

# Service Tax in India



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# Need for Service Tax

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## Introduction

Service Tax is a form of indirect tax imposed on specified services called taxable services'. Service tax cannot be levied on any service which is not included in the list of taxable services. For the purpose of levying service tax, the value of any taxable service is the gross amount charged by the service provider for the service rendered by him.



It is administered by the Central Excise Department of Ministry of Finance, Government of India .

## Brief History of Service Tax

Service tax was introduced for the first time in the year 1994, by making provisions in Chapter V of the Finance Act 1994.

Prior to 1994 the centre levied excise duties and the states levied sales tax on commodities. The centre levied excise duties on tobacco and other manufactured products produced in India, while the states levied taxes on the sale and purchase of only goods (other than newspapers) and not services. "Services" were excluded from these taxes.

However, although taxation of services was not included with those of goods, a few services were listed separately for taxation in central and state lists of the seventh schedule. The main items included under the central list were taxes on goods and passengers carried by railways, sea or air, taxes on railway fares and freights. In addition, the central government had also been levying expenditure tax on hotels and restaurants, which is basically in the nature of a

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tax on the service. Similarly, services included within the purview of taxation by the states included (i) taxes on consumption of electricity, (ii) Taxes on advertisements other than those published in the newspapers, (iii) taxes on goods and passengers carried by road or inland waterways, (iv) taxes on entertainments, amusements, betting and gambling. Besides, by virtue of 46<sup>th</sup> amendment to the Constitution, works contract and hire purchases had also been brought within the definition of 'sale of goods' and under the relevant sales tax acts. Thus, although services in general were not subject to taxation, a number of levies on specified services were separately listed under both central and state lists.

To begin with the service tax covered only the following three services rendered by:

- Insurer, carrying on general insurance business
- Telegraph Authority, in relation to a telephone connection
- Stock Broker

Later in 1996, it was extended to include three more Service Providers, i.e.

- Advertising Agency
- Courier Agency
- Telegraph Authority in relation to a pager

In 1997, the Finance Act, enlarged the levy of Service Tax to twelve more services rendered by :

- Air Travel Agent
- Clearing and Forwarding Agent
- Consulting Engineer
- Custom House Agent
- Goods Transport Operator
- Mandap Keeper
- Manpower Recruitment Agency
- Outdoor Caterer
- Pandal or Shamiana Contractor

- Rent-a-Cab Scheme Operator
- Steamer Agent
- Tour Operator
- Goods Transport Operator
- Outdoor Caterer
- Pandal and Shamiana Contractor

In the Union Budget of India for the year 2006-07, service tax has been increased from 10% to 12%. This budget also withdrew service tax exemption for the following services:

- Services provided by practicing chartered accountants, company secretary or cost accountants.
- Call Centre and Medical Transcription Centre
- Service in relation to Enterprise Resource Planning software system provided by management consultant
- Catering services provided by an outdoor caterer on a railway train and in premises of an academic institution or medical establishment

In addition, the following new heads of taxable services have been introduced with effect from 1 May 2006, which are :

- Credit card, debit card, charge card or other payment card services including services provided by an issuing bank or an acquiring bank to any other person in relation to settlement of any amount transacted through such card.
- ATM operations, maintenance and management
- Services of a registrar, share transfer agents and bankers to an issue
- Sponsorships of events, other than sports events by companies
- International air travel excluding economy class passengers
- Container services on rail, excluding the railway freight charges
- Business support services
- Recovery agents, Ship management agents
- Travel on cruise ships

- Public relation management services
- Sale of advertising space or time (other than in print media and of time slots by broadcasting agency)
- Ship management services
- Internet telephony services
- Auction services (except that under the directions or orders of a court of law or auction by the Government)

Every year new services have been brought under the tax net.

### **Need for Service Tax**

#### 1) The Phenomenal growth of the Service Sector

The Service Sector is one of the most encompassing and growing sector today. It has crossed the boundaries of finance, insurance, transport, communication and tourism to include areas such as environment, education and counseling services to name a few. This has resulted in a world boom in respect of services.

The growth of the service sector in the Indian Economy has been spectacular in the last 10 – 15 yrs. Whereas in advanced countries GDP growth has been propelled initially by manufacturing, in India it is the service sector that has led the growth .

Table 1 shows the percent share of the service sector in GDP in the year 2005-2006. We note that the share of the service sector in the country's GDP is the highest at 53.54 as compared to agriculture and allied activities, which was 18.97 and industry which was 27.39 respectively. If we compare the percentage share of these sectors from 1999-00 to 2005-06, we find that agriculture and allied activities has shown a fall in its percentage share in GDP from 25.33 during 1999-00 to 18.97 in 2005-06; Industry's share has risen from 25.42 in 1999-00 to 27.39 in 2005-06, but the rise has been rather slow. The share of the service sector has grown the most from 49.25 in 1999-00 to 53.64 in 2005-06.

TABLE-1  
GROSS DOMESTIC PRODUCT BY INDUSTRY

At Current Prices (99-00)

(% share in GDP )

|                                                     | 1999-00 | 2000-01 | 2001-02 | 2002-03 | 2003-04 | 2004-05 | 2005-06 |
|-----------------------------------------------------|---------|---------|---------|---------|---------|---------|---------|
| Gross domestic product at factor cost               | 100.00  | 100     | 100     | 100     | 100     | 100     | 100     |
| Agriculture, Forestry and fishing                   | 25.33   | 23.69   | 23.24   | 20.77   | 21.02   | 19.56   | 18.97   |
| Agriculture                                         | 23.17   | 21.48   | 21.06   | 18.55   | 18.96   | 17.62   |         |
| Forestry and logging                                | 1.09    | 1.10    | 1.07    | 1.05    | 0.96    | 0.89    |         |
| Fishing                                             | 1.07    | 1.11    | 1.11    | 1.18    | 1.10    | 1.04    |         |
| Industry                                            | 25.42   | 26.30   | 25.55   | 26.67   | 26.44   | 27.28   | 27.39   |
| Mining and quarrying                                | 2.32    | 2.37    | 2.31    | 2.78    | 2.60    | 2.64    | 2.64    |
| Manufacturing                                       | 14.74   | 15.56   | 15.03   | 15.34   | 15.35   | 15.95   | 15.89   |
| Manufacturing registered                            | 9.65    | 10.32   | 10.19   | 10.45   | 10.46   | 11.02   |         |
| Manufacturing unregistered                          | 5.08    | 5.24    | 4.85    | 4.89    | 4.89    | 4.93    |         |
| Electricity, gas and water supply                   | 2.50    | 2.39    | 2.27    | 2.39    | 2.22    | 2.14    | 2.07    |
| Construction                                        | 5.87    | 5.97    | 5.94    | 6.16    | 6.27    | 6.55    | 6.80    |
| Service                                             | 49.25   | 50.01   | 51.22   | 52.56   | 52.54   | 53.16   | 53.64   |
| Trade, hotels, transport, storage and communication | 21.53   | 22.10   | 22.67   | 23.28   | 23.92   | 24.61   | 24.92   |
| Trade, hotels and restaurants                       | 14.18   | 14.53   | 14.89   | 15.36   | 15.68   | 16.15   |         |
| Trade                                               | 12.94   | 13.24   | 13.59   | 14.02   | 14.35   | 14.69   |         |
| Hotels & restaurants                                | 1.24    | 1.28    | 1.30    | 1.34    | 1.34    | 1.46    |         |
| Transport, storage & communication                  | 7.35    | 7.58    | 7.77    | 7.92    | 8.23    | 8.45    |         |
| Railways                                            | 1.09    | 1.03    | 1.07    | 1.09    | 1.05    | 1.05    |         |
| Transport by other means                            | 4.60    | 4.82    | 4.81    | 5.09    | 5.33    | 5.57    |         |
| Storage                                             | 0.08    | 0.08    | 0.08    | 0.08    | 0.07    | 0.07    |         |
| Communication                                       | 1.59    | 1.65    | 1.82    | 1.67    | 1.78    | 1.77    |         |
| Fin. insurance, real estate & bus. services         | 12.99   | 13.16   | 13.93   | 14.67   | 14.53   | 14.27   | 14.47   |
| Banking and insurance                               | 5.90    | 5.48    | 5.96    | 6.42    | 6.23    | 6.75    |         |
| Real estate, ownership of dwell & bus services      | 7.09    | 7.68    | 7.97    | 8.25    | 8.30    | 8.52    |         |
| Community services and pers. services               | 14.73   | 14.75   | 14.62   | 14.61   | 14.10   | 14.28   | 14.25   |
| Public administration and defence                   | 6.68    | 6.54    | 6.43    | 6.29    | 6.05    | 6.11    |         |
| Other services                                      | 8.05    | 8.21    | 8.19    | 8.32    | 8.05    | 8.17    |         |

SOURCE: National Income Statistics, CMIE, October, 2006

The Services sector in India continues to expand steadily, since the beginning of the Tenth Plan in 2002-03, with annual growth of 7.0 per cent or more.

In 2005-06, the growth in the services sector continued to be broad based. Within the service sector, trade, hotels, transport and communication services continued to lead with a contribution of 24.92 per cent. The catalysts for this impressive growth were: i) The progress in expanding the railway passenger network ii) production and sale of commercial vehicles and iii) the addition to existing telephone connections, particularly mobiles. An all-time high of 4.7 million new users signed up for mobile services in January 2006, taking the total cellular subscriber base in India to around 80 million.<sup>1</sup>

Financial services (comprising banking, insurance and real estate services) have also maintained the momentum with the Indian financial markets having matured considerably.

India's IT market had a turnover of US\$ 16.2 billion in 2004-05. IT companies are expected to account for 8-10 per cent of GDP by 2008 from 1.4 per cent in 2001.<sup>2</sup>

The burgeoning trade in services has also led to the growth of this sector. According to WTO, India joined the ranks of the top ten service exporters securing the 10<sup>th</sup> place, up from the 16<sup>th</sup> rank in 2004.

The economy has been speeding ahead on the back of robust services exports. The exports in this sector grew by 71 per cent in 2004-05 to US\$ 46 billion and 75 per cent to US\$ 32.8 billion in April-September, 2005. In 2004-05, software services exports grew by 34 per cent to US\$ 17.2 billion and by 32 per cent to US\$ 10.3 billion in the first half of 2005-06. India's share in the world market for IT software and services (including BPO) increased from around 1.7 per cent in 2003-04 to 2.3 per cent in 2004-05 and an estimated 2.8 percent in 2005-06.<sup>3</sup>

A new development in services exports is the explosive growth of business services, including professional services. This has been reflected in the growth of miscellaneous services (excluding software),



which grew by 216 per cent to US\$ 16.3 billion 2004-05, and 181 per cent in the first half of the current year to reach a level of US\$ 15.4 billion and surpass even the value of software services exports.<sup>4</sup>

However, the contribution of this sector to the Government exchequer has not been commensurate with its growth. It has no doubt increased since 1994 – 95 when it was introduced, but considering the growth of this sector, the increase could have been more. The collection figures of service tax and those of customs and excise are given in Table 2. The table shows that service tax as a percentage of service sector's GDP has grown from 0.12 per cent to 0.41 per cent from 1994-95 to 2001-02. The number of tax payers has also increased, but rather slowly.

**TABLE-2**  
**GROWTH OF CUSTOMS AND EXCISE AND SERVICE TAX**  
(Rs. Crores)

| Year    | Customs | Excise | Service | No of Service Tax-Payers | Service Tax as Percentage of GDP |
|---------|---------|--------|---------|--------------------------|----------------------------------|
| 1994-95 | 26683   | 37467  | 407     | 3942                     | 0.12                             |
| 1995-96 | 35502   | 40565  | 862     | 4865                     | 0.21                             |
| 1996-97 | 42890   | 44918  | 1059    | 13981                    | 0.22                             |
| 1997-98 | 40537   | 47837  | 1586    | 45991                    | 0.29                             |
| 1998-99 | 41278   | 52454  | 1957    | 90455                    | 0.31                             |
| 1999-00 | 48315   | 61389  | 2072    | 114358                   | 0.29                             |
| 2000-01 | 47616   | 68918  | 2610    | NA                       | 0.33                             |
| 2001-02 | 54822   | 81448  | 3800    | NA                       | 0.41                             |

Source: EPW, Vol. XXXVII, No.40, October 5, 2002, p.4097

Given the phenomenal growth of the service sector in the last few years it is but expected to contribute more to the exchequer than it has been doing this far. Exclusion of this sector from the purview of indirect taxation renders the tax base narrow, and makes it difficult to enhance the tax-GDP ratio.

## 2) Efficiency

Efficiency is reflected in terms of resource allocation. When one sector or activity is untaxed, the burden of tax falls on the other sectors, thus creating a discrepancy in resource allocation, in favour of the untaxed sector. So the untaxed sector/activity grows at the expense of the taxed sectors/activities. The organized industrial sector in particular, has had to bear disproportionate burden of internal indirect taxation, which has affected the competitiveness of this sector. It is imperative to extend indirect taxes on services and integrate it with those of goods, to have neutrality in taxation and avoid distortion of consumer choice between goods and services.

**3) Equality** also suffers when services go untaxed, as more often than not, the services are consumed by the rich. Service tax would be an ideal way of reducing the disparity in incomes of the rich and the poor.

**4) The line between goods and services is often thin.** This creates intractable problems in the implementation of taxes that are designed to fall only on goods such as our duties of excise and sales taxes. With the advent of modern digital technology, the line between goods and services is getting increasingly blurred, as many products which were earlier transacted in tangible forms, are now produced and sold in forms that are intangible. This is posing a challenge for tax authorities all over the world. Service tax would take care of such problems.

**5) Service tax will pave the way for the orderly evolution of the tax system in the country.** As the state governments do not have general power to tax services along with goods, but are assigned a number of specified services., they have imposed multiple levies resulting in a haphazard evolution of the state tax systems. In a bid to include more services within the purview of taxation, states have imposed tax on hotels and restaurants. However, when the taxes on goods and services are merged to form a VAT, the multiple taxes, electricity duty, luxury taxes and passengers and goods taxes should become a part of the value added tax system, so that the tax system remains simple. Integrating the taxes on services with those of

goods will result in enhancement of the revenue productivity as well as evolve an efficient and least distorting tax system. In almost every country of the world excepting China and Malaysia where value added tax is levied, VAT is extended to both goods and services.

**6) The need to evolve a coordinated system of domestic trade taxes both at central and state levels.** In order to relieve taxes on inputs, it is important to levy the tax on both goods and services. Over the years, by extending input credit schemes, union excise duty has almost been transformed into manufacturing stage VAT. However, services have remained outside the VAT system and therefore, it has not been possible to provide credit for all input taxes. It therefore, becomes imperative to evolve a suitable mechanism to provide input tax relief on the taxes paid on services by having a coordinated system of taxation on goods and services.

### **7) New source of revenue for the Government**

Government has been looking for newer ways to enhance its revenue without pinching the poor. Service tax is the answer to this need of the government in the present scenario

### **Concluding remarks**

Taxation on services though required for the above reasons, should exempt basic public services, and other meritorious services. As in the case of taxation of goods, there should also be an exemption list to take into account the basic requirements of society. This list should not be based on whether the service provider is government or the private sector, but whether taxing the service is administratively desirable, and the service in question falls into the meritorious category contributing to physical or human resource development. Small service providers may also be exempted for administrative reasons.

### **NOTES**

- 1 IBEF (India Brand Equity Foundation), Services, April 19, 2006, <http://w.w.w.ibef.org/economy/services.aspx>.

2 IBEF (India Brand Equity Foundation), Services, April 19, 2006, <http://w.w.w.ibef.org/economy/services.aspx>.

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