied by the local bodies)
  - Central Sales Tax (levied by the centre and collected by the states)
  - Entry Tax (in lieu of octroi)
  - purchase tax
  - luxury tax
  - taxes on lottery, betting and gambling
  - state cesses and surcharges (related to supply of goods and services)
- Both the SGST and the CGST will be simultaneously collected on all transactions of goods and services except the exempted goods, goods outside the purview of GST and transactions less than the determined threshold level.
- At the inter-state level, the Integrated Goods and Services Tax will be collected by the central government with the cross utilization of tax credit. Hence, there has been insertion of a new article in the constitution- article 269A which discusses the kind of tax to be collected in course of inter-state trade or commerce.
- The CGST and the SGST are to be paid to the accounts of the centre and states separately with no cross utilization of tax credits between the central GST and the



state GST except in the case of inter-state supply of goods and services under the IGST model.

- Across states, there will be a uniform procedure for collection of both Central GST and State GST in the respective legislation.
- There will be establishment of a GST Council which will be the highest body to examine and study and make recommendations on issues related to GST to central as well as state governments. This was done through the insertion of a new article 279A, which says that within sixty days of onset of the constitution 101<sup>st</sup> amendment act 2016 which introduces GST, the President shall by order constitute the Goods and Services Tax Council which shall be constitutive of the Union Finance Minister as Chairperson, the Union Minister of State in charge of Revenue or Finance as Member and the Minister in charge of Finance or Taxation or any other member nominated by each state government as member. The Quorum of the council would consist of one half of the total members of it. A majority of not less than three fourths of members present and voting in a meeting would form a decision with the weightage of central government being one third of the total votes and that of state governments being two thirds of the total votes cast. The council should take care of arbitration of any quarrel between the central government and the states, between two or more states and between the central government and any state or states on one side and one or more states on other side.
- Based on the recommendation of the Goods and Services Tax Council, the parliament shall, by law, provide for compensation to the states for loss of revenue arising on account of implementation of the Goods and Services tax for a period of five years.
- As per the amendment, commodities like petrol, diesel, aviation turbine fuel, natural gas and crude petroleum will be included in GST on a subsequent date based on the recommendations of the GST Council [24].
- The treatment of sin goods becomes important to be discussed. The prominent ones being alcohol and tobacco. Alcohols for consumption will remain outside the purview of GST, with the states sustaining their rights to collect excise on alcohols for consumption as it has revenue implications for them. On the other hand tobacco has been incorporated in GST with states collecting SGST and the centre collecting CGST and additional excise duty.

### **Conclusion:**

The sales tax regime had witnessed extreme case of 'tax exportation' leading to rate war, where the rich manufacturing states generated revenue at the expense of poor consuming states. The real problem was the nature and performance of an origin based CST. Again, tax cascading due to breakages in the credit chain with incomplete tax credit provided to businesses was another issue in a blooming service economy. Globalisation and other issues of disparity between states necessitated tax reforms. Hence, GST was the need of the time with VAT being just a baby step towards its realisation.

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