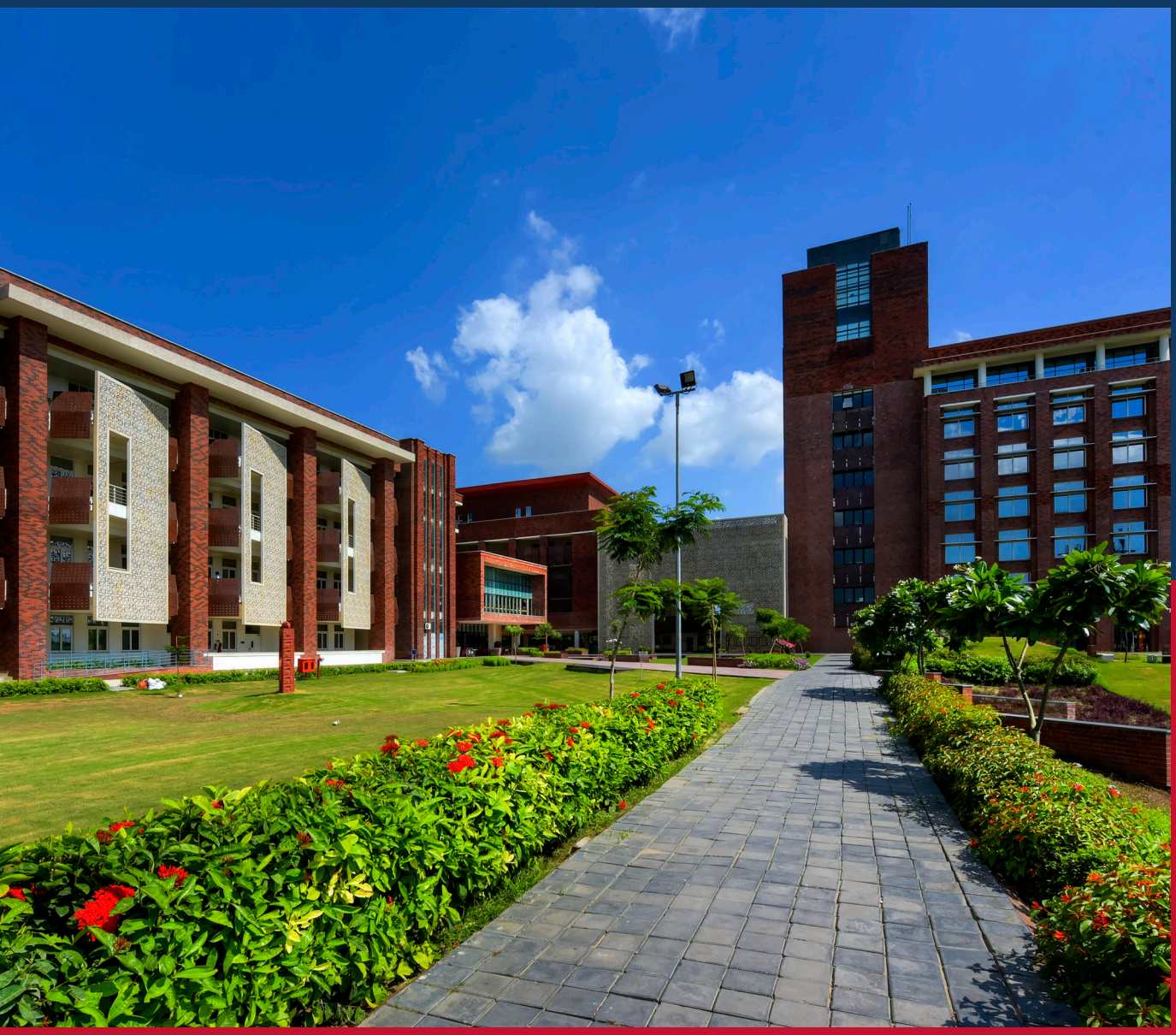
ASHOKA UNIVERSITY

ASHOKA UNIVERSITY | ICPP Isaac Centre For Public Policy



Economics of GST Evasion in the Indian Context

By Bhanu Gupta

The Value Added Tax (VAT) has become the predominant form of indirect taxation across the globe besides being a major source of fiscal revenue. According to recent estimates by Caragher (2023), around 175 countries have adopted VAT[1] . In this article, we will review the economics of VAT and explain the advantages of VAT design in curbing evasion. We will also explore how the Indian VAT system has been designed to reduce evasion under the Goods and Services Tax (GST)[2]. Finally, we will discuss the shortcomings that exist in the current Indian tax structure and the remedial steps taken by the government to check tax evasion.

Can VAT reduce evasion?

VAT is a mechanism where the value-added at each stage of the supply chain is taxed by the government. Usually, the alternative is sales tax in which the tax is levied at the final point of sales, that is, when the goods are sold by the retailer to the final consumer. Theoretically, if there is no evasion, then both sales tax and VAT should yield the same amount of revenue. In fact, VAT is more cumbersome and probably inefficient because it imposes compliance costs on all agents involved in production and not just the final retailer. Despite this, it is preferred over other forms of taxation because of the following reason:

Self–enforcement property of VAT: VAT can reduce evasion because it creates opposing incentives for agents who are upstream versus downstream in the supply chain. Let's consider an illustrative example. Consider a 3-agent supply chain which consists of a Producer (P), Wholesaler (W) and Retailer (R). P sells goods worth Rs.100 to W who in turn sells it to R for Rs.150. The retailer sells the good to the final consumer for Rs.200. Now, let's assume that the tax rate is 10%. If the cost of production is 0, then the tax liability of P is Rs.10. Similarly, the tax liability of W is Rs.5, which is 10% of the value-added at that stage. Now, the way VAT is enforced, the wholesaler will have a gross liability of Rs.15 (which is 10% of Rs.150), but can claim input tax credit (ITC) of Rs.10, which is the tax paid by the producer. Hence, his net liability will be Rs.5. W can claim this tax credit only when P has filed his taxes. In case P tries to underreport his sales to evade taxes, W will force him to report the true sales. This is called the self-enforcement property of VAT.

In the Indian context, the GST architecture enshrines the self-enforcement property. The GSTR-1 form contains the details of all the outward supplies of a seller and the identification number of each buyer. This form, in the case of monthly individual filings, is to be submitted on the 11th of each month. Once all the sellers have filed their returns, the buyers can see the ITCs credited to them in the GSTR-2A form. In case the seller hasn't filed the GSTR-1 form or has underreported the sales, the buyers can catch that online. The taxpayers then file their taxes using the GSTR-3 form on the 24th of each month. In this form, the taxpayers provide information on their total tax liability, ITC available, and net tax liability.

[1]The notable exception is the United States of America where sales tax is the main source of indirect taxes.
[2]The Goods and Services Tax was introduced in 2017. It is a VAT on both goods and services.

The Indian GST regime not only relies on the opposing incentives between the taxpayers of a supply chain to curb evasion, but it also creates an additional layer of verification through double reporting of sales. The sales reported by a taxpayer on the GSTR-1 form should match the imputed value of the inputs reported the buyers when they claim ITC. Any mismatch between the two is a potential red flag for the tax authorities. Conversely, if the ITC claimed by the buyers is more than the sales reported by the sellers, that would also signal evasion.

Last-mile evasion

Even though the VAT design can curb evasion between firms, it is not completely immune to tax evasion. The Achilles heel of the VAT is the evasion at the end of the supply chain, that is, at the retail stage. Since the final consumer or any unregistered GST buyer doesn't require ITC, they have no incentive to force the retailer to report accurate sales. The retailer can underreport sales and reduce his tax liability. Often this is done in collusion with the final consumer where the consumer gets a discount if he doesn't insist on a formal receipt (often called "pakka" bill in North India).

There is growing empirical evidence documenting the prevalence of last mile evasion or evasion at the retail stage. Pomeranz (2015) in her seminal study shows that when the tax authorities informed taxpayers that their likelihood of getting audited is going to increase, the retailers started reporting higher sales as compared to B2B firms. She argues that B2B firms respond less to increased enforcement, because they evade less taxes to begin with because of the VAT architecture. This shows that double reporting of transactions under VAT leads to lower evasion. In contrast, retailers respond more to an increase in likelihood of audit because their initial level of evasion was higher. Another compelling evidence on last-mile evasion comes from the study conducted by Naritomi (2020) where she evaluated a Brazilian program which incentivized the final consumers to report evasion by the retailers instead of colluding with them. The program provided tax rebates and monthly lottery prizes to consumers who asked for receipts by creating an online account system where the consumers could verify sale receipts reported by the firms and act as whistle-blowers by reporting discrepancies. The program led to a 21% increase in sales and a 9% increase in tax collection.

In the Indian context, last mile evasion remains a concern where anecdotally, the practice of giving informal receipts is rampant. The prevailing GST system aims to counter this in three ways. First, the e-way bill requirement not only helps in tracking the movement of goods across states but can also aid in curbing evasion at the inter-state level. Under this requirement, if a seller transports goods worth more than Rs.50,000, then he needs to carry an e-way bill during transportation. This bill can be generated only on a government online portal which allows officers at the state borders to verify the authenticity of the e-way bill. The e-way bill system creates an additional layer of paper trails for many transactions and helps

in reducing under-reporting of sales. Second, the GST law mandates all the e-commerce platforms such as Amazon and Flipkart to collect 1% tax on all sales done through their platforms. This is called tax collected at source (TCS) and reported by the e-commerce platforms to the tax authority. Thus, TCS reporting ensures that the sales done through these platforms cannot be under-reported by the sellers. Finally, the tax department has introduced an "invoice incentive scheme"[3] to encourage consumers to ask for a formal or "pakka" receipt. The consumers have to upload their invoices on an online platform and randomly selected winners receive monetary rewards. The objective of the scheme is to dissuade the final consumers from colluding with the retailers to evade taxes.

Evasion through Fake Invoices

Besides last-mile evasion, the other channel through which firms try to evade GST is by inflating their expenses. They report buying inputs from fake firms which are created specifically for this purpose and are called "invoice mills". Such firms register for a short period of time, provide fake invoices, and then disappear from the system. The large-scale prevalence of fake invoices has led to massive revenue losses to the exchequer. For instance, during the first three quarters of FY 2024, it is estimated that fake credits worth Rs.19,690 crores have been detected so far[4]. This amounts to around 12% of the monthly collections in January 2024[5].

Penal action against fake firms can vary across states which can jeopardize the cooperative spirit required for effective functioning of GST. For instance, consider a situation where an invoice mill exists in state A and issues fake invoices to a firm in state B. If state A is lackadaisical in catching fake firms, then lack of enforcement in state A can lead to overclaiming of ITC in state B which can result in a revenue loss for state B. Thus, having an effective strategy to curb fake ITC, which is consistent across states, is important for preventing acrimony between states.

Several policies have been introduced by the tax department to curb fake ITC. Since the invoice mills are likely to register and deregister quickly, the GST law encourages Aadhaar verification of all new firms that want to register under GST. Some pilot projects are also being conducted which include use of biometric verification of new registrants, as well as, integrating the GST data with other third-party datasets such as electricity bills, PDS, income tax, among others, to verify the identity of new registrants. In case that is not possible, the department can conduct a physical inspection of a new firm and cancel its registration in case of fraudulent operations. However, because of inadequate human resources, many firms continue to remain unverified. For instance, in a special drive initiated by the central government, around 21,500 firms were found to be non-existent between May to August, 2023[6].

[3]This scheme was launched in September 2023 and called "Mera Bill Mera Adhikar". Source: https://pib.gov.in/PressReleasePage.aspx?PRID=1951804
[4]Source: https://indianexpress.com/article/business/fake-credit-claims-worth-rs-19690-crore-in-fy24-till-january-haryana-delhi-lead-9235100/
[5]Source: https://pib.gov.in/PressReleasePage.aspx?PRID=2000957#:~:text=The%20gross%20GST%20revenue%20collected,05%3A00%20PM%20on%2031.01
[6]Source: https://gstcouncil.gov.in/sites/default/files/01_NCECSC_Intro.pptx

Another important step taken by the department to curb evasion has been to analyze filing patterns to determine suspicious firms and block their operations. The fake firms usually show a higher sales to profit ratio so that they can provide extra ITC to their buyers. In the extreme case, such firms might only show sales and no profits. In such a scenario, they only file GSTR-1 (which records outward supplies) and not file GSTR-3 (which is used to pay taxes). From 1st January 2022, the department does not allow any firm which has a pending GSTR-3 from filing GSTR-1. While this policy might help in preventing some fake firms from operating, it might also impose additional burden on liquidity-constrained legitimate firms and their trading partners. If a firm is liquidity constrained in a month, then it might be optimal for such a firm to delay filing its taxes and pay the penalty as mandated by law. However, because of blocking policy, such firms will not be able to file its GSTR-1 which will increase the tax liability of its buyers as they are unable to claim ITC. Thus, such a policy can be particularly harmful in sectors which often face working capital constraints.

Finally, the tax department is using e-invoicing in B2B transactions to prevent firms from claiming fake ITC. Under this scheme, the sellers validate the invoice generated by them on the Invoice Registration Portal (IRP). They can then share the copy of the validated invoice with their buyers. This system has the advantage of reducing clerical errors, removing duplicate entries of the same invoice, and creating additional paper trails for each transaction which can reduce the probability of fake invoices. Over the last few years, more and more businesses have been brought under the ambit of e-invoicing[7]. While leveraging technology to validate transactions is a step in the right direction, it also creates a significant compliance burden on the small and mid-size businesses. As yet, no publicly available systematic analysis exists on the impact of these technology-heavy interventions on taxpayers.

Importance of Human Capital in GST Administration

A key determinant for the success of a fully-digitized tax administration is providing adequate and up-to-date technical training to tax officials so that they can effectively perform data-driven enforcement. There is considerable heterogeneity in the use of technology between center and states in the implementation of GST. The Indian GST architecture is unique as the same law is implemented by both the state and central governments. At the introduction of GST, the firms whose turnovers was below Rs.5 crores per annum were divided between the state and the center in the ratio of 9:1. Larger firms and new firms were divided in equal ratio. Within a state, the number of taxpayers per tax officer vary a lot between the central and state administrations. This can potentially result in differences in several aspects of administration such as grievance redressal and issuance of refunds, among others. Additionally, while the center has a dedicated analytical wing to carefully analyze the GST data, many state governments are yet to establish a fully-functional analytical wing to curb evasion.

[7]As of 1st August 2023, all taxpayers with turnover above Rs.5 crores per annum must use e-invoicing for all the B2B transactions. A few sectors are exempted from this requirement.

There can also exist significant diversity in the methods of training and organization in various tax departments across states. For instance, the Government of National Capital Territory of Delhi does not have a dedicated cadre of cutting-edge tax officials and thus relies on officials deputed from other ministries. This is in sharp contrast to other states who do have a dedicated cadre of tax officials. Additionally, while some states have managed to leverage technology more efficiently by developing their own backend digital system to undertake GST administration even as majority of states continue to rely on the GSTN infrastructure for tax administration.[8] Thus, effectiveness of tax administration varies considerably across states and is correlated with their overall levels of economic development.

Conclusion

In this article, we have shown how the Indian GST architecture has been designed to leverage the VAT design in curbing evasion. The fully digital GST system has built in third-party reporting and double reporting of transactions in several forms to curb evasion. The tax department is also using analysis of filing behavior and other key parameters to tackle evasion and promote formalization of the economy. These steps have contributed to a robust growth in GST collections in the last few quarters. However, evasion at the retail level and prevalence of fake invoices remain a cause of concern.

The ultimate success in reducing evasion and conducting time-bound judicial proceedings against fake firms will be dependent on the quality of tax officers. These officers require adequate training in order to be able to fully exploit the rich data that is being collected on the GST portal each month, as well as leverage the intelligence reports generated by the central GST analytical wing. However, the quality of tax officers is linked to the overall levels of state capacity and human capital development. As most of the state-level taxes have been subsumed by GST, there is a realistic concern that variations in state capacity might lead to a larger dispersion in own-state revenues across Indian states.

[8]At the introduction of GST, 9 states created their own infrastructure to manage GST operations. These states are called Model 1 states and include: Andhra Pradesh, Goa, Haryana, Karnataka, Kerala, Maharashtra, Meghalaya, Sikkim and Tamil Nadu. Rest of the states use the GSTN infrastructure and are called Model 2 states.

References

1. Caragher, Jacinta. 2023. “How many countries have VAT or GST? 175.” https://www.vatcalc.com/global/ how-many-countries-have-vat-or-gst-174/ (accessed on April 1, 2024).

2. Pomeranz, Dina. “No taxation without information: Deterrence and self-enforcement in the value added tax.” American Economic Review 105, no. 8 (2015): 2539-2569.

3. Naritomi, Joana. “Consumers as tax auditors.” American Economic Review 109, no. 9 (2019): 3031-3072.