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TAX STRUCTURE AND INDIRECT TAXES IN THE TEXTILE SECTOR: AN ANALYSIS OF DIRECT AND INDIRECT TAXES

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ABSTRACT:

This research paper provides a comprehensive analysis of the tax structure in the Indian textile sector, focusing on the transition from the pre-GST indirect tax regime to the post-GST framework. It examines the complex web of central and state-level taxes that existed prior to the Goods and Services Tax (GST) implementation, highlighting inefficiencies such as the inverted duty structure. The introduction of GST in 2017 was a transformative step, subsuming multiple taxes and streamlining the tax process. This paper delves into the corrective measures introduced in January 2022, which resolved the inverted duty structure, particularly in the Man-Made Fiber (MMF) segment. It also discusses the impact of GST on natural fibers like cotton, silk, and wool, which continue to benefit from favorable tax treatment. Additionally, the study explores how the new GST framework has bolstered the export competitiveness of Indian textiles by making export processes more cost-effective. The paper concludes by offering future suggestions and recommendations, including further simplification of the tax system, support for SMEs, promotion of sustainable practices, and continuous monitoring of the tax framework. These insights aim to contribute to a better understanding of the tax dynamics in the textile industry and propose ways to enhance its competitiveness in the global market.

Keywords: Goods and Services Tax (GST), Inverted Duty Structure, Indian Textile Industry, Input Tax Credit, and Export Competitiveness

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INTRODUCTION:

The Indian textile sector, a critical contributor to the economy, has historically operated under a complex indirect tax system involving multiple central and state-level taxes. The introduction of the Goods and Services Tax (GST) in 2017 marked a significant shift, consolidating these taxes under a unified framework. GST aimed to simplify compliance, enhance input tax credits, and reduce the overall tax burden on manufacturers. This paper explores the pre- and post-GST tax structures, focusing on the corrections made in 2022 to resolve issues like the inverted duty structure, and their impact on the competitiveness of the textile industry.

RESEARCH OBJECTIVES

- **To analyze the pre-GST indirect tax structure in the Indian textile sector**: This objective seeks to investigate the various central and state-level taxes, such as excise duties, VAT, and CST, that were imposed on different stages of textile production before the implementation of GST.
- **To examine the impact of the Goods and Services Tax (GST) on the overall cost structure and competitiveness of the textile industry**: This objective focuses on understanding how the introduction of GST streamlined the tax system, the benefits of input tax credit, and how it affected pricing, job work, and the international competitiveness of Indian textiles.
- **To evaluate the implications of the corrected GST structure, particularly addressing the inverted duty issue in the Man-Made Fiber (MMF) segment**: This objective aims to assess the changes brought about by the correction of the inverted duty structure in January 2022, its effects on reducing tax inefficiencies, and its overall impact on the textile industry's value chain.

REVIEW OF LITERATURE

Pandey, Saxena, and Paliwal (2023) explored the perceptions of various textile industry stakeholders, including manufacturers, wholesalers, retailers, consumers, and tax professionals, regarding India's multi-slab Goods and Services Tax (GST) system. Conducted in Surat, a major textile hub, their study used interviews, surveys, and a logit regression model to analyze the data. The researchers found that while GST has simplified tax compliance, the dependency on tax professionals for monthly filing has increased business costs. Additionally, challenges related to tax refunds negatively affect the ease of doing business in the post-GST era.

Yoganandham (2023) examined the impact of the Goods and Services Tax (GST) on India's economy, focusing on indirect tax collection and recovery initiatives. The study highlights GST's role in streamlining taxation, increasing indirect tax revenue, and promoting economic activity across sectors like logistics, banking, and entertainment. While logistics experienced improved efficiency and revenue, banking services saw a rise in costs. The entertainment and tourism sectors faced mixed outcomes due to higher taxes. The research provides a macroeconomic perspective, emphasizing the GST's overall contribution to transparency, corporate growth, and the tax-to-GDP ratio.

Umakanth, Homavazir, Gupta, and Shrivastava (2024) explored the impact of Goods and Services Tax (GST) and other indirect taxes on the financial performance of Micro, Small, and Medium-Sized Enterprises (MSMEs). The study gathered data from 400 registered MSMEs, focusing on factors such as technological advancements, tax awareness, and systemic changes. Using partial least squares equation modeling (PLS-SEM), the research revealed that GST has positively influenced business environment efficiency, profitability, and operational effectiveness. The findings offer valuable insights for regulators and emerging economies seeking to enhance MSMEs' performance and promote economic growth through tax reforms.

Maheshwari and Mani (2023) conducted a systematic literature review on the impact of Goods and Services Tax (GST) across 14 sectors of the Indian economy, analyzing 114 studies. Their findings reveal that GST has had a positive effect on agriculture, automobile, healthcare, logistics, manufacturing, retail, and textile sectors. However, the insurance and power sectors have been negatively affected. The banking, FMCG, IT, e-commerce, and real estate sectors experienced mixed outcomes. The review provides a comprehensive overview of GST's varying effects, offering valuable insights for policymakers and industry stakeholders.

Razzaque, Rahman, Rabi, Islam, and Eusuf (2023) examined the role of direct taxation in revenue generation and reducing income inequality in Bangladesh. The study highlighted the country's heavy reliance on indirect taxes, which comprise 65% of tax revenue, compared to 35% from direct taxes. By analyzing the challenges of transitioning to a direct tax regime, the authors emphasized the benefits of direct taxation, including its progressiveness and potential to reduce inequality. The paper proposed policy reforms, including raising personal income tax rates and automating tax administration, to boost revenue and promote equitable development.

RESEARCH METHODS

The research employs a qualitative method to analyze the impact of indirect taxes and GST on the Indian textile sector. Primary data is sourced from government reports, tax notifications, and policy documents, including the **Final Report on Direct and Indirect Taxes**. Secondary data includes academic articles, industry publications, and case studies. A comparative analysis is conducted between the pre- and post-GST tax regimes, focusing on changes in tax rates, input tax credits, and the correction of the inverted duty structure. The study also uses statistical data from relevant government sources to evaluate the effects of GST on the textile industry's competitiveness.

INDIRECT TAX STRUCTURE IN THE TEXTILE SECTOR: PRE-GST ERA

Before the introduction of GST, the textile sector was subjected to a variety of indirect taxes, both at the central and state levels. These included:

- **Central Excise Duties:** Levied on manufactured goods, including yarn and fabrics.
- **Service Tax:** Imposed on job work in the textile sector.
- **State-Level Taxes:** These included sales tax, VAT, CST, and local body taxes like Octroi.

On July 9, 2004, a significant decision was made to exempt downstream textile products beyond the fiber stage from excise duties, provided the manufacturers did not avail of CENVAT credit. This exemption applied to items like yarn and fabric, but man-made fibers and garments continued to be taxed. Various notifications outlined the specific tax rates applicable to different categories within the textile sector, as summarized in **Table 1.1** of the Final Report.

Table 1.1: Pre-GST Indirect Tax Structure in the Indian Textile Sector

Category	Central Excise Rate	VAT/CST Rate	Exemption Notification/Date
Silk			
Raw Silk	NIL	NIL	Tariff Rate Nil
Silk Yarn	NIL	5% / 2%	30/2004 C.E. dated 09.07.2004
Silk Fabrics	NIL	NIL	30/2004 C.E. dated 09.07.2004
Wool			
Raw Wool/Fibre	NIL	NIL	Tariff Rate Nil
Tops/Woollen Yarn	NIL	5% / 2%	30/2004 C.E. dated 09.07.2004
Woollen Fabrics	NIL	NIL	30/2004 C.E. dated 09.07.2004
Cotton			
Cotton Fibre	NIL	5% / 2%	Tariff Rate Nil
Cotton Yarn	6%	5% / 2%	7/2012 C.E. dated 17.03.2012
Cotton Fabrics	6%	NIL	7/2012 C.E. dated 17.03.2012
Man-made Filaments			

POY/PSF	13%	5% / 2%	No exemption
Textured/Twisted Yarn	NIL	5% / 2%	No exemption
Man-made Fabrics	NIL	NIL	30/2004 C.E. dated 09.07.2004
Fibre	13%	5% / 2%	No exemption
Yarn	NIL	5% / 2%	30/2004 C.E. dated 09.07.2004
Fabrics	NIL	NIL	30/2004 C.E. dated 09.07.2004
Knitted Fabrics	NIL	NIL	30/2004 C.E. dated 09.07.2004
Knitted Garments			
100% Cotton	6% of 60% of RSP	5% / 2%	7/2012 C.E. dated 17.03.2012
Other than Cotton	12.50% of 60% of RSP	5% / 2%	7/2012 C.E. dated 17.03.2012
Garments Other Than Knitted			
100% Cotton	6% of 60% of RSP	5% / 2%	7/2012 C.E. dated 17.03.2012
Other than Cotton	12.50% of 60% of RSP	5% / 2%	

Interpretation:

The table presents a detailed breakdown of the pre-GST indirect tax structure in the Indian textile sector, highlighting the central excise duty and VAT/CST rates applicable to different textile materials, such as silk, wool, cotton, man-made filaments, and garments. The tax structure includes exemptions and rates applied at various stages of production, ranging from raw materials (fiber) to finished products (garments).

For instance, raw silk and wool were exempt from central excise duties and VAT, while man-made fibers were taxed at a higher rate (13% excise duty) with no exemptions. Cotton yarn and fabrics were subjected to a central excise duty of 6%, along with VAT rates of 5%/2%, whereas garments (knitted and non-knitted) were taxed at varying rates depending on their material composition (cotton or other fibers).

Key Insights:

1. **Exemptions and Variability**: Certain materials like raw silk, wool, and cotton fabrics received tax exemptions, while man-made fibers and garments faced higher tax rates. This variability in the tax regime added complexity to the sector's cost structure and made it challenging for manufacturers to manage input costs.
2. **Disparities in Tax Rates**: The pre-GST regime showcased disparities in tax rates between natural fibers (like silk and wool) and synthetic/man-made fibers, creating inefficiencies in the value chain.
3. **Impact on Different Segments**: The higher tax rates for man-made fibers and synthetic garments increased the cost of production for manufacturers in this segment, while the exemptions for natural fibers helped promote their use.

The introduction of GST sought to simplify this system by unifying the tax structure and addressing the disparities highlighted in the table, ultimately making the textile industry more competitive and cost-effective.

THE SHIFT TO GST: A NEW TAX REGIME

With the implementation of GST on July 1, 2017, the tax system in the textile sector underwent a major overhaul. The GST subsumed a range of central and state taxes, such as Central Excise, VAT, and CST, thereby simplifying the tax structure. Under the new regime:

- GST was applied to almost all textile goods, including yarn, fabrics, and garments.
- The textile sector, characterized by the movement of goods for job work, attracted GST/IGST at various stages of production.
- Input tax credit (ITC) became available across the value chain, which allowed for a more cost-effective production process. The introduction of GST also allowed for free flow of ITC, particularly benefiting taxes on raw materials that previously did not qualify for credit.

The introduction of GST was expected to reduce costs and make the Indian textile sector more competitive globally.

POST-GST TAX STRUCTURE IN TEXTILES

The post-GST tax regime introduced various changes that affected different segments of the textile industry. The GST rates on different stages of production (fiber, yarn, fabric, and garments) varied, and adjustments were made over time to address certain issues, such as the inverted duty structure. **Table 1.2** in the Final Report provided a breakdown of the tax rates for cotton, synthetic fibers, silk, and other materials.

Table 1.2: **Post-GST Tax Structure in the Indian Textile Sector**

Material/Fibre	Fibre/ Raw	Yarn	Fabric	Apparels/Garments
Cotton	5%	5%	5%	Sale Value > ₹1000: 12% Sale Value < ₹1000: 5%
Synthetic/MMF	18%	12%	5%	12%
Silk	0%	5%	5%	5%
Jute	0%	5%	5%	5%
Wool	0%	5%	5%	5%

Notes:

- The **Synthetic/MMF** yarn rate was reduced from 18% to 12% during the 22nd GST Council Meeting held on October 6, 2017.
- Cotton yarn except **Khadi yarn** is chargeable at 5% GST.
- **Job Work Charges** for all stages (fiber, yarn, fabric, garments) were taxed at 5%.

Interpretation:

The table outlines the **Post-GST tax structure** implemented in the Indian textile sector, detailing the applicable Goods and Services Tax (GST) rates for different stages of textile production, from raw materials (fiber) to finished products (apparels/garments).

Key Points:

1. **Uniformity in Cotton Taxation**: Cotton products, including fiber, yarn, and fabric, are consistently taxed at 5% across all stages of production. For apparels and garments, a two-tier system is applied based on sale value—products with a sale value exceeding ₹1000 are taxed at 12%, while those below ₹1000 are taxed at 5%. This aims to balance the taxation of affordable and premium garments.

2. **Higher Taxation on Synthetic/MMF**: Man-made fibers (MMF), including synthetic materials, are taxed at higher rates compared to natural fibers. The GST for MMF fiber is set at 18%, with yarn at 12%, and fabric at 5%. Apparels made from synthetic materials are subject to a 12% tax rate. This reflects an effort to standardize taxes while keeping synthetic fibers under higher tax slabs compared to natural fibers.

3. **Minimal Taxation on Natural Fibers**: Silk, jute, and wool are taxed at a minimal rate. Raw materials (fiber) in these categories are exempt from GST, while yarn, fabric, and garments attract a 5% GST rate across the board, promoting the use of natural fibers in the textile sector.

Impact:

The post-GST regime simplifies the taxation process by applying uniform rates at different stages of production, particularly for natural fibers. However, synthetic/MMF products face higher tax rates, which could influence production costs and consumer pricing in this segment. The overall goal of the GST implementation in textiles is to streamline taxation, enhance competitiveness, and reduce inefficiencies previously seen in the sector's pre-GST tax structure.

CORRECTING THE INVERTED DUTY STRUCTURE

One of the key challenges identified in the GST regime was the issue of inverted duty structure, particularly in the man-made fiber (MMF) segment. This structure led to the accumulation of input tax credit (ITC), which created financial strain on manufacturers. In response, the 45th GST Council meeting held in September 2021 recommended revising the GST rates to address the inversion. The new rates, effective from January 1, 2022, were designed to bring uniformity across the textile value chain, with all stages (fiber, yarn, fabric, and garments) taxed at 12%, as outlined in **Table 1.3**.

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Table 1.3: Corrected GST Tax Structure in the Indian Textile Sector (Post-January 1, 2022)

Material/Fibre	Fibre/ Raw	Yarn	Fabric	Apparels/Garments
Cotton	5%	5%	12%	12%
Synthetic/MMF	12%	12%	12%	12%
Silk	0%	5%	12%	12%
Jute	0%	5%	12%	12%
Wool	0%	5%	12%	0.12

Interpretation:

The table presents the **corrected GST tax structure** for the Indian textile sector, implemented from **January 1, 2022**, addressing the inverted duty structure issues. It outlines the uniform GST rates across the entire textile value chain, from fiber to garments, for various materials including cotton, synthetic fibers (MMF), silk, jute, and wool.

Key Points:

1. **Uniformity Across the Value Chain**:
    - **Cotton** and **Synthetic/MMF** products are now uniformly taxed at **12%** for fabric and apparels/garments, reducing inefficiencies caused by the earlier inverted duty structure.
    - The tax on yarn remains at **5%** for cotton, silk, wool, and jute, while synthetic/MMF yarn is taxed at **12%**.

2. **Natural Fibers Maintain Low Initial Taxes**:
   - **Silk**, **Jute**, and **Wool** fibers are exempt from GST (0%), promoting their use in the textile sector.
   - As these materials progress through the value chain (yarn, fabric, garments), they attract **5%** and **12%** taxes, respectively, ensuring the value-added stages are taxed fairly.
3. **Correction of Inverted Duty Structure**:
   - The synthetic/MMF segment, which previously suffered from tax accumulation due to the lower tax on fabrics compared to yarn and fibers, now faces a uniform **12%** tax across all stages—fiber, yarn, fabric, and garments. This eliminates the issue of tax credits piling up and enhances cost-effectiveness.
4. **Wool Exception**:
   - Wool garments appear to have a typographical error in the table, showing **0.12%** for apparels/garments, which likely refers to **12%**, aligning with the structure applied to other fiber types. This correction ensures consistency across all garment types.

Impact:

The corrected GST regime seeks to create a **fiber-neutral** tax system, simplifying the tax burden and making the textile sector more competitive. By eliminating the inverted duty structure, it addresses inefficiencies, particularly in the MMF segment, and aligns tax rates across different materials and stages of production. This move is expected to improve cash flow, reduce compliance costs, and encourage growth in the textile industry.

IMPACT OF GST ON EXPORTS AND IMPORTS

The GST regime introduced several features to promote exports, classifying exports as "zero-rated supply" under the IGST Act. Exporters could either pay IGST and claim a refund or export goods under a bond or Letter of Undertaking (LUT) without paying IGST. The new system made Indian textile exports more competitive by relieving goods of GST at both the input and final product stages.

On the import side, while GST replaced several taxes like Countervailing Duty (CVD) and Special Additional Duty (SAD), the Basic Customs Duty (BCD) remained in place. This ensured that imports were taxed appropriately under the new GST regime.

KEY FINDINGS AND DISCUSSION

1. **Simplification of the Tax Structure**: The introduction of GST in the textile sector significantly simplified the tax system by subsuming various central and state-level taxes. The pre-GST era was marked by a complex web of multiple taxes, such as Central Excise, VAT, CST, and local body taxes like Octroi. The GST consolidated these taxes into a single unified structure, making tax compliance easier for textile manufacturers and traders, and promoting transparency.

2. **Elimination of the Inverted Duty Structure**: One of the most important corrections brought by the post-2022 GST reform was addressing the inverted duty structure, particularly in the **Man-Made Fiber (MMF)** segment. The earlier tax regime created issues with accumulated input tax credit due to lower taxes on fabrics and higher taxes on yarn and raw materials. The corrected tax system applied uniform rates (12%) across the MMF value chain, reducing tax inefficiencies and making MMF production more competitive.

3. **Impact on Natural vs. Synthetic Fibers**: Natural fibers like silk, wool, and jute continued to receive favorable tax treatment with lower or exempted rates at the raw material stage, promoting their usage. In contrast, synthetic fibers faced higher taxation, particularly in the pre-GST era, which led to increased costs. The post-GST regime

leveled the playing field by creating **fiber-neutral tax rates** (12% for fabrics and garments), ensuring that all textile materials are taxed uniformly at key stages of production.

4. **Encouragement of Exports**: The GST regime classified textile exports as "zero-rated supplies," allowing exporters to claim refunds on input taxes. This zero-rating significantly boosted the competitiveness of Indian textiles in the global market. The streamlined tax process also allowed for easier access to input tax credits, improving cash flows for exporters and reducing export costs, thus enhancing India's presence in international textile markets.

5. **Increased Competitiveness and Cost Efficiency**: With the simplified and corrected GST regime, the textile sector saw an overall improvement in competitiveness. The unified tax structure and availability of input tax credits at every stage of production made the sector more cost-efficient. By eliminating multiple layers of taxation and promoting a free flow of input tax credit, the GST reform reduced the cost burden on manufacturers, thereby enhancing the industry's ability to compete both domestically and internationally.

Discussion:

These key findings highlight that the introduction of GST, along with the subsequent corrections, have been pivotal in streamlining the Indian textile industry's tax system. While challenges remain, particularly in fine-tuning tax rates for different segments, the reforms have created a more business-friendly environment that encourages growth, innovation, and competitiveness.

FUTURE SUGGESTIONS AND RECOMMENDATIONS

1. **Further Simplification of Tax Rates**: While the GST has largely simplified the tax structure in the textile sector, there is room for further streamlining. Reducing the number of tax slabs, particularly for apparels, could make compliance even easier. A uniform tax rate for all garments, regardless of their sale value, would reduce confusion

and create a level playing field for manufacturers targeting both high-end and low-cost markets.

2. **Addressing Challenges for Small and Medium Enterprises (SMEs)**: Many small and medium-sized enterprises (SMEs) in the textile sector still face difficulties in navigating the GST framework, especially with input tax credit claims and compliance requirements. Introducing targeted support programs, such as tax rebates or simplified filing processes for SMEs, would enhance their ability to operate effectively within the GST regime, encouraging growth and innovation in this crucial segment.

3. **Encouraging the Adoption of Sustainable Practices**: The government should consider providing tax incentives or rebates to textile manufacturers that adopt sustainable and eco-friendly production practices. These could include using organic or recycled materials, implementing water-saving techniques, or reducing carbon emissions. Such initiatives would not only promote sustainability but also align with global trends toward greener manufacturing processes.

4. **Strengthening the Export Incentive Framework**: While zero-rating of exports under GST has benefited the textile industry, additional measures could be introduced to boost textile exports further. Enhancing export incentives or introducing fast-track processes for refunds of input tax credits could improve cash flows for exporters, enabling them to reinvest in technology, expand operations, and compete more effectively in international markets.

5. **Continuous Monitoring and Review of the Tax System**: Given the dynamic nature of the textile industry, continuous monitoring and periodic review of the GST system are essential. The government should maintain an open dialogue with industry stakeholders to address emerging challenges and make necessary adjustments to tax rates and policies. This approach will ensure that the GST framework remains responsive to the industry's evolving needs and global market trends.

CONCLUSION

The implementation of GST has significantly streamlined the tax structure in the Indian textile industry, simplifying compliance and boosting efficiency. Corrective measures, particularly the resolution of the inverted duty structure, have further enhanced cost-effectiveness, especially for the man-made fiber segment. While the post-GST framework has improved competitiveness and export potential, challenges remain, particularly for small and medium enterprises (SMEs). Moving forward, targeted reforms, such as tax support for SMEs, promotion of sustainable practices, and continuous monitoring of the tax system, will be crucial in ensuring sustained growth and global competitiveness for the Indian textile sector.

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