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BA Economics Honours | Semester 3 | Calicut University

Tax Policy in India

Course Code: ECO3MN201 • Module 3

Module III: Indirect Taxes in India

Prior to the introduction of the Goods and Services Tax (GST) in July 2017, India's indirect tax system was characterized by a multi-layered, fragmented, and inefficient maze of central, state, and local commodity taxes. Understanding this historical indirect tax architecture is essential for comprehending the economic necessity and transformative impact of contemporary indirect tax reforms.

Unit 10: Central Excise Duty

Historically governed by the **Central Excise Act, 1944**, Central Excise Duty was a commodity tax levied by the Central Government on the statutory event of **manufacture or production of goods within India** (Entry 84 of the Union List). Key structural features included:

- Excise duty was levied at the factory gate the moment a new manufactured product emerged from the assembly line, regardless of whether the good was sold immediately or stored in a warehouse.
- *Specific vs Ad Valorem Duties:* Specific duties were fixed monetary amounts per physical unit (e.g., ₹5 per liter of petrol); Ad Valorem duties were fixed percentages of the assessed transaction value.
- *CENVAT Credit Mechanism:* The introduction of the Modified Value Added Tax (MODVAT) in 1986, later renamed Central Value Added Tax (CENVAT) in 2000, allowed manufacturers to claim credit for excise duties paid on intermediate inputs and capital goods against the excise duty payable on final finished output, mitigating input tax cascading within the central manufacturing sphere.

Unit 11 & 12: Service Tax and State Sales Tax / VAT

- **Service Tax (1994 to 2017):** India pioneered service taxation in 1994 under the finance ministership of Dr. Manmohan Singh, initially taxing only three services (telephones, non-life insurance, and stockbroking) at 5%. Administered under Chapter V of the Finance Act, 1994 using the Union's residual legislative powers (Entry 97), Service Tax expanded into a massive revenue source. In 2012, India transitioned from a positive list approach to a **Negative List Regime**, wherein all commercial services were declared taxable except for an explicit negative list of 17 essential services.
- **State Sales Tax and State Value Added Tax (VAT - 2005 to 2017):** Prior to 2005, individual State Governments levied fragmented single-point sales taxes, which caused intense interstate "tax wars" (states offering zero sales tax to attract corporate factories). Following the landmark recommendations of the Empowered Committee of State Finance Ministers (chaired by Asim Dasgupta), all Indian States transitioned between 2003 and 2005 to a harmonized **State VAT** system. State VAT was a multi-stage tax on the sale of goods within a state, allowing dealers to claim Input Tax Credit on intra-state purchases.

Unit 13: Customs Duty

Customs Duty is levied by the Central Government under the **Customs Act, 1962** on the statutory event of **importation into or exportation from India** (Entry 83 of the Union List). Unlike domestic excise and sales taxes, Customs Duty remains outside the GST framework and continues to be levied independently:

- **Basic Customs Duty (BCD):** The standard statutory tariff levied on imported merchandise based on Harmonized System of Nomenclature (HSN) tariff classifications.
- **Countervailing Duty (CVD) and Integrated GST on Imports:** Prior to GST, imports were subject to additional customs duty (CVD) to neutralize domestic central excise. Under GST, all commercial

imports are treated as interstate supplies and subjected to **IGST** under Section 3(7) of the Customs Tariff Act, ensuring complete tax neutrality between imported and domestically produced goods.

- **Protective and Trade-Remedial Duties:**
  - *Anti-Dumping Duty:* Imposed when foreign exporters dump goods in India at prices below their normal domestic market value, injuring domestic manufacturers.
  - *Safeguard Duty:* Temporary protective tariff imposed when a sudden surge in import volume threatens serious injury to domestic domestic industries.

Unit 14 & 15: Structural Defects of the Pre-GST Indirect Tax Regime

The pre-2017 indirect tax regime suffered from fatal economic defects that crippled Indian manufacturing competitiveness:

1. **Cascading Effect of Taxes ("Tax on Tax"):** CENVAT credit (Central) could not be set off against State VAT; State VAT could not be set off against Service Tax. Manufacturers paid tax on the tax already embedded in inputs, inflating retail prices by an estimated 10%–15%.
2. **Interstate Trade Barriers (Central Sales Tax - CST):** A 2% origin-based Central Sales Tax levied on interstate sales was completely non-creditable for the buyer in the destination state. To avoid CST, companies established inefficient, fragmented branch warehouses in every single Indian State, distorting supply chain logistics.
3. **Double Taxation of Transactions:** Landmark legal disputes erupted where software, restaurant meals, and works contracts were simultaneously taxed as "goods" by State VAT authorities and as "services" by Central Service Tax authorities!

Advanced Theoretical Formulations and Empirical Frameworks (Analytical Division 1)

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Empirical Methodology, Identification Strategies, and Econometric Estimation

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Comparative Institutional Analysis, Market Failures, and Policy Governance

Economic outcomes are fundamentally mediated by institutional architectures, legal property rights regimes, and regulatory governance. In emerging market economies such as India, market imperfections—including asymmetric information, transaction costs, infrastructural bottlenecks, and credit constraints—often necessitate nuanced policy interventions that differ substantially from textbook laissez-faire predictions.

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Market Efficiency	Markets clear instantaneously; price mechanism allocates resources optimally without systemic friction.	Markets are prone to structural failures, information asymmetry, and coordination coordination failures.	Targeted regulatory oversight, public investment in infrastructure, and social safety nets.
Behavioral Motivation	Hyper-rational agents maximizing expected utility with complete cognitive computational capacity.	Bounded rationality, behavioral heuristics, loss aversion, and institutional anchoring effects.	Choice architecture, behavioral nudges (NITI Aayog initiatives), and consumer financial protection mandates.
State Intervention	State role restricted to core public goods, contract enforcement, and national defense (minimalist state).	State acts as developmental catalyst, risk-absorber of last resort, and promoter of equitable distribution.	Strategic industrial policy (PLI schemes), counter-cyclical fiscal intervention, and universal public services.
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Technological Progress	Exogenous technological shocks arriving randomly (Solow neoclassical growth model).	Endogenous technological innovation driven by R&D, human capital, and intellectual property institutions.	National Innovation Foundation, Startup India, and public digital infrastructure (India Stack / UPI).

Comprehensive Empirical Analysis: The Kerala Model and Sub-National Development

In the context of the Indian economy and sub-national development paradigms, the Kerala Model of Development provides a seminal empirical case study illustrating the complex trade-offs between social development and economic growth. Characterized by high physical quality of life indicators—including near-universal adult literacy, high life expectancy, and low infant mortality rates comparable to advanced Western economies—achieved despite historically modest per capita state domestic product, Kerala demonstrates the transformative power of public social expenditure, agrarian land reforms, and decentralized local governance (Panchayati Raj institutions).

However, contemporary economic analysis also highlights structural challenges confronting this development paradigm: high educated unemployment, fiscal constraints stemming from escalating public debt servicing and pension obligations, and heavy reliance on external remittance inflows from migrant

workers in the Persian Gulf. Sustaining this high-welfare equilibrium necessitates transitioning toward a knowledge-driven economy, incentivizing high-tech manufacturing, and mobilizing sustainable sub-national fiscal resources.

Policy Synthesis and Analytical Evaluation

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