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Karmvir Singh

Pritee Chaudhary

Tamil Venden

Rakesh Deepak

Priya Goel

Shushant Kumar

Study on the impact of GST on the Indian Economy and on Investment Decisions- Lessons from abroad (Case studies from Singapore and South Korea)

SYNOPSIS

Tax systems are primarily aimed at financing public expenditures. Tax systems are also used to promote other objectives, such as equity, and to address social and economic concerns. They need to be set up to minimize taxpayers' compliance costs and government's administrative cost, while also discouraging tax avoidance and evasion. But taxes also affect the decisions of households to save, supply labour and invest in human capital, the decisions of firms to produce, create jobs, invest and innovate, as well as the choice of savings channels and assets by investors.

What matters for these decisions is not only the level of taxes but also the way in which different tax instruments are designed and combined to generate revenues. The effects of tax levels and tax structures on agents' economic behaviour are likely to be reflected in overall living standards. Recognizing this, over the past decades many OECD countries have undertaken structural reforms in their tax systems.

Unlike most developing countries, which were guided in their tax reforms by multilateral agencies such as the International Monetary Fund, Indian tax reforms have largely borne a domestic brand. Thus, even when the government sought assistance from multilateral financial institutions, the recommendations of these institutions did not directly translate into an agenda for tax reform. Despite this, the tax system reforms were broadly in conformity with international trends and advice proffered by expert groups and was in tune with international best practices. Inevitably tax policy in the country has responded to changing development strategy over the years and to the changing global scenario. Some of the changes during past few years include reduction in excise duties in post global financial & economic crisis, alignment of custom tariffs to the levels prevailing in ASEAN countries, introduction of Service tax in 1994-95 besides introduction of the Constitution(115th Amendment) Bill in the Lok Sabha in March 2011 to operationalize 'Goods & Services Tax'(GST).

INDIAN CONTEXT- In the post liberalization era India has seen multiple reforms in various sectors to augment economic growth and GST is going to be one of the most fundamental and important tax reforms in the time to come to achieve the regional development as well.

INTRODUCTION

GST is a comprehensive tax levy on manufacture, sale and consumption of goods and services at the national level. Through a tax credit mechanism, this tax is collected on value-added goods and services at each stage of sale or purchase in the supply chain.

The **Goods and Service Tax Bill** or **GST Bill**, officially known as **The Constitution (One Hundred and Twenty-Second Amendment) Bill, 2014**, proposes a national Value added Tax to be implemented in India from April 2016. "Goods and Services Tax" would be a comprehensive indirect tax on manufacture, sale and consumption of goods and services throughout India, to replace taxes levied by the Central and State governments. GST would be levied and collected at each stage of sale or purchase of goods or services based on the input tax credit method, irrespective of State. Taxable goods and services are not distinguished from one another and are taxed at a single rate in a supply chain till the goods or services reach the consumer. Administrative responsibility would generally rest with a single authority to levy tax on goods and services. Exports would be zero-rated and imports would be levied the same taxes as domestic goods and services adhering to the destination principle.

The introduction of Goods and Services Tax (GST) would be a significant step in the reform of indirect taxation in India. Amalgamating several Central and State taxes into a single tax would mitigate cascading or double taxation, facilitating a common national market. The simplicity of the tax should lead to easier administration and enforcement. As India is a federal republic GST would be implemented concurrently by the central government and by state governments.

HISTORY OF GST IN INDIA

In 2000, the Vajpayee Government started discussion on GST by setting up an empowered committee. The committee was headed by Asim Dasgupta, (Finance Minister, Government of West Bengal). It was given the task of designing the GST model and overseeing the IT back-end preparedness for its rollout.

The Kelkar Task Force on implementation of the FRBM Act, 2003 had pointed out that although the indirect tax policy in India has been steadily progressing in the direction of VAT principle since 1986, the existing system of taxation of goods and services still suffers from many problems and had suggested a comprehensive Goods and Services Tax (GST) based on VAT principle.

A proposal to introduce a national level Goods and Services Tax (GST) by April 1, 2010 was first mooted in the Budget Speech for the financial year 2006-07. Since the proposal involved reform/ restructuring of not only indirect taxes levied by the Centre but also the States, the responsibility of preparing a Design and Road Map for the implementation of GST was assigned to the Empowered Committee of State Finance Ministers (EC). In April, 2008, the EC a report to the titled "A Model and Roadmap for Goods and Services Tax (GST) in India" containing broad recommendations about the structure and design of GST. Based on inputs

from Government of India and States, The EC released its First Discussion Paper on Goods and Services Tax in India on the 10th of November, 2009 with the objective of generating a debate and obtaining inputs from all stakeholders. A dual GST module for the country has been proposed by the EC.

An Empowered Group for development of IT Systems required for Goods and Services Tax regime has been set up under the chairmanship of Dr. Nandan Nilekani. A draft of the Constitutional Amendment Bill has been prepared and has been sent to the EC for obtaining views of the States. The Goods and Service Tax Bill or GST Bill, officially known as The Constitution (122nd Amendment) Bill, 2014, would be a Value added Tax (VAT) to be implemented in India, from April 2016. GST stands for “Goods and Services Tax”, and is proposed to be a comprehensive indirect tax levy on manufacture, sale and consumption of goods as well as services at the national level. It will replace all indirect taxes levied on goods and services by the Indian Central and State governments. It is aimed at being comprehensive for most goods and services.

Legislative history

The Constitution (One Hundred and Twenty-second Amendment) Bill, 2014 was introduced in the Lok Sabha by Finance Minister, Arun Jaitley on 19 December 2014. The Bill was passed by the House on 6 May 2015, The Government attempted to move the Bill for consideration in the Rajya Sabha on 11 May 2015, however, members of the Opposition repeatedly stalled the proceedings of the House. In order to appease the Opposition's demand for further scrutiny of the Bill, Jaitley moved a motion to refer the Bill to a Select Committee. The 21 member Committee is expected to give its report by the end of the Monsoon session.

PRESENT INDIRECT TAXATION STRUCTURE

India has a system of consumption taxes levied at the Federal and State level which constitute the primary source of revenues for both the Federal Government and the States (30% of India's total tax revenues). Along with Custom duties, they constitute 47% of India's total tax revenues.

Current Sales Tax Structure

The Central Government levies

- a Central VAT (CENVAT) on the manufacture and production of goods, currently up to four different rates apply to the CENVAT (12%, 6% and 0%);
- a Service Tax(12%) on a specified list of services:
- a Central Sales Tax (CST)(2%) on inter-state sales of goods

The States levies State VATs (12.5% to 15%, 4% to 5%,1% and 0% depending on the legislations of the states) on the sales of goods within the state.

The multiple levies of several indirect taxes (CENVAT, Service Tax, CST and State VAT) however, increase the compliance burden on businesses, create uncertainties and tax cascading. For example:

- VAT compliance obligations may vary from one state to another

- Classification uncertainties have been the matters of significant disputes: what counts as manufacturing (and is subject to CENVAT) or as a service (and is subject to the service tax and can escape state VAT) is sometimes unclear.
- Selective taxation of specified services is a source of definitional ambiguities and classification disputes
- The partial coverage of CENVAT and state VATs leads also to significant tax cascading (the CENVAT is included in the value of the goods that are taxed under the state VAT).
- Under the state VAT, no credits are allowed for the inputs of the exempt sectors, which include the entire service sector subject to the Service Tax. Therefore, a service provider that pays State VAT on his physical inputs and that is subject to the Service Tax levied by the Central Government and not the State VAT cannot offset the State VAT paid on his inputs. The State VAT is therefore hidden in the price of the services.
- The CST on inter-state collected by the origin state and for which no credit is allowed by any level of government also contributes significantly to the tax cascading.
- Besides that, local importers may be tempted to shift purchases from outside the State to within the State as doing so would enable them to claim tax credits and increase their profit margin.

PROPOSED GST KEY FEATURES

1. GST is a tax on goods and services, which can be levied whenever there is a sale or provision of service, provided that at that time, the seller or service provider can claim the input credit of tax which he has paid while purchasing the goods or procuring the service. This comprehensive tax seeks to eliminate the distinction between taxable goods and taxable services. The introduction of the GST aims at establishing a continuous chain of set-off from the original producer or service provider to the retailer, eliminating the cascading effects at successive levels of the value chain. Therefore, it seeks to eliminate the incidence of 'multiple taxation' in the indirect tax system.
2. As India is a federation, where the responsibility of taxation is shared by the Union and the States, the proposed model envisions a dual system of GST. Therefore, in keeping with the constitutional mandate of fiscal federalism, both levels have distinct responsibilities to perform. Thus, a Central GST, which replaces the current CENVAT and a State GST, which replaces the current State VAT, will come within the ambit of the GST. Although this proposal has diluted what was said to be the greatest plus point of GST, *i.e.*, to have a uniform tax slab for the State and the Centre, this system is certainly more pragmatic as it will help to phase out the multiplicity of indirect taxes in India in a slow and steady fashion.
3. GST includes within its ambit the system of Input Tax Credit ('ITC'), wherein a manufacturer is allowed to deduct the tax that he has already paid on an input from the tax on final product, as done in the VAT system. Therefore, he would have an available

'credit' while calculating GST. The credits obtained through the Central and State GSTs will operate in parallel and cross-utilization of credits will not be allowed. Also, unutilized accumulated ITC has to be refunded.

4. Due to the multiplicity of taxes in the present system, basic phrases such as 'taxable event', 'supply of goods' and 'rendition of services' have not been uniformly defined. Moreover, different legislations in India define the terms 'goods' and 'services' differently. Also, in the modern world, the distinction between goods and services has become increasingly blurred due to the bundling of goods and services as well as e-commerce transactions. The current system does not prevent the same transaction from being taxed under both service tax and VAT or CST. This acts as a deterrent to economic growth. Moreover, the attempts of the Government to levy service tax and/or VAT on transactions related to immovable property have posed significant challenges to the real estate sector in the country. In order to curb these complexities, inconsistencies and unnecessary litigation, there is an urgent need to standardize the system, principles and procedures. The proposed GST system seeks to fill these gaps in the present system.
5. The GST system also seeks to nullify the present system of Central Sales Tax being imposed at source on Inter-State transactions. This will lead to a new Inter State Goods and Service Tax ('IGST') which covers such transactions, including stock transfers and consignments. This system brings out a revolutionary new principle in India, by which, inter-state transactions will be taxed at the destination and not at the source level. Similarly, services will be taxed at the state of consumption. This means that the originating State will have to pay no taxes in respect of the transaction. Specific provisions for this purpose have not been drafted as of now. The proposal envisages a system where inter-state sellers will pay IGST on value addition after adjusting available credit of IGST, CGST and SGST on their purchases.

TAXES TO BE SUBSUMED

Initially, the following Central and State taxes are recommended to be subsumed:-

Central Taxes	State Taxes
1. Central Excise Duty	1. VAT/Sales Tax
2. Additional Excise Duty	2. Entertainment Tax (unless levied by local bodies)
3. Excise Duty levied under the Medicinal and Toiletries Preparation Act	3. Luxury Tax
4. Service Tax	4. Taxes on Lottery, Betting and Gambling
5. Additional Custom duty, better known as Counter Veiling Duty ('CVD')	5. State Cesses and Surcharges, in so far as they relate to supply of goods and services
6. Special Additional Duty of Custom ('SAD') 4 percent.	6. Entry tax not in the lieu of octroi
7. Surcharges	7. Purchase tax, although States which earn large revenue through purchase tax, in fear of losing such revenue, oppose its subsumption
8. Cesses.	

Tobacco products will be subjected to GST with ITC. Alcoholic products will be kept out of the purview of GST and existing tax laws will continue to govern them. Few petroleum products, such as crude motor spirit and HSD will be kept outside the purview of GST, in accordance with the present practice in India.

TAX RATES

The tax rate under the proposed GST is likely to come down and expected to be around 16-24%. The rates are being decided on the basis of present taxes being levied by Centre and State Govt. The important factor here is Revenue Neutral Rate (RNR). GST rates of some countries are given below.

Country	Rate of GST
Australia	10%
France	19.6%
Canada	5%
Germany	19%
Japan	8%
Singapore	7%
Sweden	25%
<u>India</u>	<u>16-24 % (expected)</u>
New Zealand	15%
Pakistan	18%
Malaysia	6%
Denmark	25%

ESTIMATED IMPACT ON INDIAN ECONOMY AND INVESTMENT DECISIONS

As the GST is a consumption based tax, the dual GST system will result in increased revenue for states which consume a lot of goods and services. Lesser developed states are likely to suffer in revenue during the initial years and the Centre is expected to set up a mechanism to compensate such states during these years.

The existing tax system has distortions which allow certain goods and services to benefit over others. As the flaws of 'multiple taxation' and the cascading effect of the existing system are sought to be removed, the taxation burden would reduce as it goes down the value chain and by the time it reaches the consumer, rates will be the lowest possible. The introduction of GST will, therefore, bring about a macroeconomic dividend by reducing what has been called

“negative grey area dynamic effects”. Therefore, the overall macroeconomic effect would be to provide an impetus to economic growth.

The ‘Report of the Task Force’ observes:- “Using CGE Model, 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. The study is based on two important assumptions of full employment and that 50 percent of indirect taxes remain embedded and ‘stick’ on production and distribution. The study concludes that ‘implementation of a comprehensive GST in India will lead to efficient allocation of factors of production thus leading to gain in GDP and exports. This would translate into enhanced economic welfare and returns to the factors of production, i.e. land, labour and capital. The gains in real returns to land range between 0.42 and 0.82 per cent. Wage rate gains vary between 0.68 and 1.33 per cent. The real returns to capital would gain in the range of 0.37 and 0.74 percent. Further, the study also shows that ‘implementation of 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.”

Moreover, the effects of the introduction of GST in various other countries can be looked into to predict and assess the possible effects on revenue. In New Zealand, the GST was introduced in a neutral and efficient manner in 1987, whereby it yielded 45 percent higher revenues than what was anticipated. The Federal Manufacturers’ Sales Tax in Canada, which was similar in form to the Indian CENVAT, was repealed to introduce a GST which resulted in an increase in the potential GDP by 1.4 percent, which comprised a 0.9 percent increase in national income from higher factor productivity and 0.5 percent increase from a larger capital stock.

Therefore, it can be clearly understood that although the introduction of the GST in India will require some major changes in the current structure of operation, it is bound to increase revenue and boost the economy of the nation as such by facilitating reduction in the cost of goods and services to the ultimate customers or users.

While evaluating the economic impact of value added tax, Charlotte E. Ruebling opines, “One objective apparent in discussions concerning taxation is that the tax system encourage or at least not impair the economy’s potential for and achievement of economic growth. What, then, are some of the possible consequences of a VAT on growth? Once again it depends to some extent on the policy actions accompanying the VAT and responses to these actions.

In general we need to ask whether the private sector responds to a given tax substitution or increase by: (1) reducing consumption; (2) reducing investment 3) increasing the supply of productive resources to the market. Response (3) appears conducive to growth. However, for the growth impact of response (3) to be lasting, there must be balance between demand and the resulting increase in the supplies of goods. Slack in demand resulting in accumulations of unsold goods is a signal for a production cutback (and/or a price decline) in a market economy. In general, policies conducive to growth are those which increase supplies of productive resources and investment and those which foster conditions in which an essential balance between aggregate supplies and demands can be maintained.

The combination of responses (1), (2), and (3) to adoption of a VAT is influenced by how the VAT, the accompanying use of funds, and monetary conditions affect prices of current versus future consumption and the conditions which lead resource owners to hold or release their

resources to the market. If monetary conditions (rates of money stock growth and money turnover) do not change, relative prices will reflect the impact on prices of the tax for which the VAT was substituted or the spending undertaken by the government. A lowering of the relative price of future consumption would in many circumstances be conducive to growth of production in the economy”.

The need of the hour is for the government to focus on achieving a durable and sustainable correction in the fiscal deficit which can be achieved through tax reforms rather than reduce productive spending as was done in the recent past. In the last 3 years there has been aggressive cut back on expenditures, particularly productive spending (centre’s plan + non-plan capital expenditure + the revenue grants it gives for capital creation) in order to meet its fiscal deficit target.

Between fiscal 2012 and 2014, as revenues fell short of budgeted levels, the government cumulatively cut its productive spending by over rupees 1.9 trillion compared budgeted levels. This reduction took place in critical areas such as health, education, energy and industry. Reduction in productive expenditure for fiscal correction is undesirable from a growth perspective.

Hence, switching of expenditure from subsidies on fuel (kerosene and LPG) towards health, education ,infrastructure etc is desirable. Currently, subsidy spending is high and accounts for 80 to 90 percent of total productive spending by the government. This expenditure switching will have to be supplemented with key tax reforms like GST which will help raise tax revenues and fund the higher capital spending.

The broad conclusion drawn from these studies is that the GST reforms would have substantial impact on real output, particularly for sectors which rely heavily on tax inputs and those which compete in the international market – either exports or import competing domestic products.

As far as impact of GST on investment decision is concerned results from a survey conducted among the traders and manufacturers in Kerala throws some much needed light on the subject. The main purpose of this study was to evaluate the impact of Value Added Tax on the financial management practices of different categories of the VAT assesses of Kerala. The VAT assesses selected for the purpose of this study consist of traders and manufacturers. Out of the 1030 VAT assesses who were selected as sample, 747 assesses are traders (72.5%) and remaining 283 assesses are manufacturers (27.5%). The total number of traders involved in this study is 747. Out of the 747 traders,32.5% belongs to the LIT group and remaining 67.5% belongs to the HIT group. The total number of manufacturers included in this study is 283. Out of the 283 manufacturers, 77.7% belongs to the HIM group and remaining 22.3% belongs to the LIM group. It is found that under the VAT system of taxation ‘Investment Decision’ has decisive influence on framing the financial management policies for majority of VAT assesseees belonging to Lower Income Traders (57.2%) High Income Traders (58.7%) Lower Income Manufacturers (69.8%) and High Income Manufacturers (73.6%). In the case of 42.8% of LIT, 41.3% of HIT, 30.2% of LIM and 26.4% of HIM, the investment decision variable has not exerted much influence on framing the financial management policies under VAT system.

Thus, it would appear from the above ,that there is a positive correlation between a well-designed and efficiently administered VAT system of taxation and investment decisions made by certain sections of manufacturers and traders.

IMPACT OF GST ON INDIAN ECONOMY- SECTOR SPECIFIC

The implementation of GST will have a substantial impact on various key aspects of business, including finance and administration, sales and marketing, procurement, supply chain, working capital, cash flow and information technology. As a result, it is essential that businesses review the impact of GST on these areas to help prepare for implementation.

1. GST to reduce Manufacturing Cost

The proposed Goods and Services Tax (GST) would reduce manufacturing cost and benefit end-customers. The elimination of multiple tax structure at central and State levels would make the sector viable and globally competitive. The GST will be a dual tax with both central and state GST component levied on the same base. There will be no distinction between goods and services for tax purpose with a common legislation applicable to both.

2. Implications of GST on imports & exports

Basic Custom Duty will continue to there under GST system. However, the additional custom duty in lieu of CVD /Excise and the Special Additional Duty (SAD) in lieu of sales tax/VAT will be subsumed in the import GST. The import of services will be subject to Central GST and State GST on a reverse charge mechanism. In other words, the GST will be payable by the Importer on a self declaration basis. Place of supply rules will determine which state will have the authority to get the tax. However, the taxes so paid will be available as Input Tax Credit and therefore it would be a revenue neutral. Exports, however, will be zero rated, meaning exporters of goods and services need not pay GST on their exports. GST paid by them on the procurement of goods and services will be refunded.

3. Impact on Logistics Sector

The introduction of a national sales tax in India next year could have a similar impact on freight demand as the creation of the European single market and customs union, according to leading logistics operations.

Logistics firms are building warehouses and logistics parks across India as the country gets ready for a centrally administrated goods and services tax (GST).

The GST will standardize rates across the nation, allowing many corporations to move away from having warehouses in different states to adhere to each state tax code and employ logistics companies to manage distribution and supply chain.

With GST coming in place, a lot of consolidation is expected in this space. The case for having a warehouse in each state will disappear.

4. Impact on agriculture

In view of the fact that the base of CGST and SGST would be the same; CGST would cover all the commodities that are presently being taxed by SGST, many of the commodities that fall in the agriculture sector and do not come under the purview of manufacture, would also be covered under the CGST. This would, therefore, further extend the base of CGST. Based on the review of commodities falling in the category of 4% under SGST, it was estimated that this inclusion will

have 10% increases in the base of CGST. Accordingly, 10 percent of the revenue generated from standard rate of 8% (or 9 percent) is added to the CGST revenue to take account of change in base due to inclusion of commodities under CGST which were not manufactured goods.

5. Impact on Transportation agencies

As per the study of NDTV profit with various stakeholders it was found that Indian truck drivers clock an average of 280 km per day, much below the world average of 400 km per day and far below the 700 km the average truck driver in the US does every day. The underperformance of Indian truckers has less to do with bad roads and less fancy trucks and more about prevailing archaic laws.

Truck drivers in India spend 60 per cent of their time off roads negotiating check posts and toll plazas which has also found that there are 650-odd check posts in the country and 11 categories of taxes on the road transport sector.

Since road traffic accounts for 60 per cent of freight traffic in India, the slow movement of trucks across states leads to productivity loss. If the distance covered goes up by 20 per cent per day, Indian truck productivity would improve by 12 per cent.

Higher productivity would cut the need for buffer stocks; reduce the loss of perishable goods, cut down the need for many warehouses, etc.

Analysts say the implementation of the **goods and services tax** (GST) could provide the kind of productivity boost illustrated above.

Opinion of Few Industries over impact of GST

On the decision of The Union Cabinet approving the constitutional amendment bill to rationalise state and central indirect taxes into a harmonised goods and services tax (GST) Analysts from domestic brokerage Kotak conducted a survey and met a number of companies to discuss the implications of GST.

Here's how GST will impact some of India's leading firms:

1) **Dish TV:** The direct-to-home (DTH) industry is unlikely to get any relief on tax front, but may benefit indirectly once GST is implemented. Tax evasion in the cable industry will come down forcing operators to raise tariffs. This will allow DTH operators to raise prices.

2) **Godrej Consumer Products:** GST rate should be tax neutral for most FMCG players. However, FMCG firms will benefit from lower warehouse costs, more efficient supply-chain planning and inventory reduction.

3) **M&M:** Auto sector would benefit from reduction in duties on large SUVs and cars as GST rate is likely to be lower than the present excise plus VAT rate. Tractors may be taxed at lower rate in GST.

4) **Plastiblends:** Unorganized players, which account for a major share of the plastic industry, will come under tax net and may not be able to pay the high dealer margins they currently pay. This will help organised players like Plastiblends, which has a 13 per cent market share in the masterbatch industry.

- 5) **Page Industries:** GST will increase the tax burden, which the company says will be passed on to the consumers.
- 6) **PVR Cinemas:** The implementation of GST will lead to lower entertainment taxes. The company expects its margins to go up by about 200-300 basis points.
- 7) **Transport Corporation of India:** Demand for large warehouses will increase, which will benefit TCI. Truck utilization will also go up.
- 8) **Bharti Airtel, Idea Cellular:** Increase in service tax under GST will be passed on to the consumers.

EFFECT ON INVESTMENT DECISION

1. Boost to international investment

The new regime under GST would be less complex and more simple and by this virtue itself it has an inherited quality to invite international investment. At present every investor in India look for the possible relaxation from the current legal system which being complex is difficult to comply. Further there is always a hidden cost of compliance. Rationalization offered by the GST would allure the investment both FII and FDI.

2. Boost to domestic investment

It is expected that the GST regime will boost the domestic investment as well. Due to the availability of input Tax Credit in interstate trade and no cascading effect more capital would be available for the business. Simplicity of law will reduce the interface with the bureaucracy and therefore the apparent and hidden cost of compliance would go down.

3. Bringing down the regional disparity

In the current scheme only handful state are benefitting the investment. Those are known as producing state. At the core these states have more funds available in their hands to improve the state of infrastructure. Good infrastructure attracts investment. This investment provides local wealth and taxes. So there is a circulation of wealth in a limited geographical area which leads to disparity. In the GST regime the poor states would also gain. They would have surplus income to improve their infrastructure which would attract in investment there too.

4. End to pitfalls of tax holidays

Right now the tax holiday are cause for a faulty practice and distortion in level playing field. In the GST regime there will be no incentive for exempted area. There has to a value chain and everyone has to fall in line.

5. A logical decision when planning logistics

The current system has a negative impact when we come to the planning of logistic. Due to the non availability of interstate tax credit every big manufacturer is required to have a warehouse in each big state. They can not plan their supply chain logically.

Maintenance of warehouses and need of stock transfers has a bearing on cost. It also engages the worthy capital of business.

6. Less investment on inventory more on expansion

In the GST regime one industry that will see immediate relief is Transportation industry. The cost of transportation and time taken in transporting would go down. It will not only save the cost at the end of manufacturer and consumers but it will also reduce the need of big inventory. Resultant would be release of more capital for business and for expansion too.

ISSUES IN IMPLEMENTATION OF GST

Issues in implementation of GST can be broadly classified as that of 'designing' and 'administering' an efficient taxation system. The benefits of the proposed GST system could only be reaped if certain challenges related to design and structure of GST, are addressed by the governments.

Challenges in Designing GST

Learning from international experience, it is not expected that a faultless GST could be designed and rolled out in India as a single event, but some structural faults could easily be addressed and rectified without hampering basic spirit of the reform.

Estimation of correct tax base for GST is important to understand the tax potential and estimation of tax rate(s) to achieve revenue neutrality. Estimation of GST base depends on several structural features of GST design and the most important are - a) whether proposed GST would be origin (production) or destination (consumption) based, b) whether income or consumption type, c) whether implemented with credit (input tax) invoice based subtraction method or formula based (ad hoc) subtraction method for allowance of credit against input taxes and d) having many or a few exemptions (Rao and Chakraborty, 2013).

So far as Indian GST is concerned it would be destination based, consumption type system and it would be implemented with credit invoice based method with a few exemptions. In addition to these, there are also issues related to turnover based threshold for mandatory GST registration, special scheme for small and medium enterprises (e.g., composition / compounding scheme) and exclusions of goods and services from GST system which all make the design complex.

Estimation of revenue neutral rate for GST is a complex issue and given the complexity in the design of GST, it would be difficult to estimate RNRs without any revenue implications. Setting perfect RNR for GST cannot be a onetime event but options should be kept open to adjust the rate in future based on trial and error process depending on revenue targets of the governments.

Given the dual nature of GST, there will be two RNRs – one for Central Government on which CGST will be levied and another one for State Government. However, there is no consensus whether single SGST rate will prevail across all States or it will vary. It is also not clear whether

within SGST it would be single rate or will there be two (or multiple) rates – one lower rate and one higher rate.

Revenue importance of the tax base on which GST would be levied is different for different States, and given the federal structure of India, protecting revenue is the foremost priority of the States.

Therefore, any rule based restriction on fiscal decisions of the State will go against the spirit of cooperative federalism. There is always a tradeoff between harmonization of tax system and fiscal autonomy of States. Given the federal structure of India, it is desirable that tax rates will be harmonized across States to minimize the compliance burden. Moreover, harmonization of tax rules and regulations is more important than harmonization of tax rate from business perspective.

There are also discussions on legal restriction for the GST rate at maximum 18 percent (Government of India, 2015). However, any attempt to put a cap on GST rate will restrict the fiscal freedom of governments as they cannot set their fiscal priorities depending on their revenue needs. In addition, estimation of GST revenue neutral rate cannot be a static exercise and ideally it should reflect behavioral responses of tax rates also. GST rate depends on dynamics of the economy and if introduction of GST improves economic efficiency, it will attract investment which would have multiplier impacts on the economy and may require lower rate to achieve revenue neutrality.

However, entire revenue consideration under GST for the Central Government will not be available to finance Central Government expenditures alone, as a part of net tax collection from CGST (after deduction of cost of collection) is required to be shared with State Governments according to the recommendation of the Finance Commission. Non-inclusion of major revenue earning goods under GST (like alcohol and petroleum products), reduces the revenue importance of GST and also keeps the GST design as complex as the present system.

Inclusion of out of VAT items under GST could expand the combined (Centre and all States together) revenue under consideration by 1.4 times for 2009-10 or Rs. 4,67,124 crore. The revised States' revenue under consideration under GST would be Rs. 2,55,111 crore, which will be 32.2 percent of revenue receipts, 47 percent of total tax revenue, 67.6 percent of own tax revenue and 24.4 percent of aggregate expenditure. For Central Government, revised revenue would have been Rs. 2,12,013 crore, which will be 37 percent of revenue receipts, 33.9 percent of gross tax revenue and 20.7 percent of aggregate expenditure.

By excluding goods of major revenue importance (like petroleum products and alcohol) from GST system, both Central as well as State Governments protect their respective fiscal autonomy though it would imply continuation of tax cascading and hamper export competitiveness of domestic industries. Cascading of taxes generates revenue for government though it goes against the interest of business. Removal of tax cascading has revenue implications for government and it will affect different governments differently depending on their revenue importance of taxes subsumed under GST.

In addition, more harmonized taxation system (like GST) leads to little fiscal freedom for individual governments to deviate from common harmonized tax structure. In the long run, it could erode fiscal autonomy of governments to protect revenue by changing tax rates or any other policy measures to generate revenue.

By non-including electricity and some other sources of fossil fuels (like petrol, diesel, ATF, natural gas and crude petroleum), the proposed GST system will retain substantial cascading of taxes which will be detrimental for achieving export competitiveness of Indian industries in the international markets (Mukherjee and Rao, 2015a).

There are some misconceptions regarding GST which required clarifications. First of all, many people think that introduction of GST will widen the tax base by expansion of coverage of economic activities under the tax net and by reducing the list of exemptions. However, most economic activities are presently taxed either by Central and/ or State Governments and there is not much scope for further expanding the tax base by bringing more goods and services under the purview of GST unless we reduce the list of goods and services that kept under the exemption list.³¹ However, no consensus on thresholds and exemption has been reached among the concerned governments yet; at least the information is not available in the public domain. Therefore only possibility of expanding GST base remains if services kept under the negative list are brought under the GST.

Secondly, it is common perception that mitigation of cascading and double (multiple) taxation and lower tax burden under GST would induce better tax compliance. Even under the proposed design of GST with exclusion of goods like electricity and petroleum products, cascading of taxes would be retained (Mukherjee and Rao, 2015a). Tax payers who hitherto faced with single tax administration (e.g. retailers, service providers) would face two tax administrations and complying with different tax authorities for single transaction could enhance the compliance costs and this could work against voluntary compliance. Therefore, the argument on possibility of “lowering of overall tax burden on goods and services” (Government of India, 2015) does not have any basis.

Thirdly, it is envisaged that competitiveness of domestic industries in international market will improve as the system will remove latent and embedded taxes. However, by keeping major revenue earning as well as major energy sources like electricity, petroleum products (petrol, diesel and ATF), natural gas, crude petroleum out of the GST, the removal of cascading will be limited and therefore the impact on export competitiveness of Indian industries would be limited (Mukherjee and Rao, 2015a).

Fourthly, it assumes that GST will provide common national market for goods and services by unifying the tax structure across States. However, with the present discussion on additional 1 percent tax on inter- State supplies of goods, and since there is no consensus on common GST rates, threshold and exemptions across States, providing common national market for goods and services is very much under question.

Challenges in GST Administration

The proposed GST design suggests for dual GST where CGST and IGST will be administered by the Central Board of Excise and Customs (CBEC) and the SGST will be administered by the State Commercial Tax Department of the respective State Governments. From available policy documents in the public domain it is not clear whether in the proposed system certain common administrative functions (e.g., taxpayer registration, return filing) will be undertaken jointly or independently by each of the administrations. Since both the tax administrations will deal with

same set of taxpayers (ideally), separating common administrative functions will add compliance costs to taxpayers and additional burden on tax administration. It is also not clear whether there will be a common threshold for mandatory registration for all taxes under GST (CGST, IGST and SGST) or separate thresholds for Central and State taxes.

Harmonization of thresholds across States for registration under SGST is another area of concern which requires broad consensus among States. The issue of single registration for all States or separate registration for each State of functions/ operations for multi-State nature of businesses/ services requires clarity.

The issue of apportionment of revenue for multi-State nature of services (e.g., telecom) is an area which requires clarifications. The issue of point of taxation and place of supply rules for taxation of services are not available in the public domain yet.

With some progress in the design of Goods and Services Tax (GST), there is an emerging need to explore the options for administering the new tax regime. From the discussions and decisions taken so far, one of the important parameters of the new regime is the applicability of two taxes (Central GST, CGST and State GST, SGST) on each and every transaction of supply of good and/or service in the country. The central tax would accrue to the Central government and the state tax would accrue to the State governments. Compared to the existing regime, the proposed tax represents a significant change in the tax administration. The central tax administration would need to deal with wholesale and retail traders in addition to its existing taxpayers (e.g., manufacturers, service providers). Similarly, the state tax departments would need to deal with service providers. The workload per employee as well as the skill set associated with tax administration would have to undergo a sharp change if the taxes are to be administered by maintaining a status quo on the forms of administration. In other words, grafting the new tax on to existing tax administrations would impose a significant cost of transition in addition to higher costs of collection. On the other hand, there would be quite a sharp change in the tax environment faced by a segment of the tax payers – all tax payers other than the manufacturers who had faced one tax and one tax department (e.g., wholesale and retail traders), under new regime potentially they will face two tax departments, and potentially an increase in the compliance cost associated with the new regime, thereby raising the opportunity cost of being in the tax system. The result could either be higher evasion or higher resistance to the new tax regime. Some segments of the tax payers are already articulating a demand for addressing the sharp increase in the compliance requirements of the new regime. Rao and Mukherjee (2010) explore various options for GST administration and one of their suggestions is joint administration for common functions (highlighted in the Figure below).³⁴ In addition adoption of functional specialization based scrutiny assessment of tax payers could reduce compliance as well as administration costs. For example, Central tax authority is dealing with service providers for long time and they have better understanding to deal with service tax assessed as compared to any State tax administration. Similarly, all State tax administrations are well conversant in dealing with traders/ distributors. Therefore, coordination across tax authorities by assigning superiority of decisions taken by one tax authority over other could be mutually beneficial.

INTERNATIONAL PERSPECTIVES- CASE STUDIES ON SINGAPORE AND SOUTH KOREA

More than 140 countries have introduced GST or VAT as it is called in some form. It has been a part of the tax landscape in Europe for the past 50 years and is fast becoming the preferred form of indirect tax in the Asia Pacific region. It is interesting to note that there are over 40 models of GST currently in force, each with its own peculiarities.

While countries such as Singapore and New Zealand tax virtually everything at a single rate, Indonesia has five positive rates, a zero rate and over 30 categories of exemptions. In China, GST applies only to goods and the provision of repairs, replacement and processing services. It is only recoverable on goods used in the production process, and GST on fixed assets is not recoverable. There is a separate business tax in the form of VAT.

VAT is now the largest source of taxes on general consumption, accounting on average for 6.6% of GDP and 19.5% of total tax revenues. VAT is now employed in 33 of the 34 OECD countries, the United States being the only OECD country not to have adopted a VAT. In 1975, thirteen of the current OECD member countries had a VAT in the 1980s, while Switzerland followed shortly afterwards. The Eastern European economies introduced VAT in the late 1980s and early 1990s, some of them adopting the EU model with their future EU membership in mind.

The spread of VAT has been the most important development in taxation over the last half century. Limited to less than 10 countries in the late 1960s, it is today an important source of revenue in more than 160 countries worldwide. VAT raises approximately 20% of the tax revenue in OECD countries and worldwide. The domestic and international neutrality properties of the VAT have encouraged its spread around the world.

Introduction of VAT and its administration in New Zealand and Ghana has thrown up some contrasting results.

VAT in New Zealand:

The VAT/GST in New Zealand, is regarded as the most simple and efficient VAT in the world. The GST Act was enacted in 1985, and the tax was introduced on October 01, 1986. The Inland Revenue Department mainly administers the tax, while the Customs Department collects the tax on imported goods and those subject to excise.

The VAT is consumption-based and applied on destination principle. The law stipulates that any business with annual net-of-GST turnover exceeding NZ \$30,000 is required to register for the GST. Those making taxable supplies with annual turnover below the threshold may elect to register voluntarily.

Credit for the VAT on capital assets is one-off adjustment if the assets cost less than NZ\$10,000. For assets of over NZ\$10,000, credit is made in successive GST returns according to a specified straight-line depreciation schedule, and on the basis of an apportionment of the asset use for taxable and exempt supplies.

The VAT structure is simple with a single standard rate of 12.5% plus zero-rate and few exemptions. The zero-rate is strictly applied to a limited number of supplies, mainly exports, and taxable activities disposed as going concerns. Few VAT-exempt supplies are: (1) most financial services; (2) supply of donated goods and services by a non-profit organization;

(3) residential rental accommodation; (4) any fine metal, such as gold, silver, and platinum that is of a required fineness.

Partial exemption is allowed for firms that produce both taxable and exempt supplies. Firms can choose among the following three methods to apportion their creditable input taxes. (1) Turnover method: the credit for the input tax is determined on the basis of the ratio of the turnover of taxable supplies to the total turnover-this method is applied when the direct attribution method is technically infeasible. (3) Special method: the method is applicable when the first two methods are inappropriate. For example, when a firm's annual input tax attributable to exempt activities does not exceed the lesser of NZ\$48,000 or 5 percent of the total taxable and exempt supplies, the firm is allowed to treat itself as fully taxable- and hence, eligible to claim credit for all input taxes.

The refund from an excess of input credits over output tax should be made within 15 working days of the day following the receipt of the relevant VAT return. From March 08,1999, an interest rate of 3.38i percent is applicable to the unpaid portion of the credit, starting from the expiration of the 15th working day till the day the full refund is made.

VAT in Ghana- failure & success lessons:

In Ghana, VAT was first introduced in March,1995 to overcome the problem in the existing sales tax system, which was plagued by a narrow base, weak administration and corruption-prone physical surveillance.

The tax rate was fixed at 17.5 percent, which was significantly higher than the standard rate of 15 percent of the existing system. A new revenue collecting agency, the VAT Service was established and a new computer system was developed.

However, the system was short-lived and it was removed just three and a half months after introduction. The reasons for the failure were attributed to faulty tax policy design, poor implementation and inappropriate timing. The high introductory rate of tax was not politically acceptable.

The timing was bad as it coincided with several factors beyond the scope of VAT. Agricultural prices had shot up sharply due to unfavorable rainfall. Excise duty on petroleum products had been raised. Together with VAT this had put upward pressure on inflation. Further, lack of preparation made the VAT doomed to fail as it was launched only about 3 months after the primary VBAT legislation was passed in December 1994.

Another important reason for its failure was the conflict between the new established VAT Service and the Customs, Excise and Preventive Service(CEPS) was acute and eventually led to significant delays in the appointment of senior staff to the VAT Service and transfer of staff from CEPS to VAT Service.

The tax threshold was set too low(25 million cedi) and public education failed to reach small traders and consumers.

After the lessons had been learnt, the VAT was reintroduced in 1998. The legislation was enacted ten months prior to the adoption of the VAT. This gave sufficient time to train and recruit capable staff for the VAT Service and to prepare the public for the tax.

The rate was substantially lower at 10 percent. Exemptions were extended to many basic goods such as unprocessed food, agricultural inputs and machinery, drugs and health services, utilities, books and educational materials to quench initial public anxiety. The

threshold was raised sharply to 200 million cedi(\$80,000) and at present it has been halved to 100 million cedi.

The VAT was successful from the first year after introduction, the VAT generated 20 percent more revenues than the replaced sales tax .After less than 2 years, the government raised the rate to 12.5 percent but maintained the reduced rate of 10 percent for imports subject to VAT. It is currently planning to broaden the base by reducing the number of exemptions.

Case study 1-Singapore

GST was implemented at a single rate of 3% on 1 April 1994, with an assurance that it would not be raised for at least five years. To cushion the impact of GST on Singaporean households, an offset package was also introduced. Simultaneously, corporate tax rate was cut by 3% to 27%, and the top marginal personal income tax rate was cut by 3% to 30%. The initial GST rate of 3% was among the lowest in the world, as the focus was not to generate substantial revenue, but to allow people to get adjusted to the tax.

In 2002, the Economic Review Committee reviewed Singapore's tax policy, and recommended that further tax reform was necessary to bring in new investments. The committee noted that other countries were aggressively cutting their direct tax rates to attract internationally mobile capital and labour, and recommended that the government rely more on GST for its tax revenues, while again cushioning the impact on Singaporean households through an offset package.

The government accepted the committee's recommendations. The GST rate was increased from 3% to 4% in 2003, and to 5% in 2004. Each increase was accompanied by an offset package that was designed to make the average Singaporean household overall better off, even after accounting for the additional costs imposed by the increase in GST rates. Direct tax rates were also reduced correspondingly.

GST rate was increased to 7% with effect from 1 July 2007. The rate increase was accompanied by an offset package to help Singaporeans with the increase in GST. The package would cost the government \$4 billion over five years. The government argued that the offset package would help the majority of Singaporeans offset their increased GST costs for several years.

The offset package consisted of direct transfer benefits, in the form of cash payouts (GST credits, growth dividends, senior citizens' bonuses), CPF top-ups (post-secondary education account top-ups for students, Medisave top-ups for older Singaporeans), and rebates (on utilities and public housing service & conservancy charges). Those who earned less or lived in smaller homes received more benefits.

The government also argued that the Workfare Income Supplement, a wage subsidy, would provide significant support for lower-income workers on a continuing basis even after the GST offsets have been distributed.

The government also cut direct tax rates, continuing its practice of lowering direct tax rates since 1986. As of 2010, the top marginal rates for corporate tax stood at 17% and personal income tax at 20%, with effective rates being much lower.

As a gesture of goodwill, and to assist lower-income groups, several supermarket chains absorbed the 2% increase in GST, ranging for a period of one month to six months. They included Cold Storage, Giant Hypermarket, NTUC FairPrice and Sheng Siong. Besides FairPrice,

NTUC also absorbed the 2% increase on NTUC Foodfare, NTUC Childcare, NTUC LearningHub, NTUC Club and NTUC Healthcare, for six months.

The Singapore government has argued that the GST on its own is a flat tax, but that it is part of an overall fiscal system that is highly progressive: higher-income earners pay the highest fraction of their income in taxes, and also spend more. When all taxes were taken into account (income tax, property tax, GST and other indirect taxes), the top 10% of households accounted for 38% of the taxes paid, while the top 20% contributed 53% of all taxes. In contrast, lower-income earners receive substantially more transfers than the taxes they pay. Low- and middle-income households effectively pay 'negative' tax.

From 2006 to 2010, the second bottom decile of Singaporean households (ranked by income from work) received transfers (net of all taxes paid) amounting to 23% of their income, the 5th decile received transfers that netted off taxes paid, while the effective tax rate for the top decile was 11%. In particular, when the GST rate was raised from 5% to 7% in July 2007, a household in the bottom 20% had to pay additional GST of \$370 per year, but received an offset package of \$910 per year, in addition to permanent benefits of \$1,000 per year.

Case Study 2- South Korea

Introduction of VAT in Korea

Prior to 1980, Korean consumption tax consisted of numerous taxes. Also the percentage consumption tax occupy out of total tax income was over 60%.

After 1977, when VAT was introduced in Korea, similar taxes have been combined reducing the number of taxes.

Consumption type of VAT system, which was adopted by all countries who implemented the VAT system, was implemented in Korea.

VAT Law Structure

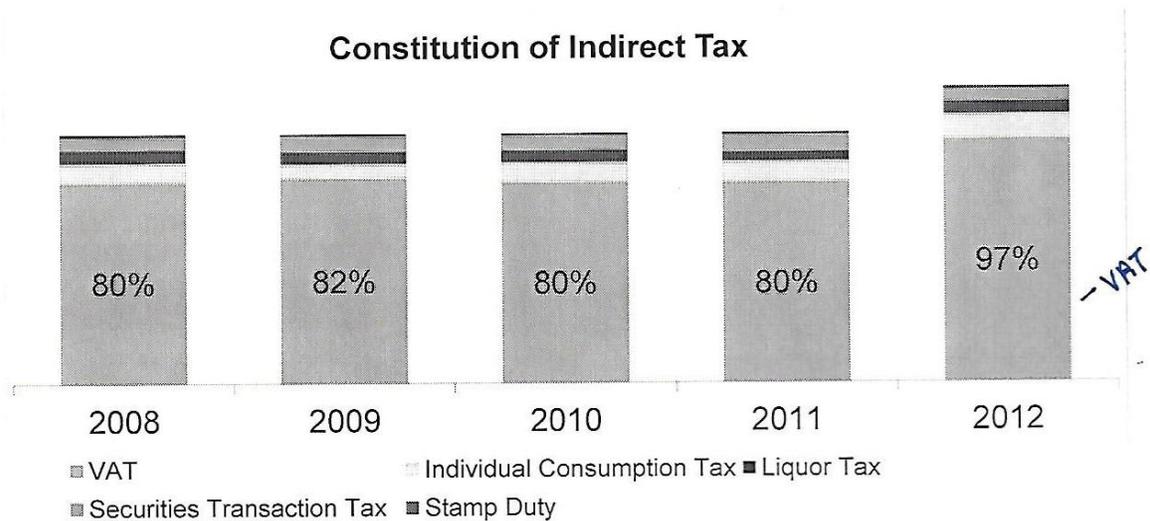
VAT laws and regulations comprised of three parts namely:-

- 1) Law which consists of 74 articles
- 2) Presidential Decree which consists of 120 articles and defines specific items delegated by law as well as defines methods in executing the law.
- 3) Ministry of Strategy and Finance Decree which consists of 77 articles and defines specific items delegated by law or Presidential Decree as well as defines the methods in executing the law or Presidential Decree.

Rulings and Interpretations

- Principle Rulings: Basic interpretations of Ministry of Strategy and Finance of the laws and regulations.
- VAT executive standards: Ministry of Strategy and Finance Executive standards on the collection of VAT.

Importance of VAT as Tax Income



Source: National Tax Service (2014)

Characteristics of the Korean VAT system

Methods of taxation for VAT

The indirect approach of the **Invoice Method** was adopted where taxes on individual products could be accurately tracked therefore facilities border adjustments. Also investments are deducted immediately possibly stimulating investment.

Transaction Subject to VAT

- 1) Supply of Goods which includes tangible goods (products, finished goods, raw materials, machines, building, etc.) and intangible goods (electric power, heat, etc.).
- 2) Provision of Services which have monetary values such as construction, hotel and restaurant, transportation, communication, banking and insurance, etc.
- 3) Import of Goods which includes carried in goods of marine products collected from international waters by foreign vessels from foreign countries and declared goods which are goods for which export declarations are received.

Transaction not subject to VAT

There are several transactions not subject to VAT. In most cases these transactions does not involve actual supply of goods and services.

Exempted Transaction

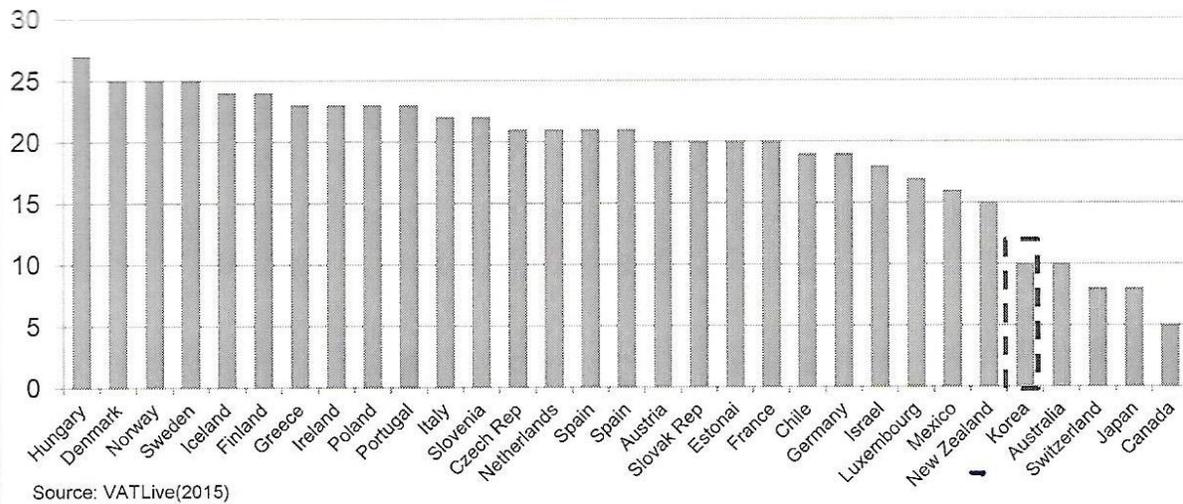
The Vat system waives the obligation to pay VAT for certain supplies of goods and services:-

- 1) Daily necessities- Unprocessed food, city water, briquette and anthracite, female hygiene products, passenger transportation.
- 2) Services related to welfare- Medical services, education, lease of houses and relevant land.
- 3) Goods and services related to culture- Books, cultural activities and non-professional sports activities, entrance to libraries, museums and etc.
- 4) Basic factors of production- Land, labour and similar personal services, financial services.
- 5) Goods and Services provided for public interest- Goods actually provided by religious organizations, goods and services provided by or to public institutions, postal services, etc.

Tax Rates

VAT tax rate of Korea is **10%**.

VAT Tax Rates Comparison



Zero Rate Transactions

It applies zero (0%) VAT rate to certain supplies of goods or services.

- 1) Applicable taxpayer- Either a resident taxpayer or a domestic company, in principle.
- 2) Applicable transaction- export of goods, providing service taken place overseas, supply of international transportation service, and other supplies of goods or providing services which are paid in foreign currencies.

Advantages of Korean VAT system

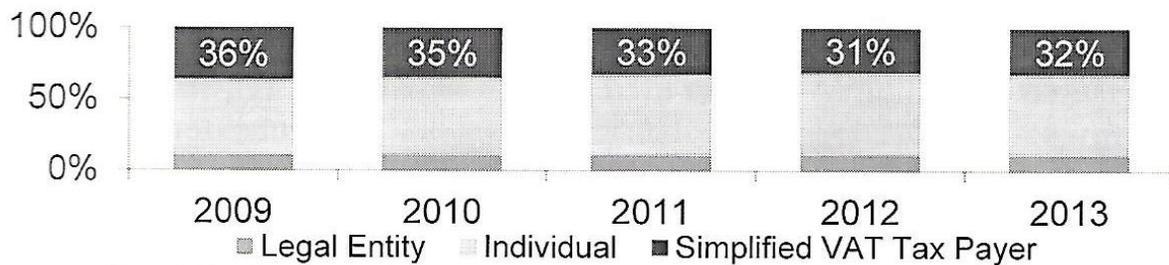
- 1) Taxation based on VAT invoices
The Korean VAT law requires taxpayers to issue a tax invoice for each transaction and does not allow input VAT deduction without those VAT invoices. Due to such requirement, each transaction is authorized automatically, preventing tax-evasions and enhances tax base. The requirement also facilitates 'documentary taxation', one of the Principles of National Tax Assessment, and increases tax revenue.
- 2) Elimination of progressive taxation
Since VAT is imposed only on added-value at each stage of transaction, progressive transaction is not allowed under the VAT system. A flat rate is applied to all transactions related to goods and services, which eliminates progressive transaction. Accordingly, the VAT system improves neutrality of taxation as well as helps enhancing markets functions through stabilizing tax administration.
- 3) Stimulation of exports and investments
The VAT system encourages exports because the VAT law does not allow zero-rated VAT for exported goods and services, so the tax payers may receive input VAT refunds. Moreover, under the Expenditure type of a VAT system adopted by most countries, capital expenditures are not subject to VAT. As a result, tax burdens on investments are reduced, and investments are promoted.

Disadvantages of Korean VAT system

1) Decreased mutual verification due to simplified VAT system

Simplified taxpayers do not issue tax invoices, making it difficult to substantiate the transactions of entrepreneurs who wish to continue from the benefit from the Simplified Tax System. Consequently, Simplified Tax System may hinder documentary taxation and become the ground for tax avoidance. Moreover, avoidance of VAT can be followed by the avoidance of individual income tax of the entrepreneurs.

Number of Tax Payers per VAT system



2) Regressive tax burden

Since VAT is imposed on goods and services consumed by ordinary citizens at a flat rate, the tax burdens for the taxpayers in a low tax bracket may be higher than the tax burdens for taxpayers in a high tax bracket. Accordingly, The VAT system may increase the gap between the wealthy and the poor, which is one of the negative aspects of capitalism. However, this regressive tax burden may be enhanced by allowing Vat-exemption on necessities, services provided for social welfares, and the goods and services related to cultural enrichment, and by imposing individual consumption taxes on luxury and durable goods.

3) Inflation

Since VAT burdens are borne by end-customers in most cases, such transfer of tax burdens may lead to inflation. However, some administrative regulations may be enforced to prevent inflation.

4) Weakening control on economy

One of the most important roles of tax policy is to control economy in both prosperous and weak conditions and to manage unexpected economic situations. However, since capital expenditures are not subject to VAT under the Expenditure type VAT structure, it is less suitable to have control on economy.

5) Excessive exemptions

VAT Exemption list has been consistently increasing since the introduction of VAT which increases cascade effect. Requests from various groups expanded exemption list with little consideration to the rational need exemption.

Future direction of the Korean VAT system

1) Reducing the number of simplified taxpayers

- Enhance mutual verification to decrease tax avoidance and secure tax income
- Out of 28 OECD nations which have introduced VAT system, only 9 nations possess VAT system similar to simplified VAT

2) Reorganize VAT Exemptions

- Exclude exemptions that are against the purpose of granting exemptions
- Extend the scope of taxable transactions, certain financial and medical services, educational institutions

Impact of VAT introduction on Korean Economy

Currently, Korea has twenty-nine taxes, of which fifteen are national. In terms of revenue, the VAT is the most important national tax, generating more than 20 percent of total tax revenue. Other major taxes are defense tax, personal income tax, corporate tax, and customs duties. Specialized excise taxes (special excise, liquor, and telephone) are also important revenue generators. The revenue from local taxes is only 10 percent of total tax revenue, whereas the taxes on tobacco and on real estate acquisition and registration are significant. The tax structure in Korea can be characterized by its heavy reliance on indirect taxes i.e., about 60 percent of total tax revenue is from indirect taxes. The dependence on indirect taxes has been criticized as the major source of the regressive nature of the overall tax burden in Korea. This "inequitable" feature of the tax system may be more clearly demonstrated by the relatively insignificant role of the personal income tax. As of 1987, less than 2 percent of GDP was collected as personal income tax, while in most Western countries the level (as of 1985) was around 10 percent. With such a low percentage, it is impossible to significantly affect the distribution of income through tax policies.

Revenue

The introduction of VAT has contributed to the steady growth of indirect tax revenue in Korea. The VAT now is the single most important source of government tax revenue. The VAT share in total tax revenue was 20.5 percent in 1978, which increased to 22.3 percent by 1983. The personal income tax, the second important source of tax revenue accounts for about 10 percent of total tax revenue. In comparing the revenue aspect of the pre-VAT indirect taxes with the post-VAT regime, the revenue effect of the special excise tax which was adopted at the time of introducing VAT should be also included. It is interesting to note that even the sum of both taxes does not much change the share of indirect taxes in total tax revenue. Although the VAT is the most important tax in terms of raising revenue in Korea, its relative contribution to total tax revenue when including the special excise tax remains more or less similar to the pre-VAT indirect tax regime.

Price Changes

As mentioned earlier, one of the reasons advanced by those who opposed the adoption of VAT was its potentially adverse impact on price changes. At the time, the Korean economy was going through a turning point and the inflationary pressure was unusually strong. The annual rate of wholesale price increase was 12.2 percent, and that of consumer price increase was 15.4 percent in 1976. The wholesale price increased by 9.0 percent, and the consumer price by 10.7 percent in 1977 when the VAT was adopted in July. Even then, the price increase was led by the food and beverage caused by the agricultural failure due to weather condition. It was only from 1979 that the increase of price of nonfood items was faster than that of food and beverage. It then appears to suggest that the introduction of VAT did not have any markedly unstable impact on price changes in Korea. Several reasons can be offered to explain this. One is that the

VAT was designed to substitute eight indirect taxes with the level of tax revenue kept constant. The price impact of differential indirect tax incidence can be said to have been fairly neutral. Secondly and more importantly, the active pricing policy must have had some dampening effects on the likely price increase. At the time of adopting VAT, the prices of 251 goods were tightly controlled by the government with the ceilings set on the factory and wholesale prices. The government also went out to publicize the recommendation of consumer prices for some sensitive consumer goods. It is worth noting that, regardless of the general economic conditions during the latter half of 1970s when the Korean economy was going through a stage of rapid increase in wage rate due to an excess demand in the labor market, the price impact of the VAT was almost neutralized in Korea.

Investment and Export

The consumption-type VAT is regarded to promote investment because the tax paid on the purchases of capital goods is fully credited. As compared with the old indirect taxes, therefore, the investment cost would be reduced by the amount of tax refunded under the VAT system, providing some incentive for investment. Since the introduction of VAT in Korea, the largest share of refund on capital investment accrued to the manufacturing sector until 1981. For example, the share of manufacturing sector in tax refund on capital investment was 73.3 percent during the second half of 1977. The second largest share accrued to the electricity and gas, accounting for 9.2 percent of the total tax refund during the same period. The electricity and gas industry sharply increased its share, receiving 47.7 percent of total tax refund on capital investment in 1982 whilst the manufacturing sector received 25.2 percent in the same year. The tax refund as a percentage of capital investment fluctuated between 0.3 percent as in 1980 and 0.8 percent as in 1978. It was 0.5 percent in 1982. One of the other stated goals of adopting VAT was the elimination of hidden tax elements in the international flow of goods with the consequence that any tax distortions in the export sector would now be removed. With the exports zero-rated under the VAT system, the indirect tax refund increased very sharply. For example, the indirect tax refund as a percentage of export increased from 0.04 percent in 1973 and 0.06 percent in 1976 to 0.09 percent in 1978 and 0.10 percent in 1982. This seems to suggest that the hidden tax elements were removed from the exportable under the new VAT system. As the relative amount of tax refund to exports increased, the tax rebate per dollar of export also increased rapidly. It was 22.7 won in 1973, which increased to 53.6 won in 1978 and to 86.6 won in 1982. During the period, the Korean won was devalued from 397.5 won to 484.0 won in December 1974 and from 484.0 won to 580.0 won in January 1980. Although it is difficult to quantify the impact of VAT on export, the above figures seem to suggest that the change of the indirect tax system removed some of the tax disadvantages placed on the export sector by the old indirect tax system.

CONCLUSION

In the light of the empirical conclusions developed in this paper, it seems appropriate to conclude by briefly noting the policy implications of the results. In the first place, the macroeconomic impact of a change to the introduction of the GST is significant in terms of growth effects, price effects, current account effects and the effect on the budget balance. Secondly, in a highly developed open economy with a high and growing service sector, a change in the tax mix from income to consumption-based taxes is likely to provide a fruitful source of revenue. Thirdly, the aggregate consumer price impact of the introduction of the GST in India on the macro-economy was both limited and temporary. Finally, despite falling outside the limited focus of this short note, we should record that some impact has also occurred in the administrative component of the compliance cost of the GST as well as a likely increase in tax revenue from the “underground” or “black” economy. The task of fiscal consolidation for this government will not be easy. There will be little scope to cut overall expenditure, as it has already been trimmed sharply in the last 2 years. The government must instead focus on switching expenditure from unproductive subsidies towards spending on sector such as health, education and infrastructure. The only way to reduce fiscal deficit, therefore, is to raise revenues as a share of GDP. To do so, the government must implement structural tax reforms such as GST, improve tax compliance and widen tax coverage. The scope to lower fiscal deficit in fiscal 2015 is limited given large roll-over of subsidies from last fiscal and little possibilities of implementation of GST within this year. Beyond that, however, implementation of GST could facilitate a much needed correction in fiscal deficit. In the base case, it is believed that partial GST – one that excludes petroleum goods is most likely. Even with this, fiscal deficit could correct to 3.3% of GDP by fiscal 2017. On the downside, a complete failure to implement GST would result in the fiscal deficit being higher at around 4-4.2% in fiscal 2016-2017. It is considered to be a major improvement over the pre-existing central excise duty at the national level and the sales tax system at the state level, the new tax will be a further significant breakthrough and the next logical step towards a comprehensive indirect tax reform in the country. It will lead to **Economic Federalism** by removing the trade barriers among the states by facilitating the free movement of goods and services as it has been seen in the case European Union.

GST system is targeted to be a simple, transparent and efficient system of indirect taxation as has been adopted by over 130 countries around the world. This involves taxation of goods and services in an integrated manner as the blurring of line of demarcation between goods and services has made separate taxation of goods and services untenable. Introduction of an Goods and Services Tax (GST) to replace the existing multiple tax structures of Centre and State taxes is not only desirable but imperative in the emerging economic environment. Increasingly, services are used or consumed in production and distribution of goods and vice versa. Separate taxation of goods and services often requires splitting of transactions value into value of goods and services for taxation, which leads to greater complexities, administration and compliances costs. Integration of various Central and State taxes into a GST system would make it possible to give full credit for inputs taxes collected. GST, being a destination-based consumption tax

based on VAT principle, would also greatly help in removing economic distortions caused by present complex tax structure and will help in development of a common national market.