Challenges and Reforms in India’s Taxation System

For Prelims: **Goods and Services Tax (GST)**, **Taxes**, **Investments**, **Minimum Alternative Tax (MAT)**, **Capital Gains Tax**, **Securities Transaction Tax**, **Corporate Tax**, **Dividends**, **101st Amendment Act, 2016**, **GST Council**, ***Vodafone International Holding Case, 2012***, **Input Tax Credit**, **Tax Evasion**.

For Mains: GST, Challenges and reforms needed in India’s taxation system.

Source: IE

Why in News?

The current tax system, particularly under the **Goods and Services Tax (GST)** framework, **retards growth** that **hinder business development**, suppress consumption, and damage India’s investment reputation.

How is the Tax System in India?

- **About taxes: Taxes** are **mandatory** financial charges or **levies** imposed by a government on **individuals, businesses, or property** to fund public services and government operations.
    - There is **no quid pro quo** between the **tax payer and the public authority**.
    - The Tax System in India consists of a **mix of Direct Taxes, Indirect Taxes and Other Taxes.**
- **Types of Taxes:**
    - **Direct Taxes**: They are **paid by individuals or entities** to the government and **cannot be transferred** to others.
    - **Indirect Taxes**: They are levied on goods and services, **collected by intermediaries from consumers** at the point of sale, and remitted to the government.
    - **Other Taxes**: These taxes are levied for **specific purposes**, often funding **infrastructure or welfare programs**.
- **Direct Taxes:**
    - **Income Tax**: It is imposed on **income** that is progressive in nature, with different slabs for various **taxpayer categories.**
    - **Capital Gains Tax**: Tax on gains from **investments**, with different rates for short-term and long-term holdings.
    - **Securities Transaction Tax**: Tax on **transactions involving securities** in the stock market.
    - **Perquisite Tax**: Tax on **benefits provided by an employer** to employees (e.g., housing, cars).
    - **Corporate Tax**: Tax paid by companies on their **earnings**, with **different slabs for various income levels.**
        - **Minimum Alternative Tax (MAT)**: MAT ensures companies pay a minimum tax, set at **18.5%**.

        - **Fringe Benefit Tax (FBT)**: Tax on **non-cash benefits** provided by employers (abolished in 2009).
        - **Dividend Distribution Tax (DDT)**: Tax on **dividends** paid by companies.
        - **Banking Cash Transaction Tax**: Tax on banking transactions (abolished in 2009).
- **Indirect Taxes:**
    - **GST**: A consumption-based tax on value-added goods and services (**ad valorem tax**), levied at each stage of the supply chain.
        - It is **regressive in nature** as it is imposed at the **same rate** on all individuals **irrespective of income**.
    - **Value Added Tax (VAT)**: Tax on goods sold, applied at each stage of the supply chain. It is imposed on goods that are **excluded from the GST regime** like alcoholic beverages, petroleum products etc.
    - **Custom Duty & Octroi**: Taxes on imported goods (Custom Duty) and on goods crossing state borders (Octroi).
    - **Excise Duty**: Tax on goods manufactured within India.
- **Other Levies (Cess):**
    - **Education Cess**: A **2% tax** to fund educational initiatives like developing classrooms, libraries, providing **scholarships** etc.
    - **Swachh Bharat Cess**: Tax introduced in **2015** to fund **cleanliness initiatives** like **Swachh Bharat Mission.**
    - **Krishi Kalyan Cess**: Tax introduced in **2016** to support **agricultural welfare** like **irrigation projects, subsidized seeds** etc.

What is the Goods and Services Tax (GST)?

- **About:** GST is a **value-added tax** applied to goods and services for **domestic consumption.**
    - It is an **indirect tax** i.e., while **consumers pay the GST**, it is **collected and remitted** to the government by the **businesses** selling the goods and services.
- **Legislative Basis:** The **101st Amendment Act, 2016** established the **GST system** by introducing a single **indirect tax regime** for the entire country by subsuming various taxes.
    - **Central taxes** subsumed under GST are **Central Excise Duty, Additional Excise Duties, Service Tax, etc.**
    - **State taxes** subsumed under GST are **State VAT (Value Added Tax), Central Sales Tax, Luxury Tax, etc.**
- **Main Features:**
    - **Supply Side:** GST applies to the **supply of goods and services**, unlike the old tax on manufacturing, sale, or provision.
    - **Destination-Based Taxation:** GST follows **destination-based consumption** taxation, **unlike the origin-based system**.
    - **Dual GST:** Both the **Centre (CGST) and States (SGST)** levy tax on a common base.
        - **Imports** of goods or services are treated as **inter-state supplies** and are subject to **Integrated Goods & Services Tax (IGST)** along with applicable **customs duties.**
    - **GST Council: CGST, SGST, and IGST rates** are mutually decided by the Centre and States, based on the **GST Council**'s recommendations.
    - **Multiple Rates:** GST is levied at five rates i.e., **0% (nil-rated), 5%, 12%, 18%, and 28%**, with item classifications determined by the **GST Council**.
- **GST Council: Article 279A** establishes the GST Council, headed by the **Union Finance Minister** and comprising **state-nominated ministers.**
    - The **Centre holds 1/3rd voting power**, while **states have 2/3rd,** with **decisions** made by a **3/4th majority**.

What are the Challenges in the Current Taxation System?

- **Retrospective Taxation**: The **55th GST Council**’s recommendation for a **retrospective**

tax amendment is a **regressive move** that disregards Supreme Court (SC) rulings.
  - The ill-advised retrospective amendment to **nullify** the **Vodafone verdict** resulted in an **international penalty of Rs 8000 crore**, which India had to pay.
    - In 2014, the former Finance Minister **Arun Jaitley termed retrospective taxation "tax terrorism".**
  - This **erodes investor confidence** and discourages long-term investments, as companies cannot rely on consistent rules.
- **Revenue Maximisation:** The GST Council's single-minded **focus** on **maximizing revenue** results in **arbitrary and exaggerated tax demands**, leading to business frustration and inefficiencies.
- **Input Tax Credit Denial**: Denying businesses **input tax credit,** particularly in sectors like real estate, is economically detrimental.
  - This **increases the final price** for consumers, **distorts market competition**, and dampens sectors that could stimulate growth.
  - In the ***Chief Commissioner of Central Goods and Service Tax & Ors. Vs Safari Retreats Case, 2024,*** the SC ruled that the real estate sector can claim **Input Tax Credit (ITC)** on construction costs for **commercial buildings used for renting or leasing purposes** that was earlier not allowed.
- **Complicated Tax Structure**: The multiple tax rates in both indirect and direct taxes, complex tax notifications, **complicated system of exemption and concessions**, and circulars create an environment that **benefits tax professionals** rather than businesses.
- **Low Direct Tax Collection:** Corporations, particularly **multinationals,** use **transfer pricing** to shift profits from **high-tax to low-tax jurisdictions**, reducing their tax liabilities.
  - Some corporations **underreport their income or overstate their expenses** to reduce their tax liability.
  - Such **low direct tax collection** forces the government to generate revenues from other sources like **high indirect tax rate, surcharge, and cess**.

What are the Consequences of Complex Tax Structure?

- **Imports Dependency**: A burdensome tax system makes **domestic manufacturing less competitive** compared to imported goods, leading to **over-reliance on foreign products.**
  - E.g**., imports** from China increased from **USD 70 billion in 2018-19 to USD 100 billion in 2023-24.**
  - It also leads to **inverted duty structure** where the **rate of tax on inputs** used is **higher** than the **rate of tax on the finished goods**.
    - The share of manufacturing in India's **GDP has fallen below 15%.**
- **Currency Depreciation**: As businesses face higher costs, reduced competitiveness, and suppressed growth, it leads to **weakening of the Indian rupee** and escalating the trade deficit.
  - It can lead to **twin account deficits** when a country has both a **fiscal deficit** and a **current account deficit**.
- **Investment Discouragement**: A complicated tax system, with **unclear structures and retrospective amendments,** creates uncertainty for investors and negatively impacts **ease of doing business**.
- **Lower Revenue Collection**: Businesses struggle to navigate the complex tax system, resulting in either **underreporting or tax evasion.**
  - Lower revenue collection forces the government to **resort to higher taxes** to meet fiscal targets, which leads to a **cycle of stagnation**.
- **Downward Economic Spiral**: Lower growth, reduced investment, and rising imports create a vicious cycle that **undermines long-term economic stability and perpetuates inefficiencies.**

Way Forward

- **Streamline GST:** A more **simplified and uniform tax rate structure** should be introduced to ensure ease of doing business, especially in sectors like real estate and infrastructure.
  - India must focus on simplifying the tax framework by rationalizing rates. E.g., three GST rates on popcorn i.e., **Unlabelled (5%), Labelled ready-to-eat (12%) and Caramelized (18%).**

- **Tax Certainty:** Avoid frequent amendments or **arbitrary tax demands** that are essential to establish clear and consistent tax rules.
    - **End retrospective taxation** that has been **detrimental** to investor confidence.
- **Optimize Revenue Collection**: Leverage **digital platforms and artificial intelligence** to improve tax collection efficiency and prevent evasion.
    - Technology can help in identifying **tax anomalies**, ensuring businesses report accurately, and preventing underreporting.
- **Focus on Economic Growth**: The tax system should **prioritize long-term growth over revenue maximization,** as a growth-oriented policy expands the tax base in the future.
- Improving **Corporate Tax Collection:** Conduct regular and thorough audits of corporate tax filings to **identify potential underreporting, evasion, or fraud.**
    - Offer incentives like **early payment discounts** or **lower penalties for early voluntary disclosures** of tax errors or omissions to encourage companies to pay taxes on time.

Drishti Mains Question:

Q. Analyze the impact of a complex taxation system on functioning of India's economy and suggest reforms to enhance its competitiveness.

UPSC Civil Services Examination Previous Year Question (PYQ)

Prelims

Q.Consider the following items: (2018)

1. Cereal grains hulled
2. Chicken eggs cooked
3. Fish processed and canned
4. Newspapers containing advertising material

Which of the above items is/are exempted under GST (Good and Services Tax)?

(a) 1 only

(b) 2 and 3 only

(c) 1, 2 and 4 only

(d) 1, 2, 3 and 4

Ans: (c)

Q. What is/are the most likely advantages of implementing ‘Goods and Services Tax (GST)’?(2017)

1. It will replace multiple taxes collected by multiple authorities and will thus create a single market in India.
2. It will drastically reduce the ‘Current Account Deficit’ of India and will enable it to increase its foreign exchange reserves.
3. It will enormously increase the growth and size of the economy of India and will enable it to overtake China in the near future.

Select the correct answer using the code given below:

(a) 1 only

(b) 2 and 3 only

(c) 1 and 3 only

(d) 1, 2 and 3

Ans: (a)

Mains

Q. Explain the rationale behind the Goods and Services Tax (Compensation to States) Act of 2017. How has COVID-19 impacted the GST compensation fund and created new federal tensions? **(2020)**

Q. Enumerate the indirect taxes which have been subsumed in the Goods and Services Tax (GST) in India. Also, comment on the revenue implications of the GST introduced in India since July 2017. **(2019)**