Fiscal Deficit and Goods and Services Tax (GST) in India: Issues and Challenges

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Background

The Fiscal deficit of India is currently increasing at very fast rate and strict measures needs to be undertaken to bring it under control to avoid serious consequences. According to Kelkar committee report, the trends in the current year, 2012-13, suggests a likely fiscal deficit of around 6.1 percent which is far higher than the budget estimate of 5.1 percent of GDP, if immediate mid-year corrective actions are not taken. Runaway fiscal deficits, leading to unsustainable levels of public debt, can cause diverse forms of macroeconomic imbalances varying with the means through which the deficit is financed. High fiscal deficits tend to heighten inflation, reduce room for monetary policy stimulus, increase the risk of external sector imbalances and dampen private investment, growth and employment. The current account deficit was already high at 4.2 percent of GDP in 2011-12 and could deteriorate further. Apart from this, the consequences of not quickly taking credible effective measures for correcting the current fiscal deficit is likely to be a sovereign credit downgrade and flight of foreign capital. This will invariably further weaken the rupee and negatively impact the capital markets and the banking sector. High fiscal deficit limits the scope for reduction in interest rates, which may severely impact the growth of private sector.

When we compare India’s fiscal deficit with other emerging nations, we get a clear picture. Cross-country benchmarking suggests that India is clearly an outlier in terms of major fiscal indicators and currently has the least room for counter-cyclical fiscal policy response. According
to the report India stands second only to Egypt among 27 major emerging markets, measured in terms of inflation, real interest rates, exchange rates, current account deficit, cyclically adjusted budget balances and general government debt levels. The situation is all the more dangerous now, much more so than in the past, because we have a surge in young people looking for jobs. For India, elasticity of employment to GDP growth is 0.4 then growth. Say for GDP growth rate of about 7 per cent per annum, would give us 2.8 per cent employment growth. With a labor force growth of 2.5 per cent, this would provide adequate employment opportunities. However, if growth slips to say six percent (at which it currently is), and employment growth slows below 2.4 per cent, unemployment would rise. We cannot overemphasize the need and urgency of fiscal consolidation. Growth rate is coming down and inflation seems to give us no sound sleep. The external payment situation is at alarming level. The global economy is likely to be more turbulent, making repayment of external borrowing more difficult. Potentially, if no action is taken, we are likely to be in a worse situation than in 1991 for several reasons.

The process of fiscal consolidation will cause some short term pain which should equally be shared. With determined policy action and smart political moves, the pain of self imposed fiscal correction now will avoid the pain of externally enforced involuntary fiscal correction few years down the line.

**Recommendations of Kelkar Committee**

The Kelkar Committee (September 2012) appointed by Government of India for addressing the issue of fiscal consolidation came up with various recommendations to bring fiscal deficit under control. For our research we consider implementation of GST as one of the most important areas through which fiscal deficit can be controlled.
Introduction

GST is a form of indirect tax which Govt. of India is planning to introduce. It is considered to be an extension of Value added tax (VAT). Prior to the introduction of VAT in the Centre and in the States, the people bore the burden of multiple taxation in the form of pre-existing Central excise duty and the State sales tax systems. Inputs were first taxed, and then after the produced goods with input tax load, were taxed again. This resulted in a problem of multiple taxation with had cascading effect.

When VAT was introduced in place of Central excise duty, a set-off was given, i.e., a deduction is made from the overall tax, as the inputs were already taxed. In the case of VAT in place of sales tax system, a set-off is given from tax burden for input tax paid, and also for the tax paid on previous purchases. With VAT, the problem of cascading effect of tax was removed. Benefit of set-off can be obtained only if tax is duly paid on inputs (for Central VAT), and on both inputs and on previous purchases (for State VAT).

Need for GST

Although the VAT is successful, there are still certain shortcomings in the structure of VAT (at both the Central and at the State level). For Central VAT (CENVAT) of the Government of India, there are several Central taxes, such as additional customs duty, surcharges, etc, which are not included under CENVAT, and thus keeping the benefits of comprehensive input tax and service tax set-off out of reach for manufacturers and service providers. Value-added chain in the distribution trade is out of the loop of CENVAT. The introduction of GST at the Central level will include comprehensively more indirect Central taxes and integrate goods and service taxes for the purpose of set-off relief, and also widen the dealer base by capturing value addition in the distributive trade and increased compliance. The will ultimately result in increase in the revenue for the government.

For state level VAT, there are several indirect taxes on goods and services, such as luxury tax, entertainment tax, etc., which are not included in under the umbrella of VAT. Moreover, in the present State-level VAT scheme, CENVAT load on the goods are included in the goods to be
taxed under State VAT, and thus resulting in multiple taxation. This CENVAT should be removed to avoid taxing same commodity 2 times.

Today, majority of goods are produced by the combination of physical inputs and services, which demands the integration of VAT on goods with tax on services at the State level, with the close eye to avoid cascading effect service tax.

GST will remove cascading effects of CENVAT and service tax with set-off, and establish a continuous chain of set-offs from the original producer’s point (as well as service provider’s point) up to the retailer’s level. This is the core idea of GST. Till now the power to levy taxes on services was with central government, however GST ask these powers to be shared with the states. A Constitutional Amendment requires to be made for giving this power also to the States.

The GST at the State-level is important for the following reasons:
(a) System of comprehensive set-off relief, including set-off for cascading burden of CENVAT and service taxes,
(b) Subsuming of several taxes.
(c) Removal of burden of CST.
Because of the removal of cascading effect, the burden of tax under GST on goods will fall.

**Highlights of GST**

The basic principal governing behind GST is to have single Taxation System for Goods and Services across the country. Currently Indian economy has various taxes on Goods and services such as Sales tax, Service tax, Excise, Entertainment tax, Luxury tax etc. The new proposed system will have the below mentioned taxes:
a. State Level GST (SGST)
b. Central Level GST (CGST)
In case of Central GST, following Taxes will be subsumed under CGST. Currently, these taxes are separately levied by the central government.

- Central Excise Duty
- Additional Excise Duty
- Service Tax
- Additional Custom Duty (CVD)
- Special Additional Duty
- Education Cess and Secondary and Higher Secondary education Cess

Following taxes will be subsumed with SGST. Currently, these taxes are separately levied by the state government.

- VAT/ Sales Tax
- Entertainment Tax (unless it is levied by local bodies)
- Luxury Tax
- Tax on lottery
- State cess and Surcharge to the extend related to supply of goods and services.

The basic principal for subsuming of taxes in GST is provided as follows:

- Those taxes which are associated with import / manufacture /production of goods or provision of services at one end and the consumption of goods and services on other end.
- The taxes, levies and fees which are not related to supply of goods & services should not be subsumed under GST.

Taxes on items containing alcohol and petroleum product will continue to be taxed as per existing practices. Tax on Tobacco products will be subject to GST. But government has power to levy extra tax.

The taxpayers whose gross annual turnover is less than Rs.1.5 Crore are exempted from CGST and SGST.

PAN based identification number will be allowed to each taxpayer to have integration of GST with Direct Tax.

Exports are fully exempted with Zero rates.
GST Rate Structure:
Two Rate Structure
  ➢ A lower rate for necessary items and goods of basic importance
  ➢ Standard rate for goods in General

Important divisions under GST

Charging Tax
The dealers registered under GST (Manufacturers, Wholesalers and Retailers and Service Providers) are required to charge GST at the specified rate of tax on goods and services that they supply to customers. The supplier must deposit this amount of GST with the Government.

Getting Credit of GST
If the recipient of goods or services is a registered dealer, he can claim a credit for the amount of GST he has paid, provided he holds a proper tax invoice. This “input tax credit” is set off against any GST (Output), which the dealer charges on goods and services, which he supplies, to his customers.

Ultimate Burden of Tax on Last Customer
To sum it up in a simple way, the dealers or the service providers acts as a tax collecting agents for the government. They charge GST, but do not get to keep the money with themselves, they to deposit it to government. The ultimate burden of the tax falls on the end consumer of the goods and services, as this person gets no credit for the GST paid by him to his sellers or service providers.

Tax Period
The tax period will have to be decided by the respective law and normally would be monthly and/or quarterly. On a particular tax period, which is applicable to the dealer concerned, the dealer has to deposit the tax if his output credit is more than the input credit after considering the opening balance, if any, of the input credit. Basically is the net off the position at the input and the output stage of trade.
Registration
Dealers will have to register themselves for GST. This category of people includes the service providers, suppliers, wholesalers, manufacturers, and retailers. An unregistered dealer doesn’t have the power to charge GST to his customers. He can neither claim credit for the GST paid by him nor can he issue tax invoices.

Exempted Goods and Services
Certain goods and services may be declared as exempted goods and services and in that case the input credit cannot be claimed on the GST paid for purchasing the raw material in this respect or GST paid on services used for providing such goods and services.

Refunds
If for a tax period the input credit of a dealer is more than the output credit then he is eligible for refund subject to the provisions of law applicable in this respect. The excess may be carried forward to next period or may be refunded immediately depending upon the provision of law.

Zero Rated Goods and Services
Export of goods and services are zero-rated and GST paid by the exporters of these goods and services is refunded. This is the main difference between ‘Zero rated goods and services’ and ‘exempted goods and services’.

Tax Invoice
Tax invoice is an important document in the GST and a dealer registered under GST can issue a tax invoice and on the basis of this invoice the credit (Input) can be claimed. Normally a tax invoice must bear the name of suppliers’ details, purchasing dealers details and the description of goods sold or service provided.
Issues and Challenges for GST implementation in India

Legislative Challenge
As per the announcement from the ministry of finance, the GST was supposed to be implemented by April 2010. However it didn’t materialized. The actual challenge is not of drafting a model GST but of its proper implementation and smooth transition from the current system of taxation to the GST. The nation’s forward march towards globalization, demands important changes in financial system, insurance sector, foreign exchange regulations, etc. with an aim of attracting more investments in the manufacturing and service sectors. From both domestic and foreign investment perspective a suitable reform in Indirect tax is required to do away with the multiplicity of taxes thereby reducing tedious compliance, high cost of transaction and uncertainty in tax liability for a business.

Simple taxation regime will change the outlook of the business community from having tax-driven model to focus more on growth of the company. GST is a tax on every economic supply in the distribution chain which adds value to the product in making. The taxable event is ‘supply of goods’ and ‘supply of services’. Any transfer of right to use goods will constitute supply of goods, and, any supply not involving goods will be supply of service. However, the tax is worked out on the value-added component of the supply. This can be done by calculating the intrinsic value of the product before it is processed and after it is processed and giving set off/credit of tax suffered at previous stage, called input stage, to avoid cascading effect. Thus, the entire supply chain up to final consumer gets taxed with in-built mechanism of input stage credit.

As supplies not involving goods will be supply of service, the umbrella for services will be very large. Global standards are considered for taxing of services. At the outset, Government of India has to deal with several challenges. The federal character of the Constitution of India is essentially the independence of States to raise their own revenues and manage their expenses, and accordingly the Constitution provided powers to the Union territories and the States to levy and collect taxes. In order to enable the Centre and the State Governments to levy GST, the Constitution of India requires amendment to provide for powers to levy and collect GST both by the Union and the States, and making the existing power of states and Union as null. If the power is handed over to Union, then the Central Government can implement a single GST law for the
Union and the States. However, if the power is divided between the Centre and the States, then the States can exercise its own power to raise revenue without any interference from central government. It is important to have a common opinion among different states when it comes to giving up of its power to charge taxes. A common GST is the need of the hour which will ensure a seamless taxation regime to function across India.

**Revenue sharing arrangement**
Currently most of the states require financing from the central government over and above the money raised by them through taxation, as the expenditure is more than revenue generated by them. The dual GST system will offset certain industry from Centre to States thus resulting in reduction in the revenue generated for the Central government. Ultimately, this will make centre to depend on revenue-rich States to share funds with revenue-low States.

There are many challenges to deal with type of mechanism. Below mentioned are few them:
- Proper revenue accounting and collection
- Technological up-gradation
- Revamping banking system for State-wise revenue allocation
- Political willingness and support etc.

New tax system should ensure that states get adequate funds to finance governance and development. India, being an emerging nation, will need funds constantly and the need will rise in the coming years. Central Government will have to do a balancing act between the revenue-rich States and revenue-low States by properly sharing the revenue as per their needs.

**Effective Credit Mechanism**
The success of dual GST model will depend on effective credit mechanism to avoid cascading effect of multi-stage taxation in the supply chain. The effective credit mechanism is the backbone of the new tax system. For Central GST, it is easy to give credit anywhere in India. This can be seen from the success of the present CENVAT scheme. But, for State GST presently there are issues in giving credit to inter-State transactions. The challenge is to treat both the Centre GST and State GST as a single point to make way for credit across India in a seamless manner. Moreover, the credit should be allowed for all inputs, raw materials, capital goods, input services and all business expenses treating the business entity as a unit. It is essential to have
broad based definition for input goods and input services to avoid eruption of any kind of litigation in future. Even a single litigation at any point of operation of the company will hamper the functioning of the successive points in the supply chain.

**Dealing with transitional issues**
There are a many customs duty exemption notifications which control various schemes under Foreign Trade Policy which are linked to the system of extant regime under customs and central excise. The transition to GST will affect such schemes. The impact could be very huge and may leads to chaos and uncertainty. A large number of agreements between the import houses and government, export houses and government will have to be suitably amended for changed liability in view of new GST. The Government should devise special mechanism and provisions to deal with such kind of issues. In case of offence related to conditions mentioned in Foreign Trade Policy or Customs exemption notifications or agreement, GST should provide with proper document to work out the liability, which will avoid the need to refer to past provisions.

**Centralized Administration for large units**
Large tax paying units with branches across India will face problem of multiplicity of compliances. Respective State GST may not exempt such units. The difficulty would be to provide ease of compliance to such units. Centralize registration should be place for credit/set off and payment for large units, to avoid multiplicity of compliances under different taxing jurisdictions. This will be dealt under central GST.

**Explosion of Assesses**
The dual GST model will increase the number of assesses. The main reason is taxing to every economic supply in the distribution network. The new GST regime requires a paradigm shift in taxation. The new system will align India with global tax system. It will see the nation having uniform tax structure. Business houses will have to change their model of operation to avoid burdening its customers with additional tax, with an eye on having competitive price of its product. The new system will bring in transparency in the economy, the government needs ot take care that it doesn’t burden the end consumer beyond his capacity.
Conclusion

The problem of fiscal deficit is one of the serious issues before Govt. of India. Many experts have suggested measures to control this problem. The FRBM Act was also passed for addressing this issue. However, in spite of these developments, the problem is not under control as per expectations. The approach by the Govt. so far is controlling expenditure and there by fiscal deficit. What is required is to focus on revenue side also. In this regards, the GST is an effective solution. Introduction of GST is not only will increase revenue of the Govt. but also simplify the tax structure in India. However, introduction of GST is not an easy task. Govt. needs to address the execution of legislation passed for GST. Smooth transition from existing tax system to GST is challenging. Revenue sharing is another big challenge before the Govt. as the State always wants to have more shares in the revenue of the Centre. Administration issues are also a hurdle in GST implementation. Many Trade Associations and Chambers of Commerce have reservations about certain provisions of GST. Thus, taking the affected parties into confidence by making them aware about its benefits is absolutely necessary. Above all political commitment for implementation at the earliest would certainly help to control the fiscal deficit.

References

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