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ORIGINAL ARTICLE

# THE ORIGIN AND GROWTH OF SERVICE TAX IN INDIA

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**Abstract:**

*An interesting aspect of the tax system in India is that except for a few specified services assigned to the states such as the entertainment tax, passengers and goods tax, and the electricity duty, the services were not specifically assigned to either the center or the states. This omission violated the principle of neutrality in consumption as it discriminated against the goods component of consumption. Because services are relatively more income elastic, the tax system is rendered less progressive when these are not taxed (Bird &Wilson). An even more important argument for taxing services is to enable a coordinated calibration of a consumption tax system on goods and services because services enter into goods production and vice versa.*

**KEYWORDS:**

Origin , Growth of Service Tax , electricity duty , economy.

## INTRODUCTION

The provision of imposing service tax on different services was not provided in the original constitution of India. The process of economic development has changed the contribution from different sector of the economy to the country's GDP. The historical predominant agricultural sector's contribution to GDP has been declining and the service sector rising. There were two basic issues needs to be addressed, (1) rising the government revenue, and (2) treating both goods and service sector equally by same kind of tax treatment. By considering the importance of issues, the Tax Reforms Committee of 1990 headed by Professor Dr.Raja J. Chelliah recommended the imposition of tax on selected services.(Chelliah) Based on the above recommendations (after certain modifications), Dr.Manmohan Singh, then Union Finance Minister, in his budget speech for the year 1994-95 introduced the new concept of service tax and stated that "there is no sound reason for exempting services from taxation, when goods are taxed and many countries treat goods and services alike for tax purposes.

The Tax Reforms Committee has also recommended imposition of tax on services as a measure for broadening the base of indirect taxes. I, therefore propose to make a modest effort in this direction by imposing a tax on services of telephones, non-life insurance and stock brokers."(India) Thus initially service tax was imposed on 3 services. The successive finance ministers widened the service tax net in their budgets. As on 2012, there were about 128 services in the net of service tax.

To enable parliament to formulate by law principles for determining the modalities of levying the Service Tax by the Central Government and collection of the proceeds there of by the Central Government and the State, the amendment vide constitution (95th amendment) Act, 2003 has been made. Consequently, new article 268 A has been inserted for Service Tax levy by Union Govt., collected and appropriated by the Union Govt., and amendment of seventh schedule to the constitution, in list I-Union list after entry 92B, entry 92C has been inserted for taxes on services as well as in article 270 of the constitution the clause (1) article 268A has been included.

The number of taxable services has also not only increased, the rate of service tax which was 5%

in the year 1994 has also taken a leap to the 12%. The tax collections have also grown manifold since 1994-95 i.e. from Rs.410 crores to Rs. 97,389 crore in 2011-12. Although there was no specific authority to tax services, the central government levied taxes on three services in 1994–95: insurance other than life insurance, stock brokerages, and telecommunications. The list was expanded in succeeding years and now includes more than one twenty eight services. The Expert Group on Taxation of Services recommended extending the tax to all services, providing an input tax credit for both goods and services, and eventually integrating the services tax with goods tax.

**Levy and assessment**

Service Tax is administered by the Central Excise & Service tax Commissionerates and the Service Tax Commissionerates working under the Central Board of Excise & Customs, Department of Revenue, Ministry of Finance, Government of India. LTUs are also collecting Service Tax in respect of the Large Tax Paying units registered with them. The unique feature of Service Tax is reliance on collection of tax, primarily through voluntary compliance.

Government has from the very beginning adopted a flexible approach concerning Service Tax administration so that the assessees and the general public gain faith and trust in the tax measure so that voluntary tax compliance, one of the avowed objectives of the Citizens Charter, is achieved. Substantive and procedural liberalization measures, adopted over the years for this purpose, are clear manifestations of the above approach. Following are some of the measures adopted in that direction:

Under Section 67 of the Finance Act, 1994, Service Tax is levied on the gross or aggregate amount charged by the service provider on the receiver. Rule 6(1) of the Service Tax Rules, 1994 has provided that Service Tax shall be paid to the credit of the Government account in respect of the services deemed to be provided as per the rules framed in this regard.

Service tax is levied on specified taxable services and the responsibility of payment of the tax is cast on the service provider. System of self-assessment of Service Tax Returns by service tax assessees has been introduced from 2001. The jurisdictional Superintendent of Central Excise is authorized to cross verify the correctness of self assessed returns. Tax returns are expected to be filed half yearly. Central Excise officers are authorized to conduct surveys to bring the prospective service tax assessees under the tax net. Directorate of Service Tax at Mumbai oversees the activities at the field level for technical and policy level coordination.

**Table 1.Service tax rates in India**

| Sl.No | Year | Service tax rate |
|---|---|---|
| 01 | 1994-95 | 5% |
| 02 | 2003-04 | 8% |
| 03 | 2004-05 | 10% |
| 04 | 2006-07 | 12% |

The above table shows the service tax rates in India. The effective rate includes Education cess of 3 percent along with the existing rate. The levy of service tax on these services is effective from 1994-95 and the rate of service tax has been enhanced from 5 percent to 8 percent in 2003-04, 10 percent in 2004-05. At present it is 12 percent. Besides this 3% Education Cess on the amount of service tax has also been introduced.

Under Section 67 of the Finance Act, 1994, Service Tax is levied on the gross or aggregate amount charged by the service provider on the receiver. However, in terms of Rule 6 of Service Tax Rules, 1994, the tax is permitted to be paid on the value received. This has been done to ensure that providers of professional services are not inconvenienced, as in many cases, the entire amount charged may not be received by the service provider and calling upon him to pay the tax on the billed amount in advance would have the effect of asking him to pay from his own pocket. It would also make the levy a direct tax, which is against the very scheme of Service Tax. Corporate assessees are given the liberty to pay tax on the value of taxable service, provided by them in a month, by the 25th of the following month to enable them to finalize the accounts. Further, the individual assessees are required to pay the levy only once in a quarter. The process of registration of assessees has been considerably simplified. No separate accounts have been prescribed for the purposes of Service Tax. It has been provided that accounts being maintained by the assessees under any other law in force would be sufficient. This has placed the Department at considerable inconvenience to itself, so as to minimize difficulties for the assessees.

The Finance Act'2001 has introduced self assessment for service tax returns; thereby sparing the assessees from the rigorous of routine scrutiny and assessment Frequency of filing the returns is minimized. Filing of Statutory return has been made half yearly and by the 25th of the month following the half-year. This is in replacement of the monthly/quarterly returns prescribed earlier. Penal provisions do exist in respect of Service Tax also. Failure to obtain registrations, failure to pay the tax, failure to furnish the prescribed returns, suppression of the correct value of the taxable services and failure to comply with notice do attract penal provisions as prescribed. But, it is specifically provided that no penalty is imposable on the assessees for any of the above failures, if the assessees prove that there was reasonable cause for the failure. This provision has been inserted to take care of the genuine difficulties of the new assessees.

**Analysis of Service Tax Revenue**

The service tax was introduced in India, in 1994-95 to broad base the Indian tax system and increases the revenue of the government to meet its various development plans. The Service Tax collections have shown a steady rise since its inception in 1994. The detailed growth of service tax is shown below in the table 1.The tax collections have grown manifolds since 1994-95. In the inception there were only three services with 5 percent tax rate yielded 410 crores with 3943 assessees.

Similarly, in 1995-96 with same tax rates the revenue growth realized was 101 percent, i.e. 846 crores with 4866 of assessees. During the year 1999-2000, the total revenue generated from the service tax were 2072 crores, and the total number of services brought under tax net were 27 with the number of assessees of 115495.

Similarly, for the year 2003-04 the service tax rate raised from 5 percent to 8 percent. The revenue realized was about 7890 crores, the annual growth of revenue was around 91 percent compared with the immediate last year, i.e. 2002-03. Total services brought under tax net were 58, the number of assessees were 403856.

Likewise, for the year 2009-10 the service tax rate was 12 percent. The revenue realized was about 58319 crores, the annual growth of revenue was minus 3,93 percent compared with the immediate last year, i.e. 2008-09. Total services brought under tax net were 117, the number of assessees were 1307286.

There is a substantial growth in the assessee's base from 403856 nos. in 2003-04 to 7, 74,988 number in 2004-05. It indicates a growth of almost 91%, which is significantly robust ever after 1994-95 in comparison with 74% growth rate of previous year.

**Table 2.The total service tax revenue and assessees**

| FinancialYear | Revnue Rs. Crores | % Growth | No. of Services taxed | No.of Assessees | % Growth |
|---|---|---|---|---|---|
| 1994-95 | 410 | Base year | 3 | 3943 | Base Year |
| 1995-96 | 846 | 101 | 3 | 4866 | 19 |
| 1996-97 | 1022 | 24 | 6 | 13982 | 187 |
| 1997-98 | 1515 | 49 | 18 | 45991 | 228 |
| 1998-99 | 1787 | 18 | 30 | 107479 | 133 |
| 1999-00 | 2072 | 16 | 27 | 115495 | 7.45 |
| 2000-01 | 2540 | 23 | 26 | 122326 | 5.91 |

| | | | | | |
|---|---|---|---|---|---|
| 2001-02 | 3305 | 26 | 41 | 187577 | 53 |
| 2002-03 | 4125 | 25 | 51 | 232048 | 24 |
| 2003-04 | 7890 | 91 | 58 | 403856 | 74 |
| 2004-05 | 14196 | 80 | 71 | 774988 | 91 |
| 2005-06 | 23053 | 62 | 84 | 846155 | 9.18 |
| 2006-07 | 37482 | 63 | 99 | 940641 | 11.17 |
| 2007-08 | 51133 | 36 | 100 | 1073075 | 14.08 |
| 2008-09 | 60702 | 19 | 106 | 1204570 | 8.78 |
| 2009-10 | 58319 | -3.93 | 117 | 1307286 | 8.53 |

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## CHALLENGES BEFORE THE SERVICE TAX:

Service tax administration in India has before it multi-dimensional challenges. Some of them are related to the very nature and growth of service sector in the economy and others relate to procedural aspects of the service tax collection.

The growth of service sector at a high rate offers opportunities as well as challenges to bring under the tax net hitherto uncovered services. This offers tremendous revenue potential to the Government. It is expected that in due course Service Tax would reduce the tax burden on international trade (Customs duty) and domestic manufacturing sector (Excise duty). So a planned growth of service tax would be commensurate with the goals of economic liberalization and globalization. This process requires levy of taxes on new services without substantial rise in the rate or cost of collection.

The proposed Goods and Service Tax is a part of the tax reforms that centre on evolving an efficient and harmonized consumption tax system in the country. Presently, there are parallel systems of indirect taxation at the Central and State level. The existing Service Tax System poses an imminent challenge, to reform its synergies, to eventually harmonize itself in the GST regime, as and when it is rolled out. Successful integration of goods and service tax would give India a world-class tax system and will bring in improved tax collection. In a way, it will boost our economy and enable us to compete at the global front. As a result, our system will eventually match the international standard in the sphere of indirect taxation. It will also end the long standing distortions of differential treatments to the manufacturing and service sectors. The effort to prepare for a smooth integration with the GST without any hardship to public is a big challenge that needs to be handled at the field as well policy level.

No doubt, the twin goal of revenue maximization and introduction of the culture of voluntary tax compliance also throw up major challenge before the service tax administration in the country. The Department has taken several steps to upgrade the skill of the officers handling Service Tax and equip them with necessary expertise. Training programmes on the issues related to Service Tax are regularly conducted for the Departmental officers. A Manual for scrutiny of Service Tax Returns has been prepared by the Central Board of Excise to enable the Departmental officers to carry out the scrutiny of Service Tax returns in a methodical and systematic manner. At the same time, the Govt. has also taken several facilitation measures for the tax payers. To assist them in the filing of Service Tax returns, Service Tax Returns Preparer (STRP) Scheme has been launched in 2009.

## FUTURE GROWTH PATH FOR SERVICE TAX IN INDIA:

Service tax is envisaged as the tax of the future. Well synchronized taxation on manufacturing, trade (domestic & international) and service without giving rise to cascading effect of taxation would be an ideal worth pursuing in the immediate future. This would bring in VAT in its truest sense, though the ultimate objection ushers in the regime of Goods and Service Tax (GST). Continued growth in GDP accompanied by higher rate of growth in service sector promises new & wider avenues of taxation to the Government. If the tax on services reduces the degree of intensity of taxation on manufacturing and trade without forcing the Government to compromise on the revenue needs, then one of the basic objectives of taxing the service sector would be achieved.

Voluntary tax compliance on the part of taxpayers demands prudent accounting practices and transparency in the conduct of their business. Marginal rates of taxation would be conducive in this process. Many new services may be brought under the tax net in future. The inclusion of all value added services in the tax net would yield larger amount of revenue and make the existing tax structure more elastic.

Advanced economies of Western Europe, North America and Far East have share of service sector in their GDP ranging from 60% to 80%. The growth in absolute quantum of GDP and proportion of Service-sector in GDP holds promise for larger revenue generation without increasing the existing level of taxation

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**Rationale for Goods and Services Tax (GST)**

The differential multiple tax regime across sectors of production leads to distortions in allocation of resources thus introducing inefficiencies in the sectors of domestic production. With regard to India's exports, this leads to lack of international competitiveness of the sectors which would have been relatively efficient under distortion-free indirect tax regime. Add to this, the lack of full offsets of taxes loaded on to the fob export prices. The export competitiveness gets negatively impacted even further. Efficient allocation of productive resources and providing full tax offsets is expected to result in gains for GDP, returns to the factors of production and exports of the economy.

While indirect taxes paid by the producing firms get offsets under state VAT and CENVAT, the producers do not receive full offsets particularly at the state level. The multiplicity of taxes further adds the difficulty in getting full offsets. The Joint Working Group of the Empowered Committee of the State Finance Ministers submitted its report on the proposed Goods and Services Tax (GST) to the Finance Minister in November 2007. A dual GST, one for the Centre and other for the states, would be implemented by 1 April 2010. The new system would replace the state VAT and the CENVAT.

Despite the success of VAT in the context of the Indian economy, there are still certain shortcomings in the structure of VAT both at the Central and at the State level as discussed earlier. Now, the proposal for Goods and Services Tax (GST) is not to replace VAT entirely, but to complement the VAT system or to tackle certain shortcomings of the VAT system. In other words, we can say that the introduction of GST in India is not an entirely new initiative, but it is to rectify certain basic implementation problems of VAT so that the tax system would be more beneficial for the economy and can function more smoothly. So, this is an attempt to improve the existing VAT system further as also the tax system of India. In the present State-level VAT system, there is a problem of what we may call 'tax overlapping' between Centre and State taxes. The problem is nothing but the Central Value Added Tax or CENVAT on certain commodities remains included in the value of goods to be taxed under State VAT. In Indian Constitution, taxes upon goods and services can be classified under three lists, namely Union List, State List and Concurrent List. Now, certain taxes can be levied either by the Centre or the State. For instance, land revenue taxes can be levied by States only whereas Railways is Centre's provision and State cannot levy any tax on this. Hence, there is a complete separation of taxes on items that are preserved for either State or Union list (and there is no issue of overlapping of taxes). But, goods or services (for example, trade and commerce in food stuffs) that belong to the concurrent list are subject to tax by both Centre and States.

Now, what is the problem? The same set of goods are taxed repeatedly, once by Centre and then by State (those goods and services that are in the concurrent list). This phenomenon 'tax upon tax' is called the cascading effect which complicates the tax system What is the rationale for Goods and services Tax (GST) (and increases administrative cost unnecessarily) since the same good is taxed again. This 'CENVAT Tax Element in State-level Tax' needs to be removed. (For this reason, there is a need for a constitutional amendment as discussed later). Chart-i: overlapping and non-overlapping centre-state Taxes

**Central and state VAT:**

In the VAT system, taxing service sector is practically difficult. First, due to the tremendous advancement of the information technology and digitization, the distinction between goods and services has become very complicated. In Indian context, the definition of goods is so framed that it should include intangibles like copyright and software. However, software upgrades (which are goods) can be supplied as part of a contract for software repair as well as maintenance services. Some other examples where an object can be 'services' and 'goods' simultaneously are as follows-

an on-line subscription to newspapers could be viewed as service, but online purchase and download of a magazine or a book would be treated as a purchase of goods.

Telecommunication services (for instance, wallpaper for mobile phones, ring tones, jokes, cricket scores and weather reports) also have similar problems, as some of them are treated as goods.

Nowadays, goods and services are being packaged as composite bundles and sold to final consumers under a range of supply-chain arrangements. Hence, there is a lacuna in the existing VAT system where the aspect of taxing services is not very clear-cut.

The Central GST and the State GST would be levied simultaneously on every transaction of supply of goods and services (except the exempted goods and services, goods that are outside the purview of GST and the transactions that are below the prescribed threshold limits). Moreover, both would be levied on the same price or value unlike State Value Added Tax (which is levied on the value of the goods inclusive of CENVAT and hence creates unnecessary cascading effect as discussed earlier). While the location of the supplier and the recipient within the country is immaterial for the purpose of CGST, sGsT would be chargeable only when the supplier and the recipient are both located within the state. We have discussed that aspect of IGST later where the transactions are taking place across the States.

## CONCLUSION

Service tax is levied on specified taxable services. At present, over 128 services are classified as taxable. As of 1st April 2012, the rate of service tax is 12 percent. In addition, education excess of 3% of the service tax is levied on taxable services. Thus the effective rate of service tax is 12.36%. Service providers are permitted to claim input tax credits of specified taxes, i.e. service tax, excise duty, a portion of the Customs duty, etc., paid on capital goods, inputs and services procured and used in the provision of service. The Central Government has notified elaborate rules for this. Separately the Central Government has also notified specific rules for determining value of taxable services, import and export of services, point which tax would be levied on services, etc.

The current system of taxing specified services is likely to undergo a paradigm change post the implementation of the proposed negative list of services. Under the proposed scheme, i.e. negative list of services, all services except those specified in the negative list or specifically exempted, would be brought under the scope of service tax. For this purpose, services are comprehensively defined as any activity carried out by a person for any other person for a consideration.

The differential multiple tax regime across sectors of production leads to distortions in allocation of resources thus introducing inefficiencies in the sectors of domestic production. With regard to India's exports, this leads to lack of international competitiveness of the sectors which would have been relatively efficient under distortion-free indirect tax regime. Add to this, the lack of full offsets of taxes loaded on to the fob export prices. The export competitiveness gets negatively impacted even further. Efficient allocation of productive resources and providing full tax offsets is expected to result in gains for GDP, returns to the factors of production and exports of the economy.

While indirect taxes paid by the producing firms get offsets under state VAT and CENVAT, the producers do not receive full offsets particularly at the state level. The multiplicity of taxes further adds The difficulty in getting full offsets.

In sum, implementation of a comprehensive GST in India is expected to lead to efficient allocation of factors of production thus leading to gains in GDP and exports. This would translate into enhanced economic welfare and returns to the factors of production, viz. land, labour and capital. Implementation of a comprehensive GST across goods and services is expected to increase India's GDP. GST would lead to efficient allocation of factors of production. The overall price level would go down. It is expected that the real returns to the factors of production would go up. The efficiency of energy resource use improves in the new equilibrium.

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